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Research and Development (R&D) Tax Credit - Second Exposure Draft Legislation

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its comments on the Second Exposure Draft (**ED**) of legislation and Explanatory Memorandum (**EM**) relating to the new Tax Credit for Research and Development (**R&D**).

The Taxation Institute notes, with some concern, the tight time frame for consideration, given the Easter break, particularly after the release of the first exposure draft so close to the Christmas break.

A number of changes are welcome, in particular:

- Provision of more detail in respect of the support for some overseas R&D activities
- Modification of the software exclusions to be broadly in line with other industries
- Changes to the treatment of items on the exclusion list.
- Simplification of the definitions to remove references to innovation and high levels of technical risk
- Removal of the requirement for R&D Plans

However, some areas of technical review have not lead to changes or the clarity needed to provide certainty for the users of the new tax credit system and, in our view, fall short of meeting stated policy objectives.

Uncertainty of interpretation and potential for the inconsistent interpretation of legislative provisions in the EM manifests in the need for further or better clarification.

The principles by which R&D activities are to be identified must be clear and beyond doubt if the stringent administrative and review procedures outlined in the ED are to operate without creating substantial amounts of disputation. Our specific concerns are outlined below.

1. Core and Supporting R&D activities

While the Taxation Institute has no major issues with the drafting of the definition of core R&D activities in 355-25, there are serious concerns with the interpretation of that definition as evidenced in the EM.

The examples in the EM appear to favour identifying those activities which may not qualify for the tax credit and concentrate on limiting the tax credit to an arbitrary number of core activities, with very little indication of situations where supporting or directly related activities would qualify for the benefit.

In order to fully understand why some activities do not constitute core activities, a logical and valid explanation is required. In the absence of clear and rational guidelines as to why the mixing of chemicals, for example, as outlined below does not constitute a part of an experiment, it is difficult, if not impossible, to provide information for registration in an acceptable format. It is the Taxation Institute's concern that unnecessary, costly and time-consuming disputation may arise if the current uncertainty is not rectified.

Example 2.4: EcoStartup I, provides a potential example of this issue. In that example, the EM attempts to suggest, without any sufficient explanation, that:

> *"… 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 …"*

are not part of the scientific method which entails a *"… systematic progression of work based on scientific principles and using an approach that proceeds from hypothesis to experiment, observation, and leads to logical conclusions"* (refer ED Para 2.12), but are merely supporting R&D activities *"directly related to the core R&D activity*".

These activities would arguably be core R&D activities because they appear to be an absolutely integral and essential part of, and not merely incidental or related to, the eligible experiment, such that the experiment cannot take place without them.

This is a fundamental issue that warrants further clarification based upon what is currently in the EM, especially when it says, without further clarification or justification, that:

> *"… an activity will not fall within the scope of the experiment merely because the experiment cannot take place without it."*

The example in the EM makes it appear that activities such as the research crucial to forming the underlying hypothesis (researching the properties and applications of the chemicals) and steps in undertaking an eligible experiment (mixing and measuring ingredients) have been arbitrarily classified as supporting R&D activities, in spite of the draft definition of core R&D activities in the ED.

2. Supporting activities and production

The application of the dominant purpose rule to production related activities will further penalise R&D carried out in anything other than a pure research context. The R&D tax credit will be of limited value to small and medium enterprises (**SMEs**) in these circumstances, as they typically cannot afford to undertake activities outside a commercial or production setting, arguably limiting the quantum of the tax incentive available.

This must surely be an unintended consequence of the legislation as one of the stated objectives of the new tax credit regime was to focus the benefit on the SME sector where it is considered the greater additions to R&D will occur. This objective does not appear to be achieved by the interpretation of the provisions in the EM thus far. The dominant purpose test clearly adds an additional administrative burden on a sector which should be the beneficiary of benefits flowing from the tax credit.

Further, the Taxation Institute notes that the feedstock provisions, as provided in the current R&D tax concession, already eliminate substantial, so called, production costs involved with R&D activities and therefore the Taxation Institute questions the need for the dominant purpose test in addition to the feedstock provisions.

The Taxation Institute notes that the examples in the EM have included numerous scenarios where production related activities would not qualify because of the dominant purpose test. The Taxation Institute suggests that for the sake of balanced consideration it would be prudent to include examples of R&D activities where production activities would qualify as eligible despite the dominant purpose test. The current examples do not serve to highlight the point at which that distinction is made or which facts will be considered relevant in making that decision.

In relation to R&D activities undertaken by a company to resolve technical knowledge gaps, in order to enable it to fulfil a contract for design and development of a final product, the question needs to be asked if any production activities will ever be seen as being undertaken dominantly for R&D rather than for the fulfilment of the contract. The answer to this inquiry is not evident from the materials provided and requires further attention.

3. Software

The Taxation Institute welcomes the proposed removal of the multiple sale test currently applying to R&D activities involving software development.

Application of the fundamental definition of R&D activities to software development places this industry broadly in line with R&D eligibility for other industries; this decision reflects a rational approach to a fundamental industry which underpins economic growth and increased productivity and competitiveness.

The Taxation Institute appreciates that purely in-house software development for internal administration of business functions may not, at this point in time, merit additional government support and could result in significant revenue foregone.

However, the term ‘solely or primarily’ for internal use may be interpreted subjectively. The extent to which the software is used, or is intended to be used, by non-related parties will be difficult to quantify. We recommend that ‘primarily’ is removed and that software that is developed solely for internal use remains subject to the exclusion from core R&D activities.

4. Feedstock

The Taxation Institute acknowledges that the Government has advised that the “augmented” feedstock provisions, previously proposed, will not be incorporated into the final legislation, and that feedstock legislation that currently apply to the R&D tax concession will also apply to the R&D tax credit.

These provisions however, were not included in the ED. It remains unclear how the feedstock provisions will interact with the proposed definitions and, in particular, the requirement that production related activities be undertaken for the dominant purpose of supporting core R&D activities.

The Taxation Institute looks forward to the re-written feedstock rules and anticipate that they will rectify the many short comings of the existing rules without the need for any further scope limitations. The opportunity to comment on these new provisions would be greatly appreciated.

5. Integrity Provisions – expenditure not at risk

The Taxation Institute submits that the legislation to address "expenditure not at risk" in subsection 355-405 is unnecessary. The EM has not provided an example of the potential application of the provision, and in the absence of such information the Taxation Institute is at a loss to foresee a scenario in which it could apply which would not also attract the operation of the many other anti-avoidance and integrity provisions.

In particular we note that the following provisions are available and have a legitimate sphere of operation in the tax credit regime:

- The "on behalf of" test in the condition for R&D activity
- Feedstock provisions
- The dominant purpose test
- Tighter definitions of core and supporting activities
- The arm's length provision
- Part IVA
- Balancing charge provisions
- Exclusion list
- Audit and review procedures

In view of the above and the lack of specific mischief which this provision would protect against we submit that it is not a necessary part of the tax credit regime.

The Taxation Institute is also concerned, that it may be applied in a manner which is currently unintended at some future date. The lack of examples as to its application only further reinforces these concerns.

6. Grouping Rules

The grouping rules within the ED have been aligned with the small business entity provisions under Division 328. These provisions provide that an entity is 'connected with' another entity when there is 40% or higher control of that entity. The current R&D tax concession grouping rules require that control be greater than 50%.

This can result in a company being connected with two companies who each have 40% or higher control of the first company, which under the existing grouping rules would not have considered to be grouped with each other.

This will have a significant impact on the determination of turnover for a small business and, therefore, its entitlement to the refundable 45% R&D tax credit.

In order to achieve the policy objectives of providing increased benefits to SMEs, the Taxation Institute recommends that the grouping rules be retained at the greater than 50% control criteria. The wording used in Item 2 of section 355-100(1) could be used at Item 1 so that it aligns with the exception for exempt entities.

7. Administration

The Taxation Institute notes that the ED appears to give greater powers to Innovation Australia (**IA**) to unilaterally reclassify activities and reject registrations. The Institute is concerned that such wide powers can only be supported by appropriately qualified and trained personnel.

With such tight definitions and requirements to access the tax credit it would be as difficult to decide what does or does not constitute scientifically or technically new information or knowledge, without recourse to the applicants or to industry experts.

The procedure in the past has been to undertake monitoring visits post self-assessment and to gain information from the applicant before making decisions as to eligibility. This will not necessarily be the case under the new ED.

In addition, IA is not required to make any of its decisions or findings within particular time-frames. For example, under section 27A, IA is required to decide whether to register or refuse to register an entity, in contrast to the current legislation which states that “the Board shall register the company” (refer section 39J of the *Industry Research and Development Act* 1986). However, there is no specified timeframe by which it must make, or be deemed to have made, this decision.

According to section 355-700, only findings made within 4 years after the end of a year of income are binding on the Commissioner, there is no provision which details the consequences of no decision being made by IA under section 27A within this 4 year period.

As a company is not entitled to the R&D tax credit unless it is registered in respect of R&D activities, it would appear that a company may lose its entitlement if a decision is never made by IA. That is, it appears that until the IA makes a decision the applicant is at risk of losing its deduction for R&D activities altogether. This is not in line with other income tax assessment processes which deem assessments to be made by the Commissioner on the date of lodgement of its income tax return.

Apart from questions of procedural fairness with respect to individual companies, it is submitted that the extensions of power undermine the attractiveness of the R&D tax credit as an incentive to undertake eligible R&D activities. The process being so complex, difficult and involving the exercise of subjective opinions of AusIndustry staff, it would be a disincentive to the SME sector in particular. This would also seem to contradict the stated policy objective to encourage the SME sector to access this credit.

8. Conclusion

The Taxation Institute acknowledges and welcomes the positive changes made in the second ED as compared with the first draft. However, the ED still contains complexities which are not clearly explained in the EM.

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Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact the Taxation Institute’s Tax Counsel, Angie Ananda on 02 8223 0011.

Yours faithfully

David Williams
President