2008-2009-2010

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Treasurer, the Hon Wayne Swan MP)

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Chapter 1
Introduction to the new research and development tax incentive

Outline of chapter

1.1 This second exposure draft amends the law to provide a new tax incentive for research and development (R&D). This chapter provides an overview of the new R&D tax incentive.

1.2 The new R&D tax incentive provides eligible entities with a tax offset for expenditure on eligible R&D activities and for the decline in value of depreciating assets used for eligible R&D activities. The new R&D tax incentive replaces the existing R&D Tax Concession for income years commencing on or after 1 July 2010.

1.3 The operative rules for the new R&D tax incentive are primarily contained in a new Division 355 of the *Income Tax Assessment Act 1997* (ITAA 1997). The extensive and complex provisions in the *Income Tax Assessment Act 1936* (ITAA 1936) that govern the existing R&D Tax Concession will be repealed.

1.4 The administrative rules for the new R&D tax incentive are contained in a new Part III of the *Industry Research and Development Act 1986* (IR&D Act). It sets out the role of Innovation Australia in relation to the administration of the new R&D tax incentive.

Context of amendments

1.5 In the 2009-10 Budget, the Government announced that it would replace the R&D Tax Concession with a new, streamlined tax incentive. The Government issued a consultation paper titled *The new research and development tax incentive* in September 2009. A first exposure draft of the legislation for the new scheme was released in December 2009. This second exposure draft, released in March 2010, includes changes to ensure that the legislation is clearer and to remove unintended consequences.

1.6 The new R&D tax incentive is the biggest reform to business innovation support for more than a decade. It cuts red tape and provides a more targeted incentive for companies to invest in R&D. The new R&D tax incentive is also an opportunity to ensure support for business R&D, is consistent with the underlying rationale for government intervention and delivers value for money for taxpayers.

The case for public support for R&D

1.7 Innovation is recognised internationally as an important driver of productivity and economic growth. It encompasses a wide range of activities in the economy including workforce skills, venture capital, knowledge transfer, technology uptake, management practices and R&D.

1.8 In a global economy, companies invest in R&D to improve their competitiveness and ongoing profitability. Broader economic factors such as macroeconomic stability, competitive markets, efficient credit markets and access to skilled labour are important influences on a firm's decision to invest in R&D.

1.9 Knowledge produced by a firm's R&D often has benefits for other firms or the economy as a whole. That is, the R&D can have a net positive economic impact beyond the benefits accruing to the firm doing the R&D. However, a firm may choose not to undertake such R&D because of the cost and/or the uncertain returns from such activities. In such situations, less R&D may occur than would be desirable.

1.10 A carefully targeted incentive would lower the cost of doing R&D and help to boost productivity and economic growth. To this end, the new R&D tax incentive redirects assistance to activities that are more likely to deliver such economy-wide benefits. It also significantly improves the incentive for smaller firms to undertake R&D.

Summary of new law

1.11 The new R&D tax incentive provides eligible entities with a tax offset for expenditure on eligible R&D activities and for the decline in value of depreciating assets used for eligible R&D activities. The rate of the tax offset and whether it is refundable depends primarily on the aggregated turnover of the R&D entity.

R&D activities

1.12 Eligible R&D activities are categorised as either 'core' or 'supporting' R&D activities. Generally, only R&D activities undertaken in Australia will qualify for the new R&D tax incentive. However, support will be provided to R&D activities conducted overseas in limited circumstances where the activities cannot be undertaken in Australia.

Core R&D

1.13 Core R&D activities are experimental activities:

- 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:
  - is based on principles of established science; and
  - proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and
- that are conducted for the purpose of acquiring new knowledge (including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services).

1.14 Further to this test, some activities are specifically excluded from being core R&D.

1.15 Under the R&D Tax Concession, core R&D activities had to involve 'innovation' (defined as involving an appreciable level of novelty) or high levels of 'technical risk' (defined in terms of applying the scientific method to close a knowledge gap). Four overlapping tests were used to give meaning to these concepts.

1.16 The new definition of 'core R&D' uses clearer language instead of relying on terms such as 'considerable (or appreciable) novelty' and 'high levels of technical risk' and the overlapping tests that were associated with these terms. In essence, the new definition recognises that the taxpayer needs new information (to solve a problem, develop a new product or improve a process) and needs to do an experiment to discover that knowledge.

Supporting R&D

1.17 Supporting R&D activities are activities directly related to core R&D activities. However, production activities (or any activities excluded from being a core R&D) must be undertaken for the dominant purpose of supporting core R&D in order to qualify as supporting R&D.

1.18 Under the R&D Tax Concession, supporting R&D activities were undertaken for a purpose directly related to conducting core R&D activities.

1.19 The new definition of 'supporting R&D' imposes a stricter test on activities that an entity is more likely to be undertaking for normal operational reasons. However, such activities remain eligible where the dominant purpose for conducting them is to support core R&D.

R&D conducted overseas

1.20 Generally, only R&D activities conducted in Australia qualify for the incentive. Innovation Australia can give approval for an R&D activity to be conducted overseas, but only where:

- there are physical limitations on an R&D activity being conducted in Australia;
- the activity to be conducted overseas has a significant scientific link to core R&D conducted in Australia; and
- the expenditure on the activity to be conducted overseas is less than that incurred on core R&D conducted in Australia.

1.21 Chapter 2 provides further information about the range of eligible R&D activities.

R&D entities

1.22 The following entities (known as R&D entities in the new law) can claim the new R&D tax incentive:

- corporations that are Australian residents for tax purposes;
- foreign corporations that carry on R&D activities through a permanent establishment in Australia; and
- public trading trusts with a corporate trustee.

1.23 R&D entities will be able to claim the new R&D tax incentive for their expenditure on eligible R&D activities regardless of where the resulting intellectual property is held. This will strengthen the case for companies to conduct their R&D activities in Australia.

1.24 Chapter 3 contains further information about the types of entities eligible for the new R&D tax incentive.

R&D expenditure

1.25 The new R&D tax incentive provides R&D entities with a tax offset for expenditure on eligible R&D activities and for the decline in value of depreciating assets used for eligible R&D activities. Neither tax offset is subject to an expenditure cap.

1.26 The minimum expenditure threshold of $20,000 continues to apply under the new R&D tax incentive, except in relation to expenditure on R&D activities performed for an R&D entity by an entity registered as a research service provider and contributions to a cooperative research centre.

1.27 As an integrity measure, R&D entities are only able to obtain the tax incentive for expenditure incurred to an associate entity when they actually pay the amounts incurred. In addition, the feedstock rule from the current law is to be retained.

1.28 Chapter 3 explains in more detail when an R&D entity can claim a tax offset for their expenditure on R&D activities.

The R&D tax offsets

1.29 The rate of tax offset, and whether it is refundable, depends primarily on the aggregated turnover of the R&D entity.

- A 45 per cent refundable tax offset is available to R&D entities with an aggregated turnover of less than $20 million (unless they are a tax exempt entity or majority owned or controlled by tax exempt entities).
- A 40 per cent non-refundable tax offset is available for all other R&D entities. R&D entities accessing the non-refundable tax offset can carry forward any unused offset amounts, under the tax offset carry forward rules.

1.30 Providing tax offsets rather than enhanced deductions for R&D provides entities with greater certainty about the after-tax benefit of the incentive.

1.31 Chapter 3 contains further information on the operative rules for the two tax offsets.

Worked examples

1.32 The following examples demonstrate the assistance available to small innovative companies under the new R&D tax incentive, compared to the R&D Tax Concession. More detailed examples are contained in Chapters 2 and 3.

Example 1.1

Green Light manufactures solar powered outdoor lighting. The company has an annual turnover of $4 million. During 2010-11 the company incurs $1 million of expenditure on eligible R&D activities.

Based on its turnover (which is less than $5 million) and R&D expenditure (less than $2 million), Green Light could, under the existing law, have claimed a refundable tax offset of $375,000 under the R&D tax offset.

- ($1,000,000 × 125% × 30% = $375,000)

Under the new R&D tax incentive, the company will be able to receive a refundable tax offset of $450,000 when it lodges its tax return for the income year.

- ($1,000,000 × 45% = $450,000)

Example 1.2

Big Ideas Inc has an annual turnover of $4 million. During 2010-11 the company incurs $2.5 million of expenditure on eligible R&D activities.

Based on its turnover and R&D expenditure, Big Ideas would, under the existing law, have missed out on the R&D tax offset. While the company meets the turnover test, it has exceeded the expenditure cap. Big Ideas would nevertheless be able to claim the 125 per cent R&D Tax Concession.

Under the new R&D tax incentive, Big Ideas will be able to claim a refundable tax offset of $1,125,000 when it lodges its tax return for the income year.

- ($2,500,000 × 45% = $1,125,000)

Example 1.3

NuStart Enterprises produces organic fertilisers. The company has an annual turnover of $10 million but is currently in a tax loss situation. The company incurs $1 million of expenditure on eligible R&D activities in 2010-11.

Under the existing law, NuStart would only have been able to claim the 125 per cent R&D Tax Concession on its expenditure, allowing it to add $375,000 to its tax loss.

- ($1,000,000 × 125% × 30% = $375,000)

The potential benefit of this tax deduction will only be enjoyed when the company has sufficient profits to start paying income tax.

Under the new R&D tax incentive, the company will be able to receive a refund of $450,000 when it lodges its tax return for the income year.

- ($1,000,000 × 45% = $450,000)

Transitional provisions

1.33 The new R&D tax incentive will apply to income years commencing on or after 1 July 2010. Further, special transitional arrangements will apply in situations where R&D activities straddle income years where the existing law and the new law apply.

1.34 Chapter 4 provides further detail on the application, savings and transitional provisions.

Administration

1.35 The new R&D tax incentive will operate largely on a self-assessment basis.

1.36 Innovation Australia will have an enhanced role in registering and assessing eligible R&D activities to increase certainty for taxpayers. In particular, it will significantly increase its advisory services, including through public guidance and findings and private advance findings. These advisory services will ensure that taxpayers are better informed about their entitlements and obligations under the new incentive.

1.37 The Australian Taxation Office will continue to determine whether an amount of expenditure is validly incurred for eligible R&D activities, as registered with Innovation Australia.

1.38 Chapter 5 provides further information on the role of the Innovation Australia in relation to the new R&D tax incentive.

Chapter 2
Meaning of research and development activities

Outline of chapter

2.1 This chapter sets out what will qualify as research and development (R&D) activities for purposes of attracting a tax offset under the new R&D tax incentive.

2.2 The new R&D tax incentive retains some elements of the framework for R&D activities that exists for the R&D Tax Concession located in sections 73B to 73Z of the *Income Tax Assessment Act 1936* (ITAA 1936). (For example, the distinction between core and supporting R&D activities continues.) However, these elements have been refined so that the new scheme better aligns with the rationale for providing a general subsidy for business R&D.

Context of amendments

2.3 The Government announced in the 2009-10 Budget that it would replace the existing R&D Tax Concession with a new, more streamlined R&D tax incentive from 1 July 2010.

2.4 The two core components of the new incentive are a 45 per cent refundable R&D tax offset for R&D entities with an aggregated turnover of less than $20 million and a non-refundable 40 per cent tax offset for larger R&D entities. Accompanying this is a tighter definition of 'eligible R&D activities'.

2.5 The Government issued a consultation paper titled *The new research and development tax incentive* in September 2009.

2.6 This was followed up by exposure draft legislation and explanatory material in December 2009.

Comparison of key features of new law and current law

New law	*Current law*
A distinction is made between core R&D activities and supporting R&D activities.	A distinction is made between core R&D activities (without that term being used) and supporting R&D activities (for a directly related purpose).
The definition of core R&D activities focuses on the requirement for an experiment that is conducted using the scientific method in order to address a significant knowledge gap.	Core R&D activities are defined in terms of overlapping tests relating to experiments, innovation, technical risk, purpose and scientific approach.
Supporting R&D must be directly related to core R&D activities.	Supporting R&D must be carried on for a purpose directly related to the carrying on of core R&D activities.
Production activities can be supporting R&D activities if undertaken for the dominant purpose of supporting core R&D activities.	Production activities can be supporting R&D activities.
Listed activities are specifically excluded from being core R&D activities.	Listed activities are specifically excluded from being core R&D activities.
Activities on the exclusions list can qualify as supporting R&D activities if undertaken for the dominant purpose of supporting core R&D activities.	Activities on the exclusions list can qualify as supporting R&D activities.
In-house software for the internal administration of business functions is excluded from being a core R&D activity.	In-house software is excluded from being a core R&D activity by a requirement that software development activities be for the purpose of supply to at least two other entities.
The feedstock provision will be moved to the *ITAA 1997*.	Where goods or materials are produced or acquired in order to be the subject of processing or transformation in R&D activities, a feedstock adjustment applies to reflect the extent to which the value of the outputs from the processing or transformation offsets the cost of the goods or materials.

Detailed explanation of new law

Object of new law

2.7 The rationale behind the new R&D tax incentive lies in the combination of the potential for scientific and technological uncertainty to discourage R&D activities and the potential for R&D activities to generate new information that also benefits the wider Australian economy. A tax incentive that induces such R&D activities to proceed has the potential to provide a public benefit (in the form of the spread of additional knowledge) that exceeds the cost of the incentive. ***[Schedule 1, item 1, subsection 355-5(1)]***

2.8 Accordingly, the definition of R&D that is eligible for the tax incentive centres around the activities that are most likely to produce spillover benefits that, in the absence of the incentive, might not go ahead because of their cost and uncertain outcomes. ***[Schedule 1, item 1, subsection 355-5(2)]***

Meaning of R&D activities

2.9 The legislation makes a key distinction between 'core' and 'supporting' R&D activities. For R&D to be recognised as occurring, there must be an activity — or more typically a set of related activities — that satisfies the criteria of core R&D. Once core R&D has been identified, certain supporting activities can also be considered to be R&D activities. ***[Schedule 1, item 1, section 355-20]***

2.10 The following sections discuss the criteria for activities to qualify as R&D under either of these headings. Examples of how the tests apply are consolidated in the final section of this chapter.

Core R&D activities

2.11 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 relationships 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. ***[Schedule 1, item 1, section 355-25]***

2.12 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. ***[Schedule 1, item 1, paragraph 355-25(a)]***

2.13 This requirement for the scientific method establishes a threshold for the knowledge gap and degree of uncertainty that an eligible experiment will be seeking to address. That is, the knowledge of whether something is scientifically or technologically possible, or how to achieve it in practice, will not be deducible by a competent professional in the field on the basis of current knowledge, information or experience.

2.14 Further, there will be a significant risk that the outcome of eligible experiments will not be the desired one. The potential for this risk to deter firms from undertaking knowledge-generating R&D is what underlies the rationale for the R&D tax incentive.

2.15 It will be a question of fact whether the uncertainty being resolved is significant enough to warrant application of the scientific method, rather than less rigorous knowledge discovery and problem solving techniques, such as 'trial and error'. This consideration will become increasingly relevant where experiments are repeated or prolonged, particularly if carried out in a production context.

2.16 Experimental activities that qualify as core R&D will be for the purpose of acquiring new knowledge or information. This purpose test will not be satisfied by experimental activities that merely confirm what is already known — even though that knowhow might not exist within the firm conducting the activities. ***[Schedule 1, item 1, paragraph 355-25(b)]***

2.17 The test can be met by the purpose of acquiring or generating knowledge in the practical form of knowledge or information about the creation of new or improved materials, products, devices, processes or services. Where experimental activities occur in the context of normal production activities, the experiments may entail the direct production or use of an actual material, product, device, process or service.

2.18 The need to employ the scientific method will reflect a threshold degree of novelty in the new ideas being tested. That is, the knowledge that is being sought will go beyond validating a simple progression from what is already known and beyond merely implementing existing knowledge in a different context or location. Rather, the gap between existing knowledge and the hypothesis being investigated will be significant enough to require application of the scientific method.

2.19 This reflects the R&D tax incentive's object of generating the knowledge benefits that arise from conducting R&D — rather than subsidising the application of the knowledge produced by that R&D.

Where the line is drawn between conducting R&D and applying the results of R&D will be a question of fact.

2.20 When applying the test, the 'purpose' of experimental activities means the dominant (or sole) purpose for which the activities are undertaken. In discerning the dominant purpose for undertaking experimental activities, regard must be had to the overall circumstances within which they are conducted.

2.21 With very few exceptions, R&D undertaken by companies will have an ultimate commercial objective. This fact of itself does not affect a conclusion that particular experimental activities are conducted for the purpose of knowledge — the focus of the R&D tax incentive is not 'R&D for R&D's sake'.

Scope of core R&D

2.22 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.

2.23 This scope may be narrower than what the firm might view as its R&D 'project'. An activity will not fall within the scope of the experiment merely because the experiment cannot take place without it — although such a 'non-core' activity can still qualify as an eligible R&D activity if it meets the criteria for supporting R&D.

Supporting R&D activities

2.24 Activities that 'support' core R&D assist the conducting of the experimental activities, but without being part of the experiments. These activities are distinguished from experimental activities in that they do not lead, via the logical progression of work, to the experimental results.

2.25 Supporting R&D activities are directly related to their core R&D activities, in that they have a direct, close and relatively immediate relationship with the actual experimental activities. Supporting activities can, however, occur before, during or after the experimental activities and at either a proximate or remote location. ***[Schedule 1, item 1, subsection 355-35(1)]***

2.26 As a general rule, activities directly related to core R&D activities can be eligible for the R&D tax incentive along with their associated core R&D activities. This reflects the fact that supporting activities will usually be required in order for the targeted core R&D activities to take place. To the extent that, by requiring supporting

activities, core R&D activities are imposing an additional cost, it is appropriate that the supporting activities be recognised as a cost of conducting the R&D.

2.27 However, where supporting activities would have been undertaken anyway for normal operational reasons, they do not impose an additional cost on the company that arises from its R&D activities and so the R&D tax incentive is not intended for them.

2.28 In particular, it is not intended that the R&D tax incentive cross-subsidise normal production activities. Accordingly, production activities will only be eligible where the dominant purpose for conducting them is to support core R&D. Production activities are those that produce goods and services, along with their directly related activities. ***[Schedule 1, item 1, subsection 355-35(2)(a)&(b)]***

2.29 This dominant purpose test also applies to activities that are on the exclusions list (see below). ***[Schedule 1, item 1, subsection 355-35(2)(c)]***

2.30 Dominant purpose means the prevailing or most influential purpose. Implicit in the dominant purpose test is the acknowledgment that activities can serve, or be conducted for, more than one purpose. Accordingly, the fact that an activity serves both an R&D and a commercial objective does not preclude it from qualifying as supporting R&D.

2.31 Conversely, the fact that certain activities are necessary in order for core R&D to occur does not suffice to show that those activities are undertaken for the dominant purpose of supporting core R&D. Nor will the test be satisfied merely because the activities occur in close proximity (in time and space) to the experimental activities. These qualifications can be particularly significant where core R&D is conducted in the context of normal production.

2.32 In discerning the purpose for undertaking an activity, regard must be had to the overall circumstances within which the activity is conducted. Being a purpose test, it is possible that activities that are similar in appearance might qualify as supporting activities in one context but not in another.

2.33 A critical consideration will be the extent to which the activities in question will also achieve outcomes (particularly production or other commercial goals) over and above assisting the conduct of the core activities, and the importance of those outcomes in the context. The examples appended to this chapter illustrate various considerations that can be relevant in various contexts.

Exclusions list and core and supporting R&D

2.34 As a matter of policy, certain activities are excluded from being considered as core R&D. Additionally, the exclusion list serves to clarify that certain activities would not meet the tests for core R&D activities. ***[Schedule 1, item 1, paragraph 355-30]***

2.35 However, an activity undertaken by an R&D entity that is excluded from being core R&D can still qualify as a supporting R&D activity if it is directly related to core R&D and is undertaken for the dominant purpose of supporting core R&D.

2.36 This dominant purpose test also applies to the listed activities in circumstances where they are not undertaken as experimental activities.

2.37 That is, listed activities can never be core R&D and can only be supporting R&D in circumstances where they are undertaken for the dominant purpose of supporting core R&D. ***[Schedule 1, item 1, subsection 355-35(2)(c)]***

Software

2.38 Software will be subject to the same eligibility tests as other forms of R&D with the exception of certain 'in-house' software.

2.39 The existing exclusion for 'in-house' software comprising a 'multiple sales' requirement, has been removed, reflecting the fact that ongoing developments in e-commerce and software distribution methods have meant it no longer adequately reflects the original policy intent.

2.40 A new software core R&D exclusion has been incorporated into the exclusions list rather than in a separate provision. The exclusion clarifies that activities related to the development, modification or adaptation of software are not eligible core R&D where the software is solely or primarily developed for internal business administration by the entity (or connected entities) for which it was developed. ***[Schedule 1, item 1, paragraph 355-30(o)]***

2.41 The exclusion encompasses software that is for use in the day-to-day administration of the business such as business application, management information system and enterprise resource planning software. The exclusion reflects the fact that such software activities are site-specific, can usually be expected to be undertaken by the relevant business without an incentive, and that consequently, the additional public benefit from subsidising such activities is limited.

2.42 The exclusion does not extend to software developed in-house that is of an applied nature, such as that which forms an integral part of an

electrical or mechanical device, such as home appliances or industrial equipment. Similarly, the exclusion does not apply to software activities undertaken to support a larger R&D project, and which may qualify as supporting R&D activity.

Feedstock adjustment

2.43 The new R&D tax incentive will contain a feedstock adjustment broadly along the lines of the current feedstock rule.

2.44 The current R&D Tax Concession contains a feedstock rule, which applies where goods or materials are produced or acquired in order to be the subject of processing or transformation in R&D activities.

2.45 The current rule effectively acts to reduce the amount that is recognised as a cost of the R&D activities where the outputs from the processing or transforming are marketable. The feedstock cost eligible for the tax concession is reduced to the extent that the cost of producing or acquiring the goods or materials and the cost of energy used in the processing or transformation are recovered from the value of the output. Essentially, this means that only the 'net cost' of the feedstock and the energy to transform/process it is eligible for the concession.

2.46 Drafting of the feedstock adjustment provisions for the R&D tax incentive was not completed at the time of release of this revised exposure draft package.

Examples illustrating the R&D activities tests

2.47 The following examples use a range of fictitious science and business scenarios to illustrate the application of the tests for core and supporting R&D. Not all elements of the tests are comprehensively discussed in each example. Neither are the activities that fall into core and supporting R&D exhaustively listed.

EcoStartup

2.48 The following series of EcoStartup examples illustrates a straightforward application of the core R&D and supporting R&D tests in a non-production context.

EcoStartup I

2.49 Example 2.1 illustrates a pure R&D activity that precedes commercial production and has no bi-products.

Example 2.1: EcoStartup I

EcoStartup was formed to investigate the potential for a chemical known as C23 to be added to petrol to reduce greenhouse gas emissions. The company devises an R&D plan and systematically conducts documented experiments to investigate this idea, by measuring exhaust emissions produced from a range of engines by different amounts of the additive for fuels across a range of octane values. The test batches are consumed in these experiments. EcoStartup's experiments prove successful and the company then decides to manufacture and sell the fuel additive.

Core R&D activities

The idea has a scientific basis, as C23 has several analogous properties to a compound K32 — which is known to reduce greenhouse gas emissions in cars but is only available in limited quantities — so the hypothesis has a scientific basis. C23 is widely available but normally used as a paint additive; that it can serve as a fuel additive to target greenhouse gas emissions would be new knowledge. The related chemistry is complex and underdeveloped, such that whether C23 can be used in this way cannot be determined in advance from current knowledge.

EcoStartup's experimental activities address a knowledge gap that can only be addressed by applying the scientific method. They are conducted for the purposes of acquiring new knowledge. The activities do not fall within the scope of any items on the exclusions list. EcoStartup's experimental activities are core R&D.

Supporting R&D activities

EcoStartup can also claim as supporting R&D activities those that are directly related to core R&D. EcoStartup's directly related activities include 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. These activities do not lead, via the logical progression of work, to the experimental results. They are, however, part of the firm's overall R&D project and have a direct, close and relatively immediate relationship with the actual experimental activities that constitute the core R&D.

EcoStartup does not need to subject its supporting activities to the dominant purpose test, as the supporting activities are not activities on the core exclusions list and are not of a kind that produces goods or services. Nor do they contribute to activities that produce goods or services. It is not relevant that the activities contribute to experiments that, by their success, could lead to subsequent production.

EcoStartup II

2.50 Example 2.2 illustrates the supporting activities test in relation to incidental bi-products.

Example 2.2: EcoStartup II

As a variation on *EcoStartup I*, assume that the number of tests needed for each particular fuel batch is uncertain prior to the experiments. Accordingly, each batch is made sufficient to accommodate the maximum number of tests that might be required. EcoStartup sells the leftovers to a nearby oil refinery to blend away in its general production.

Supporting R&D activities

EcoStartup's supporting activity of blending the test batches would be a production activity. Accordingly, that activity will only qualify as a supporting R&D activity if conducted for the dominant purpose of supporting the experiments.

The quantities of fuel blended for the test batches were justified by the analysis in the experimental plan and the actual amounts that would be left over were uncertain and incidental. Accordingly, the activity of preparing the test batches was for the dominant purpose of supporting core R&D.

Smartread

2.51 Example 2.3 illustrates the scope of the purpose test for core within the overarching commercial purpose of R&D and the impact of using production facilities for supporting activities.

Example 2.3: Smartread

Smartread manufactures tyres. It also conducts an ongoing research program testing new compounds with a view to developing improved products that it can exploit commercially. The test tyres are produced using Smartread's normal production facilities (which only allow one compound to be used in a given production run). The production aspects of the compounds (such as how they function during the moulding process) were not at issue for Smartread's tests. Smartread's research program does not produce any marketable outputs.

Core R&D activities

Although the research has an overriding commercial objective, the relevant purpose of Smartread's experimental activities is to create knowledge in the form of product improvements. Accordingly, Smartread's experimental activities can satisfy the tests for core R&D if they are a valid application of the scientific method to address a knowledge gap.

Supporting R&D activities

The cost of the activities involved in actually manufacturing the test tyres (such as running the production line) will be determined in the same way as a normal production run, using normal accounting principles. That is, plant costs, floorspace rent, labour and corporate overheads will be attributed to the cost of the activity of manufacturing the test tyres.

This activity of manufacturing the test tyres is directly related to the experiments but constitutes a production activity, so the dominant purpose test applies. In the context of Smartread's experimental plan, the manufacture of the test tyres does not have the prospect of producing commercial outputs. The dominant purpose test is satisfied so the activity is a supporting R&D activity and Smartread is eligible for a tax offset on the costs attributable to the activity.

Boulevard Mining

2.52 The following series of Boulevard Mining examples illustrates the distinction between conducting and applying R&D in a production environment.

Boulevard Mining I

2.53 Example 2.4 illustrates how the tests apply where existing technologies are modified to apply in a novel application, adjacent to normal production, with the experimental activities supported by otherwise normal production activity.

Example 2.4: Boulevard Mining I

Boulevard Mining commences work on a previously unmined fork in a coal seam at its Evans Range mine. It decides to use the new fork to undertake an R&D project aimed at allowing it to use wider tunnels, to increase the amount of coal that can be safely and economically extracted from future tunnels.

The project utilises existing knowledge about a new truss design developed elsewhere for cantilevered stadium roofs along with existing knowledge about safe tunnel widths for black coal. The project

investigates the extent to which using the new truss design in various scales with various modifications will allow tunnels to be widened, using measurements of the forces being generated in the supported tunnel structure.

Boulevard's mine plan indicates that the seam will be mined regardless of the outcome of the experiments. The coal extracted from the tunnel used for the experiments is mixed and sold with the other output of the mine.

Core R&D activities

The experimental activities pertain to addressing the uncertainty over how the truss will function as a tunnel support, rather than a cantilever roof support, to allow significantly wider tunnels. The experiments are conducted for the purpose of acquiring new knowledge.

The truss will be subject to forces of a significantly different nature to those in its previous applications. Further, how the truss design interacts with tunnel widths and shapes cannot readily be determined using existing knowledge of the properties of trusses and tunnels. Rather, application of the scientific method is required in this instance to address the gap in knowledge.

The experimental activities are core R&D activities.

Supporting R&D activities

In order for the experiments with the truss to take place, tunnelling of various widths and shapes needs to be undertaken into the coal seam. This tunnelling has a direct, close and relatively immediate relationship with the actual experimental activities. Accordingly, it is a directly related activity.

However, in addition to creating a tunnel, the tunnelling also produces coal, so the dominant purpose test applies. In this instance, it is clear from the mine plan that the dominant purpose of undertaking the tunnelling activities is to allow the seam to be mined, rather than to support experimental activities. Accordingly, the tunnelling activity does not qualify as a supporting R&D activity. This outcome would apply were Boulevard to sell the coal or use the coal itself (for example, as fuel or as an input to a coking oven) or stockpile it for later use.

Boulevard Mining II

2.54 Example 2.5 illustrates the tests where the knowledge gained from experiments incorporating production activity is implemented in subsequent customised applications that involve trial and error that is systematically conducted and monitored.

Example 2.5: Boulevard Mining II

The project in *Boulevard Mining I* is successful and the technique is applied throughout the Evans Range mine. Due to the shape of the coal seam, the preferred tunnel width varies throughout the mine. The optimal combined specification of truss and tunnel shape for each preferred tunnel width can only be finalised as the work is in process. This work is systematically logged for future reference.

The scope of core R&D activities at Evans Range only extends to the amount of experimentation necessary to acquire the new knowledge to create the improved process — not to the determination of all of the various combinations of truss scale and tunnel width used in the mine.

In this instance, it was found that experiments with 10 combinations proved sufficient to ascertain the relationship between the two factors and prove the hypothesis that the truss can function as a tunnel support to allow significantly wider tunnels. When using the technique in other tunnel widths at the Evans Range mine, the experimental results can be interpolated and, by monitoring forces as the work is in progress, the structure 'fine tuned' by adding reinforcing segments or adjustments to the tunnel shape.

Although these implementation activities entail a degree of trial and error in applying the knowledge gained from the *Boulevard Mining I* activities, they do not demand the application of the scientific method.

Also, these subsequent activities are conducted for the purpose of applying knowledge, rather than acquiring knowledge.

Consequently, the implementation of the technique developed in *Boulevard Mining I* does not constitute R&D activities.

Mimic Mining

2.55 Example 2.6 illustrates how the tests apply where the knowledge gained from experiments incorporating production activity is applied in a different location. Although unique circumstances will be faced in different contexts, resolving how to apply known technology in the face of those circumstances will not, of itself, constitute R&D activities.

Example 2.6: Mimic Mining

Mimic Mining learns of the technique developed at the Evans Range mine and applies it to a mine it owns in the Oates Range that is of similar geological structure. In the knowledge that the technique is feasible, Mimic Mining replicates the experiments undertaken by Boulevard Mining.

Mimic Mining's experimental activities are not undertaken for the purpose of generating new knowledge. The experiments at Evans Range by Boulevard Mining have proven the hypothesis that it is feasible to use the new truss design to significantly widen tunnel sizes.

Consequently, Mimic Mining is not undertaking eligible R&D activities. Rather, the adoption by Mimic Mining of the Evans Range technique at Oates Range — along with similar adoption by other mining companies — exemplifies the spillover benefits that the R&D tax incentive seeks to foster.

Boulevard Mining III

2.56 Example 2.7 illustrates, by way of contrast with Mimic Mining, that resolving how to apply known technology in a fundamentally different location can potentially constitute R&D activities.

Example 2.7: Boulevard Mining III

Boulevard Mining also has a mine in the Bowers Valley, where, based on current knowledge, the coal is considered too crumbly for the approach developed at the Evans Range mine to be usefully applied. However, Boulevard Mining conducts further experiments that discover the truss can, with modification, still permit significant increases in tunnel widths for crumbly coal seams.

This outcome could not be determined from the Evans Range experiments and its feasibility could only be ascertained by application of the scientific method. The Bowers Valley experimental activities were conducted for the purpose of producing knowledge, rather than merely to resolve routine problems in applying knowledge.

As with the implementation of the approach at the Evans Range mine in *Boulevard Mining II*, the scope of the Bowers Valley mine R&D activity would only extend to the extent necessary to establish whether the truss could be used to significantly increase tunnel width in crumbly coal seams and to ascertain the relationship between truss and tunnel width. It would not extend to determining the actual specifications when applying the approach throughout the mine, which has similar geological characteristics.

Boulevard Mining IV

2.57 Example 2.8 illustrates the dominant purpose test for supporting activities where production activities are contingent upon the outcome of the experimental activities and there is no 'Plan B'.

Example 2.8: Boulevard Mining IV

As a variation on *Boulevard Mining I*, Boulevard Mining decides instead to conduct the tunnel support experiments (which constitute R&D activities) at Marginal Prospect, a new mine it is about to commence, rather than at Evans Range. Should the experiments fail, the Marginal Prospect Mine will not proceed at currently foreseeable coal prices.

In order for the experiments to occur, roads and access tunnels need to be built, which will be used for ongoing mining operations should the mine proceed. The company banks on the experiments being successful, and builds the roads to the standard necessary to service the mine over its expected 10-year production life, and with numerous passing bays to accommodate movement of significant output when the mine is in full production. The company also commences constructing a lengthy railway spur line to the mine and coal train loading facilities.

Supporting R&D activities

The road and access tunnel construction activities are directly related to the experimental activities. However, because they either are, or contribute to activities that will produce coal, the dominant purpose test applies.

In discerning the dominant purpose for these supporting activities, regard would be had to their place in the company's overall activities and plans in relation to the Marginal Prospect site.

In this instance, it is evident that, although the road and access tunnel will initially be used for the experiment, the company mainly envisaged them as infrastructure for future mining operations. Accordingly, the construction activities were not for the dominant purpose of supporting the core R&D and so do not constitute supporting R&D activity. Activities that maintain the road and supply light and ventilation to the tunnels during the experimental period would qualify.

Grandheap Mining

2.58 Example 2.9 illustrates applying the core R&D and supporting R&D tests where the experimental activities are linked to live production activities.

Example 2.9: Grandheap Mining

Grandheap Mining undertakes experimental activities on the ability of new ground vibration sensor technology to assist in optimising slope angles for overburden heaps. The experiments utilise in a new way

technology developed for vulcanology. The ability of this technology to reliably identify incipient heap instability prior to a collapse occurring is uncertain.

Grandheap Mining conducts the experiments in the course of its disposal of overburden at a working mine site, Compact Gorge. Grandheap will apply the findings to minimise the land area lost to overburden heaps at a range of open cut mines it operates, by allowing slope angles to safely approach more closely the actual angle at which the heap would fail. Due to the restrictive geography of the Compact Gorge site, minimising the number of overburden heaps will be a key factor in maximising access to the minerals there.

Core R&D activities

At the initial stages it would be fairly straightforward to demonstrate that the activities are being undertaken to test the hypothesis that the new sensor technology can reliably identify incipient heap instability.

As the number of experiments progresses, closer scrutiny would be expected as to whether further heaps were still part of the experimental activities related to resolving technological uncertainty, or were more appropriately considered to be the application of that technology to resolve routine uncertainty about the optimal slope angle for a particular heap. That is, whether the state of knowledge had reached the point where, using the innovative sensor technology, a competent professional in the field could determine when the appropriate slope angle had been reached.

Regard would be had to factors such as Grandheap's original plan[1] for the experimental activities, the results obtained and the statistical rationale for the number of trials. The nature of the business case (in terms of future savings) for prolonged costly experiments could also be a key consideration in determining whether the activities were primarily for other than the purpose of acquiring knowledge.

Although Grandheap conducted all of the 'tests' at Compact Gorge in a similar manner, it was found that the state of knowledge had reached the point that the hypothesis had been established. Accordingly, those latter activities, despite their form and appearance, did not satisfy the purpose test for core R&D.

The experimental activities would include 'incremental' building of overburden heaps beyond the known safe slope angle, along with clearing of overburden from collapsed heaps.

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[1] Although, under the new R&D tax incentive, *ex ante* preparation of an R&D Plan is not a statutory requirement for registration, documented planning will still form an appropriate part of evidencing a systematic progression of work.

Supporting R&D activities

Testing the vibration sensors at Compact Gorge requires a supply of overburden. The activity of extracting overburden and delivering it to the site of the experiments has a sufficiently direct, close and relatively immediate relationship with the experimental activities to be considered directly related.

However, removing the overburden and carting it away from the open cut contributes to mining activities, which are production activities. Accordingly, the dominant purpose test applies to the activities of removing and carting overburden.

It is clear from Grandheap's mining plan that the overburden would be removed regardless of the experiments with the sensors, in order to access mineral deposits. Further, there is no apparent difference between the activity of removing overburden used in the experiments and removing overburden subsequent to the experiments. In the context of Grandheap's activities at Compact Gorge, the dominant purpose of removing and carting the overburden is to access mineral deposits rather than supporting the core R&D activities. Accordingly, removing and carting the overburden do not qualify as supporting R&D activities.

Similarly, basic heap building, which is not part of the experimental activities, would fail the dominant purpose test for supporting activities.

Matryoshkoala

2.59 The following series of Matryoshkoala examples illustrates the tests where experimental activities occur within a normal production run. The extent of the experiment relative to the normal production activities can be a guide to the purpose of activities.

Matryoshkoala I

2.60 Example 2.10 illustrates the tests for a small scale experiment conducted in conjunction with a factory production run.

Example 2.10: Matryoshkoala I

Matryoshkoala operates a factory manufacturing koala shaped Russian dolls from wood. The production line produces the seven sizes of doll halves in sets of bare forms, which it then paints, glazes, assembles in the nested form and packages. The speed of the production line is constrained by the need to allow the paint on the dolls to dry before the set of dolls can be coated in glaze and nested inside each other prior to moving to the packaging stage of the production line.

Matryoshkoala has learned of a new fast drying permeable polymer glaze that is used to protect leather from scratching while still allowing it to breathe. Matryoshkoala conducts experiments on whether, in a production line context, using this glaze might allow the dolls to be glazed and nested before the paint has fully dried, such that the paint does not smudge and does finish drying in storage. Because the glaze serves to protect the design painted on the dolls, the experiments will also investigate the maximum thickness of glaze that will be permeable enough to allow the paint beneath to dry.

A production line diversion is fitted with a spare glazing unit and glaze tank, to allow several sets of test doll to be coated with the permeable glaze in various formulations and thicknesses in conjunction with a normal production run. The diversion also contains a spare nesting machine to allow the test doll halves to be nested at an earlier than usual stage of the production line and set aside for examination.

The test dolls will not be sold with the firm's normal output, as they will be inconsistent due to the range of glaze formulations and thicknesses being tested. Also, they will be subject to considerable handling during the inspections. Those not retained for future reference are to be donated to a local preschool.

These experiments had preceded by removing several dolls from a normal production run as they approach the glazing machine, and spray coating them by hand with the polymer glaze. The results were ambiguous, but suggested the glaze might work as intended.

Core R&D activities

The experimental activities are for the purpose of acquiring new knowledge about the drying and permeability properties of the glaze — specifically the effect of nesting the doll halves before the glaze has dried — for varying formulations and thicknesses of glaze. The outcome of the experiment cannot be determined from existing knowledge about the glaze, and the application of the scientific method is required to address the knowledge gap. Further, the hypothesis can only be tested by replicating how the materials would be handled in a production line context.

The experimental activities qualify as core R&D.

Operating the diversionary stage of the production line where the test dolls are coated with the glaze and assembled would form part of the experiment.

The less formal manual trial prior to the experiments proper would also form part of the core R&D activities.

Supporting R&D activities

Matryoshkoala's experiment on an alternative glaze can only be done on a production line, so activities involved in the production run that have a direct, close and relatively immediate relationship with the actual experimental activities will be activities directly related to the core R&D. However, being production activities, the dominant purpose test applies.

The main production line is operated for the dominant purpose of conducting the normal production run rather than supporting the experiment. Consequently, its operation will not fall within the scope of eligible supporting R&D activities.[2]

Matryoshkoala II

2.61 Example 2.11 illustrates the tests for an experiment conducted in the midst of a full scale production run and the relationship to the 'pre-production' exclusion.

Example 2.11: Matryoshkoala II

Due to concerns over the viscosity and curing properties of the test glaze, the experiment is next run at full scale, to also test whether the glaze will clog the lengthy ducts leading to the glaze applicator over the duration of a typical production run. A range of formulations that proved acceptable for the dolls in the first experiment will be tested, for their feasibility with respect to the ducts.

The dolls produced in the experiment will again not be a consistent product that can be sold through normal distribution channels. However, Matryoshkoala agrees a 'job lot' price with an exporter that will ensure a satisfactory margin over the cost of materials and running the full production line.

Core R&D activities

The hypothesis being tested is that the various formulations of glaze will remain sufficiently fluid over the duration of a normal production run. The core R&D will therefore include the processes from the glaze storage tanks through to the nozzles on the glazing unit, such as operating the pumps, changing the formulations and monitoring the ducts and nozzles. These are activities that lead, via the logical progression of work, to the experimental results.

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[2] However, the cost of producing the painted doll halves used in the glazing experiment would be eligible as a feedstock input (in the same way as were the painted doll halves sources externally). Normal cost attribution rules would be used to determine the cost of the test dolls.

Supporting R&D activities

The production line supplies and removes the dolls that the test nozzles apply the glaze to, which has a direct, close and relatively immediate relationship with the experimental activities, and so running the production line is a directly related activity. Because it is also a production activity, the dominant purpose test applies.

In determining the dominant purpose for the production run, several considerations are relevant. Running the production line to some extent is necessary to supply dolls and move them away from the glazing unit to a place where they can be inspected, so there is a purpose of supporting the experiment. However, that production run goes beyond the needs of the experiment by also nesting the dolls and packaging them — but the design of the production line makes it impractical to not also perform those integrated activities. A further important consideration is that conducting the production run along with the experiment is profitable in its own right — such that it would be done regardless of whether necessary for the experiment — so there is a commercial purpose.

In this instance, the determinative factor lies in the reason why the production line needs to be run and the related consequences. The requirements of the experiment could not be met simply by running the nozzles into a bucket for the duration of a normal production run. Glazing the dolls is a part of the experiment itself, to test whether the glaze has retained the necessary fluidity when exiting the nozzles to apply evenly without flecking. The production run differs significantly from a normal commercial run due to the inconsistent glazing outturns that the experiment anticipates, together with the risk of flecking.

Together, these factors indicate that the dominant purpose for running the production line is to support the experiment, rather than to make commercial use of the available glaze. Profitably disposing of the resulting dolls is incidental to this dominant purpose.

Accordingly, the directly related activities in relation to running the production line are for the dominant purpose of supporting the experiment, so they qualify as supporting R&D activities.

Exclusions

This full scale experiment is not captured by the ‘pre-production activities’ exclusion. It is an experiment that needs to be run at full scale, rather than a trial or ‘shake down’ run for an activity close to entering a production phase. Similarly, the adjustments to the production line were made for the purpose of the experiment, rather than ‘tooling up’ in preparation for entering production.

Matryoshkoala III

2.62 Example 2.12 illustrates the tests for an experiment conducted on a portion of a production line that is run at full scale.

Example 2.12: Matryoshkoala III

Matryoshkoala adopts the experimental glaze, allowing it to considerably shorten the paint and glaze drying sections of its production line to free up floorspace for other activities. A resulting tight turn causes recurring problems for the chain that drives the conveyor belt through this 10 metre section of the production line.

Matryoshkoala hypothesises that the optical recognition device it uses in the quality control section of the line can be modified to reliably detect chain movement anomalies and trigger a mechanical jolt to set the chain back on its cogs.

Modifications are devised and made to the optical recognition device and related software and the mechanical 'kicker' designed and fabricated.

The system is brought up to satisfactory performance in offline tests, but a lengthy test in the actual production line is required to prove the hypothesis. Conducting the test while making a full production run ensures that the test section of the production line is subject to realistic loads.

Core R&D activities

The lengthy test with the production line running is a part of the experiment, as it is part of the logical progression of work that leads to the experimental results. However, although running the production line as a whole might be necessary for the experiment, only running the 10 metre section encompassing the tight turn would form part of the experiment.

The cost of the experiment would include a reasonable apportionment of the cost of running the production line. Matryoshkoala apportions on a 'length in metres' basis, plus a loading for the extra power costs and maintenance this section gives rise to because of the extra drag caused by the tight turn.

Supporting R&D activities

Although running the full production line is, to some extent, necessary for the experiment, it also serves the commercial purpose of producing standard dolls. In determining the dominant purpose for the production run, regard would be had to the perceived likelihood that the run would be normal from a production standpoint and the

implications for production costs were the line to be subject to interruptions. Also relevant would be whether actual doll production was necessary in order to provide a realistic test load.

It was found that interruptions from the test equipment not working as intended would be comparable with those that had been experienced from the chain jumping off in the period prior to the experiment. It was not credible that Matryoshkoala would attempt a full production run if serious delays were likely, due to the cost of the glaze that would need to be pumped to waste out of the lengthy ducts. A realistic test load could have been achieved without the risk of painting and glazing doll halves, by using available halves that had the correct weight but had been rejected at quality control due to paint imperfections.

Accordingly, in the circumstances, it was found that the dominant purpose of conducting a full production run was commercial, rather than to support the experiment. That is, Matryoshkoala, quite sensibly, took the economic opportunity to piggyback onto the experiment.

Hayk Hockey Stix

2.63 Example 2.13 illustrates the tests where the experimental activities are a subset of a long production run.

Example 2.13: Hayk Hockey Stix

Hayk Hockey Stix produces field hockey sticks in large numbers for supply to a world market. Hayk experiments with integrating a multi-axial scanner with an existing numerically controlled laser guided cutting and rasping machine. If successful, this will allow real time detection of output that is outside of tolerances, allowing faulty adult sticks to be recut — if necessary to a junior specification — prior to leaving the machine.

Statistical analysis determines that in a production run of 1,000 sticks the cutting and rasping machine would generate sufficient out-of-tolerance sticks to test, to the 95 per cent confidence level, whether the scanner can accurately identify them.

Hayk has a large order, so it integrates the experiment into a production run of 5,000 sticks. The production stage itself consists of little more than the machine in question, which accepts pre-cut lengths of timber and produces the cut forms, which are rested for curing prior to further processing.

Core R&D activities

Cutting and rasping the first 1,000 sticks of the 5,000 stick production run would be part of the experiment. The cost of the experiment would include a reasonable apportionment of the cost of running that

production stage over the 5,000 stick production run. Hayk apportions on a 'per stick' basis, plus a loading for stopping the line to check for false positives.

Had the experiment generated extra waste from false positives, the cost of that would form part of the cost of the experiment.

Supporting R&D activities

The remainder of the 5,000 stick production run is undertaken for the dominant purpose of commercial production.

Tabby Marine

2.64 The following linked examples for Tabby Marine illustrate the tests where R&D activities are conducted through the production of a marketable product. In all three stages, the experimental activities are conducted on prototypes that are intended for sale.

Tabby Marine I

2.65 Example 2.14 illustrates the tests where normal production components are unsuccessfully matched with experimental ones, increasing the overall cost of what ultimately turns out to be a normal production unit.

Example 2.14: Tabby Marine I

Tabby Marine manufactures catamarans. Generally four boats are under construction at any one time. Tabby experiments with a novel combination of steering rudder and propeller screw, in the hope of achieving increased speed without sacrificing steering control. Trials with models were considered, but found not to be an economical or reliable option. Tabby constructs a prototype catamaran using its usual design, but with the test rudder-screw assembly fitted. The boat is otherwise fully fitted out as usual for eventual sale. Trials are then conducted on open water.

The experiment fails and the vessel is refitted with a conventional rudder and screw and sold for the usual price. Tabby retains the rudder-screw assembly for possible further experiments.

Core R&D activities

The experimental activities are deemed to satisfy the tests for core R&D with respect to applying the scientific method to test a hypothesis about the test rudder-screw assembly for the purpose of generating knowledge about the creation of new/improved products.

The experimental activities principally entail developing and testing the design using a computer model and, separately, testing the fabricated assembly in sea trials.

Fabricating the rudder-screw assembly from the computer-tested design was, in this instance, a routine step and was not a part of the logical progression of work that led to the experimental results. Consequently, it is not a core R&D activity, but may qualify as a supporting R&D activity.

Supporting R&D activities

As the experiments pertain to testing how the rudder-screw assembly operates with Tabby's standard hull design, constructing the hull (and other boat elements that are necessary for the experiments) would be directly related activities and so potentially be eligible as supporting activities. However, because they are production activities, the dominant purpose test would also apply.

Although earmarked for the experiment, the conventional hull was predominantly constructed with a view to the commercial sale of a finished boat. The experiments only affected whether that boat would be sold with the experimental rudder-screw assembly or a regular rudder and screw. Had the R&D not been undertaken, the hull would have been constructed as part of Tabby's normal business activities. The dominant purpose of its construction was commercial and so constructing the hull is not a supporting R&D activity.

Fitting out the catamaran has direct, close and relatively immediate relationship with the experimental activities, by aiding crew comfort. However, in the context of Tabby's activities, the dominant purpose of the fit out is to assist completing the boat for eventual sale and so it does not qualify as a supporting R&D activity.

Fabricating the rudder-screw assembly was a directly related production activity that was only undertaken to support the experiments on the design. As there was no obvious alternative use for the assembly (should it fail to perform as hoped) it is a relatively straight forward matter to show that the dominant purpose for constructing it was to support the experiments. Accordingly, along with installing and removing the test rudder-screw assembly (to allow a conventional rudder and screw to be fitted for the ultimate sale), fabricating the test assembly would qualify as a supporting R&D activity.

Tabby Marine II

2.66 Example 2.15 illustrates the tests where modified production components are matched with experimental ones in a follow-up experiment that produces immediate commercial rewards.

Example 2.15: Tabby Marine II

In the following year, Tabby Marine attaches the removed rudder-screw assembly to a second prototype catamaran with modified hull segments. The tests are successful. The prototype is sold at a premium and the modified catamaran design, with the novel rudder-screw assembly, is put into full production.

Had the modified segments been unsuccessful, it would have been impractical to replace them with conventional segments.

Core R&D activities

These experiments test a different hypothesis about the test rudder-screw assembly and are still for the purpose of generating new knowledge about the rudder-screw assembly design.

The experimental activities principally entail developing and testing the design for the modified hull segments using a computer model[3] and testing, in sea trials, the performance of the resulting catamaran hull in combination with the rudder-screw assembly.

Fabricating the modified hull segments from the design proved problematic due to tight curves in the design and the need for joints accommodating segments entering at varying angles. Tabby's boatbuilders tried several approaches, consulted colleagues and researched boatbuilding articles to overcome the challenges. These were not experimental activities because the uncertainty was of a kind that could be resolved by a competent professional in the field on the basis of current knowledge, information or experience.

Supporting R&D activities

Although the modified catamaran incorporated mainly conventional catamaran hull segments, it was not a practical option to rebuild the boat with purely conventional segments — all of the hull construction was committed to the experimental design. Further, there was significant uncertainty as to how marketable the finished boat would be. Accordingly, constructing all of the hull was for the dominant purpose of supporting the experiment and so would qualify as supporting R&D activity (inclusive of the failed attempts to fabricate the modified segments).

[3] The treatment of software that is developed as part of an R&D project is illustrated in example 2.18.

Tabby Marine III

2.67 Example 2.16 illustrates the tests where a prototype fails and is made from overspecified materials.

Example 2.16: Tabby Marine III

Tabby then experiments with applying the novel rudder-screw assembly design to a similarly modified monohull boat. With an eye to the luxury market, Tabby uses expensive timbers when building this boat. Being optimistic, Tabby also completes the fit out to a high standard, gold plating numerous interior surfaces, prior to commencing sea trials.

The results for the monohull boat are disappointing and the experiment is discontinued. The unsuccessful monohull prototype is sold at a loss as being usable but with performance limitations.

Core R&D activities

Again, these experiments tests a different hypothesis about the test rudder-screw assembly and are still for the purpose of generating new knowledge about the rudder-screw assembly and modified hull segments. In this instance, application of what is still only proven as catamaran hull technology to a monohull is a significant step that requires scientific experimentation to assess its feasibility.

In the context of an experiment occurring, translating the catamaran hull modifications to the existing monohull design, along with related computer testing, would be included in core R&D.

Supporting R&D activities

Constructing the modified monohull is a supporting R&D activity. It is not relevant that the materials used in the experimental activities (such as the planking for the hull) were of a higher standard than necessary to conduct the experiment.

The luxury fit out will not qualify as a supporting R&D activity, as it was clearly conducted for the dominant purpose of the commercial sale of the prototype. It is not relevant that the experiment failed and the boat was sold at a loss.

Whist Constructions

2.68 Example 2.17 illustrates the rules where experimental activities are an integral part of an inherently one-off production task under a fixed price contract.

Example 2.17: Whist Constructions

Whist Constructions enters into a fixed price contract to construct a bridge across River Gorge. Whist tendered on the basis of using a suspension bridge.

The type of rock to which the suspension cables must be anchored has known weaknesses. Whist hopes to address this weakness by an innovative approach to anchoring that would only need holes drilled to a narrow diameter and would spread the forces along the depth of the drill hole.

The anchor design is tested *in situ* at the point in the construction schedule that anchors would normally be inserted. As it was not economical to halt construction and wait for load test results, the identical non-test anchors were also fabricated in advance and installed as soon the installation and activation procedure had been verified. As usual, the anchors are closely monitored as the load increases throughout construction of the remainder of the bridge.

Core R&D activities

The hypothesis being tested is that the modified anchor design will hold in this rock type when subjected to the design forces of the bridge. In this instance, the scientific approach is needed to determine whether this is so. Further, significant uncertainty remained after computer simulations.

Whist's experimental activities include developing and finalising its original conception for the design using a computer model, and installing the necessary number of test anchors into the drill holes while closely monitoring their activation. The experimental activities would also include monitoring the test anchors as they were subjected to load.

However, the experimental activities do not extend to installing and testing all of the anchors — only to the extent necessary to acquire the new knowledge about the improved product and related process (the new anchor design and its installation). Beyond this, installing and routinely testing anchors is part of the non-experimental activities involved in building the bridge using the knowledge gained from the experiment.

Although, in conducting the experimental activities, Whist has an overarching purpose of completing the bridge, the dominant purpose of the experimental activities is the more immediate creation of knowledge in the form of an improved anchor design and its installation process. Accordingly, the purpose test for core R&D is satisfied and the experimental activities constitute core R&D.

Supporting R&D activities

The core R&D activities (including final load testing on the test anchors) can only be fully conducted by building a complete bridge at a site such as River Gorge. However, building the River Gorge bridge is not, for the most part, a supporting R&D activity. The dominant purpose of the normal bridge building activities is building a bridge in order to fulfil Whist's contractual obligations.

Fabricating (or sourcing) the anchors would be directly related to the experiment, as all of the anchors either will either be used in the experiment or contribute to the bridge's completion, which allows the test anchors to be tested to the full load. Fabricating sufficient test anchors to conduct the experiment would be for the dominant purpose of allowing the experiment to take place, and so would qualify as a supporting R&D activity.

Anchors beyond those used in the actual experiment contribute to finalising the bridge, which allows the full load test on the test anchors. They also, through routine monitoring, provide a supplementary source of data. However, as with the rest of the bridge (which also serves to assist the full load test) the dominant purpose for fabricating and installing the non-test anchors is the commercial purpose of completing the bridge.

Two Wheels, E C Plus, and Sanctuary

2.69 The following examples illustrate the application of the rules in relation to software development projects, including the application of the software core R&D exclusion.

Example 2.18: Two Wheels

Two Wheels Ltd, undertakes a project to develop a new gearbox for motorcycles. The project involves investigating the potential for using multiple lay shafts within a gear box in order to reduce its overall size without compromising effectiveness. Such an approach has not been attempted before and it is not known whether it will succeed.

Computer aided engineering and simulation software is used to explore how such a gearbox might be designed and developed. While the software needs to be adapted for the project in question, this is achieved using existing application program languages, and is within the design capabilities of the software used.

Core R&D activities

The outcomes of the software activities are not uncertain and are not intended to achieve new knowledge in relation to computer science as the adaptation is based on existing knowledge. The software activities, by themselves, would not constitute core R&D activities. However, assuming for the example that the larger gearbox project itself constitutes an eligible R&D project, the software activities may constitute eligible supporting activities.

Supporting R&D activities

While developed for in-house use, the software is applied in nature rather than related to the administration of the business, and consequently would not have fallen within the software exclusion were it core R&D. As such, under the supporting R&D rules, Two Wheels only need demonstrate that the software activity was directly related to the core R&D project. The software activities are eligible as supporting R&D activities.

Example 2.19: E C Plus

A software company, E C Plus Ltd, wants to develop a new computer language that will simplify and streamline the coding of on-line software applications without impacting on functionality. E C Plus intends to release the language as open-source in order to promote its uptake and thereby support E C Plus's longer term business strategy. As the proposed language differs significantly from those currently used, a series of development, evaluation and testing activities needs to be systematically undertaken to ascertain whether its idea is workable, and if so, how it performs relative to existing software applications.

Core R&D activities

Considerable uncertainty exists regarding the project, which needs to be addressed through a structured series of activities. These activities are conducted for the purpose of generating new knowledge in relation to computer science and information technology. The activities are core R&D.

Core R&D software exclusion

The software is not being developed for use by E C Plus or a related or connected entity for internal business administration purposes. The exclusion does not apply to the project activities.

Example 2.20: Sanctuary

Sanctuary Ltd, a financial institution, intends to reengineer its disparate systems for managing customer accounts into one customer focused system.

As part of the project, Sanctuary also intends to build a secure payment system that operates by providing customers with a single-use encryption 'key' via a mobile device, allowing them to access their accounts in a secure manner over the internet. Developing such a system will require an experimental process to develop and effectively utilise the advanced cryptographic algorithms and protocols such a system will require.

During the experiment, Sanctuary discovers that the new customer accounts system will also need to be further modified in order for the payments system to operate in a secure manner.

Core R&D activities

The outcome regarding the proposed new secure payment system cannot be determined in advance, as it is dependent on the successful development and operation of the envisaged new secure algorithms and protocols. To address this uncertainty, a systematic process involving design, evaluation and testing is undertaken. The software is being developed to provide a new service for customers, and not for Sanctuary's internal administration, and so the core R&D exclusion does not apply. The activities related to the development of the secure payment system are core R&D.

The re-engineering of customer account software involves developing and/or modifying software solely or primarily for use by Sanctuary for its internal administration and are excluded from being core R&D.

Supporting R&D activities

The activities related to customer accounts are software activities for Sanctuary's internal administration and so are subject to the dominant purpose test. That is, they may be eligible as supporting R&D activity if the dominant purpose for undertaking them was to support the core R&D activities. In this case, the dominant purpose for the integration of the disparate systems was to streamline Sanctuary's customer accounts system. These activities are not supporting R&D.

However, the additional modification made to the customer accounts system undertaken to test the ability of the payments system to operate in a secure manner was undertaken for the dominant purpose of supporting the core R&D project. The modification activities qualify as eligible supporting R&D activities.

Chapter 3
Tax offsets for research and development

Outline of chapter

3.1 Schedule 1 to this second exposure draft amends the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936) to introduce new research and development (R&D) tax offsets, which have the following main features:

- the types of entity that are eligible for the offsets (called an R&D entity in the new law) are a corporation that is an Australian resident, a foreign corporation that is carrying on R&D activities though a permanent establishment in Australia and a public trading trust with a corporate trustee;
- an R&D entity is entitled to a tax offset if the total of its notional R&D deductions is at least $20,000;
- the main notional deductions are for:
  - expenditure on registered R&D activities during the income year; and
  - the decline in value of a depreciating asset used for registered R&D activities during the income year (if certain other conditions are satisfied);
- the offset that an R&D entity is entitled to is a refundable tax offset if the annual turnover of the entity (and certain related entities) for that income year is less than $20 million (and one or more exempt entities do not own or control more than 50 per cent of the entity). Otherwise, the R&D entity is entitled to a non-refundable tax offset; and
- the quantum of the refundable tax offset is equal to 45 per cent of the total of notional R&D deductions while the quantum of the non-refundable tax offset is equal to 40 per cent of the entity's total notional R&D deductions.

The exposure draft is accompanied by amendments to the *Income Tax Rates Act 1986* also necessary for the new R&D tax offset rules.

3.2 Part 1 of Schedule 3 contains related amendments to the tax offset rules in the ITAA 1997. Part 3 of Schedule 3 contains consequential amendments to the ITAA 1997, most of which are explained in this Chapter because they are important to the overall operation of the new R&D tax incentive. Other consequential amendments in Part 3 of Schedule 3 are explained in Chapter 4.

3.3 The concept of R&D activities is discussed in detail in Chapter 2 of this explanatory material.

3.4 In this chapter, legislative references are to the ITAA 1997, except where indicated.

Context

3.5 The existing law contains extensive and complex provisions (sections 73B to 73Z of the ITAA 1936) dealing with R&D expenditure. These deliver an array of deductions and a tax offset, in different circumstances, which can be summarised as follows:

- a base 125 per cent R&D tax concession that provides an increased tax deduction for certain expenditure on registered Australian-owned R&D activities;
- a 175 per cent premium R&D tax concession that provides an additional deduction to the base concession for expenditure that exceeds the average of the corporation's previous three years of Australian-owned R&D expenditure;
- an R&D tax offset that allows small corporations to cash out the value of deductions relating to Australian-owned R&D, which is of benefit if they are in a tax loss situation:
  - the tax offset is (broadly) available to corporations with an annual group turnover of less than $5 million and whose aggregate R&D expenditure is greater than $20,000 and whose group aggregate R&D expenditure is not more than $2 million per year;
  - eligible corporations can choose to receive the tax offset in lieu of deductions available to them under both the base concession and the 175 per cent premium; and
- a foreign incremental tax concession that provides deductions for foreign-owned R&D is as follows:

- 100 per cent deduction for the base expenditure amount; and

- an additional 75 per cent deduction for additional expenditure over the three-year average.

3.6 The Government announced in the 2009-10 Budget that it would replace the existing R&D Tax Concession with a new, more streamlined R&D tax incentive from 1 July 2010.

3.7 The two core components of the new incentive are:

- a 45 per cent refundable R&D tax offset for R&D entities with an aggregated turnover of less than $20 million; and

- a non-refundable 40 per cent tax offset for larger R&D entities. Accompanying this is a tighter definition of R&D activities.

3.8 The Government issued a consultation paper titled *The new research and development tax incentive* in September 2009.

Summary of new law

3.9 Under the new R&D incentive the main benefits are available as tax offsets. The types of entity eligible for the offsets (called an R&D entity in the new law) are a corporation that is an Australian resident, a foreign corporation that is carrying on R&D activities though a permanent establishment in Australia and a public trading trust with a corporate trustee. An entity that is exempt from income tax is not an R&D entity.

3.10 An R&D entity is entitled to a tax offset if the total of its notional R&D deductions is at least $20,000. It is also entitled to a tax offset for certain R&D expenditure incurred to a research service provider, regardless of the level of its notional deductions. A notional deduction is an amount that an entity cannot actually deduct because it is a step in working out the entity's entitlement to a tax offset. (If the entity could actually deduct the amount it would obtain a double benefit for the same amount of expenditure or depreciation.)

3.11 An R&D entity is entitled to notional deductions for the following (if certain other conditions are satisfied):

- expenditure on R&D activities during the income year;

- the decline in value of a depreciating asset used for R&D activities during the income year; and
- a balancing adjustment for depreciating assets used for R&D activities.

3.12 The R&D entity is entitled to a refundable tax offset if the annual turnover of the entity (and certain related entities) for that income year is less than $20 million (and one or more exempt entities do not own or control more than 50 per cent of the entity). Otherwise, the R&D entity is entitled to a non-refundable tax offset.

3.13 The quantum of the refundable tax offset is equal to 45 per cent of total notional R&D deductions while the quantum of the non-refundable tax offset is equal to 40 per cent of the entity's total notional R&D deductions.

Comparison of key features of new law and old law

New law	*Current law*
The two core components of the new incentive are: • a non-refundable 40 per cent R&D tax offset; and • a 45 per cent refundable R&D tax offset for (broadly) R&D entities with an aggregated turnover of less than $20 million.	An array of deductions and a tax offset (summarised under the heading 'Context' in paragraphs 3.5 to 3.8) are available for eligible corporations. The primary benefit is an increased tax deduction equal to 125 per cent of certain expenditure on registered Australian-owned R&D activities.
The types of entity eligible for the tax offsets (called R&D entities) are: • a corporation that is an Australian resident; • a foreign corporation that is resident of a country with which Australia has a double tax agreement and carries on business through a permanent establishment in Australia; and • a public trading trust with a corporate trustee. An entity that is exempt from income tax is not eligible for the tax offsets.	The types of entity eligible for the R&D concession are Australian corporations and public trading trusts.

New law	***Current law***
An R&D entity is entitled to a tax offset if the total of its notional R&D deductions is at least $20,000. It is also entitled to a tax offset for certain R&D expenditure incurred to a research service provider, or as a monetary contribution to a cooperative research centre (CRC), regardless of the level of its notional deductions.	Entitlement to a tax offset or a 125 per cent deduction is generally limited to corporations whose aggregate R&D expenditure is greater than $20,000. There is an exception for certain R&D expenditure to a registered research agency. Entitlement to a tax offset is limited to a corporation with an annual group turnover of less than $5 million and whose group aggregate R&D expenditure is not more than $2 million per year.
An R&D entity can notionally deduct amounts under the R&D provisions for the income year for: • certain expenditure on registered R&D activities; • a decline in value of depreciating assets used for registered R&D activities; • a balancing adjustment for those depreciating assets used only for R&D activities; • R&D expenditure incurred to an associate in an earlier income year and paid in the current income year; • a decline in value of R&D partnership assets; and • a monetary contribution to a cooperative research centre.	125 per cent deductions are available for: • expenditure on R&D activities; • a decline in value of depreciating assets used for R&D activities; • a balancing adjustment for depreciating assets used for R&D activities; • R&D partnership expenditure; and • a decline in value of R&D partnership assets.
An R&D entity is entitled to a refundable tax offset if the annual turnover of the entity (and certain related entities) for that income year is less than $20 million. It is also necessary that one or more exempt entities do not control more than 50 per cent of the entity. Otherwise, the R&D entity is entitled to a non-refundable tax offset.	A corporation is (broadly) entitled to choose a refundable tax offset if it has an annual group turnover of less than $5 million and its group aggregate R&D expenditure is not more than $2 million per year. An entity cannot choose that offset if one or more exempt entities own or control more than 25 per cent of the entity.

New law	*Current law*
The quantum of the refundable tax offset is equal to 45 per cent of the notional R&D deductions. The quantum of the non-refundable tax offset is equal to 40 per cent of the entity's notional R&D deductions.	Where a corporation chooses to convert a 125 per cent deduction to a tax offset, that is equivalent to a tax offset worked out as 37.5 per cent of relevant amounts.
The deductions under the R&D provisions are notional deductions. They are worked out as a step in calculating an entitlement to an R&D tax offset.	A corporation can obtain actual R&D deductions. However, where a corporation chooses a tax offset instead of a deduction, it cannot actually deduct any amount under the R&D provisions for that income year.
The tax offset entitlements are not reduced for government grants or amounts recouped from government. Instead, an entity is liable to pay extra income tax • on Australian government grants it acquits against R&D activities for which entitlements to R&D tax offsets arise; and • on its other recoupments from an Australian government of expenditure on R&D activities for which entitlements to R&D tax offsets arise. The extra income tax is equal to 20 per cent of the grant or recoupment.	A corporation's R&D deductions are reduced to 100% where the corporation (or certain related entities) receives: • an Australian government grant in respect of expenditure on R&D activities that project; or • a recoupment from an Australian government.

Detailed explanation of new law

3.14 An R&D entity is entitled to a tax offset if the total of its notional R&D deductions for an income year is at least $20,000.

3.15 If the aggregated turnover of the R&D entity for that income year is less than $20 million (and one or more exempt entities do not control more than 50 per cent of the entity), the entity is entitled to a refundable tax offset equal to 45 per cent of the notional R&D deductions. Otherwise the entity is entitled to a non-refundable tax offset equal to 40 per cent of the notional R&D deductions.

3.16 The main notional deductions are for certain expenditure on registered R&D activities and the decline in value of a depreciating asset used for registered R&D activities (if certain other conditions are satisfied).

3.17 An R&D entity is also entitled to a tax offset for certain R&D expenditure incurred to a research service provider, or as a monetary contribution to a cooperative research centre, regardless of the level of its notional deductions. Whether that offset is a refundable 45 per cent offset or a non-refundable 40 per cent offset also depends primarily on whether the aggregated turnover of the entity is less than $20 million.

Types of entity that are eligible for R&D tax offsets

3.18 The following types of corporation, called an ***R&D entity*** in the new law, are eligible to obtain an R&D tax offset if they satisfy the following relevant conditions:

- a corporation incorporated under an Australian law;
- a corporation incorporated under foreign law that is an Australian resident for income tax purposes; and
- a corporation incorporated under foreign law that:
  - is a resident of a country with which Australia has a comprehensive double tax agreement; and
  - carries on business in Australia through a permanent establishment (within the meaning of the term 'permanent establishment' in that agreement).

[Schedule 1, item 1, section 355-40]

3.19 A public trading trust that has a body corporate acting as trustee is also eligible for an R&D tax offset. Public trading trusts are broadly taxed like a company for income tax purposes. ***[Schedule 1, item 1, section 355-40 and Schedule 3, item 46, subsection 102T(9)]***

3.20 Corporate limited partnerships are not eligible for an R&D tax offset because they can have a partner other than a corporation. [***Schedule 3, item 45, section 94J of the ITAA 1936]***

3.21 This exposure draft extends eligibility for the R&D Tax Concession in that eligibility was previously limited to Australian corporations and public trading trusts. The primary reason for extending eligibility is so that the R&D provisions do not discriminate against

foreign corporations from a country with which Australia has a comprehensive double tax agreement where that corporation is an Australian resident or has a permanent establishment in Australia. A tax information exchange agreement, an agreement signed in conjunction with a tax information exchange agreement that only allocates taxing rights over a few, limited categories of income or an airline profits agreement is not a comprehensive double tax agreement.

3.22 The Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model) contains a Non-Discrimination Article. That article prevents discrimination on the grounds of nationality by providing that nationals of one country may not be treated less favourably, with respect to taxation, than nationals of the other country in the same circumstances. It also prevents more burdensome tax treatment of tax residents of one country who have a permanent establishment in the other country who are carrying on the same activities as tax residents of that other country. Since 2003, Australia has generally included Non-Discrimination Articles in its comprehensive double tax treaties with 'carve outs' for certain Australian laws (mainly anti-avoidance provisions and R&D).

3.23 From an R&D perspective, the broader eligibility in this exposure draft includes only corporations that have a permanent presence in Australia in that they are an Australian resident (regardless of where they are incorporated) or have a permanent establishment here through which that corporation carries on its business.

Entities ineligible for R&D tax offsets

3.24 An exempt entity, which is an entity all of whose income is exempt from income tax, is not an R&D entity. The new R&D incentive is not designed to deliver subsidies to exempt entities, which may be eligible for grants under Government grant programs. ***[Schedule 1, item 1, section 355-40]***

3.25 For a consolidated or multiple entry consolidated (MEC) group, a subsidiary member cannot apply to be registered (see detailed explanation in Chapter 5). Even without this rule, in a consolidated or MEC group the head company (and not a subsidiary) would get the R&D tax offset.

Entitlement to a tax offset and amount of the tax offset

Work out total of notional deductions

3.26 To work out whether an R&D entity is entitled to an R&D tax offset it is necessary to add up all the amounts that the entity can notionally deduct under the R&D provisions for the income year for:

- R&D expenditure;
- decline in value of R&D assets;
- balancing adjustment for R&D assets;
- R&D expenditure to an associate in an earlier income year;
- decline in value of R&D partnership assets (where the entity is a partner in certain partnerships);
- a balancing adjustment for R&D partnership assets; or
- as a monetary contribution to a cooperative research centre.

[Schedule 1, item 1, section 355-100]

Total of notionally deductible amounts is at least $20,000

3.27 An R&D entity is entitled to a tax offset if the total of its notional R&D deductions is at least $20,000. If the aggregated turnover for the entity is less than $20 million, its tax offset is equal to 45 per cent of the total deductions.

R&D entity controlled by exempt entities

3.28 If one or more exempt entities control the R&D entity in a way described in section 328-125 (which is about where an entity is connected with another entity) the entity's tax offset is equal to 40 per cent of the total deductions. In working out whether one or more exempt entities control the R&D entity in a way described in section 328-125, it is necessary to apply that section as if the 'control percentage' were 50 per cent, instead of 40 percent.

3.29 The 50 per cent threshold is double the 25 per cent cap that exists under the current R&D tax offset. This will encourage collaboration between exempt entities (such as universities) and small firms while still providing some protection against the R&D Tax offset being used to fund non-business R&D (that receives public support through other programs).

3.30 If the aggregated turnover for the entity is at least $20 million, its tax offset is equal to 40 per cent of the total deductions.

3.31 Whether the tax offset is a refundable tax offset depends primarily on the aggregated turnover of the entity and is explained under the heading 'Is the offset refundable or non-refundable?' in paragraphs 3.41 and 3.42. ***[Schedule 1, item 1, section 355-100]***

3.32 The existing law also contains a rule requiring an aggregate R&D amount of at least $20,000. This threshold rule reflects that, in general, a small amount of R&D expenditure is less likely to result in significant innovation outcomes. Small claims also have the potential to impose disproportionate administrative costs relative to the benefit afforded to the claimant and the community.

Aggregated turnover

3.33 'Aggregated turnover' is already defined in the income tax law in the small business entity provisions (Division 328). Here, it is the sum of the annual turnovers of the R&D entity, any entity connected with the R&D entity and any entity affiliated with the R&D entity, excluding any dealings between those entities.

3.34 'Turnover' is also defined in the existing small business entity provisions. The general rule is that an entity's annual turnover for an income year is the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business. Therefore, if the R&D entity is not carrying on a business at any time during the income year, its annual turnover is nil. However, it would still be necessary to take into account the annual turnover of any entity connected with the R&D entity and any entity affiliated with the R&D entity.

Example 3.1: Entitlement to a tax offset where notional deductions are at least $20,000

In the 2011-12 income year New Thingummies Pty Ltd, a corporation incorporated in Australia, carries on a business in Australia that includes research and development activities that it conducted wholly in Australia. Its aggregated turnover for the income year is $250,000.

New Thingummies incurs expenditure on R&D activities for which it is entitled to a notional deduction of $180,000 (under section 355-100). It is also entitled to a notional deduction of $20,000 for decline in the value of depreciating assets (under section 355-200) but to no other notional deductions under Division 355.

As the aggregated turnover of New Thingummies is less than $20 million, it is entitled to a tax offset equal to $90,000 (45 per cent

of $200,000). Also, as its aggregated turnover is less than $20 million, the offset is a refundable tax offset (see detailed discussion under the heading 'Is the offset refundable or non-refundable?' in paragraphs 3.41 and 3.42).

Total of notionally deductible amounts is less than $20,000

3.35 If the total of the amounts that the entity can notionally deduct under the R&D provisions for the income year is less than $20,000, it can only obtain a tax offset in the limited circumstances explained below. ***[Schedule 1, item 1, section 355-100]***

Expenditure incurred to a research service provider

3.36 An R&D entity can obtain an offset, regardless of the level of its notional R&D deductions, for expenditure incurred to a research service provider (that is not an associate of the entity) for the provider to provide services within a research field for which the provider is registered under the *Industry Research and Development Act 1986* (IR&D Act). ***[Schedule 1, item 1, section 355-100]***

3.37 The amount of the offset is equal to 45 per cent or 40 per cent (depending primarily on the entity's aggregated turnover) of the amount of expenditure satisfying these conditions. ***[Schedule 1, item 1, section 355-100]***

3.38 ***Research service provider*** has the same meaning it has in the IR&D Act. In that Act the term means any body of persons, whether or not incorporated, registered to provide services in one or more specified research fields to registered R&D entities. ***[Schedule 1, item 1, section 355-100]***

3.39 There is a similar exception in the current law. The continuance of the exception is intended to encourage entities that expend only small amounts on R&D activities to use research service providers. ***[Schedule 1, item 1, section 355-100]***

Example 3.2: Entitlement to a tax offset where notional deductions are less than $20,000

In the 2011-12 income year Novel Methods Pty Ltd, a corporation incorporated in Australia, carries on a business in Australia and has an aggregated turnover for the income year of $150,000.

Novel Methods is entitled to a notional deduction of $15,000 for expenditure it incurred to Ace Research Agency, a research service provider (that is not an associate of the entity) for Ace to provide a service in a specified research field for which Ace is registered under the IR&D Act. It is not entitled to any other notional deductions under Division 355.

Novel Methods is entitled to a tax offset of $6,750 (45 per cent of $15,000), even though its total notional R&D deductions are less than $20,000.

Expenditure incurred as a monetary contribution to a cooperative research centre

3.40 An R&D entity can also obtain an offset, regardless of the level of its notional R&D deductions, for expenditure incurred as a monetary contribution to a cooperative research centre. (These contributions are explained further in paragraphs 3.146 to 3.154) The amount of the offset is equal to 45 per cent or 40 per cent (depending primarily on the entity's aggregated turnover but also on whether the entity is controlled by exempt entities) of the amount of expenditure satisfying these conditions. ***[Schedule 1, item 1, subsections 355-100(1) and (2)]***

Is the offset refundable or non-refundable?

3.41 Whether the tax offset to which an R&D entity is entitled is a refundable tax offset depends on the aggregated turnover of the entity (discussed above under entitlement to a tax offset). If the aggregated turnover for the income year is $20 million or more, the offset is a non-refundable tax offset. If the aggregated turnover is less than $20 million, the offset is a refundable tax offset, provided that the entity is not (broadly) owned or controlled by one or more exempt entities (with their affiliates). ***[Schedule 3, item 4, section 67-30]***

3.42 The rules applying to refundable tax offsets and non-refundable tax offset are explained under the heading 'Application of the tax offset rules' in paragraphs 3.104 to 3.106.

R&D deductions are notional only

3.43 An R&D deduction to which an entity is entitled under the R&D provisions in Division 355 is a notional deduction in that it is a step in calculating an entity's tax offset entitlement. The entity cannot actually deduct the relevant amount in working out its taxable income (under section 4-15 of the ITAA 1997) because that would result in a double benefit — a deduction and a tax offset — for the same amount of expenditure or depreciation. ***[Schedule 1, item 1, section 355-110]***

3.44 Although deductions under Division 355 are not taken into account in working out an entity's taxable income, those notional deductions are treated as deductions for many purposes of the income tax law. It is important to attract various rules in the income tax law that apply in relation to deductions because there is no similar legislative infrastructure for tax offsets. Thus, an amount that an entity can deduct under the R&D provisions is treated as an actual deduction for:

- a provision that prevents some or all of an amount being deducted, for example:
  - Division 26 (about some amounts that an entity cannot deduct, or cannot deduct in full);
  - Division 27 (effect of input tax credits on deductions);
  - the forgiveness of commercial debt provisions (currently in Schedule 2C to the ITAA 1936 but the Tax Laws Amendment (Transfer of Provisions) Bill 2010 proposes to transfer these provisions to Division 245 of the ITAA 1997);
  - Subdivision 57-G (denial of certain deductions) in Schedule 2D (tax exempt entities that become taxable) of the ITAA 1936; and
  - the general anti-avoidance provisions in Part IVA of the ITAA 1936;
- a provision that changes the income year in which an amount can be deducted (for example, the prepayment rules in Subdivision H of Division 3 of Part III of the ITAA 1936);
- a provision that includes an amount in assessable income wholly or partly because an amount has been deducted (for example, the rules about recoupment of deductible amounts in Subdivision 20-A);
- the cost base rules in the capital gains and losses provisions (commonly known as capital gains tax (CGT)) in Parts 3-1 and 3-3; and
- the R&D provisions themselves.

[Schedule 1, item 1, section 355-110]

3.45 Where one of those provisions requires or permits the Commissioner of Taxation (Commissioner) to do a thing (for example, hold an opinion, form a judgment, or make a determination), the Commissioner can do that thing as if the R&D notional deduction is an actual deduction. ***[Schedule 1, item 1, section 355-110]***

3.46 For the avoidance of doubt, where the prepayment rules (in Subdivision H of Division 3 of Part III of the ITAA 1936) apply to work out the amount of an R&D deduction for expenditure, the amount is treated as deducted under the deduction provisions for R&D expenditure (section 355-200 or 355-480), not under the prepayment rules. ***[Schedule 1, item 1, subsection 355-100(4)]***

Example 3.3: Application of prepayment rules to R&D deductions

In the 2011-12 income year Upfront Payments Pty Ltd, a corporation incorporated in Australia, carries on a business in Australia that includes R&D activities. Its aggregated turnover for the income year is $800,000, which means that it is a small business entity for the purposes of the income tax law.

On 1 June 2012 Upfront Payments incurs expenditure of $150,000 for services to be provided by a contractor over three years (1,095 days). That expenditure satisfies the conditions for a notional deduction for R&D expenditure set out in section 355-200. For the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936 the deduction under section 355-200 is treated as an actual deduction (section 355-200).

Section 82KZM applies to the deduction under section 355-200 because:

- Upfront Payments is a small business entity (and has not chosen not to apply section 82KZMD to the expenditure);
- the expenditure is not 'excluded expenditure' (as defined in section 82KZL);
- the eligible service period for the expenditure is longer than 12 months; and
- a deduction under section 355-200 would, apart from section 82KZM, have been allowed in the year Upfront Payments incurred the expenditure.

The effect of section 82KZM is that the deduction under section 355-100 is spread over the service period. In the 2011-12 income year Upfront Payments is entitled to a deduction for the expenditure under section 355-200 of $4,110 ((30 / 1,095) × $150,000).

Example 3.4: Application of Part IVA to R&D deductions

During the 2012-13 income year Big Claims Pty Ltd incurs expenditure of $10 million on an R&D activity in a way that satisfies section 355-200 (when notional deductions for R&D expenditure arise). Big Claims lodges its income tax return for the 2012-13 income year, and thus self assesses, on the basis that it is entitled to an R&D tax offset equal to $4.5 million (45% of $10 million).

However, the notional deduction of $10 million was obtained by Big Claims under a scheme that Big Claims entered into for the dominant purpose of obtaining the notional deduction. The notional deduction of $10 million is a tax benefit obtained by Big Claims in connection with a scheme to which Part IVA of the ITAA 1936 applies. For the purposes of Part IVA, including the definition of 'tax benefit', a notional R&D deduction is treated as if it were an actual deduction (section 355-110).

Under section 177F (cancellation of tax benefits etc), the Commissioner determines that the whole of the amount of $10 million is not a notional deduction allowable to R&D and amends the assessment of Big Claims so that it is not entitled to any tax offset for the income year.

Big Claims might nevertheless be able to establish an entitlement to deduct the $10 million (or part thereof) under section 8-1, assuming none of it is capital or of a capital nature. Alternatively, the Commissioner might decide that he should make a compensating adjustment to permit a section 8-1 deduction under paragraph 177F(3)(b) of the ITAA 1936.

Conditions applying to R&D expenditure, decline in value of R&D depreciating assets and balancing adjustment for depreciating assets

Registration

3.47 To be eligible for an R&D deduction — for either R&D expenditure or decline in value of depreciating assets used for R&D activities — the R&D entity must be registered under section 27A of the IR&D Act for the activities for which it uses the asset. The registration rules are discussed in more detail in Chapter 5. ***[Schedule 1, item 1, sections 355-200 and 355-300]***

3.48 For the balancing adjustment for depreciating assets used only for R&D activities, it is necessary that the R&D entity be registered for the income year in which the balancing adjustment event happens (see more details under the heading 'Balancing adjustment for depreciating assets used only for R&D activities' in paragraphs 3.92 to 3.96). ***[Schedule 1, item 1, section 355-310]***

Where activities must be conducted

3.49 An R&D entity is eligible for notional deductions in relation to R&D activities it conducts solely within Australia or an External Territory. ***[Schedule 1, item 1, paragraphs 355-205(1)(a), 355-210(a) and (b) and 355-215(a) and (b)]***

Overseas activities

3.50 An R&D entity is also eligible for notional R&D deductions for an overseas R&D activity conducted for the R&D entity while a finding by Innovation Australia under section 28B of the IR&D Act is in force for the R&D activity. ***[Schedule 1, item 1, paragraphs 355-205(d) and (e)]***

3.51 A number of conditions must be satisfied before the Board issues a positive finding under section 28B in relation to an activity conducted, or to be conducted, outside Australia and its external territories. The activities:

- must be R&D activities covered by positive findings under section 28A;
- must have a significant scientific link to core R&D activities conducted in Australia;
- must not be able to be conducted in Australia;
- must incur less expenditure than the related activities conducted in Australia.

[Schedule 2, item 1, sections 28B and 28BA of the IR&D Act]

R&D expenditure that can be eligible for a notional R&D deduction

The standard case — activities conducted by or for the R&D entity

3.52 Generally, an R&D entity is only entitled to a tax deduction in relation to R&D activities conducted for the entity (whether by the R&D entity for itself or by another entity for it). Also, an entity cannot deduct its expenditure on R&D activities if it conducts those activities to a significant extent for another entity. ***[Schedule 1, item 1, section 355-205]***

3.53 This retains a key rule from the existing law commonly known as the 'on own behalf' rule. This rule is intended to limit eligibility for a notional R&D deduction to where an R&D entity is the major benefactor from the expenditure it incurs on the R&D activities. In certain situations, the rule also prevents duplication of claims by different R&D entities. ***[Schedule 1, item 1, section 355-205]***

3.54 Determining the major benefactor of expenditure on R&D activities involves examining the extent to which R&D activities are carried out for the R&D entity compared to the extent to which they are carried out for any other entity. This is tested by weighing up three key criteria, namely who:

- 'effectively owns' the know-how, intellectual property or other similar results arising from the R&D entity's expenditure on the R&D activities;
- has appropriate control over the conduct of the R&D activities; and
- bears the financial burden of carrying out the R&D activities.

In short, the question of whether an R&D activity is conducted for an R&D entity is a question of fact, determined by whether the activity is conducted in substance to provide the majority of knowledge benefits resulting from the activity, such as access to intellectual property, to this entity

3.55 Whether an R&D entity has effective ownership involves reviewing all the circumstances surrounding the conduct of the relevant activities and the ownership and control of, and/or ability to utilise, the intellectual property or similar results obtained from the expenditure on the R&D activities.

Example 3.5: Operation of 'on own behalf' rule

A Pty Ltd and B Pty Ltd are both R&D entities. They both enter into a contract under which B Pty Ltd is to carry out specified services that qualify as R&D activities under Subdivision 355-A. A Pty Ltd has no expertise in the particular R&D field, but has given broad direction to B Pty Ltd in the contract about the specifications it wants achieved by the work. A Pty Ltd is obliged to pay B Pty Ltd for the cost of those services, irrespective of the results obtained.

A is the major benefactor of the R&D expenditure it has incurred, through being the only entity which can access intellectual property arising from the R&D activities, for its own commercial purposes. B does not benefit at all in relation to this intellectual property or any other knowledge benefits gained. B conducts the R&D activities for A, and not to any extent for itself.

Example 3.6: Operation of 'on own behalf' rule where activities conducted jointly

X Pty Ltd and Y Pty Ltd both operate in the same industry and decide to pool their resources and undertake R&D activities jointly in a field of common interest. They both contribute equally to a pool of funds to fund the R&D activities, on the understanding that they will both have the same right to use the results of those activities in their respective businesses on completion of the activities.

Despite conducting R&D activities jointly, X and Y are not partners for income tax purposes. They do not carry on a business in common and are not in receipt of any income jointly.

The interests of X and Y in the know-how developed from the expenditure on the R&D activities are the same and commensurate with their respective expenditures. So both entities have effective ownership of the results arising from their own expenditures. Further, the expenditure of each of X and Y is not a recoupment or reimbursement of the other's expenditure, so X and Y each bear their share of the financial burden of the R&D activities. While the R&D activities might be said in one sense, to be conducted for them both, their joint input into what activities are carried on, their sharing of the financial burden and the nature of their respective interests in the results, where neither can fetter use by the other, means that their separate expenditures are not on R&D activities conducted to a significant extent for the other.

Permanent establishments

3.56 Under Australia's comprehensive double tax treaties, the business profits attributable to a permanent establishment of a foreign resident are calculated as if the permanent establishment were an entity that was separate and independent of the foreign corporation (that is, the profits of the permanent establishment are determined on the basis of arm's length dealings).

3.57 Where the R&D entity is a foreign corporation carrying on its business through a permanent establishment in Australia and incurs expenditure for the purposes of that permanent establishment, as opposed for other parts of the body corporate, the 'on own behalf' rule is satisfied. ***[Schedule 1, item 1, paragraph 355-205(1)(a)]***

R&D activities conducted for foreign corporations

3.58 The new incentive also retains an exception to the 'on own behalf' rule that currently exists for certain activities conducted by the R&D entity for one or more foreign corporations that are related to the R&D entity (called foreign-owned R&D in the existing law). Each of the

foreign corporations for whom the activities are conducted must be a resident of a country with which Australia has a comprehensive double tax agreement. ***[Schedule 1, item 1, subsection 355-205(1) and section 355-215]***

3.59 Also, the R&D activities must be conducted under a written agreement between the R&D entity and each foreign corporation for the activities to be performed by:

- the R&D entity; or
- another entity directly or indirectly under another agreement to which the R&D entity is a party.

[Schedule 1, item 1, section 355-215]

3.60 The written agreement(s) will identify the one appropriate eligible R&D entity that is entitled to the offset. ***[Schedule 1, item 1, paragraph 355-215(d)]***

3.61 Finally, R&D entities performing the activities as a subcontractor are ineligible for a tax offset. In this way, double deductions under the new concession for the same expenditure will be prevented. ***[Schedule 1, item 1, paragraph 355-215(e)]***

R&D activities conducted by a permanent establishment for other parts of the foreign corporation

3.62 The new R&D incentive has an exception to the 'on own behalf' rule for a permanent establishment of a foreign resident corporation that corresponds to the above exception for R&D activities conducted for a foreign corporation. ***[Schedule 1, item 1, subsection 355-205(1) and section 355-210]***

3.63 It applies where the permanent establishment incurs expenditure for R&D activities conducted for the body corporate, but not for the purposes of that permanent establishment. There must also be written evidence of that. ***[Schedule 1, item 1, subsection 355-205(1) and section 355-210]***

Expenditure that is not eligible for a notional R&D deduction

3.64 The following types of expenditure are expressly excluded from eligibility for a tax offset:

- expenditure incurred for interest (within the meaning of interest in the withholding tax rules) payable to an entity;
- expenditure that is not at risk; and

- expenditure on core technology.

[Schedule 1, item 1, section 355-220]

3.65 These types of expenditure do not warrant the enhanced tax benefits available under the R&D tax offsets. They all need to be considered under the normal deduction provisions of the income tax law. ***[Schedule 1, item 1, section 355-220]***

3.66 In the current law, these types of expenditure are eligible for 100 per cent deduction under the R&D provisions (except for core technology expenditure which has a special treatment). Allowing normal tax rules to apply to these expenditures is much simpler than bringing the expenditures into the R&D regime and applying a different rate of benefit. It also ensures that capital expenditures, that under normal tax principles should be written off over a number of years, do not receive the anomalous treatment of being immediately deductible.

3.67 Expenditure that is not at risk is discussed under the heading of 'Integrity rules' in paragraphs 3.130 and 3.133.

Interest

3.68 Here, interest has the same broad meaning as it has in the withholding tax rules in Division 11A of Part III of the ITAA 1936. This includes an amount in the nature of interest (for example, a discount on a security) and a dividend on a non-equity share.

Core technology expenditure

3.69 Expenditure is excluded from an R&D deduction if it is incurred in acquiring technology for the purpose of R&D activities directed towards obtaining new knowledge based on that technology or creating new or improved things (for example, materials, products, devices) based on that technology. This exclusion is aimed at expenditure incurred by an R&D entity in 'bringing in' technology that is already developed and does not extend to expenditure that the entity incurs in developing technology itself.

Cost of a depreciating asset

3.70 Expenditure included in the cost of a depreciating asset (except an intangible asset) for the purposes of working out notional decline in value of the asset under the new R&D provisions is also excluded from the R&D expenditure provision. This simply reflects the priority of the R&D depreciating asset rules over the expenditure rules. ***[Schedule 1, item 1, section 355-220]***

Buildings

3.71 Expenditure incurred to acquire or construct a building (or part of a building or an extension, alteration or improvement to a building) is also ineligible for a notional R&D deduction. These expenditures are considered under the normal rules applying to buildings, especially Division 43. ***[Schedule 1, item 1, section 355-220]***

3.72 There is an exception for expenditure on a building that is plant. That expenditure is specifically excluded from Division 43 and so a building that is plant is subject to the depreciating asset rules in Division 40. Consequently, an R&D entity may be able to obtain a notional R&D deduction for the decline in value of a building that is plant. ***[Schedule 1, item 1, sections 355-220 and 355-300]***

Entitlement to notional R&D deduction for R&D expenditure

3.73 An R&D entity is entitled to a notional R&D deduction for expenditure to the extent that:

- the entity satisfies the conditions (about registration and where activities must be conducted) applying to both R&D expenditure and decline in value of R&D depreciating assets (explained above);
- the expenditure is of a kind eligible for an R&D deduction (also explained above); and
- the entity incurs expenditure during the income year (other than an amount it incurs to an associate but does not pay until a later income year) on one or more registered activities.

[Schedule 1, item 1, section 355-200]

3.74 Thus, the general rule is that expenditure on R&D activities is deductible for the income year it is incurred. There are exceptions to this rule where:

- an amount of expenditure is incurred to an associate (which has its normal broad meaning in the income tax law); or
- the rules about prepayments of expenditure for services to be provided over a period apply (explained further under the heading 'Prepayments of expenditure for services' in paragraphs 4.27 to 4.29).

3.75 Also, an R&D entity's entitlement to a notional deduction does not arise until the entity is registered for the income year in which it conducts the activities on which the entity incurs the expenditure. However, the year of registration does not, of itself, affect the income year for which the R&D entity is entitled to a notional deduction. That is, once registration occurs, the entitlement is for the income year in which the expenditure is incurred, subject to the associate and prepayment rules referred to above.

3.76 The words 'to the extent that' in the expenditure rule permit the apportionment of undissected amounts of expenditure between R&D activities and other activities. For example, where an R&D entity incurs expenditure on salary and employer superannuation contributions for an employee who works partly on R&D activities (that satisfy the tests explained in Chapter 2) and partly on other unrelated activities.

Expenditure incurred to an associate

3.77 If the R&D entity incurs an amount of expenditure to an associate and pays the amount in the same year, that amount is deductible in that year (assuming other conditions are satisfied). Payment has its general legal meaning in the income tax law, which includes constructive payment. Therefore, in working out whether an R&D entity has paid an amount to another entity, and when the payment is made, the amount is taken to be paid to the other entity when the R&D entity applies or deals with the amount in any way on the other's behalf, or as the other directs. ***[Schedule 1, item 1, section 355-200]***

3.78 However, if the R&D entity does not pay the amount incurred until a later income year, the entity has a choice. The entity can choose to deduct an amount (or, if relevant, obtain a non-R&D tax offset) under the normal income tax provisions (for example, the general deduction provision, section 8-1). The entity must make the choice by the time it lodges its income tax return for the most recent income year before the income year in which it paid the amount.

3.79 It would usually do this by claiming a deduction (or a non-R&D tax offset) in its income tax return (although it could also do so by requesting an amendment of an assessment to deduct the expenditure in the income year it was incurred). Having claimed the deduction (or obtained a tax offset) for this expenditure, the R&D entity foregoes any entitlement to a notional R&D deduction in the year of payment. This cannot be reversed, for example, by later requesting an amendment of the assessment to disallow the deduction claimed. ***[Schedule 1, item 1, sections 355-200 and 355-480]***

3.80 If the entity does not choose to deduct the amount under the normal income tax provisions and pays the amount to the associate in an income year after it was incurred, the entity is entitled to a notional R&D deduction in the year of payment. ***[Schedule 1, item 1, section 355-480]***

Example 3.7: Expenditure incurred to an associate but not paid until a later income year

Ingenious Plans Pty Ltd, a corporation incorporated in Australia, carries on a business in Australia that includes R&D activities. In the 2011-12 income year Ingenious Plans incurs expenditure of $20,000 to an associate for the associate to carry out R&D activities on its behalf. However, Ingenious Plans does not pay the $20,000 until the 2012-13 income year.

Ingenious Plans is registered for the activities for the income year in which they were conducted. The expenditure also satisfies the various conditions in section 355-200 for the expenditure to be deductible. Nevertheless, Ingenious Plans cannot deduct the expenditure to the associate in the 2011-12 income year because the amount was not paid in that income year.

In lodging its income tax return for the 2011-12 income year Ingenious Plans did not take the expenditure to the associate into account in working out the amount of a deduction under any provision outside Division 355 or any entitlement to a tax offset.

Ingenious Plans is entitled to a notional R&D deduction for the expenditure of $20,000 for the 2012-13 income year.

Entitlement to notional deduction for the decline in value of R&D depreciating assets

3.81 An R&D entity is entitled to a notional R&D deduction for the decline in value of a depreciating asset if:

- the entity satisfies the conditions (about registration and where the activities are conducted) applying to both R&D expenditure and decline in value of R&D depreciating assets (explained above);
- the asset is:
  - a tangible asset other than a building (or part of a building); or
  - a building that is plant;

- the entity used the asset during the income year for conducting R&D activities; and
- the entity would be entitled to deduct an amount under the depreciating asset provisions (Division 40) if those provisions applied with certain changes.

[Schedule 1, item 1, section 355-300]

3.82 The entity cannot deduct an amount if the asset has been pooled with other assets for working out deductions for depreciating assets. Conversely, the entity cannot allocate a depreciating asset to a low value pool or one of small business pools after the R&D depreciating asset provisions have applied to the asset. ***[Schedule 1, item 1, paragraph 355-300(f); Schedule 3, item 24, subsection 40-425(8); Schedule 3, item 99, subsection 328-175(9) of the ITAA 1936]***

Notional application of depreciating asset provisions

3.83 Working out whether the entity would be entitled to deduct an amount under the depreciating asset provisions (Division 40) if those provisions were applied with certain changes is called the notional application of Division 40. This notional application is for the purposes of working out the notional R&D deduction for the decline in the value of a depreciating asset and any balancing adjustment for a depreciating asset used only for R&D activities (and also amounts excluded from deduction as R&D expenditure). ***[Schedule 1, item 1, section 355-300]***

Purpose of conducting R&D activities

3.84 The main change made in working out the notional Division 40 deduction is that references to the purpose of producing assessable income or a taxable purpose are replaced with references to the purpose of conducting one or more R&D activities (except in limited specified cases). The object of this change is to work out the notional Division 40 deduction based on its use for R&D activities. The notional deduction is reduced to the extent that the asset is used for a purpose other than R&D activities. The R&D entity may be entitled to an actual Division 40 deduction for that other use (for example, the other use is in carrying on a business for the purpose of producing assessable income). ***[Schedule 1, item 1, section 355-305]***

Buildings and capital works other than buildings

3.85 The second change is to assume that Division 40 does not apply to a building (or an extension, alteration or improvement to a building) for which the entity can deduct an amount under the capital works provisions in Division 43. Nor does it apply to a building (or an extension, alteration

or improvement to a building) for which the entity could have deducted an amount under Division 43 if the entity had started work before a particular date or used the building for R&D activities. The object of the change is to replace the rule in Division 40 that excludes capital works for which you can get deduct amounts under Division 43. The result is that an R&D entity can get an R&D deduction (and therefore, a tax offset) for the decline in value of capital works that are not buildings that it uses in R&D activities. ***[Schedule 1, item 1, section 355-305]***

Uses to ignore

3.86 In working out the notional deduction for decline in value of a depreciating asset, it is necessary to ignore uses of the asset that would not satisfy the various conditions. In particular, it would be necessary to ignore uses for R&D activities that:

- were not registered for the income year in which they were conducted;
- did not meet conditions about where activities must be conducted; or
- did not satisfy the 'on own behalf' test.

[Schedule 1, item 1, paragraph 355-300(b) and section 355-305]

Effective life

3.87 In working out the effective life of a depreciating asset it is necessary to estimate the period that the asset can be used by an entity for one or more of these:

- a taxable purpose;
- the purpose of producing exempt income or non-assessable non-exempt income; or
- the purpose of conducting R&D activities, assuming that this is reasonably likely.

[Schedule 3, items 18 to 20, subsections 40-95(9), 40-100(4) and 40-105(1) to (3)]

3.88 This applies both for a taxpayer self assessing effective life and for the Commissioner making a written determination of effective life. ***[Schedule 3, items 18 to 20, subsections 40-95(9), 40-100(4) and 40-105(1) to (3)]***

3.89 Where it is reasonably likely that an asset will be used for the purpose of conducting R&D activities, it is also necessary, in having

regard to the period within which the asset is likely to be scrapped or abandoned, to disregard reasons attributable to technical risk in conducting R&D activities. ***[Schedule 3, items 18 to 20, subsections 40-95(9), 40-100(4) and 40-105(1) to (3)]***

3.90 There are similar rules about effective life, so far as they relate to R&D activities, in the existing R&D provisions (section 73BG of the ITAA 1936). Those rules apply for working out both notional and actual deductions. In the new law, those provisions are located in Division 40. Locating the rules about effective life in one place should assist readers. As the rules apply for working out actual Division 40 deductions as well as notional deductions for the R&D provisions, there is no strong reason to locate the rules in the R&D provisions.

No change in decline in value method

3.91 A taxpayer generally has a choice of two methods — the prime cost method and the diminishing value method — in working out the decline in value of a depreciating asset and cannot change methods. If an R&D entity has previously worked out actual deductions under Division 40 for an asset, it must use the same method in working notional deductions under Division 40, and vice versa. ***[Schedule 3, item 17, subsections 40-65(6) and (7)]***

Balancing adjustment for depreciating assets used only for R&D activities

3.92 Where an R&D entity has used a depreciating asset only for R&D activities, it is or has been entitled to R&D decline in value deductions and a balancing adjustment event happens (for example, the entity sells or scraps the asset), a balancing adjustment is worked out. This is necessary so that a taxpayer's income tax position over time reflects the actual decline in value of the assets, rather than the estimates on which depreciation deductions have been based. The balancing adjustment results in a further ('catch-up') notional R&D deduction or an uplifted amount being included in assessable income (to claw back excessive deductions). ***[Schedule 1, item 1, section 355-310]***

3.93 For this balancing adjustment to apply, it is also necessary that the R&D entity be registered for the income year in which the balancing adjustment event happens. Where an entity has ceased R&D activities in a previous income year and scraps an asset in the current income year, it is not appropriate for the entity to obtain the enhanced benefits of the R&D provisions for the decline in value that may have occurred (in whole or part) after R&D activities ceased. Nor will an uplifted amount be included in assessable income. ***[Schedule 1, item 1, section 355-310]***

3.94 If the R&D entity would have been entitled to a balancing deduction under the standard balancing adjustment provision of section 40-285 (assuming the changes discussed under the heading 'Notional application of depreciation provisions' in paragraphs 3.83 to 3.91), the entity is entitled to an R&D deduction of an equivalent amount. That R&D deduction is included in the calculation of the entity's tax offset. ***[Schedule 1, item 1, section 355-310]***

3.95 Conversely, if an amount would have been included in assessable income of the R&D entity under the standard balancing adjustment provision of section 40-285 (assuming the changes discussed under the heading 'Notional application of depreciating asset provisions' in paragraphs 3.83 to 3.91), the sum of that amount (the section 40-285 amount) plus an additional amount is included in the entity's assessable income. The additional amount is included to reflect that the R&D entity has obtained enhanced benefits in the form of an offset at 40 or 45 per cent on the decline in value. ***[Schedule 1, item 1, section 355-310]***

3.96 The additional amount is equal to one third of so much of the section 40-285 amount as does not exceed the total decline in value. The factor of one third is based on an offset rate of 40 per cent (rather than the higher 45 per cent rate that generally applies to R&D entities with an aggregated turnover of less than $20 million). ***[Schedule 1, item 1, section 355-310]***

Example 3.8: Balancing adjustment for depreciating assets used only for R&D activities

B Pty Limited was incorporated in Australia and carries on a business in Australia that includes R&D activities that it conducts wholly in Australia. Its aggregated turnover for each income year is under $20 million. B has a standard income year ending on 30 June.

On 1 July 2011, B purchases a mass spectrometer for use in carrying on its R&D activities. The unit costs $30,000. B assesses the effective life of the unit as five years and chooses the prime cost method for calculating its decline in value.

During the 2011-12 and 2012-13 income years, B uses the unit only in carrying on its R&D activities. It sells the unit on 31 December 2012 for $15,000.

As B only ever used the unit for undertaking R&D activities, it will work out a balancing adjustment under section 355-310. It is entitled to a notional deduction equal to the amount calculated under subsection 40-285(2), which is equal to the termination value less the adjustable value. The termination value is $15,000. The adjustable value is equal to the opening adjustable value less the decline in value during the 2012-13 income year. The opening adjustable value is

> $24,000. The decline in value is $3,000. Accordingly, the adjustable value is $21,000.
>
> B is entitled to a notional deduction of $6,000 ($21,000 − $15,000) under subsection 355-310(2). Assuming B has total notional R&D deductions over $20,000 for 2012-13, B is entitled to an offset of $2,700 (45% of $6,000) in respect of the sale of the unit.

Balancing adjustment for assets used partly for R&D activities

3.97 A balancing adjustment must also be worked out where an R&D entity has used a depreciating asset partly for R&D activities and partly for another purpose that is a taxable purpose (for example, the purpose of producing assessable income) under the capital allowance provisions.

3.98 The existing balancing charge provision that covers this case, section 40-292, is replaced by a similar provision that reflects the new R&D provisions.

3.99 In working out reductions in the balancing adjustment amount for non-taxable use, use for the purpose of conducting R&D activities is assumed to be use for a taxable purpose. ***[Schedule 3, item 24, section 40-292]***

3.100 If the R&D entity is entitled to a balancing deduction under the standard balancing adjustment provision of section 40-285, the amount of the balancing deduction is increased. The amount is increased by half if the R&D entity's aggregated turnover is less than $20 million and one third in other cases. The factors by which the deduction amount is increased are equivalent to the 45 per cent and 40 per cent rates at which the R&D tax offsets are calculated. ***[Schedule 3, item 24, section 40-292]***

3.101 If an amount is included in the R&D entity's assessable income under section 40-285, the amount assessable is increased by one third of an amount worked out under a formula. The factor of one third is concessional for those R&D entities with an aggregated turnover of at least $20 million but is used for simplicity reasons. ***[Schedule 3, item 24, section 40-292]***

3.102 The formula adjusts the amount worked out under section 40-285 so that it does not exceed the asset's total decline in value. It then applies a factor so that the amount being clawed back reflects that proportion of the decline in value of the asset represented by total notional R&D deductions. ***[Schedule 3, item 24, section 40-292]***

Example 3.9: Balancing adjustment for assets used partly for R&D activities

C Pty Limited was incorporated in Australia and carries on a business in Australia that includes R&D activities that it conducts wholly in Australia. Its aggregated turnover for each income year is under $20 million.

On 1 July 2011, C purchases a mass spectrometer for use in its business. The unit costs $30,000. C assesses the effective life of the unit as five years and chooses the prime cost method for calculating its decline in value. C uses the unit 50 per cent of the time for carrying on ordinary business activities and 50 per cent of the time for carrying on R&D activities.

During the 2012-13 income year, C sells the unit on 31 December 2012 for $15,000. C is entitled to a deduction under subsection 40-285(2) which is equal to the termination value less the adjustable value. The termination value is $15,000. The adjustable value is equal to the opening adjustable value less the decline in value during the 2012-13 income year. The opening adjustable value is $24,000. The decline in value is $3,000. Accordingly, the adjustable value is $21,000. C is entitled to a deduction of $6,000 ($21,000 − $15,000) under section 40-285.

C is also entitled to an additional deduction under section 40-292. As a result of the use of the asset in R&D activities for 50 per cent of the time it has been held by Company A, Company A has been entitled to notional deductions of $4,500 (1/2 × ($6,000 + $3,000)) under section 355-300. Subsection 40-292(2) requires the company to calculate an amount under subsection 40-292(5) as follows:

$$\frac{\text{Sum of R\&D deductions} \times \text{adjusted section 40-285 amount}}{\text{Total decline in value}}$$

$$\frac{\$4{,}500 \times \$6{,}000 = \$3{,}000}{\$9{,}000}$$

Subsection 40-292(3) provides that a company is entitled to increase its section 40-285 deduction by the amount worked out by multiplying the amount worked out under subsection 40-292(5) by one half (because it has an aggregated turnover of less than $20 million).

C is entitled, under subsection 40-292(3), to increase its section 40-285 deduction by 1/2 × $3,000 = $1,500. Its total section 40-285 deduction is $7,500 ($6,000 + $1,500).

Relationship between R&D depreciating asset rules and R&D expenditure rules

3.103 The R&D depreciating asset rules have priority over the R&D expenditure rules where an R&D entity incurs an amount of expenditure that is included in the cost of a depreciating asset for working out notional deduction for decline in value under Subdivision 355-D. The object is that the notional deduction for the expenditure and, therefore, the R&D tax offsets, should be spread over the effective life of the assets. ***[Schedule 1, item 1, section 355-300]***

Application of the tax offset rules

Refundable tax offsets

3.104 If the offset is a refundable tax offset the normal income tax rules for refundable tax offsets apply. These include the priority rules about how a taxpayer's tax offsets must be applied against their basic income tax liability (subsection 63-10(1)). A refundable tax offset is applied after all other tax offsets, except the tax offset that arises from the payment of franking deficit tax. If there is an excess the taxpayer is entitled to a refund, subject to the rules in Divisions 3 (Treatment of payments, credits and RBA surpluses) and 3A (Refunds of RBA surpluses and credits) of Part IIB of the *Taxation Administration Act 1953*, which cover how the Commissioner must apply credits, including refunds. Under those rules the Commissioner may allocate the credit to a running balance account or apply a credit against a particular tax debt (for example, a goods and services tax debt).

3.105 The new refundable tax offset provision is included in Division 67, which covers refundable tax offsets. ***[Schedule 3, items 2 to 4, sections 67-23 and 67-30]***

Non-refundable tax offsets

3.106 If the offset is not a refundable tax offset, it is applied before refundable tax offsets but after all other tax offsets (such as a foreign income tax offset). An R&D entity may carry forward a non-refundable tax offset to a later year, provided that it satisfies the standard rules about the carry-forward of tax losses (Division 65). ***[Schedule 3, item 1, subsection 63-10(1)]***

An R&D entity obtains a grant or other recoupment from an Australian government

3.107 Subdivision 355-G adjusts the overall benefit an R&D entity receives where activities eligible for the R&D tax incentive also constitute a project that receives a government grant or other recoupment.

3.108 The adjustment is primarily designed to address the simple case where an R&D entity spends its own money on R&D activities along with a matching amount that is funded by a grant. Without a clawback adjustment, the R&D entity would enjoy both a tax incentive and a matching grant in relation to the spending of its own money, along with a tax incentive in relation to the spending that was funded by the grant. This 'triple benefit' that derives from the R&D entity's self-funded outlay is to be neutralised by a clawback adjustment to the grant.

3.109 For simplicity, this clawback adjustment is effected by making extra income tax payable on the grant an amount equivalent to the two R&D incentive amounts. As a further simplicity measure, the tax incentive is taken to be a 10 percentage point premium over the 30 percent company tax rate; that is, the R&D entity is taken to have received the tax offset at the standard rate of 40 per cent, rather than a possible 45 per cent. The grant clawback is payable as an extra income tax on the grant at a rate of 20 per cent.

Example 3.10

EcoStartup receives a $1 million grant in relation to eligible R&D activities that it conducts. The grant requires EcoStartup to spend a total of $2 million (including the grant money) on specified R&D activities, which EcoStartup does during the income year the grant was received.

EcoStartup receives an R&D tax offset of $800,000 on its $2 million dollars of project spending (40% of $2m). However, to claim the offset, EcoStartup forwent a $2 million dollar tax deduction that would have provided a tax benefit worth $600,000. The incentive component of the offset is therefore $200,000 (10% of $2m).

EcoStartup's $1 million outlay has given rise to a government grant of $1 million and a $200,000 R&D tax incentive. EcoStartup incurs a $300,000 income tax liability in relation to the grant. The grant is therefore worth more to EcoStartup than the R&D tax incentive.

The tax incentive is clawed back by a 20 per cent tax on the grant amount. The project as a whole is left with an effective government subsidy equivalent to the after-tax value of the grant.

Detailed provisions

3.110 A clawback adjustment arises where an entity (the 'recipient') receives, or becomes entitled to receive a recoupment (including a grant) from an Australian government agency or State/Territory body that is applied to expenditure on R&D activities for which the recipient is entitled to the R&D tax incentive. The relationship between the grant and how it is applied is explained in more detail below. ***[Schedule 1, item 1, sections 355-435 and 355-440]***

3.111 Grants are considered to be applied to R&D expenditure when the recipient 'acquits' them against R&D activities for purposes of accounting for how the grant money has been applied. Amounts so applied are termed 'R&D acquittals'. ***[Schedule 1, item 1, subparagraph 355-445(1)(a)(i)]***

3.112 Similarly, retrospective grants are considered to be applied to R&D expenditure where they reimburse the recipient for R&D expenditure they have previously undertaken. Amounts so applied are termed 'R&D receipts'. ***[Schedule 1, item 1, subparagraph 355-445(1)(a)(ii)]***

3.113 A clawback adjustment will only arise where the recipient is actually entitled to the R&D tax incentive in relation to the R&D activities to which the grant has been applied. That is, in addition to the activities themselves satisfying the tests for core or supporting R&D activities, the other eligibility tests for a tax offset would need to be satisfied; such as in relation to registration, overseas activities, 'on own behalf', non-cash payments to associates and 'expenditure not at risk'. ***[Schedule 1, item 1, paragraph 355-445(1)(b)]***

3.114 The clawback adjustment is calculated on the sum of the 'R&D acquittals' and 'R&D receipts' (that is, the total of grant applied to R&D expenditure). Where a grant is repayable, any repayments are taken into account by reducing the sum of the R&D acquittals and receipts by the amount of grant repayments (if any). The resulting figure (termed the 'R&D portion') is the base for calculating the clawback adjustment. Making a grant repayment can retrospectively reduce the R&D entity's income tax liability for the income year in which the clawback adjustment was made. ***[Schedule 1, item 1, paragraph 355-445(1)(c) and section 355-450]***

3.115 Similar rules apply where the recoupment is other than a grant. Where such a recoupment is received during an income year and applied to R&D expenditure that has been incurred for which the R&D entity is entitled to a tax offset, a clawback adjustment will apply to the amount of the recoupment that is applied to R&D expenditure. ***[Schedule 1, item 1, subsection 355-445(2) and section 355-450]***

3.116 The clawback adjustment takes the form of extra income tax payable on the 'R&D portion' amount in the year a recoupment is applied to R&D expenditure (the 'trigger year') at the rate of 20 per cent. ***[Schedule 1, item 1, section 355-450]***

3.117 Grants provided under the CRC Program are exempt from clawback. ***[Schedule 1, item 1, subsection 355-440(1)]***

Relationship with core income tax rules

3.118 The extra income tax increases the basic income tax liability on the entity's taxable income beyond the amount that is worked out by simply applying the income tax rates to the entity's taxable income. After that basic income tax liability is worked out, in accordance with the normal rules total tax offsets are subtracted from the basic income tax liability. The requirement to pay extra income tax operates in the same way as the requirement for primary producers to pay extra income tax as an averaging adjustment under Subdivision 392-C. ***[Schedule 1, item 54, section 4-25]***

Amendments of the Income Tax Rates Act 1986

3.119 The Income Tax Rates Amendment (Research and Development) Bill 2010 amends the *Income Tax Rates Act 1986* to provide that the rate of additional income tax payable under Subdivision 355-G of the ITAA 1997 on all or part of a recoupment is 20 per cent. ***[Schedule 1 to the Income Tax Rates Amendment (Research and Development) Bill 2010, items 1 to 3, subsection 12(7), section 12B and section 31 of the Income Tax Rates Act 1986]***

Integrity rules

3.120 Integrity rules apply to the following:

- expenditure incurred while not at arm's length ***[Schedule 1, item 1, section 355-400]***;
- disposal of R&D results ***[Schedule 1, item 1, section 355-410]***;
- expenditure reduced to reflect group mark-ups ***[Schedule 1, item 1, section 355-415]***; and
- expenditure not at risk ***[Schedule 1, item 1, section 355-405]***.

3.121 These rules correspond to similar integrity rules in the existing R&D provisions.

Expenditure incurred while not at arm's length

3.122 If the expenditure incurred in a non-arm's length transaction or in a transaction with an associate is greater than the market value of the R&D activities, the expenditure is instead taken to have the market value. ***[Schedule 1, item 1, section 355-400]***

Relationship with international transfer pricing provisions

3.123 Section 136AB of the ITAA 1936 is amended to clarify the relationship between the proposed non-arm's length transaction section (section 355-400) and the international transfer pricing provisions in Division 13 of Part III of the ITAA 1936. If section 355-400 and Division 13 could otherwise apply, the potential operation of section 355-400 is to be disregarded. This leaves Division 13 to apply comprehensively in the international area, subject to the terms of any relevant double tax treaty. ***[Schedule 3, item 44, subsection 136AB(2) of the ITAA 1936]***

3.124 The result is that the relationship of section 355-100 with Division 13 is the same as that of section 70-20, the non-arm's length rule for trading stock.

Disposal of R&D results

3.125 The assessable income of an R&D entity includes an amount if:

- it is entitled to a notional deduction for expenditure on R&D activities or for using a depreciating asset for R&D activities; and
- it receives, or becomes entitled to receive, an amount:
  - for the results of any of the activities;
  - from the grant of access to, or the right to use, any of those results;
  - attributable to the entity having incurred the expenditure or having used the asset for R&D activities (including an amount that it is entitled to receive irrespective of the results of the activities); or

– from disposing of a CGT asset, or from granting a right to occupy or use a CGT asset, where the disposal or grant resulted in another entity acquiring a right to access or use any of those results.

[Schedule 1, item 1, section 355-410]

3.126 The amount assessable is generally the amount received or receivable. However, where the amount is from disposing of a CGT asset, or from granting a right to occupy or use a CGT asset, the assessable income amount is the amount received or receivable less the cost of the asset (just before the disposal or grant). ***[Schedule 1, item 1, section 355-410]***

Reducing deductions to reflect mark-ups within groups

3.127 If one or more entities connected with the R&D entity incur R&D expenditure for which the R&D entity can notionally deduct an amount and that expenditure was incurred when those entities were connected or affiliated with the R&D entity, then the amount that the R&D entity can notionally deduct may be reduced. ***[Schedule 1, item 1, section 355-415]***

3.128 The amount notionally deducted by the R&D entity is reduced to the extent that R&D expenditure paid to the connected entity or affiliate exceeds the actual cost of the R&D goods or services to the connected entity or affiliate (that is, the goods or services are 'marked-up'). ***[Schedule 1, item 1, section 355-415]***

3.129 Expenditure that is not notionally deductible because of the operation of this 'mark up' rule may be deductible under the ordinary deduction provisions of the law.

Expenditure not at risk

3.130 Expenditure that is not at risk (for example, if there is guaranteed return under a financing arrangement or an indemnity) is not eligible for a notional R&D deduction but the ordinary deduction rules may apply. ***[Schedule 1, item 1, section 355-405]***

3.131 Expenditure is not at risk to the extent that, when the expenditure is incurred, the R&D entity (or an associate) could reasonably be expected to receive an amount of consideration:

- as a result of the expenditure being incurred or because of anything that happened before then; and

- irrespective of the results of the activities on which the entity incurs the expenditure.

[Schedule 1, item 1, section 355-405]

3.132 The inclusion of the requirement that the entity reasonably expects to receive the amount of consideration irrespective of the results of the activities on which the entity incurs the expenditure is consistent with the way the Commissioner has administered the existing law about expenditure not at risk. For example, the Commissioner would not apply the existing law where the expectation of receiving consideration under a contract for the development and sale of a product was based both on the terms and conditions of that contract and also the entity's experience and technical capability concerning the degree of confidence about successfully performing that contract. Where this product development involved R&D activities it cannot be said that the expectation of receiving consideration under this contract exists irrespective of the results of these activities. ***[Schedule 1, item 1, section 355-405]***

3.133 As under the existing law, the rule about expenditure not at risk does not apply to R&D activities conducted by the R&D entity for one or more foreign corporations that are related to the R&D entity. Nor does it apply to the corresponding permanent establishment case – where activities are conducted by a foreign corporation though a permanent establishment in Australia for other parts of the corporation. ***[Schedule 1, item 1, subsection 355-405(4)]***

R&D partnerships

3.134 The proposed rules contain a group of rules (Subdivision 355-H) that set out in detail how the tax offset rules apply to certain partnerships called R&D partnerships.

3.135 An ***R&D partnership*** is a partnership in which each of partners is an R&D entity. Here, partnership has its normal defined meaning, which includes a general law partnership and an association of persons in receipt of ordinary or statutory income jointly. ***[Schedule 1, item 1, subsection 355-505(1)]***

3.136 Similarly to the existing law, the partnership provisions have the effect that the R&D tax offset is available to an R&D entity that is a partner in an R&D partnership. Rather than being taken into account in determining a partner's individual interest in the net income or partnership loss of a partnership (under Division 5 of Part III of the ITAA 1936), the benefits are directly available to the individual partners that are R&D entities. ***[Schedule 1, item 1, sections 355-100 and 355-545]***

3.137 A central concept in applying the R&D partnership provisions is the ***partner's proportion*** of various amounts (for example, expenditure, turnover or recoupment) attributable to the R&D partnership that each partner is treated as entitled to, or bearing. The proportion is the partner's interest in the net income or partnership loss of the R&D partnership, unless the partners have agreed that the partners should bear or be entitled to a different proportion. ***[Schedule 1, item 1, section 355-505(2)]***

R&D partnership expenditure

3.138 An R&D entity that is a partner in an R&D partnership is treated as incurring that entity's partner's proportion of the expenditure incurred by the partnership. This deeming rule enables the R&D entity to get a notional deduction for that proportion of the partnership's R&D expenditure if the other conditions for the notional deduction (about registration, where the activities are conducted, the 'on own behalf' rule (and its alternatives in section 355-205) and excluded expenditure) are satisfied. ***[Schedule 1, item 1, subsection 355-515]***

3.139 An important condition that must still be met by the individual partner is registration – the registration rules in the IR&D Act do not provide for a partnership to register.

Activities conducted by the partnership treated as conducted by each partner

3.140 To facilitate the R&D tax offset being available to each R&D entity that is partner in an R&D partnership, there is also a set of deeming rules that treat:

- a thing done by, or in relation to, a R&D partnership as done by, or in relation to, the partner;
- R&D activities conducted by or for the R&D partnership as if they were conducted by or for the partner (but not the partnership) in a corresponding way;
- relationships that the R&D partnership has with other entities in relation to the R&D activities as if the partner had corresponding relationships with those other entities; and
- such other changes as having been made to the R&D provisions as are appropriate having regard to that partner's proportion of amounts attributable to the R&D partnership.

[Schedule 1, item 1, section 355-515]

A partner's aggregated turnover

3.141 Under the existing aggregated turnover rules (in Division 328 of the ITAA 1997), if an R&D entity is a partner in an R&D partnership the entity's aggregated turnover can include the whole of the annual turnover of the partnership (for example, if the partner controls the partnership in the way described in section 328-125). If an R&D entity's aggregated turnover does not so include the whole of the annual turnover of a partnership, for the new R&D provisions it includes the partner's proportion of the R&D partnership's annual turnover. ***[Schedule 1, item 1, section 355-510]***

Example 3.11: R&D partnership

A Pty Ltd is in a general law partnership with B Pty Ltd and C Pty Ltd. A Pty Ltd, B Pty Ltd and C Pty Ltd were all incorporated in Australia. As part of the partnership's business, the partnership incurs expenditure of $150,000 during the 2012-13 income year on R&D activities. The partnership conducts those R&D activities in Australia for the partnership (and not for one or more other entities). Each of A Pty Ltd, B Pty Ltd and C Pty Ltd registers for those R&D activities for the 2012-13 income year.

The annual turnover of the partnership for that income year is $6 million and, apart from the partnership, the aggregated turnover of A Pty Ltd would be nil.

The partnership of A Pty Ltd, B Pty Ltd and C Pty Ltd is an R&D partnership because each is an R&D entity (being a body corporate incorporated under an Australian law). The aggregated turnover of A Pty Ltd for the 2012-13 income year is $2 million (1/3 of $6 million).

A Pty Ltd is treated as incurring expenditure of $50,000 (1/3 of $150,000) during the 2012-13 income year on the R&D activities for which A Pty Ltd is actually registered (section 355-505). The R&D activities are also treated as conducted by or for A Pty Ltd in Australia (section 355-507). Therefore, A Pty Ltd is entitled to a notional deduction of $50,000 for the 2012-13 income year (assuming that no other provision applied to limit or exclude the notional deduction).

As the aggregated turnover of A Pty Ltd is less than $20 million, it is entitled to a tax offset equal to $22,500 (45% of $50,000), assuming A Pty Ltd is not entitled to any other notional R&D deductions.

Other partnership rules

3.142 The partnership rules also contain special rules about:

- notional deductions for a decline in the value of depreciating assets of R&D partnerships ***[Schedule 1, item 1, section 355-525]***;
- balancing adjustments for R&D partnership assets only used for R&D activities ***[Schedule 1, item 1, section 355-530]***;
- balancing adjustments for R&D partnership assets used both for general tax purposes and R&D activities ***[Schedule 3, item 24, section 40-293]***;
- disposal of R&D results for R&D partnerships ***[Schedule 1, item 1, section 355-535***; and
- recoupment of expenditure incurred by an R&D partnership ***[Schedule 1, item 1, section 355-540]***.

3.143 Where an association of persons is in receipt of income jointly but is not a general law partnership (commonly called a tax law partnership), the ATO interprets the decline in value provisions in Division 40 as applying to the individual persons, not the tax law partnership.

Associations of persons that are neither general law partnerships nor tax law partnerships

3.144 Under the existing law, in determining whether a relationship between persons for the purpose of engaging in R&D activities is a partnership, the engaging by those persons in R&D activities is treated as carrying on a business with a view to profit (subsection 73(3B) of the ITAA 1936). This deeming rule is stated as applying 'for the purposes of this Act' (for example, the rule applies for the purposes of Division 5 (Partnerships) of Part III of the ITAA 1936).

3.145 It is not clear that the rule in subsection 73(3B) does anything useful. The R&D expenditure is effectively attributed to the individual partners anyway (under subsection 73(3A)). Subsection 73(3B) effectively requires persons to lodge a partnership return (for non-R&D deductions) even though they are neither general law partners nor in receipt of income jointly. Accordingly, the new law does not contain a provision equivalent to subsection 73B(3B).

Cooperative research centres

3.146 The Cooperative Research Centre (CRC) program is a program administered by the Commonwealth that links researchers with industry to focus R&D efforts on addressing major challenges and progressing towards utilisation and commercialisation. A CRC is an incorporated or unincorporated organisation, formed through medium to long-term collaborative partnerships between publicly funded researchers and end users. CRCs must comprise at least one Australian end-user (either from the private, public or community sector) and at least one Australian higher education institution (or research institute affiliated with a university).

3.147 Taxpayers and the Australian Taxation Office have encountered difficulties in applying the existing partnership rules to CRCs because of the complexity of the existing law. In particular, difficult issues have arisen in relation to determining the true nature of the structure adopted and on whose behalf the activities are carried out within that structure, as well as in ascertaining the timing of any available R&D deductions. These issues are compounded because CRCs are not all required to adopt the same structure, so each one needs to be considered on its own facts.

3.148 The exposure draft contains a new simpler treatment for entities participating in a CRC. The key change is that notional deductions arise when monetary contributions are made under the program rather than when those contributions are actually expended on the R&D activities of the centre.

3.149 An R&D entity is entitled to a notional R&D deduction for a monetary contribution it incurs under the program if the entity is registered for the activities on which the contribution is spent. The notional deduction does not arise until the entity is actually registered, which in some cases could be for an income year after the R&D entity incurs the contribution. However, the notional deduction for the monetary contribution still applies to the income year in which the contribution was incurred. ***[Schedule 1, item 1, subsection 355-580(1)]***

3.150 An R&D entity's entitlement to a tax offset in relation to a notional deduction for an amount contributed to a CRC is (like certain R&D expenditure incurred to a research service provider) regardless of the level of its total notional deductions. ***[Schedule 1, item 1, subsection 355-100(2)]***

3.151 The Commonwealth's contributions to a CRC do not qualify for an 'up front' notional R&D deduction for a monetary contribution. A company operating a CRC under the incorporated model would be eligible for a notional deduction for a monetary contribution out of its own

funds but not for the contribution of Commonwealth funds. This second exposure draft does not expressly exclude the possibility that an R&D entity could obtain a notional deduction for expenditure on the CRC's R&D activities out of Commonwealth funding (see also paragraph 3.155). ***[Schedule 1, item 1, subsection 355-580(2)]***

3.152 It is intended that program conditions be used to limit CRCs to spending contributions by R&D entities on R&D activities eligible for a tax offset.

3.153 To prevent double benefits in respect of the same amounts, an R&D entity cannot obtain a notional R&D deduction for:

- a monetary contribution, other than under the specific rule about monetary contribution to a CRC;
- expenditure incurred under the CRC program out of monetary contributions of an R&D entity; or
- decline in value of an R&D depreciating asset whose cost includes expenditure incurred under the CRC program out of monetary contribution that is notionally deductible.

[Schedule 1, item 1, subsections 355-580(3) and (4)]

3.154 Where an entity makes a non-monetary contribution (for example, a depreciating asset or the work of an employee) to a CRC, the normal R&D provisions would apply. In practice, it is tax exempt entities that commonly make non-monetary contributions and those entities are not eligible for an R&D tax offset.

Example 3.12: Incorporated CRC

Company A is a participant in an incorporated CRC. In the 2012-13 income year Company A incurs a liability of $100,000 under the participant agreement to Company O, which operates the CRC. Company O spends the $100,000 on R&D activities during the income year. The Board registers Company A for those R&D activities two months after the end of the 2012-13 income year.

When Company A lodges its income tax return five months after the end of the 2012-13 income year, it is entitled to a notional deduction of $100,000 for its monetary contribution. It incurred the monetary contribution during the 2012-13 income year and is registered for the R&D activities on which the contributions were spent.

3.155 This second exposure draft does not clarify the treatment of CRC expenditure on R&D activities out of Commonwealth funding. That issue is to be considered further before the introduction of the legislation to Parliament. Nevertheless, should the existing treatment continue there would be tracing requirements, which could add to compliance burdens.

Consolidated groups

3.156 Under Part 3-90 of the ITAA 1997 subsidiary members of a consolidated group or MEC group are treated as part of the head company of the group for income tax purposes.

3.157 Therefore, as is the case under the existing law, Division 355 will apply to a consolidated group or MEC group as if it were a single entity. This means that, for example:

- expenditure incurred by the subsidiary on R&D activities is taken to be incurred by the head company;
- R&D activities conducted for the subsidiary by a third party are taken to have been conducted for the head company; and
- R&D activities conducted by one member of the group for another member of the same group are taken to have been conducted by the head company on its own behalf.

3.158 If an entity joins a consolidated group or MEC group part way through an income year, the joining entity must work out the amount of income tax payable on its taxable income for the period before the joining time as if it were an income year (section 701-30). The joining entity will be entitled to R&D tax offsets that relate to R&D activities undertaken before the joining time provided that it is a registered R&D entity for the income year.

3.159 The head company of the group will be entitled to R&D tax offsets that relate to R&D activities undertaken after the joining time provided that it is a registered R&D entity for the income year.

3.160 The head company of the group must be a registered R&D entity for the income year as the joining entity's status as a registered R&D entity is not imputed to the head company. In this regard, a subsidiary member of a consolidated group or MEC group cannot seek registration or findings for R&D activities of the group (section 30GA of the IR&D Act).

3.161 The existing R&D law contains rules to ensure they operate effectively for consolidated groups and MEC groups (sections 73BAA to 73BAG of the ITAA 1936). Insofar as they remain relevant, these provisions are replicated in the new law.

3.162 The new law replicates the existing provisions that clarify the history that is taken into account for the purposes of working out the aggregated turnover of:

- the head company after a subsidiary member has joined its consolidated group or MEC group; and
- an entity after it ceases to be a member of the group.

[Schedule 3, item 104, sections 716-505 and 716-510]

3.163 Section 355-215, which is about R&D activities conducted for a foreign entity, applies if, so far as is relevant, the R&D activities are conducted under a written agreement which is binding on the R&D entity and each foreign corporation. A new provision is being inserted to clarify that the section applies to the head company of a consolidated group or MEC group as if the head company were bound by an agreement during any period that a subsidiary member of the group is bound by the agreement. ***[Schedule 3, item 104, section 716-500]***

Imputation

3.164 Generally, a franking debit arises in an entity's franking account when, so far as is relevant, the entity receives a refund of income tax (item 2 in the table in section 205-30 of the ITAA 1997). A refund of income tax includes the amount of any tax offset which the entity is entitled to under Division 355, to the extent that the tax offset is refunded to the entity. ***[Schedule 3, items 94 and 95, section 205-35]***

3.165 If a company's franking account is in deficit at the end of an income year, the entity is liable to pay franking deficit tax (section 205-45). A company's franking account could be in deficit at the end of an income year because a franking debit arises when the entity receives a refund of a tax offset which the entity is entitled to under Division 355. This would have the effect of immediately clawing back the tax offset that is refunded.

3.166 To prevent this outcome, a franking debit will not arise in an entity's franking account under item 2 in the table in section 205-30 to the extent that a refund of income tax is attributable to the refund of a tax offset which the entity is entitled to under Division 355. The franking debit is effectively deferred. ***[Schedule 3, item 93, subsection 205-30(2)]***

3.167 Generally, a franking credit arises in an entity's franking account when, so far as is relevant, the entity pays a pay as you go (PAYG) instalment or income tax (items 1 and 2 in the table in section 205-15). However, where a debit has not been made to an entity's franking account because a refund of income tax is attributable to the refund of a tax offset which the entity is entitled to under Division 355, a franking credit will not arise in respect of the payment of a PAYG instalment or income tax until these deferred franking debits are recovered. ***[Schedule 3, items 91 and 92, subsections 205-15(1) and (4)]***

Example 3.13

Radical Innovations Pty Ltd is an R&D entity.

In year 1, Radical Innovations Pty Ltd incurs $100,000 R&D expenditure, has no taxable income and is entitled to a refundable tax offset under Division 355 of $45,000. Consequently, the company receives a refund of income tax of $45,000. Paragraph 205-30(2)(b) ensures that a debit does not arise in its franking account under item 2 in the table in subsection 205-30(1) as a result of the refund.

In year 2, Radical Innovations Pty Ltd does not incur any R&D expenditure and its taxable income is $100,000. The company pays income tax of $30,000, which gives rise to a credit in its franking account of $30,000 less any amount worked out under the method statement in subsection 205-15(4). The steps in that method statement are worked out as follows:

Step 1: Identify any income years before the payment of tax was made for which the company received a refund of income tax — year 1.

Step 2: Add up the part of the refund that is attributable to a tax offset that is subject to the refundable tax offset rules — $45,000.

Step 3: Subtract any reduction under subsection 205-15(4) of a franking credit for any earlier payment by the entity — nil.

The result after applying the method statement for year 2 is $45,000. Therefore, the franking credit of $30,000 is reduced, but not below zero. Consequently, no franking credit arises in Radical Innovations Pty Ltd's franking account in year 2.

In year 3, Radical Innovations Pty Ltd does not incur any R&D expenditure and its taxable income is $120,000. The company pays income tax of $36,000, which gives rise to a credit in the company's franking account of $36,000 less any amount worked out under the method statement in subsection 205-15(4). The steps in that method statement are worked out as follows:

Step 1: Identify any income year before the payment of tax was made for which the company received a refund of income tax — year 1.

Step 2: Add up the part of the refund that is attributable to a tax offset that is subject to the refundable tax offset rules — $45,000.

Step 3: Subtract any reduction under subsection 205-15(4) of a franking credit for any earlier payment by the entity — $30,000.

The result after applying the method statement for year 3 is $15,000. Therefore, the franking credit of $36,000 is reduced by $15,000. As the deferred franking debits are now fully recovered, a franking credit of $21,000 arises in Radical Innovations Pty Ltd's franking account in year 3.

Other matters

Assessments and objections

3.168 The primary meaning of ***assessment*** is the ascertainment of the amount of taxable income (or that there is no taxable income) and the tax payable thereon (or that there is no tax payable) (subsection 6(1) of the ITAA 1936).

3.169 Under the core provisions of the income tax law, section 4-10 governs how to work out how much income tax you must pay for an income year. In subsection 4-10(3), step 3 is working out your tax offsets for the income year. Working out the amount of tax offsets, including any refundable tax offsets, is a step in working out your income liability and, therefore, part of the assessment process.

3.170 That means that, under the existing law, the amount of a refundable tax offset is covered by a notice of assessment. If a taxpayer is dissatisfied with the amount of a tax offset under an assessment for the taxpayer, the taxpayer may object against the assessment under section 175A of the ITAA 1936. However, subsection 175A(2) prevents a taxpayer objecting against a 'nil assessment' unless the taxpayer is seeking an increase in its liability.

3.171 The exposure draft amends the law so that an R&D entity can object against a nil assessment in relation to the amount of an R&D refundable tax offset. This is in addition to the existing objection rights. ***[Schedule 1, item 1, section 355-699]***

Findings of Innovation Australia binding on the Commissioner

3.172 The Commissioner is bound by the following findings of the Innovation Australia Board where the finding is set out in a certificate given by the Board to the Commissioner and the finding is made within four years after the end of the income year (or the last of the relevant income years):

- a finding about an R&D entity's registration (under section 27A of the IR&D Act);
- a finding about activities yet to be completed (under section 28A of the IR&D Act); or
- a finding about whether particular technology is core technology (under section 28GA of the IR&D Act).

[Schedule 1, item 1, section 355-700]

3.173 For a finding about an R&D entity's registration, the Commissioner is bound for the purposes of an assessment of the entity for the income year(s) for which the finding is made. For a finding about activities yet to be completed, the Commissioner is bound for the purposes of an assessment of the entity for the year in which the entity applied for the advance finding and the next two income years. ***[Schedule 1, item 1, section 355-700]***

Amendment of assessments

3.174 Currently the Commissioner has an unlimited period to amend an assessment to increase the liability of a taxpayer to give effect to existing R&D provisions in the ITAA 1936. The unlimited period is repealed, which is consistent with the recommendations in the Treasury discussion paper titled *Review of Unlimited Amendment Periods in the Income Tax Laws*. ***[Schedule 3, item 48, subsection 170(10A)]***

3.175 In the new law, the Commissioner generally has a period of four years to amend an assessment to give effect to the R&D provisions. To achieve this for all types of R&D entity, it will be necessary to amend the *Income Tax Regulations 1936* after the new R&D provisions are enacted.

3.176 Innovation Australia effectively has a time limit of four years from the end of the relevant income year to make a finding about registration under Division 2 of Part III of the IR&D Act. ***[Schedule 1, item 1, sections 355-700 and 355-705]***

3.177 There will also be special contingent amendment periods where:

- Innovation Australia gives the Commissioner a certificate setting out a finding about registration, activities outside Australia or core technology (and that finding was made within four years after the end of the income year or the last of the relevant income years); or

- a decision is made on internal review (under section 30D of the IR&D Act) or by the Administrative Appeal Tribunal (including under subsections 34D(2), 42C(2) or 43(1) or 42D of the *Administrative Appeal Tribunal Act 1975*) or a court about an R&D entity.

[Schedule 1, item 1, section 355-705]

3.178 In these cases, the Commissioner has a period of two years from the giving of the certificate, or the decision being made, to amend an assessment to give effect to the certificate, or decision (respectively). This is consistent with recommendation 3 in the Treasury discussion paper.

Relationship of R&D provisions to other income tax provisions

3.179 The R&D provisions in Division 355 have priority over other offset and deduction provisions, except where specifically indicated. So, where an entity's expenditure (or use of a depreciating asset) satisfies the conditions for a notional R&D deduction and also another deduction (or tax offset), the entity is entitled to the R&D deduction but not the other deduction or tax offset. This is consistent with the general scheme of the income tax law (for example, under the no double deduction rule in section 8-10) that taxpayers are not entitled to a double benefit for the same amount of a loss, outgoing or other detriment. ***[Schedule 1, item 1, section 355-710]***

Chapter 4
Application rules, transitional rules and consequential amendments for the new tax offsets

Outline of chapter

4.1 Schedule 4 to this second exposure draft contains the application, savings and transitional provisions for the new research and development (R&D) tax offsets. These provisions:

- apply the new R&D provisions to work out an R&D tax offset for an assessment of income tax for an income year commencing on or after 1 July 2010;
- ensure that, despite the repeal of the existing R&D provisions, those R&D provisions can still apply, and be administered, for certain things done (for example, expenditure incurred) before the repeal of the existing provisions; and
- establish special transitional arrangements to broadly address some situations that straddle income years where the existing law and the new provisions apply.

4.2 Parts 2 to 6 of Schedule 3 to this exposure draft contain consequential amendments to the *Income Tax Assessment Act 1997* (ITAA 1997), the *Income Tax Assessment Act 1936* (ITAA 1936), the *Income Tax (Transitional Provisions) Act 1997* and the *Taxation Administration Act 1953* that are necessitated by the enactment of the new R&D provisions.

4.3 In this chapter, legislative references are to the ITAA 1997, except where indicated.

Application, savings and transitional provisions

Application of new law

4.4 The main application rule is that new R&D provisions apply to work out an R&D tax offset for an assessment of income tax for an income year commencing on or after 1 July 2010. Consequently, the things eligible for a tax offset under the new provisions are:

- expenditure incurred in an income year commencing on or after 1 July 2010; and
- the use of depreciating assets in an income year commencing on or after 1 July 2010.

[Schedule 4, subitem 1(1)]

4.5 There are also supplementary application rules, consistent with the main rule, to ensure that for any things that do not affect an assessment, the new R&D provisions also apply to an income year commencing on or after 1 July 2010. ***[Schedule 4, subitem 1(1)]***

4.6 The existing R&D provisions in sections 73B to 73Z of the ITAA 1936 are repealed. This change and other repeals in this exposure draft apply on the same basis as the inclusion of the new R&D provisions described above. Therefore, the existing R&D provisions apply to assessments for income years commencing before 1 July 2010. ***[Schedule 3, item 44 and Schedule 4, subitem 1(1)]***

4.7 The general result that the application, savings and transitional provisions are designed to produce is that:

- the existing R&D provisions apply to expenditure incurred, and the use of depreciating assets, in an income year commencing before 1 July 2010; and
- the new provisions apply to expenditure incurred, and the use of depreciating assets, in an income year commencing on or after 1 July 2010.

Savings provisions

4.8 The exposure draft includes savings provisions to ensure that, despite the repeal of the existing R&D provisions, those R&D provisions can still apply, and be administered, for:

- any act done or omitted to be done (for example, expenditure incurred);
- any state of affairs existing;
- any period (for example, an income year) ending,

before the repeal of the existing provisions. ***[Schedule 4, item 1]***

4.9 To this end, the exposure draft includes savings provisions to:

- prevent the making or amending of an assessment being affected by anything that is repealed or amended by this exposure draft, if the assessment relates to a period or event before the repeal or amendment;
- preserve powers, duties, rights and obligations in relation to the time before the repeal or amendment, if a right or obligation already existed before the repeal or amendment;
- ensure that powers, duties, rights and obligations can still come into existence after the repeal or amendment if they relate to an earlier period or event. (For example, an eligible company may object under Part IVC of the *Taxation Administration Act 1953* in an income year commencing on or after 1 July 2010 about a notice given under former section 73IA of the ITAA 1936 for an income year commencing before 1 July 2010);
- preserve the effect of an assessment (for example, the evidentiary effect) (it is not clear that this is necessary but this is being done as a matter of caution); and
- disregard the repeal of provision for the purposes of another provision dependent on the repealed provision, as a precaution against the possibility that a repealed provision was an element in the operation of another provision that is still operative (it is not clear that this is necessary but this is being done as a matter of caution).

[Schedule 4, items 3 to 5]

4.10 The above rules about assessments and powers, duties, rights and obligations specifically extend to the repeal of two provisions about an administrative penalty for failing to give details of an initial clawback amount (subsection 286-75(3) and paragraph 286-80(2)(b) of Schedule 1 to the TAA 1953). This had been done for the avoidance of doubt. ***[Schedule 4, subitem 3(2)]***

4.11 Neither the existence nor the content of the savings provisions changes the scope or application of section 8 of the *Acts Interpretation Act 1901*. That section provides, among other things, that the repeal of a provision does not affect its previous operation, the existence of any rights or liabilities it created or any investigation of, or penalties for, breaches of the provision. ***[Schedule 4, item 6]***

Transitional provisions

4.12 In addition to the application and savings provisions, some special transitional arrangements are necessary. Broadly, these address some situations that straddle:

- one or more income years where the existing law applied; and
- one or more income years where the existing law applies.

4.13 In this section, 'old law income year' means an income year commencing before 1 July 2010 and 'new law income year' means an income year commencing on or after 1 July 2010.

Depreciating assets

4.14 Under the existing law, an R&D deduction is allowed for decline in value of a tangible depreciating asset used for R&D activities. If that asset is also used for R&D activities in an income year starting on or after 1 July 2010, the new R&D provisions about notional deductions for the decline in value of R&D depreciating assts apply. Thus, tangible depreciating assets are eligible for the new rules, regardless of when they were acquired. To facilitate this, a number of special provisions are necessary to ensure that:

- the normal rules that limit the ability of an R&D entity to change the method of calculating decline in value apply ***[Schedule 4, item 10, section 40-67 of the Income Tax (Transitional Provisions) Act 1997]***;

- a determination or calculation of effective life that was made under the existing law continues to apply ***[Schedule 4, item 11, section 40-105 of the Income Tax (Transitional Provisions) Act 1997]***; and

- an entity cannot allocate a depreciating asset to a low value pool or one of the small business pools after the existing R&D decline in value provisions have applied to the asset ***[Schedule 4, item 13, section 40-430 of the Income Tax (Transitional Provisions) Act 1997]***.

4.15 There are also transitional balancing adjustment provisions to cover cases where:

- an entity used a depreciating asset for R&D activities when the existing R&D provisions applied and when the new R&D provisions applied; and

- a balancing adjustment event happens in an income year starting on or after 1 July 2010.

Asset used only for R&D activities

4.16 If an asset used only for R&D activities has a termination value less than its adjustable value, the entity is entitled to a notional deduction worked out under section 355-310 of the new law. In doing so, the use of the asset for the purpose of conducting R&D activities in old law income years is treated in the same way as the use of the asset for the purpose of conducting R&D activities in new law income years. ***[Schedule 4, item 15, section 355-320 of the Income Tax (Transitional Provisions) Act 1997]***

4.17 If the asset's termination value is greater than its adjustable value, an amount is included in assessable income under subsection 355-310(3) of the ITAA 1997. The calculation is similar to that where the asset is used only under the new law except that it takes into account that deductions under the old law were only uplifted by 25 per cent. Deductions under the new law are treated as uplifted by one third (based on an offset rate of 40 per cent (rather the higher 45 per cent rate that generally applies to R&D entities with an aggregated turnover of less than $20 million). ***[Schedule 4, item 15, section 355-320 of the Income Tax (Transitional Provisions) Act 1997]***

Assets used partly for R&D activities

4.18 If an asset used partly for R&D activities has a termination value less than its adjustable value, the entity is entitled to a deduction worked out under section 40-292 of the ITAA 1997. In applying section 40-290 of the ITAA 1997, the use of the asset for the purpose of conducting R&D

activities in old law income years is treated in the same way as the use of the asset for the purpose of conducting R&D activities in new law income years. ***[Schedule 4, item 12, section 40-292 of the Income Tax (Transitional Provisions) Act 1997]***

Registration

4.19 In determining whether an entity qualifies for an R&D tax offset, it is necessary for a variety of provisions that the concept of registration also includes registration under the existing registration provisions. Those provisions include:

- section 355-200, which allows a notional deduction for R&D expenditure; and
- section 43-35, which allows an actual deduction for building works used for R&D activities.

[Schedule 4, item 15, section 355-200 of the Income Tax (Transitional Provisions) Act 1997]

Prepayments of R&D expenditure

4.20 The existing law has specific rules for expenditure defined as 'advance R&D expenditure' under subsection 73B (1) of the ITAA 1936. Those specific rules broadly spread the amount of a deduction over a number of income years where expenditure is incurred to a registered research agency for services to be provided over a period of 13 months. A special transitional rule will ensure that the existing law continues to apply to that expenditure actually incurred in an income year starting before 1 July 2010 but taken by subsection 73B(11) to be incurred in an income year starting on or after 1 July 2010. To ensure this result, registration under the new registration rules is taken into account. ***[Schedule 4, item 15, section 355-550 of the Income Tax (Transitional Provisions) Act 1997]***

Expenditure reduced to reflect group mark-ups

4.21 A transitional rule ensures that for the purposes of the integrity rule about intra-group mark-ups (section 355-415), the calculation of any reduction in the amount of the notional deduction disregards any amount that has already been taken into account under the corresponding rule in the existing law. ***[Schedule 4, item 15, section 355-415 of the Income Tax (Transitional Provisions) Act 1997]***

Undeducted core technology expenditure

4.22 As explained in Chapter 3 (in paragraphs 3.64 to 3.66 and 3.69) the special treatment of core technology expenditure under the existing law is to cease and normal income tax treatment is to apply. Special transitional arrangements will ensure that any undeducted core technology expenditure is eligible for deduction.

4.23 If the core technology is a depreciating asset (for example, a patent), the provisions for deducting amounts for depreciating asset will apply on the basis that the opening adjustable amount is the amount of undeducted expenditure in relation to the asset. ***[Schedule 4, item 15, sections 355-600 and 355-605 of the Income Tax (Transitional Provisions) Act 1997]***

4.24 If any core technology is not a depreciating asset, the undeducted expenditure is deductible in equal proportions over five income years, starting in the first income year commencing on or after 1 July 2010. This is somewhat similar to the treatment of certain business capital expenditure that is not otherwise taken into account (under section 40-880 of the ITAA 1997). ***[Schedule 4, item 15, sections 355-600 and 355-610 of the Income Tax (Transitional Provisions) Act 1997]***

Consequential amendments

4.25 Some amendments to provisions of the income tax law outside the new R&D provisions (in Division 355) are explained in Chapter 3 because they are important to the overall operation of the new R&D tax incentive. Examples include the amendments to the tax offset rules and to the depreciating asset rules in relation to their use for R&D activities.

4.26 This chapter explains the other consequential amendments.

Prepayments of expenditure for services

4.27 As discussed in Chapter 3 under the heading 'R&D deductions are notional only' in paragraphs 3.43 to 3.46, the deductions under Division 355 are treated as actual deductions for the purposes of the rules about the period of deductibility of certain advance expenditure (in Subdivision H of Division 3 of Part III of the ITAA 1936).

4.28 To ensure that the advance expenditure provisions can apply to the new R&D provisions in a similar way that they apply to the expenditure under the existing R&D provisions, the exposure draft makes a series of amendments to the advance expenditure provisions. These involve changes in section references and terminology to those used in the

new law. ***[Schedule 3, items 6 to 14, sections 82KZL, 82KZM, 82KZMA, 82KZME and 82KZMF of the ITAA 1936]***

4.29 The advance expenditure provisions are also amended to ensure that they can apply to R&D expenditure deductible under section 355-55 where that expenditure is capital. There is no sound reason to exclude capital expenditure that is deductible under the R&D provisions. Indeed, an additional reason why the advance expenditure provisions should apply is that capital expenditure would not be immediately deducted under ordinary tax principles. ***[Schedule 3, item 5, definition of 'excluded expenditure' in subsection 82KZL(1) of the ITAA 1936]***

Recoupment of deductible expenditure

4.30 As explained in Chapter 3 under the heading 'R&D deductions are notional only' in paragraphs 3.43 to 3.46, the deductions under Division 355 are treated as actual deductions for the purposes of the rules about recoupment of deductible expenses in Subdivision 20-A.

4.31 The recoupment provisions in Subdivision 20-A are also amended so that they can apply generally to the recoupment of amounts deductible under the R&D provisions in Division 355. Without the amendment, Subdivision 20-A would apply only where the recoupment was by way of insurance or indemnity. ***[Schedule 3, items 69 and 70, section 20-30]***

4.32 The recoupment provisions in Subdivision 20-A can only include an amount in assessable income up to the amount received by the taxpayer as recoupment. The proposed claw back provisions (discussed above) can recover the enhanced benefit received by a taxpayer but are limited to where the recoupment (or grant) is from an Australian government agency. So, where a recoupment is received other than from an Australian government agency, provisions are needed to ensure that the taxpayer has not obtained a benefit where it has incurred no net expenditure. This exposure draft does not contain the necessary provisions, which will be developed for the final legislation.

Capital works

4.33 The capital works provisions in Division 43 are amended to:

- replace references to the existing R&D provisions with references to the new R&D provisions; and
- reflect the terminology used in the new provisions.

[Schedule 3, items 26 to 41, sections 43-35, 43-70, 43-90, 43-100, 43-140, 43-195, 43-210 and 43-215]

Capital gains and losses

4.34 As explained under the heading 'R&D deductions are notional only' in paragraphs 3.43 to 3.46, notional R&D deductions are treated as actual deductions for the cost base rules in the capital gains and losses provisions (commonly known as capital gains tax (CGT)). Consequently, the existing provisions that exclude certain deductible expenditure from the cost base or reduced cost base of a CGT asset apply to expenditure that is notionally deductible under the new R&D provisions.

4.35 There are consequential amendments to the CGT provisions to:

- replace references to the existing R&D provisions with references to the new R&D provisions; and
- reflect the terminology used in the new provisions.

[Schedule 3, items 73 to 90, sections 104-235, 104-240, 108-55, 110-45, 118-24 and 118-35]

Definitions

4.36 The amendments to the taxation law discussed in this chapter have necessitated the inclusion of various new definitions in the Dictionary in the ITAA 1997 (and the repeal or amendment of some others). The substantive effects of these changes are discussed in Chapter 3. ***[Schedule 1, items 2 to 9, subsection 995-1(1)]***

Checklists

4.37 The amendments to the taxation law have necessitated the amendment of various checklists in the ITAA 1997. ***[Schedule 3, items 56 to 68, sections 9-5, 10-5, 12-5, 13-1 and 20-5]***

Other consequential amendments

4.38 There are also consequential amendments to various other provisions of the tax law to:

- replace references to the existing R&D provisions with references to the new R&D provisions;
- reflect the terminology used in the new provisions; and

- reflect the repeal of various existing R&D provisions, where there are no corresponding new provisions.

[Schedule 3. items 49 to 53, 71, 72, 96 to 98, 100 and 105 to 110]

Chapter 5
Administrative arrangements for the research and development tax incentive

Outline of chapter

5.1 Schedule 2 to this exposure draft amends the *Industry Research and Development Act 1986* (IR&D Act) to provide a framework to support:

- the registration and assessment of activities as research and development (R&D) activities by Innovation Australia (the Board);
- the recognition and registration of research agencies, known as Research Service Providers (RSPs), by the Board; and
- internal review of decisions made by the Board and, if necessary, the subsequent review of these decisions by the Administrative Appeals Tribunal (AAT).

Context of amendments

5.2 The new R&D tax incentive will operate on a self assessment basis: entities will assess for themselves whether they are eligible under the rules contained in new Division 355 of the *Income Tax Assessment Act 1997* (ITAA 1997).

5.3 A key function of the Board will be to enhance the integrity of the program by managing a process of registration for activities. Registration allows the Board to undertake risk assessment and compliance work, complementing integrity measures undertaken by the Commissioner of Taxation (Commissioner). In conducting this risk assessment and compliance work, the Board will confirm or reject an R&D entity's self assessment of certain activities as 'core' or 'supporting' R&D activities as defined under new Division 355 of the ITAA 1997.

5.4 The Board will also have a function in examining and making findings about R&D conducted outside Australia, to enable R&D entities

to access an R&D tax offset for certain types of activities that are conducted overseas.

5.5 To provide certainty for R&D entities, the Board will also be able to provide public advice and advisory materials, make generalised public findings about whether activities are core R&D or supporting R&D activities. Public advice issued by the Board will be binding on the Board, but not the Commissioner. R&D entities may apply for private findings before or after an activity is registered by the Board. Taken together this enhanced advisory framework will ensure that the new tax incentive is targeted appropriately and administered effectively.

5.6 The Board will also have a role in ensuring a minimum standard of qualification and capability of entities registered as RSPs. The Board must maintain a register of RSPs.

5.7 The new arrangements will appear as new Part III of the IR&D Act, which will replace existing Part IIIA. Although the R&D Tax Concession program will be discontinued from the end of the 2009-10 income year, the Board will still require ongoing powers in relation to activities conducted prior to the end of the 2009-10 income year. These powers will be saved to ensure the Board is able to continue to carry out its duties with respect to activities conducted under the R&D Tax Concession program.

Summary of new law

Registration of research and development activities

5.8 In order to claim a tax offset for R&D activities conducted in Australia, R&D entities will need to register their activities with the Board. While registration is a precondition of eligibility for the tax offset, registration does not, by itself, render the activities that are the subject of the registration eligible R&D activities.

5.9 The R&D tax incentive operates on a self assessment basis; that is, an R&D entity will assess for itself whether the activities conducted in an income year are eligible R&D activities as defined under new Division 355 of the ITAA 1997. As part of this process, R&D entities will be required to separately identify core and supporting R&D activities. However, the Board is able to make findings about activities that confirm or reject an R&D entity's self assessment of its activities. Board findings about whether activities are R&D activities can arise in three ways:

- the Board may make findings about an application for registration, or activities that have been registered, of its own accord;

- the Board must examine and make findings on activities that have been registered if it is requested to do so by the Commissioner; and

- the Board may make findings on whether registered activities are R&D activities upon application by an R&D entity.

5.10 Findings by the Board that activities are or are not core R&D or supporting R&D activities are binding on the Commissioner when making a decision in relation to whether expenditure associated with the activities is or is not R&D expenditure and claimable under the R&D tax incentive rules. The Board may also release policy guidance about how it makes determinations in relation to the nature of activities.

5.11 R&D entities which disagree with a finding made by the Board may request an internal review of the finding by the Board. The Commissioner may also request an internal review of a finding (see Review of Board decisions below).

Advance findings

5.12 An R&D entity may request a finding about the nature of activities before it is possible to register these activities. These advance findings can be sought in relation to an activity where an R&D entity:

- has completed the activity in an income year (but before it is possible to register the activity);

- has yet to complete the activity; or

- has yet to conduct the activity, but can reasonably be expected to do so in the current or next two income years.

5.13 The ability of the Board to make an advance finding is intended to increase certainty for R&D entities in relation to whether the Board considers certain activities to be core R&D activities or supporting R&D activities, before the entity applies to register the activity.

Findings about overseas activities

5.14 R&D entities must apply to the Board for a finding about activities being conducted or proposed to be conducted, outside Australia,

if the R&D entity wishes to claim a tax offset in relation to expenditure on those activities. The Board will give a positive finding in relation to these activities if it is satisfied that certain requirements are met, including the requirement that the activities are covered by an advance finding (see Advance findings above) and also that they cannot be conducted in Australia.

5.15 Claims for a tax offset in relation to expenditure on overseas activities may only be made where a positive finding about the overseas activities is in force. Findings are in force in the income year in which the application for the finding is made.

Findings about core technology

5.16 An R&D entity or the Commissioner may apply to the Board for a finding that particular technology is or is not core technology. Technology is core technology if a purpose of R&D activities was or is to obtain new knowledge, make improvements or continue the development of that technology.

5.17 The effect of a finding by the Board that technology is core technology is that the tax offset will not be available for expenditure incurred on acquiring the technology or the right to use the technology.

Registration of entities as Research Service Providers

5.18 The Board may register an entity as an RSP capable of providing services in one or more specified fields of research if the Board is satisfied that the entity meets certain criteria (which will be specified in regulations made under the IR&D Act). The Board will maintain a register of RSPs and make this register available for inspection on the internet, and publish a list of RSPs in its annual report.

5.19 As a transitional arrangement for the 2010-11 income year, Australian research agencies who are registered under section 39F of the IR&D Act on 30 June 2010 will be taken to automatically be registered as RSPs. These entities, and new entities which are registered in the future, will need to renew their registration on an annual basis.

Review of Board decisions

5.20 Certain decisions by the Board are reviewable decisions and any person whose interests are affected will have the right to request an internal review of the decision within 28 days (or further period allowed by the Board). The Commissioner can also request an internal review of

these decisions at any time. Applications may also be made to the AAT for a review of an internal review decision.

Comparison of key features of new law and current law

New law	*Current law*
The new Part III of the IR&D Act specifies the powers of the Board in relation to the new R&D tax incentive.	The current Part IIIA of the IR&D Act specifies the powers of the Board in relation to the R&D Tax Concession program.
The Board may register core and supporting R&D activities upon application by R&D entities. Head entities must register instead of any of their subsidiaries which would otherwise be entitled to registration. The Board may revoke an entity's registration in certain circumstances.	The Board may register R&D activities upon application by eligible companies, including subsidiaries. The Board cannot revoke a registration.
The Board may make findings on whether activities are (or are not) core R&D activities and whether activities are (or are not) supporting R&D activities. Registrations are automatically varied to be consistent with the Board's findings. Findings may be made at the discretion of the Board, or on application by an R&D entity, and must be made at the request of the Commissioner.	The Board may issue certificates in relation to whether registered activities are R&D activities. Findings can be made at the discretion of the Board and must be made at the request of the Commissioner.
An R&D entity, or an entity nominated in regulations acting on behalf an R&D entity, may request an advance finding to confirm that an activity which is not yet able to be registered is a core or supporting R&D activity, if the activity was completed in the income year in which the application is made or if the activities can reasonably be expected to be conducted or completed within three years.	An eligible company may request an advance registration that provides it with a right to register its R&D activities. Advance registration decisions have effect for up to three years.

New law	*Current law*
An R&D entity must apply to the Board for a finding if it wishes to claim a tax offset in relation to activities conducted outside Australia. The Board must be satisfied that the activities satisfy a number of conditions, including that the activities are the subject of a positive advance finding, and cannot be conducted in Australia.	An eligible company must apply to the Board for a provisional certificate in relation to overseas R&D activities before the commencement of those activities if it wishes to claim the Tax Concession for those activities. The overseas activity must be part of a larger Australian project and overseas expenditure must not exceed 10 per cent of total project expenditure.
The Commissioner or an R&D entity may ask the Board to make a finding that particular technology is or is not core technology for R&D activities.	The Commissioner may ask the Board to issue a certificate stating whether particular technology is or is not core technology in relation to R&D activities.
The Board may register RSPs for an income year. All registrations are renewed at the same time every year.	The Board may register Australian research agencies for a period of 12 months.

Detailed explanation of new law

Registration of activities

5.21 Registration of R&D activities that were conducted in the previous income year is a precondition of eligibility for the R&D tax offset. On application by an R&D entity, the Board must make a decision to register, or refuse to register, core R&D activities and supporting R&D activities conducted during an income year. ***[Schedule 2, item 1, subsection 27A(1)]***

5.22 Supporting R&D activities are defined in section 355-35 of the ITAA 1997 by reference to their connection to specific core R&D activities. Consistent with this, where the Board registers a supporting R&D activity, the registration must also specify the core R&D activity or activities to which the supporting activity is connected. ***[Schedule 2, item 1, subsection 27A(3)]***

5.23 Where the connected core R&D activities are not conducted in the same income year as the supporting R&D activities, the registration must identify the income year in which those core activities were registered or are proposed to be registered. The connected core R&D activities can be undertaken in a past, present or future income year. If the connected core R&D activities were undertaken prior to the end of the R&D tax concession under 73B of the ITAA 1936, the core R&D

activities must have been registered under section 39J of the IR&D Act and must satisfy the definition of core R&D activities contained in section 355-25 of the ITAA 1997. ***[Schedule 2, item 1, subsection 27A(3) and Schedule 4, item 21]***

5.24 The Board's decision to register activities for an R&D entity must be made consistently with any findings that have been made by the Board about the application under subsection 27B(1), and any advance findings about the activities already in force under subsection 28A(1). This means that, for example, the Board cannot register an R&D entity for particular activities if it has already made a finding that those activities are not R&D activities. ***[Schedule 2, item 1, subsection 27A(2)]***

5.25 An applicant that wishes to be registered will be required to self assess whether or not it is an R&D entity. R&D entities are defined in section 355-40 of the ITAA 1997. While an entity may otherwise be eligible to be an R&D entity, it will not be permitted to register under section 27A if it is a subsidiary member of a consolidated group or MEC group. ***[Schedule 1, item 1, section 355-40 and Schedule 2, item 1, section 30GA]***

5.26 If the Board becomes aware that it has registered R&D activities of an entity that is not an R&D entity (for example, because the body is an unincorporated joint venture, or is the subsidiary of another R&D entity), the registration can be revoked by the Board. ***[Schedule 2, item 1, subsection 27N(1)]***

5.27 The Board must notify the R&D entity of its decision to register or refuse to register the R&D entity for activities for an income year. ***[Schedule 2, item 1, section 27C]***

5.28 As the new R&D tax incentive is a self assessment regime, the majority of applications to the Board will be registered without formal examination in relation to the activities conducted in the income year in question. Therefore, registration of activities does not, by itself, render the activities that are the subject of the registration eligible R&D activities.

Applications for registration of activities

5.29 Applications for registration must be made within:

- ten months after the end of the income year in which the activities were conducted ***[Schedule 2, item 1, subparagraph 27D(c)(i)]***; or
- a further period allowed by the Board, in accordance with the decision-making principles ***[Schedule 2, item 1, subparagraph 27D(c)(ii)]***.

5.30 The responsible Minister will make, by legislative instrument, the decision-making principles under section 31A, which will apply to the Board's decision about whether to accept an application outside the 10-month period.

5.31 The Board will determine and publish the approved form for applications. Applications will be reviewed to ensure that they are in accordance with the approved form and that all information required by that form has been supplied, as failure to do so may result in the Board refusing to register the applicant's activities. ***[Schedule 2, item 1, subsection 27D(a)]***

5.32 Regulations may specify certain information or other material which must be included in an approved form. ***[Schedule 2, item 1, subsection 31(3)]***

5.33 It may be necessary for a fee to accompany an application for registration. The amount of the fee, if any, will be specified in regulations and will be determined by reference to the cost of providing the registration service. ***[Schedule 2, item 1, paragraph 27D(b)]***

Findings about applications

5.34 The Board may choose to consider an application in more detail and make a formal finding in relation to all or some of the activities mentioned in the application. These findings may impact on the registration of the R&D entity and its activities. ***[Schedule 2, item 1, section 27B]***

5.35 The Board may make one or more of the following findings in relation to an application by an R&D entity:

- that all or part of an activity mentioned in the application was a core R&D activity (if the Board is satisfied that the activity meets the definition in section 355-25 of the ITAA 1997) and was conducted during the income year ***[Schedule 2, item 1, paragraph 27B(1)(a)]***;
- that all or part of an activity mentioned in the application was not a core R&D activity (if the Board is not satisfied that the activity meets the definition in section 355-25 of the ITAA 1997) or was not conducted during the income year ***[Schedule 2, item 1, paragraph 27B(1)(b)]***;
- that all or part of an activity mentioned in the application was a supporting R&D activity in relation to an identified core R&D activity (if the Board is satisfied that the activities meet

the definitions in sections 355-25 and 355-35 of the ITAA 1997) and was conducted during the income year. ***[Schedule 2, item 1, paragraph 27B(1)(c)]***; and/or

- that all or part of an activity mentioned in the application was not a supporting R&D activity (if the Board is not satisfied that the activity meets the definition in section 355-35 of the ITAA 1997), was not conducted during the income year or was not conducted in relation to past (registered), present (will be registered) or future (could be registered) core R&D activities. ***[Schedule 2, item 1, paragraph 27B(1)(d)]***.

5.36 In making its findings, the Board is not confined by the manner in which the R&D entity categorises particular actions as 'activities'. If the Board considers that some part of an activity nominated by the applicant as an R&D activity meets the definition but another does not, the Board may make a positive finding in relation to that part of the activity that it considers does meet the definition.

5.37 In addition, in making its finding, the Board is not confined by the R&D entity's classification of an activity as a core R&D activity or a supporting R&D activity. If the Board considers that an activity classified by the R&D entity as a core R&D activity is a supporting R&D activity (or vice versa), the Board may register the activity as appropriate.

5.38 If the Board makes a finding, it may specify in the finding the period during which the finding applies; that is, the times during the income year that it is satisfied the entity was conducting the R&D activity. For example, the entity might have been carrying out an activity for the entire income year, but for only part of that year it was carried out for the dominant purpose of supporting a core R&D activity, and thus it was only an R&D activity for certain times. ***[Schedule 2, item 1, subsection 27B(2)]***

5.39 The Board need not consider every activity in an application for registration. The Board may make findings in relation to some activities nominated in an application, while not making findings about others that, despite not making a finding, the Board is satisfied are R&D activities.

5.40 The activities in the application may be the subject of an earlier advance finding under subsection 28A(1). In this circumstance, the advance finding will prevail over a finding under subsection 27B(1) to the extent of any inconsistency. This means that an R&D entity can rely on an advance finding provided that it conducts the R&D activities as described in that finding. However, if the activities conducted are materially different to those described in an advance finding, the advance finding does not apply to the actual activities conducted and the Board may make a finding under section 27B about those activities without

breaching the consistency rule. ***[Schedule 2, item 1, subsection 27B(3) and section 31B]***

Positive findings

5.41 The Board is able to make positive findings in respect of activities within an application; namely, that the activities identified by the applicant are R&D activities. It makes these findings if it is satisfied, on the basis of the information provided, that the activity meets the definitions in section 355-25 or section 355-35 of the ITAA 1997, as relevant. The Board may also release policy guidance about how it applies this test.

5.42 In relation to a finding that an activity is a supporting activity, the Board would ordinarily also satisfy itself that the nominated core activity to which the supporting activity relates meet the definition of a 'core R&D activity'. The Board need not make a finding in order to satisfy itself with regards to related core activities.

5.43 The core activity may be undertaken in a past, present or future income year. If the relevant core activity will not be undertaken until a later income year (and hence cannot be registered yet), the Board will need to satisfy itself as to whether, if that nominated core activity were to be carried out in the same income year as the supporting activity, it would meet the definition of a 'core R&D activity'. ***[Schedule 2, item 1, subparagraph 27B(1)(c)(ii)]***

5.44 A positive finding by the Board in respect of particular activities is confirmation of the applicant's self assessment that nominated activities are R&D activities. Once the Board has made such a finding, the Commissioner is bound to treat the activities which are the subject of the finding as R&D activities when determining whether expenditure incurred in relation to the activity in question is R&D expenditure for the purposes of Division 355 of the ITAA 1997. However, the Commissioner may request a review of a finding. ***[Schedule 1, item 1, subparagraph 355-700(1)(a)(i) and Schedule 2, item 1, subsection 30C(4)]***

5.45 It is not necessary for the applicant to have a finding in respect of its activities in order to be eligible to claim a tax offset. It is only necessary that those activities be registered.

Negative findings

5.46 The Board can make negative findings in respect of activities within an application if it is not satisfied that it should make a positive finding; for example, if it is not satisfied that a nominated activity meets the relevant tests in section 355-25 or section 355-35 of the ITAA 1997 as noted above.

5.47 There are a number of reasons why the Board might not be satisfied that the activity meets the relevant definition.

- The Board may be of the opinion that the activity fails one or more components of the tests in the ITAA 1997. For example, an activity may have been nominated as a core activity, but the Board may not be satisfied that it satisfies the definition of core R&D activities in section 355-25 of the ITAA 1997, or may be satisfied that it is an activity of the type specified in section 355-30 of the ITAA 1997.

- For supporting R&D activities, the Board might consider that the dominant purpose of the relevant activity was not to support a core activity. Additionally, if the Board makes a negative finding in relation to particular nominated core R&D activities, any activities conducted in support of those activities would likewise not be eligible for registration as supporting R&D activities.

- The Board may have insufficient evidence available to it to be satisfied that the activity is an R&D activity. This may be because the applicant did not provide all required information (see additional information requests below), or because the information made available is not sufficient to satisfy the Board in the circumstances of the case.

5.48 The Board may also find that, despite the described activity appearing to meet the definition of R&D activities, the activity was in fact not conducted during the income year. ***[Schedule 2, item 1, subsection 27B(1)]***

Additional information requests

5.49 The Board has the power to request, in writing, that the applicant provide it with any additional information it requires for the purposes of making a decision. The Board can ask that the applicant provide the additional information in a particular format which is acceptable to it in the circumstances. ***[Schedule 2, item 1, subsection 27E and subsection 31(2)]***

5.50 The Board may require that the information be provided in the approved form within 30 days or a further period allowed in accordance with decision-making principles. ***[Schedule 2, item 1, section 27E]***

5.51 If the Board is still unable to make a positive finding on the information provided, or the applicant does not provide the further information as requested, the Board may reach a negative finding on the basis that it is not satisfied that the activity meets the relevant definition.

Consequence of findings

5.52 If the findings made by the Board confirm all aspects of the application that the Board considered, the Board will register all those activities for the applicant for the income year. Any other activities nominated in the application for the applicant for the income year which are not the subject of a finding are nonetheless registered as they are not the subject of a negative finding. ***[Schedule 2, item 1, subsection 27A(2)]***

5.53 If the findings made by the Board are inconsistent with the application (that is, the Board makes negative findings about some activities nominated by the applicant), the Board will only register the applicant in relation to those activities for which it makes positive findings (that is, activities which the Board is satisfied meet the definition of core R&D activity or supporting R&D activity). ***[Schedule 2, item 1, subsection 27A(2)]***

5.54 If the findings made by the Board are entirely inconsistent with the application (that is, the Board determines that no activities nominated by the applicant are core R&D or supporting R&D activities), the Board will refuse to register the applicant in respect of any activities. ***[Schedule 2, item 1, subsection 27A(2)]***

5.55 The Board must inform an applicant in writing of the Board's decision about an application for registration of activities. Where the Board has registered the nominated activities without making any findings, it is only necessary to provide notice of registration to the applicant. ***[Schedule 2, item 1, subsection 27C(1)]***

5.56 If the Board has made one or more findings as part of the registration process, it must provide a copy of the notice to both the applicant and the Commissioner. The notice must include a certificate in respect of each finding, which sets out:

- a description of each finding;
- the Board's reasons for the finding;
- the activity affected by the finding; and
- any other matters (if any) specified in the regulations.

[Schedule 2, item 1, subsection 27C(2)]

5.57 The notice must also inform the applicant of its right to have each decision (the decision whether or not to register, and the decision in respect of each finding) reviewed under Division 5. ***[Schedule 2, item 1, section 30B]***

5.58 If the Board fails to comply with these notice requirements, however, it does not affect the validity of the Board's findings. If the Board makes more than one finding in relation to an application, there is no need for the Board to issue separate documents relating to each finding. All certificates can be contained in the same document. ***[Schedule 2, item 1, section 27C]***

5.59 If the Board is in a position to make a finding about activities under both sections 27B and 28A, the Board need not make two separate findings. For example, an R&D entity may apply for an advance finding about completed activities late in an income year, then apply for registration as soon as it is able to in the following income year before the Board has made a finding in relation to the advance finding request.

Post registration process

5.60 The Board is able to examine the registration of an R&D entity with a view to confirming that the registered activities are R&D activities. This examination can take place at any time, in relation to a registration year (that is, the income year in which the activities were conducted). However, a finding by the Board only binds the Commissioner for the purposes of an R&D entity's income tax assessment for the income year if the finding is made within four years after the end of the income year (by operation of subsections 355-700(1) and 355-705(1) of the ITAA 1997).

5.61 There are three circumstances in which the Board would examine a registration:

- the Board may examine a registration at its own discretion, at any time ***[Schedule 2, item 1, subsection 27F(2)]***.
- the Board must examine a registration if requested to do so by the Commissioner. In these circumstances, the Board will check whether activities that are the subject of the request are registered activities, and if so, make a finding about whether these activities are core or supporting R&D activities. This examination can take place at any time, in relation to a registration year ***[Schedule 2, item 1, paragraph 27F(3)(a)]***.
- the Board must examine a registration if an R&D entity applies (in the approved form, and accompanied by the fee, if any, specified in regulations) for particular findings. In relation to each activity the subject of the request, the Board must either make a finding about the activity, or refuse to make a finding, in response to the application ***[Schedule 2, item 1, paragraph 27F(3)(b), paragraph 27F(4)(b) and section 27FA]***.

5.62 A finding made by the Board may differ from that sought (for example, the Board might make a negative finding about an activity where the applicant sought a positive finding, or it might make a positive finding in relation to some but not all of the activity). The Board may also refuse to make a finding that is requested by an R&D entity if that is consistent with the decision-making principles made under section 31A. ***[Schedule 2, item 1, section 27F]***

5.63 As a result of an examination under section 27F, the Board may make one or more of the following findings in relation to the entire registration (that is, all activities registered by the entity), or part of the registration (only some of the activities) of an R&D entity:

- that all or part of a registered activity was a core R&D activity (if the Board is satisfied that the activity meets the definition in section 355-25 of the ITAA 1997) and was conducted during the income year in which the activity was registered ***[Schedule 2, item 1, paragraph 27H(1)(a)]***;

- that all or part of a registered activity was not a core R&D activity (if the Board is not satisfied that the activity meets the definition in section 355-25 of the ITAA 1997) or was not conducted during the income year in which the activity was registered ***[Schedule 2, item 1, paragraph 27H(1)(b)]***;

- that all or part of a registered activity was a supporting R&D activity in relation to an identified core R&D activity (if the Board is satisfied that the activities meet the definitions in sections 355-25 and 355-35 of the ITAA 1997) and was conducted during the income year in which the activity was registered ***[Schedule 2, item 1, paragraph 27H(1)(c)]***; and/or

- that all or part of a registered activity was not a supporting R&D activity (if the Board is not satisfied that the activity meets the definition in section 355-35 of the ITAA 1997), was not conducted during the income year or was not conducted in relation to past (registered), present (will be registered) or future (could be registered) core R&D activities ***[Schedule 2, item 1, paragraph 27H(1)(d)]***.

5.64 If the Board makes a finding, it may specify in the finding the period during which the finding applies; that is, the times during the income year that it is satisfied the entity was conducting the R&D activity. For example, the entity might have been carrying out an activity for the entire income year, but for only part of that year it was carried out for the dominant purpose of supporting a core R&D activity, and thus it was only an R&D activity for certain times. ***[Schedule 2, item 1, subsection 27H(2)]***

5.65 In some circumstances, the Board may already have considered some or all of the registered activities of an R&D entity (for example, because it examined the application for registration of those activities under subsection 27B(1), or already examined the registration under section 27F, or granted an advance finding in respect of the activities under section 28A). In these circumstances, these earlier findings will prevail over a new finding under subsection 27H(1) to the extent of any inconsistency. This ensures that an R&D entity can rely on a finding, once made, in respect of its activities ***[Schedule 2, item 1, section 31B]***.

5.66 However, if the activities conducted are materially different to those described in an advance finding, the activities conducted are not covered by the finding and the Board may make a finding under section 27H about those activities without breaching the consistency rule.

Positive findings

5.67 The Board is able to make positive findings in respect of the activities it examines; namely, that the activities registered in relation to the R&D entity are R&D activities (either core or supporting). It will make these findings if it is satisfied, on the basis of the information provided, that the activity meets the definitions set out in section 355-25 or section 355-35 of the ITAA 1997, as relevant. The Board may also release policy guidance about how it applies this test.

5.68 In relation to a finding that an activity is a supporting activity, the Board would ordinarily also make a finding about the core activity to which the supporting activity relates. If the relevant core activity will not be undertaken until a later income year (and hence cannot be registered yet), the Board will need to satisfy itself that the nominated core activity to which the supporting activity relates meet the definition of a 'core R&D activity'. The Board need not make a finding in order to satisfy itself with regards to related core activities.

5.69 The core activity may be undertaken in a past, present or future income year. If the relevant core activity will not be undertaken until a later income year (and hence cannot be registered yet), the Board will need to decide whether, if that nominated core activity were to be carried out in the registration year (that is, the same income year as the supporting activity), it would meet the definition of a 'core R&D activity'.
[Schedule 2, item 1, paragraph 27H(1)(c)]

5.70 A positive finding by the Board in respect of particular activities is confirmation of the applicant's self assessment that nominated activities are R&D activities. Once the Board has made such a finding, the Commissioner is bound to treat the activities that are the subject of the finding as R&D activities when determining whether expenditure incurred

in relation to the activities in question is R&D expenditure for the purposes of Division 355 of the ITAA 1997. However, the Commissioner may request a review of a finding. ***[Schedule 1, item 1, subparagraph 355-700(1)(a)(ii) and Schedule 2, item 1, subsection 30C(4)]***

Negative findings

5.71 The Board can make negative findings in respect of activities registered by the entity if it does not have the necessary level of satisfaction to make a positive finding; that is, if it is not satisfied that a registered activity meets the relevant definition in the ITAA 1997.

5.72 There are a number of reasons why the Board might not be satisfied that the activity meets the relevant definition.

- The Board may be of the opinion that the activity fails one or more components of the tests in the ITAA 1997. For example, an activity may have been nominated as a core activity, but the Board may not be satisfied that it satisfies the definition of core R&D activities in section 355-25 of the ITAA 1997, or may be satisfied that it is an activity of the type specified in section 355-30 of the ITAA 1997.

- For supporting R&D activities, the Board might consider that the dominant purpose of the relevant activity was not to support a core activity. Additionally, if the Board makes a negative finding in relation to particular nominated core R&D activities, any activities conducted in support of those activities would likewise not be eligible for registration as supporting R&D activities.

- The Board may have insufficient evidence available to it to be satisfied that the activity is an R&D activity. This may be because the applicant did not provide all required information (see additional information requests below), or because the information made available is not sufficient to satisfy the Board in the circumstances of the case.

5.73 The Board may also find that, despite the described activity appearing to meet the definition of R&D activities, activity was in fact not conducted during the income year. ***[Schedule 2, item 1, subsection 27H(1)]***

Additional information about examinations

5.74 To facilitate an examination, the Board may request additional information, or types of information, about an R&D entity's registration from that entity. The request must be in writing and may specify the

period within which the additional information it requires must be provided (30 days, or such longer period as the Board allows, in accordance with the decision-making principles). ***[Schedule 2, item 5, section 27G]***

5.75 The Board can ask that the applicant provide the additional information in a particular format which is acceptable to it in the circumstances. ***[Schedule 2, item 5, subsection 31(2)]***

5.76 If the Board is still unable to reach a positive finding on the basis of information provided, or the R&D entity does not provide the further information, the Board may reach a negative finding on the basis that it is not satisfied that the activity meets the relevant definition.

Consequence of findings

5.77 If the findings made by the Board confirm all aspects of a registration that the Board considered, the registration remains unchanged.

5.78 If any findings made by the Board under section 27H(1) are inconsistent with a registration of an R&D entity's activities, the registration is automatically varied so that it is consistent with the finding. Registrations will only be automatically varied as a consequence of a valid finding which is in force. If the Board makes a finding which is deemed to have no effect under section 31B because it is inconsistent with an earlier finding by the Board, this will have no effect on the entity's registration. ***[Schedule 2, item 1, section 27L and section 31B]***

5.79 Automatic variation under section 27L is intended to align an R&D entity's registration with any findings that are made by the Board. For example, if the Board makes a finding under section 27H(1) that particular registered activities are not R&D activities, the entity's registration is automatically varied so that the activity the subject of the finding is not a registered activity. ***[Schedule 2, item 1, section 27L]***

5.80 The Board must inform an R&D entity and the Commissioner in writing of the Board's findings in respect of any of the entity's registered activities which were examined by the Board. ***[Schedule 2, item 1, subsection 27J(1)]***

5.81 The notice must include a certificate in respect of each finding, which sets out:

- a description of each finding;
- the Board's reasons for the finding;

- the registered activity affected by the finding;
- the effect of the finding on the entity's registration; and
- any other matters (if any) specified in the regulations.

[Schedule 2, item 1, subsection 27J(2)]

5.82 The notice must also inform the applicant of its right to have each decision (the decision whether or not to register, and the decision in respect of each finding) reviewed under Division 5 ***[Schedule 2, item 1, section 30B]***.

5.83 The Board must also notify an R&D entity in writing of a decision refusing to make a finding in response to an application by the entity. The notice must include the Board's reasons for refusing to make a finding. The reasons for refusing to make a finding must be consistent with the decision making principles. ***[Schedule 2, item 1, paragraph 27F(4)(b), subsection 27J(3) and section 31A]***

5.84 If the Board fails to comply with these notice requirements, however, it does not affect the validity of the Board's findings, or the status of the entity's registration as varied by the Board. If the Board makes more than one finding in relation to a registration, there is no need for the Board to issue separate notices relating to each finding. All certificates can be contained in the same document. ***[Schedule 2, item 1, subsection 27J(5) and subsection 30A(2)]***

Variations of registration

5.85 A registered R&D entity may request a variation to its registration by way of application in the approved form, and payment of the fee (if any) specified in the regulations. This might involve removing particular activities, reclassifying activities as core or supporting activities, or amending the times during which activities were conducted.

5.86 If the Board is satisfied that the requested variation is consistent with any findings it has made under sections 27B and 27H, and the variation is justified in accordance with the decision-making principles, the Board may vary the registration. The Board may request additional information from the R&D entity to assist with its decision, if necessary. Such a request may be made in the same way as a request under section 27E (that is, it may request for specified information, or kinds of information, and may ask that the information be given in the approved form and within a prescribed timeframe). ***[Schedule 2, item 1, section 27M]***

5.87 A registration that has been varied, either because of a Board finding or on request of the entity, is deemed always to have existed as varied. This rule reflects the fact that although activities may have been miscategorised by the R&D entity in its registration, the Board's decision does not itself change the nature of the activities. While an entity is able to rely upon self assessment to register activities, if those activities are later found by the Board to have been incorrectly registered, for example, the entity cannot purport to claim expenditure in relation to those activities at any time. This rule also prevents administrative complexity resulting from maintaining two or more different variations of the same registration during one income year. ***[Schedule 2, item 1, section 27L and subsection 27M(4)]***

Revoking registrations

5.88 The Board may revoke the registration if it is satisfied that there was no time at which an entity was an R&D entity when a registered activity was conducted. It may also revoke an entity's registration on request of the R&D entity. Such a request must be in the approved form, and accompanied by the fee, if any, prescribed in the regulations. ***[Schedule 2, item 1, section 27N]***

5.89 The revoking of a registration for an income year has the effect that the activities that are the subject of the registration are taken never to have been registered. This reflects the fact that a registration is in respect of a particular year of income. If an entity was not eligible to be registered by the Board at any time, or the entity does not wish to be registered for an income year, the entity cannot purport to claim expenditure at any time in relation to any activities in that income year. ***[Schedule 2, item 1, subsection 27N(4)]***

5.90 A decision by the Board to revoke a registration is reviewable. The Board must notify the entity and the Commissioner if it revokes a registration and the reason for the revocation. ***[Schedule 2, item 5, section 27N, section 30A and section 30B]***

Other findings

5.91 In addition to findings about applications to register and findings about registration, the Board may also make findings under Division 3 in relation to:

- Advance findings – whether an activity:
  - that has been completed (but is not yet able to be registered);

– is being conducted in the income year in which the application for the finding is made; or

– that has yet to be conducted (but it is reasonable to expect that the activity will be conducted in the income year in which the application for the finding is made or the next two income years),

is an R&D activity;

- Findings in relation to overseas activities – whether an activity cannot be conducted in Australia; and

- Findings in relation to core technology – whether a particular technology is core technology for R&D activities.

5.92 R&D entities (and, in some circumstances, entities specified in regulations under section 28AA acting on behalf of R&D entities) may apply to the Board to make any or all of the above findings. All applications for these findings under must be in the approved form and accompanied by a fee (if any) specified in the regulations ***[Schedule 2, item 1, section 28D].***

5.93 The Commissioner may request that the Board make findings in relation to core technology. The Board must comply with such a request. ***[Schedule 2, item 1, subsection 28BB(3)]***

5.94 The Board has the power to request that any additional information it requires to make a finding under this Division be provided to it. It can require that this information be provided in the approved form, and within 30 days after the request was given or any further period allowed (in accordance with the decision-making principles). ***[Schedule 2, item 1, section 28E]***

5.95 The Board must give notice to an R&D entity about each of its decisions in relation to the nature of activities (advance findings under section 28A(1)), whether an activity cannot be conducted in Australia (findings under section 28B(1)) or a decisions about core technology (findings under section 28BB(1)). This includes a decision to make one or more findings, or a decision to refuse to make a finding.

5.96 The notice must include a certificate in relation to each finding (if any) that sets out:

- a description of the finding;

- the Board's reasons for the finding;

- a description of the activity or technology affected by the finding; and
- any other matters (if any) specified in the regulations.

5.97 The Board must give the Commissioner a copy of the notice if the notice includes one or more certificates. If the Board makes more than one finding, there is no need for the Board to issue separate documents relating to each finding. All certificates can be contained in the same document. ***[Schedule 2, item 1, section 28C]***

5.98 The notice must also advise the applicant of its review rights in respect of the decision (whether that is a decision to make or refuse to make a finding). ***[Schedule 2, item 1, section 30B]***

5.99 If the Board fails to comply with these notice requirements, however, it does not affect the validity of the Board's findings. ***[Schedule 2, item 1, subsection 28C(4) and subsection 30B(2)]***

Advance findings

5.100 An R&D entity may apply to the Board for an advance finding in relation to activities that are not yet able to be registered.

5.101 An R&D entity may request that the Board make an advance finding in relation to one or more activities that have been completed during the income year. This occurs where an R&D entity completes an activity in an income year and, in that same income year, wishes to apply to the Board for a finding in order to seek certainty about the nature of the activity. This application can only be made before it is possible to register the activity under section 27A. ***[Schedule 2, item 1, paragraph 28A(2)(a)]***

5.102 Where the Board makes an advance finding about a completed activity, the Board may specify in the finding the period during which the finding applies; that is, the times during the income year that it is satisfied the entity was conducting the R&D activity. ***[Schedule 2, item 1, subsection 28A(3)]***

5.103 An R&D entity may also request that the Board make an advance finding in relation to activities that are in the process of being undertaken at the time of the request, or which it has not yet conducted. The Board will only give an advance finding in relation to activities that have not yet been conducted if it is satisfied that, on an objective basis, it is reasonable to expect that the activities will be conducted in the current or next two income years. ***[Schedule 2, item 1, subsection 28A(2)]***

5.104 Additionally, an entity (or a class of entity) specified in the regulations (an authorised person) will be able to apply for an advance finding on behalf of one or more R&D entities, provided that the authorised person has the written consent of the R&D entity or entities. Authorised persons may make a single joint application on behalf of multiple R&D entities, where the application relates to the same activity, and that application is treated as if each R&D entity had made a separate application. In these circumstances, the Board would, for example, issue findings to each R&D entity, and give notice of decisions to the R&D entities. For example, regulations might be made which permit an RSP to make such an application, so that the RSP can provide certainty to R&D entities for whom it carries out a particular activity that the activity is an R&D activity and can be registered by the entities under section 27A. ***[Schedule 2, item 1, section 28AA]***

5.105 The Board may make one or more of the following findings in respect of an activity:

- that the activity is a core R&D activity (if it is satisfied that the activity meets the definition in section 355-25 of the ITAA 1997);

- that the activity is a supporting R&D activity (if it is satisfied that the activity meets the definition in section 355-35 of the ITAA 1997) in relation to one or more core R&D activities for which the R&D entity is or could be registered; or

- that the activity is neither a core R&D activity nor a supporting R&D activity (if it is not satisfied that the activity meets the definition of core R&D activity or supporting R&D activity).

[Schedule 2, item 1, subsection 28A(1)]

5.106 In making a decision in response to an application, the Board is not confined by the characterisation of actions by the R&D entity as a particular 'activity'. If the Board considers that only part of what is described by the R&D entity in its application as a single 'activity' satisfies the requirements set out in subsection 28A(1), the Board may make a finding in relation to the part of the activity it considers meets the requirements. This part then becomes 'the activity' for the purposes of the positive finding and the entity's registration.

5.107 The Board may refuse to make an advance finding that is requested by an R&D entity in relation to all or part of an activity if it is justified in accordance with the decision-making principles. ***[Schedule 2, item 1, paragraph 28A(1)(d)]***

5.108 An advance finding remains in force for the income year in which it is made, and the next two income years.

5.109 An advance finding is not the same as registration and is not a substitute for registration. The R&D entity will need to register the activities that are subject to the advance finding in relation to each income year in which the activities are conducted in order to be eligible to claim an R&D tax offset in relation to expenditure on those activities. The Board must register the activities consistently with any advance findings that it has made under section 28A. ***[Schedule 2, item 1, subsection 27A(2)]***

5.110 Once made by the Board, an advance finding binds the Commissioner for the year the application was made, and the next two income years, by operation of subsection 355-700(2) of the ITAA 1997. For example, assuming that other requirements for claiming the R&D tax offset are met, if the Board makes a positive advance finding (that activities are R&D activities) and those activities are later registered, the Commissioner is bound to treat the activities as R&D activities when making a decision about whether expenditure associated with the activity is R&D expenditure for the purposes of new Division 355 of the ITAA 1997.

5.111 A finding is only binding in respect of the assessment of the R&D entity. It cannot be used by another entity in relation to activities conducted by that other entity. ***[Schedule 2, item 1, subsection 27A(2)]***

5.112 An advance finding only relates to the activity nominated by the R&D entity and which is made subject to a finding by the Board. If the R&D entity, having received an advance finding, conducts an activity which differs materially from that described in the advance finding, the advance finding will not apply to the activity conducted. The R&D entity cannot rely on that finding in respect of this new activity (nor is the Commissioner bound to treat it as an R&D activity).

5.113 While an advance finding in respect of particular activities made by the Board under section 28A is in force, a later finding in respect of those activities has no effect to the extent of any inconsistency. This applies to a later, inconsistent, finding under section 28A (Advance findings), section 27B (Findings about applications for registration) or section 27H (Findings about a registration). ***[Schedule 2, item 1, section 31B]***

5.114 However, if the activities are materially different ('different activities') to those described in an advance finding (for example, the R&D entity changes its plans in relation to activities to be conducted), the R&D entity may apply for an advance finding in relation to the different activities.

5.115 That an activity conducted is materially different to the activity described in the advance finding has no bearing on whether the activity conducted is or is not an R&D activity. The Board need not make findings about the activity conducted in determining whether to register the activity conducted, but may do so without breaching the consistency rule in section 31B.

Findings about activities to be conducted outside Australia

5.116 Generally, the R&D tax incentive is intended to support activities conducted in Australia. However, in certain circumstances, a tax offset is available for activities conducted outside Australia and its external territories.

5.117 An R&D entity may only claim a tax offset in respect of expenditure on R&D activities conducted outside Australia if it has a finding from the Board under section 28B in relation to those activities (paragraph 355-205(1)(d) of the ITAA 1997). Upon application to the Board by an R&D entity in relation to an activity, the Board must either:

- make a finding that that all specified conditions are met in relation to all or part of the activity (the overseas activity) ***[Schedule 2, item 1, paragraph 28B(1)(a)]***;
- make a finding that that one or more of the specified conditions are not met in relation to all or part of the activity ***[Schedule 2, item 1, paragraph 28B(1)(b)]***; or
- refuse to make a finding about the activity (if a refusal is justified in accordance with the decision-making principles) ***[Schedule 2, item 1, paragraph 28B(1)(c)]***.

5.118 The effect of the first kind of finding (a finding that all conditions are satisfied – a positive finding) is that a tax offset may be available in respect of expenditure in relation to those activities from the time the finding is in force.

5.119 A finding under section 28B is in force in the income year in which the application for the finding is made and is valid for the duration of the overseas activity. The tax offset will not be available in respect of expenditure on those activities if the Board makes a negative finding or refuses to make a finding, or for activities which are completed before any finding under section 28B is in force. ***[Schedule 2, item 1, subsections 28B(2)]***

5.120 In order to make a positive finding, the Board must be satisfied that the activity meets certain criteria:

- the Board must be satisfied, at the time it makes a finding about an activity under section 28B, that the activity is covered by a positive finding under paragraph 28A(1)(a) or (b) (an advance finding that an activity is an R&D activity). In practice, seeking a finding under section 28B will involve seeking a finding under section 28A simultaneously. ***[Schedule 2, item 1, subsection 28BA(1)]***

- the Board must be satisfied that the overseas activity has a significant scientific link to one or more Australian core R&D activities.

  – Australian core activities are activities that have been conducted, are in the process of being conducted, or are to be conducted within Australia or an external Territory. The activities must be registered under section 27A for an income year, or the Board must be satisfied (on an objective basis) that they are reasonably likely to be conducted and be registered under section 27A for an income year. ***[Schedule 2, item 1, subsection 28BA(2)]***

  – The presence of a significant scientific link means that the Australian core activities cannot be completed without the overseas activity being conducted, and the conditions (if any) specified in the regulations are met. ***[Schedule 2, item 1, subsection 28BA(3)]***

- the Board must be satisfied that the activity cannot be conducted in Australia or the external Territories, for one or more of the following reasons:

  – conducting it requires access to a facility, expertise or equipment that is not available in Australia or the external Territories;

  – the activity is precluded from being conducted in Australia or the external Territories due to the operation of quarantine laws; or

  – one or more reasons to be specified in regulations.

  [Schedule 2, item 1, subsection 28BA(4)]

- the Board must be satisfied that the Australian core activities and supporting activities will entail a greater financial commitment than the total overseas activities. That is:

– the total amount (including actual and reasonably anticipated amounts in all income years) to be spent by any entity on any overseas activities (core and supporting activities) and other activities conducted overseas which have a significant scientific link to the Australian core activities;

must be less than

– the total amount (including actual and reasonably anticipated amounts in all income years) to be spent on the Australian core activities, and supporting R&D activities conducted or to be conducted to which those overseas activities are linked under the significant scientific link test, and activities which are supporting R&D activities in relation to those core activities.

[Schedule 2, item 1, subsection 28BA(5)]

5.121 The total amount, including actual and reasonably anticipated amounts in all income years, on activities conducted overseas includes expenditure incurred on:

- overseas activities (that is, activities which satisfy all conditions under section 28BA) ***[Schedule 2, item 1, paragraph 28BA(5)(a)]***; and

- activities to be conducted overseas which also have a significant scientific link to the Australian core activities, but which are not overseas activities as defined (for example, because they are anticipated to be conducted outside the timeframe required by paragraph 28A(2)(c)) ***[Schedule 2, item 1, paragraph 28BA(5)(b)]***.

5.122 In making a finding under subsection 28BA(1), the Board is not confined by the characterisation of actions by the R&D entity as a particular 'activity'. If the Board considers that only part of what is described by the R&D entity in its application as a single activity satisfies the requirements set out in subsection 28BA(1), the Board may make a finding in relation to the part of the activity that it considers meets the requirements. This part then becomes the 'overseas activity' for the purposes of the finding.

Core technology findings

5.123 An R&D entity or the Commissioner may apply to the Board for a finding that particular technology is or is not core technology. Upon

request by the R&D entity or the Commissioner in relation to R&D activities, the Board must do one of the following things:

- make a finding that the technology is core technology for the R&D activities;
- make a finding that technology is not core technology for the R&D activities; or
- refuse to make a finding about the technology and the R&D activities (if justified in accordance with the decision-making principles).

[Schedule 2, item 1, subsection 28BB(1)]

5.124 Technology is core technology for R&D activities if:

- a purpose of the R&D activities was or is:
  - to obtain new knowledge based on that technology; or
  - to create new or improved materials, products, devices, processes, techniques or services to be based on that technology; or
- the R&D activities were or are an extension, continuation, development or completion of the activities that produced the technology.

[Schedule 2, item 1, subsection 28BB(2)]

5.125 Unlike other positive findings under this Part, a finding by the Board that technology is core technology is disadvantageous to the R&D entity concerned, because the effect of the finding is that the tax offset will not be available for expenditure incurred on acquiring the technology or the right to use the technology (see subsection 355-220(2) of the ITAA 1997).

5.126 The Board must make a finding if requested to do so by the Commissioner. The Board may also make a finding in respect of the technology and the activities on its own initiative. ***[Schedule 2, item 1, subsections 28BB(3) and (4)]***

5.127 The Commissioner might seek a finding in the course of determining the availability of an offset for expenditure on the R&D activities, or an R&D entity might seek a negative finding to obtain certainty that its expenditure will not be excluded.

Registration of entities as Research Service Providers

5.128 The Board has a role in the R&D tax incentive to ensure a minimum standard of capability in the provision of contracted R&D by RSPs. It will make the list of RSPs publicly available for the use of R&D entities wishing to access RSP services.

5.129 R&D entities which use the services of an RSP are not required to meet the $20,000 expenditure threshold requirement for R&D expenditure by operation of subsection 355-100(2) of the ITAA 1997. This is intended to enable R&D entities to access expertise in Australia's public and private R&D organisations, to reduce unnecessary duplication of R&D facilities, and to improve the overall effectiveness of Australia's R&D effort through collaboration.

5.130 The Board ensures this minimum standard by granting registration to entities that satisfy the criteria set out in the regulations. Registration is given in respect of specified fields of research which the organisation has shown that it is capable of undertaking. ***[Schedule 2, item 1, section 29A]***

5.131 Entities wishing to become RSPs must apply to the Board for registration as an RSP qualified to provide services in one or more specified research fields to registered R&D entities. An application for registration must be in the approved form and be accompanied by a fee (if any) prescribed in regulations for this purpose. ***[Schedule 2, item 1, section 29C]***

5.132 Upon receipt of an application by an entity, the Board must decide whether to register or refuse to register the entity as an RSP. Regulations will specify the criteria the entity must meet to satisfy the Board that it is capable of providing services to R&D entities in one or more specified fields of research. Specified fields of research will be prescribed in the regulations. ***[Schedule 2, item 1, sections 29A and item 15AA]***

5.133 The Board may request that further information be provided about an application for an RSP registration and may request that information be provided within 30 days after the request was given. If the applicant fails to comply with the request, the Board can refuse to consider the application. The Board will make a decision about whether to accept information outside the period specified in the notice in accordance with the decision-making principles. ***[Schedule 2, item 1, section 29D and subsection 29G(3)]***

5.134 The Board may also need to make inquiries for the purpose of determining whether the applicant meets the criteria for an RSP registration in relation to an application for registration. It may notify the

entity in writing of its intention to do so and may require that the entity pay up to $1,000 (or any higher amount prescribed by regulations) towards the cost of determining whether the applicant meets the criteria for registration. The Board may refuse to consider the application for registration or variation until this fee is paid. ***[Schedule 2, item 1, section 29E and subsection 29G(3)]***

5.135 Registrations are valid up until the end of the financial year in which the application is lodged. However, if an application is lodged within two months of the end of a financial year, then the registration will be valid until the end of the following financial year. ***[Schedule 2, item 1, subsection 29E(1)]***

5.136 At least two months before the end of each financial year, the Board must give a notice to each RSP, asking if it wishes to continue to be registered under section 29A, and attaching an approved continuation of registration form. The form will include a statement about whether the RSP wishes to continue and is capable of continuing to be an RSP, and whether there is any variation to the approved fields of research in relation to which it wishes to be registered. The Board may revoke the registration in question if the RSP does not return the completed form within 30 days or any further period allowed by the Board (in accordance with the decision-making principles). Revocation will take effect at the end of that financial year. ***[Schedule 2, item 5, subsections 29F(2) and (3)]***

5.137 In certain cases RSPs may wish to vary their registrations. This might occur where an RSP wishes to change the fields of research in relation to which it is registered. For example, a senior researcher who specialises in a particular research field for an RSP retires and the RSP is unable to find a replacement. As the RSP is no long able to provide research services in that particular field, it applies to the Board to vary its registration as an RSP under section 29G. The variation would involve the removal of the particular research field from the RSPs listed fields of research.

5.138 The Board may vary the registration where the RSP applies for the variation and the Board is satisfied that the RSP would still meet the eligibility criteria in the regulations if the registration were varied as requested. ***[Schedule 2, item 1, subsection 29G(1)]***

5.139 Applications for variation of registrations must be in the approved form and accompanied by the fee (if any) specified in the regulations. ***[Schedule 2, item 1, subsection 29G(2)]***

5.140 The Board may request information about an application for variation of registration, or make inquiries about such an application, in

the same manner as in relation to applications for registration. ***[Schedule 2, item 1, subsection 29G(3)]***

5.141 The Board may also vary a registration without the request of the RSP if it is satisfied that the RSP does not meet the criteria for registration in the regulations in so far as those criteria relate to a research field for which the provider is registered. For example, an RSP may be unable to provide a service to an R&D entity in a research field for which it is registered. Upon being made aware of this situation, the Board may investigate the RSP to form its own conclusion as to the RSP's capability in relation to the particular research field. Although the Board may reach agreement with the RSP in relation to the RSP's capability in relation to the particular research field, the Board may also conclude that the RSP is not capable of providing services in relation to the particular research field and vary the RSP's registration accordingly under section 29H. ***[Schedule 2, item 1, section 29H]***

5.142 The Board may also revoke a registration if an RSP requests the Board to do so, or if the Board is satisfied that the RSP:

- no longer meets the criteria for registration in relation to any field of research; or
- has breached a requirement of registration prescribed in the regulations.

A revocation or variation of a registration of an RSP is prospective. This is, a decision by the Board to revoke or vary the registration of an RSP will have effect from the date of the notice, taking account of the application of section 29 of the *Acts Interpretation Act 1901*. ***[Schedule 2, item 1, section 29J]***

5.143 The Board is required to notify an RSP in writing of any decision whether or not to register the entity, or a decision to vary or revoke its registration. The notice must also set out the reasons for the Board's decision in question and inform the RSP of its right to have the decision reviewed. ***[Schedule 2, item 1, section 30B]***

5.144 The Board is also required to maintain a register of RSPs, which must include details of registrations in force and registrations that have been revoked under this Division (in the current or previous financial year). It is intended that the register will contain the name of each registered RSP, the field of research for which it has been approved, and contact details. This register must be made available to the public via the internet, and published in the Board's annual report. The keeping of this register may assist R&D entities in decisions about subcontracting R&D activities. Subsection 29K(2) notes that the register is not a legislative

instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. The register is merely an administrative record and is not legislative in character. ***[Schedule 2, item 1, section 29K and item 27]***

5.145 As a transitional arrangement for 2010-11, entities registered on 30 June 2010 as Australian research agencies under section 39F of the current IR&D Act will be deemed to be registered as RSPs, for the fields of research they were registered, from the commencement of this Part. From the 2011-12 income year onwards, these entities will need to be registered under this Division in order to continue to operate as RSPs. ***[Schedule 4, item 17]***

Review of Board decisions

5.146 Most decisions made by the Board in its function relating to the R&D tax incentive can be reviewed through an internal review process. The list of reviewable decisions in this regard is set out in section 30A. Examples of reviewable decisions include:

- decisions relating to applications by R&D entities to register activities as R&D activities;
- decisions relating to registration of R&D activities, including variations and revocations of registrations;
- decisions relating to findings that activities are or are not R&D activities;
- decisions relating to applications or registrations of RSPs (including variation, revocation and extensions of time); and
- decisions to provide an extension of time for making an application or for providing further information.

An example of a non-reviewable decision is a decision to allow a different amount of additional time to that requested by an R&D entity. ***[Schedule 2, item 1, section 30A]***

5.147 When the Board makes a reviewable decision, as listed under section 30A, it is required to give written notice of the making of the decision, the reasons for the decision and the entity's right to have the decision reviewed under Division 5. However, a failure of the Board to give such notice does not affect the validity of the underlying decision.

5.148 Some provisions of the Act already expressly require notice to be given of a particular decision which is a reviewable decision (such as the notices required under sections 27C, 27J, or 28C). These notices will

fulfil the requirements of section 30B if they include the information listed in that section (that is, it is not necessary to provide a second notice under section 30B). Where the provision relating to a particular decision does not expressly provide for the notice requirement, however, the notice must be given in accordance with section 30B. ***[Schedule 2, item 1, section 30B]***

Applications for internal review of reviewable decisions

5.149 An application for internal review of a decision can be made by or on behalf of a person affected by a reviewable decision. This application must be made in the approved form within 28 days after the entity to which the decision relates is notified of the Board's decision, unless the Board has allowed an extension to this time period in accordance with the decision-making principles. ***[Schedule 2, item 1, section 30C]***

5.150 The Commissioner may also apply for a review of a reviewable decision at any time after the reviewable decision is made. ***[Schedule 2, item 1, subsection 30C(4)]***

5.151 In reviewing its decision, the Board is not limited to considering only the information it had at the time the reviewable decision was made. It is able to consider new information that has come to light since the reviewable decision was made. Any new information that an entity wishes to be considered as part of the review should be provided to the Board as part of the application for internal review ***[Schedule 2, item 1, subsection 30C(3)]***.

5.152 If the Board receives an application for review of a reviewable decision, it must review the original decision and make a decision to:

- confirm the reviewable decision;
- vary the reviewable decision; or
- set aside the reviewable decision and make a new one in its place.

[Schedule 2, item 1, subsection 30D(2)]

5.153 If the Board does not make a decision within 90 days of receiving an application for review, then the Board is taken to have made a decision confirming the reviewable decision. Where a decision is taken to have been made for this reason, the Board is required to notify the entity that sought the review. However, the deemed decision is disregarded if the Board makes a decision after the expiration of the

90 days, and an application for review of the deemed decision by the AAT has yet to be made. ***[Schedule 2, item 1, subsections 30D(3) and (4)]***

5.154 Under the *Administrative Appeals Tribunal Act 1975* (AAT Act), notice of an internal review decision must be given to any person whose interests are affected by the decision. Additionally, written notice of an internal review decision, including reasons for the decision, must be given to the Commissioner specifically under subsection 30D(6).

5.155 The Board's decisions determine the entity's registration status or the nature of an entity's activities for a particular year of income. As decisions, including review decisions, have impact for an entire year of income, it is necessary that internal review decisions take effect on the day on which the original reviewable decision took effect. ***[Schedule 2, item 1, subsection 30D(5)]***

Review by the Administrative Appeals Tribunal

5.156 Where the Board has made, or is taken to have made by the operation of subsection 30D(3), an internal review decision, applications may be made to the AAT for review of that internal review decision in accordance with section 29 of the AAT Act. Where the Board is taken to have made a decision because of the operation of subsection 30D(3), applications must be made within 28 days starting on the day on which the internal review decision is taken to have been made. This ensures that the lack of a decision by the Board does not prevent entities having recourse to the AAT. ***[Schedule 2, item 1, subsection 30E(3)]***

5.157 Due to the commercially sensitive nature of R&D conducted by entities, hearings of proceedings for review of internal review decisions are to be held in private. The AAT may also give directions as to who may be present during all or part of a hearing of the proceedings and also give directions of a kind mentioned in paragraphs 35(2)(aa), (b) or (c) of the AAT Act, which relate to the publication or disclosure of information.

5.158 Variations or substitutions of internal review decisions by the AAT take effect from the day on which the reviewable decision took effect (that is, the decision is treated as if it were always made in the form made by the AAT). ***[Schedule 2, item 1, section 30E]***

Other matters

Research and development entities joining and leaving consolidated groups

5.159 For administrative simplicity, it is intended that only the head company of a consolidated or MEC group will be considered to be the

R&D entity with respect to R&D activities conducted by any entities in the group for an income year. To facilitate this, only that head company, and not any of the subsidiary companies, may register under section 27A, or apply for findings, in respect of activities conducted by any member of the group. This is the case even if the activities are conducted entirely by a subsidiary member of the group. ***[Schedule 2, item 1, section 30GA]***

5.160 When an R&D entity (the joining entity) joins a consolidated or MEC group part way through an income year, it can be registered in respect of the R&D activities that it has carried out only in relation to that part of the year that it was not part of the corporate group. The head company will need to register in respect of the activities for the part of the year that they were conducted by an entity in its group. Additionally, findings which related to the joining entity are deemed to apply to the head company. For example, if the Board has made an advance finding (the actual finding) in relation to an activity to be conducted by the joining entity, a corresponding advance finding (the deemed finding) will apply to the head company from the time the joining entity joins the consolidated group. That deemed finding would cease to apply to the head company if the joining entity leaves the group. ***[Schedule 2, item 1, section 30GB]***

5.161 Similarly, when an entity leaves a consolidated or MEC group (the leaving entity) and becomes an R&D entity in its own right (that is, it is no longer prevented from applying for registration or findings by section 30GA), findings that were made while the leaving entity was a member of the group, in respect of activities to be conducted by the leaving entity, are taken to apply to the leaving entity. The original finding will then cease to apply to the head company. ***[Schedule 2, item 1, section 30GC]***

5.162 For example, if the Board has made an advance finding in relation to an activity, if the leaving entity conducts the activity after it leaves the group, the advance finding will apply to the leaving entity from the time it leaves the consolidated group and will cease to apply to the consolidated group.

Approved forms

5.163 There is a requirement for certain things to be in the relevant approved form in several provisions in Part III. For example, applications for registration of R&D activities under section 27D, and applications of internal review under section 30C. The Board may also choose to require that particular information be given in the approved form in certain circumstances (for example, further information requested under section 27E).

5.164 A thing is in the approved form if it is in writing in a form approved by the Board, and includes the information required by the form and any other material required by the form (including documents). ***[Schedule 2, item 1, subsection 31(2)]***

5.165 The Board may approve a form in writing. Regulations may also specify information or other material which must be required by the form. For example, the regulations might require approved forms to provide registration data such as R&D expenditure on core and supporting R&D activities, which should be recorded consistently over time. ***[Schedule 2, item 1, subsection 31(3)]***

5.166 Forms approved by the Board are not legislative instruments as defined by section 5 of the *Legislative Instruments Act 2003* as they are administrative in nature.

Decision-making principles

5.167 The Minister is empowered to make principles with which the Board must comply in making certain decisions under Part III. These decisions are:

- whether to allow a further period for something to be given other than the specified period in Part III;
- whether refusing to make a finding sought under Part III is justified; and
- whether a proposed variation under section 27M is justified.

5.168 The Minister will make these decision-making principles by way of a legislative instrument. ***[Schedule 2, item 1, section 31A]***

Inconsistency between findings

5.169 A finding made under Part III in relation to an R&D entity has no effect to the extent of any inconsistency with a finding already in force in relation to the R&D entity. This means that entities can rely on earlier findings made by the Board, as these findings cannot be overridden by later findings under the same or a different provision. ***[Schedule 2, item 1, section 31B]***

5.170 For example, if the Board makes an advance finding under section 28A(1) that particular activities proposed to be conducted by an R&D entity are core R&D activities, a later finding by the Board under section 27B(1) that those activities are supporting R&D activities when they are registered the following year has no effect. The registration is automatically varied to be consistent with the advance finding.

Consequential amendments

5.171 Part 2 of Schedule 2 introduces a number of defined terms to subsection 4(1) of the IR&D Act. These terms are required for the operation of the new Part III of the IR&D Act, and many rely on definitions in the ITAA 1997. ***[Schedule 2, items, 5, 6A to 8, 10, 11A, 12, 13A to 15, 18B and 19]***

5.172 Part 2 of Schedule 2 repeals the following obsolete terms from subsection 4(1) of the IR&D Act:

- approved research institute;
- company;
- finance scheme guidelines; and
- research and development activities.

5.173 These terms are no longer required under the new R&D tax incentive. ***[Schedule 2, items 4, 6, 11, 15A]***

5.174 As a consequence of the new Part III, the reporting requirements in the Board's annual report have been amended. The Board will now report on the number of applications for registration under section 27A of the IR&D Act and the amount of offsets involved. Its report must also include an analysis of the R&D tax offset scheme for the financial year, and provide a list of current RSPs and their fields of research, as well as RSPs deregistered in the current and previous income years, as at the end of the year. ***[Schedule 2, items 26 and 27]***

5.175 Amendments to the information-sharing provisions of the IR&D Act will permit the Board to disclose information to other government agencies, in particular the Australian Taxation Office, to facilitate whole-of-government input, as necessary, for administration of the new R&D tax incentive. ***[Schedule 2, items 28 to 31]***

5.176 Regulations may specify fees for making applications to the Board under Part III and a method for indexing the fees. These fees must not amount to taxation. ***[Schedule 2, item 48A]***

Application and transitional provisions

5.177 Part III of the IR&D Act will apply in relation to income years commencing on or after 1 July 2010. Section 29F of the IR&D Act (as inserted by Schedule 2) applies in relation to financial years commencing on or after 1 July 2010. ***[Schedule 4, item 1]***

5.178 The R&D Tax Concession will be discontinued from 1 July 2010. However, the Board will still require powers in relation to the R&D Tax Concession after this date, and some provisions in Part IIIA will be preserved in transitional arrangements. The Board will, for example, continue to register R&D activities that were conducted in the 2009-10 income year under 39J of Part IIIA. In the income years following 2009-10, the Board will continue to undertake assessments and reviews under Part IIIA as necessitated by circumstances. ***[Schedule 4, items 2 and 3]***

5.179 Entities registered as Australian research agencies under section 39F on 30 June 2010 are taken to be registered under new section 29A as RSPs. ***[Schedule 4, item 17]***