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19 April 2010

Dear Paul

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

Please find enclosed KPMG's submission in respect of the Research and Development (R&D) Tax Incentive – Second Exposure Draft Legislation and Explanatory Materials released on 31 March 2010.

Whilst we acknowledge Treasury's fiscal constraints, the extreme narrowing of eligibility and added complexity will most likely deliver a substantial windfall to Treasury.

We also acknowledge those areas in which we believe the second Exposure Draft makes progress towards an effective R&D tax credit regime likely to foster the achievement of the government's policy objectives. However, we note that the number and complexity of issues involved are such that a deadline of 19 April prevents the proper in-depth consideration warranted.

In general, we note that the second exposure draft still contains a number of significant qualifications in relation to the definition of R&D activities and complexities as to its operation.

We are, therefore, concerned that the framework outlined therein is unnecessarily restrictive and entirely inconsistent with established R&D incentive norms. As such, the Government is unlikely to achieve its stated policy aims, particularly in relation to small and medium sized enterprises.

We would be pleased to continue to work with you to assist in achieving the Government's stated policy objectives.

Yours sincerely

David H Gelb
Partner

KPMG

R&D Tax Credit Second Exposure Draft Legislation

KPMG submission

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Contents

Executive Summary

Overview

Australia has operated a world-renowned R&D tax regime for the past 25 years, which has delivered great economic and social benefits for Australia.

This has occurred throughout multiple paradigm shifts in technology, particularly those empowered by information technology.

In that sense, the intrinsic elements of what qualifies as R&D has proven to be flexible and adaptable.

In the context of recent Government sanctioned reviews, namely the Productivity Commission and the Cutler Review, there is a unanimous view that, whilst enhancements are desirable, a quantum shift from the status quo is unequivocally unnecessary.

This has been endorsed by a plethora of industry associations and companies in their numerous submissions to the 2009 Consultation Paper and the first draft of the Exposure Draft Legislation.

Notwithstanding this, we do acknowledge that Treasury has concerns on the level of claims for expenditure on R&D, which is of particular importance in the context of the prevailing Budget.

Further, whilst we commend Treasury's intention to ensure the correctness of R&D claims and the attendant compliance processes, there is a strong likelihood that the legislation will not deliver the Government's stated policy.

In other words, our view is that there is a better approach in which the Government can spend $1.4b per annum to incentivise R&D, without imposing undue administrative complexity and costs on companies, particularly SMEs.

In summary, our key points of contention are;

- the proposed revised definition of R&D will create uncertainty, complexity and place undue administrative cost on companies, particularly SMEs; and
- the purported 'softening' of the 'dominant purpose' test for supporting activities should not apply to the 'exclusions list', and its application to 'production activities' will be problematic in practice and we believe inconsistent with the stated policy intent.

We also reiterate that we are willing to work with Treasury to achieve an outcome which will reconcile with the Government's policy intent and Treasury's fiscal constraints.

Introduction

KPMG appreciates the opportunity to comment on the second exposure draft of the Tax Laws Amendment (Research and Development) Bill 2010 (2nd ED) released on 31 March, however we note that the number and complexity of issues involved are such that a deadline of 19 April prevents the proper in-depth consideration warranted, or obtaining sufficient feedback from our client base.

Accordingly, our comments on the 2nd ED in this submission should not necessarily be read as exhaustive.

Limited recognition of applied research and experimental development

The inconsistency of the Explanatory Memorandum (EM) with the 2nd ED is perhaps most obvious and detrimental to the government's policy objectives in its lack of recognition of either applied research or experimental development as a core R&D activity[1]. This is despite these being internationally accepted components of the spectrum of R&D activity as described, for example, in the Frascati manual[2].

As a result, in addition to Australian firms being placed at a competitive disadvantage, as a nation, Australia will be at a disadvantage in attracting multinational companies' R&D expenditure at a time of increased tax competition – contrary to the stated objective of attracting spillover benefits from R&D activity in Australia.

Supporting activities, dominant purpose and production related activities

KPMG also notes with disappointment that not only has the dominant purpose rule for supporting activities from the first Exposure Draft of this legislation released 18 December 2009 (1st ED) been retained in the 2nd ED but that the application of this impractical test has now been extended to exclude any large scale production related activities from supporting activities.

As we noted in our previous submission, the dominant purpose rule would restrict the eligibility of costs incurred on supporting activities to an extent which would severely compromise the R&D tax credit's policy objectives. This problem is only exacerbated by the extension of the dominant purpose test to production related activities - since its practical application in a commercial context would lead to wholesale ineligibility of otherwise bona fide R&D activity worthy of government support.

In addition, due to the complexity of their practical application and the resultant uncertainty, both the dominant purpose and production activity rules would place significant additional compliance burdens on taxpayers. Moreover, this compliance burden will fall most heavily on the small to medium enterprises government policy purports to favour.

As the dominant purpose test is also implicit in the definition of core R&D activities, it would appear that if an activity is undertaken for the dominant purpose of R&D it is likely to satisfy the definition of core activity. Therefore, those activities directly related to, or which are necessary for, the conduct of the core activities, but which are not for the dominant purpose of generating new knowledge are still fundamental to the conduct of R&D and ensure that the core R&D activities can arrive at their logical conclusion.

Whilst we acknowledge that limitations are necessary in order to qualify for Government support, the inclusion of a dominant purpose test – as an additional criteria in respect of production activities – will, in the context of industrial R&D programs, exclude activities genuinely necessary for the conduct of the R&D activities.

Inconsistency between 2nd ED and EM

KPMG has serious concerns with a number of aspects of the proposed legislation and in particular, the policy intent behind its drafting as evidenced by the EM.

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[1] In particular, as evidenced by EM examples 2.4, 2.5 and 2.6
[2] Frascati Manual, OECD, 2002, paragraph 63

The EM appears to limit eligible R&D activities, compromising concepts critical to the achievement of the stated government policy objectives of encouraging innovative risk-taking. The interpretation of the proposed law contained in the EM appears to apply an unnecessarily restrictive interpretation of that law compared with its common, ordinary meaning.

A court of law should only have regard to this extraneous material where the meaning of the legislation itself is unclear. Given the subjective nature of whether activities are R&D or not, the resultant uncertainty created for taxpayers and the potential for the law's administrators to rely on the EM for guidance, KPMG submit that without significant alteration, the combination of the 2nd ED and the EM is unworkable.

Augmented feedstock

We welcome the removal of the augmented feedstock rule contained in the 1st ED which, had it been enacted, would have negated much of the incentive elements of the R&D tax credit. However, at this time, we await further details of the proposed re-writing of the current feedstock rules and their interaction with other elements of the R&D tax credit.

We would welcome an opportunity to review and comment on the new feedstock rules when they are available.

Software

In particular, whilst we have concerns as to the administration of the proposed law, KPMG welcomes the proposed removal of the outdated multiple sale test currently applying to R&D activities involving software development.

As we have noted previously, software development is endemic to virtually all modern economic activity with firms realising associated economic returns from third parties in a variety of ways. Accordingly, KPMG agree that, as a matter of guiding principle, software development should not be treated differently from any other form of R&D activity.

We also appreciate that purely in-house software development does not merit additional government support and would result in significant revenue foregone.

Conclusion

KPMG acknowledges the important progress made in the drafting of the 2nd ED in the removal of the proposed augmented feedstock rules and the necessary alignment of its treatment of software development with other forms of R&D activity.

However, we would stress that the overarching issue of the inconsistency of the EM with the 2nd ED is such that taxpayers and practitioners can have no certainty as to the underlying policy intent of the law nor its application by administrators. The resultant compliance burden on taxpayers, especially SMEs, should be unacceptable for a government keen to encourage innovation.

Combined with the dominant purpose and production activities rules, the interpretative leaps evident in the EM mean that, if enacted, the 2nd ED would leave Australia with an extremely narrow definition of R&D, severely limiting the recognition of applied research and experimental development.

The 2nd ED and EM would effectively create an additional threshold of generating new knowledge from all R&D.

Whilst KPMG acknowledges the government's budgetary constraints and the attendant need for revenue neutrality, it submits that the restrictive approach adopted in the 2nd ED and EM is far from optimal in terms of achieving the stated policy objectives, is unworkable in its current form and requires further revision.

1 Core R&D activities

As an overarching comment, we note that the drafting of the definition of core R&D in section 355-25 is not, of itself, particularly problematic – albeit that we comment below on aspects of that drafting that could improve certainty and encourage risk-taking innovation.

In addition, we note that it is not clear to us why a definition of R&D activities, which has been effective in promoting industrial R&D for over two decades requires such significant changes. The independent reviews undertaken in recent years, including the Cutler Review, did not recommend wholesale changes to the definition but merely refinement and increased guidance as to what constitutes qualifying R&D activities.

1.1 Combination of activities

KPMG, however, has serious concerns with the interpretation of that definition as evidenced in the EM which appears to make an illogical leap from the common ordinary meaning of the draft law itself. As a result, the EM interprets section 355-25 to severely limit the recognition of applied research or experimental development as a core R&D activity.

The definition of core R&D activities and the EM at paragraphs 2.9 and 2.11 acknowledge that core activities are made up of a number of activities which in combination would satisfy the definition. However, the examples provided in the EM, still appear to evaluate the definition on a single activity basis. Whilst we acknowledge that not all situations can be covered in the EM, this type of ambiguity should be resolved. This becomes particularly relevant in determining the boundary between an experimental activity and a supporting activity.

1.2 Innovation

We note that the drafting of section 355-25 removes the explicit requirement of activities exhibiting innovation and that the EM recognises at paragraph 2.18 that innovation is likely to be present in activities involving technical risk. Prima facie, the removal of innovation as a criterion is largely helpful since the determination of an appreciable element of novelty in the current law is a source of subjectivity.

1.3 Established science

In addition, section 355-25 (a) represents a re-wording of the current criteria for high levels of technical risk and as such, has the benefit of maintaining established understanding and practice in this regard.

Where section 355-25 (a)(i) refers to principles of ‘established’ science, we would suggest that in many instances, innovative solutions to problems may involve adapting the use of technology in a manner not necessarily recognised as an ‘established science’ but nevertheless resulting in the advancement of that technology. Accordingly, we would suggest that the word ‘established’ is removed and ‘science’ be extended to ‘science or technology’.

1.4 Generation of new knowledge

Whilst section 355-25(b) primarily replicates the current definition of research and development activities at 73B(1) at (a) (i) and (ii), the second ED now creates an additional requirement for the generation of new knowledge by creating a single composite criteria rather than providing two alternatives. Accordingly, the impact of this change rests on the interpretation of 'generating new knowledge'. This, at best dilutes the eligibility of experimental development work necessary for the creation of new or improved products, processes, materials, etc. This experimental development is the fundamental method which industry provides benefits to the wider Australian economy.

In this regard, the EM states that this requirement will not be satisfied where "experimental activities merely confirm what is already known – even though that knowhow might not exist within the firm" [EM paragraph 2.16].

However, this requirement is not apparent from a reading of the proposed law taking the words at their common, ordinary meaning. The EM's restrictive interpretation implies that in order for the purpose to be eligible, the core R&D activities must have been in the pursuit of universally unknown knowledge.

The test for new knowledge must continue to be knowledge that, at the time the activity commences, either does not exist or, if it does, is inaccessible on commercially acceptable terms after reasonable diligent enquires have been made.

Further, much worthwhile R&D activity which would give rise to spillover effects involves applied research and experimental development. That is, the application of existing knowledge in a novel context.

In the EM (Eco Startup example) even new knowledge created by the company that is then applied, even though for the first time, is treated as a supporting activity.

Australia is great at inventing. Commercialising new ideas is where the assistance of the tax credit is vital to improving its success rate and productivity. However we often lack the critical mass necessary and accordingly, need to be smart in applying, adapting and extending existing technology.

If the definition proposed were to prevail, Australian firms unable to access or afford relevant know-how would be precluded from claiming an R&D tax credit even though they might be engaged in otherwise eligible pure research in pursuit of such knowledge. This would place Australian firms at a marked competitive disadvantage.

Such a requirement would represent a quantum shift in government policy, effectively narrowing the availability of the R&D tax credit to pure research activities such that applied research and experimental development would be largely precluded from eligibility.

Such a definition would be at odds with the definition of R&D in the Frascati Manual[3] and with international norms – placing Australia at odds with other jurisdictions at a time of increased competition for a share of global R&D expenditure by multinational corporations.

In order to avoid this suboptimal policy outcome in respect of 'new knowledge', the EM requires revision to clarify:

- that the definition of new knowledge must have reference to the contextual setting within which the knowledge is sought; and

- that the global existence of knowledge does not preclude its being new to the firm conducting the R&D.

We acknowledge that the application of existing knowledge without technical risk does not represent core R&D. However, the EM requires revision to acknowledge that the application of existing knowledge in a sufficiently novel context represents the generation of new knowledge where it improves materials, products, devices, processes or services such that the improvement represents an increase in knowledge. Notwithstanding a very specific context at example 2.7, in general, the EM implies that such activities would not qualify as core R&D despite their innovative nature.

[3] Frascati Manual, OECD 2002, Paragraph 63

The creation of new or improved materials, products, processes or services should be retained as separate/alternative purpose, to ensure that 'experimental development' activities continue to be encouraged in Australia as they are internationally.

1.5 Determining New Knowledge

The definition of core R&D activities requires that the activities are undertaken for the purpose of "generating new knowledge (including knowledge about the creation of new or improved materials, products, devices, processes or services)".

The evolution of technology can develop at an extremely rapid pace. This is particularly so in the Information Communication and Technology sector, but is also true of most areas of technological advancement in all sectors.

Based on past experience, the assessment of what was "new" at the time the R&D activities are undertaken has been a recurrent cause for dispute in technical reviews and audit activity.

To ensure that an objective and appropriate assessment of the "new" knowledge being generated can be made, it would be beneficial to remove the word "current," from the definition as it is not sufficiently specific to determine a precise point in time. The word "current" is open to being misconstrued as "contemporaneous with the assessment".

As an alternative, the phrase "available at the time the activities are being undertaken" could be inserted after the words "knowledge, information or experience". This would provide some certainty that the assessment of what is "new" is considered at the time the core R&D activities are being undertaken.

Given that the assessment period allowed for determining compliance with the definition can be up to four years, the influence of hindsight can, and does, substantially influence the process of assessment. This is particularly so after technologies have been well accepted and integrated into common usage.

Our concern, therefore, is to ensure that no dispute can arise as to the point in time at which the technology is considered to be "new".

As stated above, this determination should also be made on the basis of knowledge which is commercially available to the company.

1.6 Scope of Experimental Activities

As generally understood, an experiment would start with a hypothesis, include a range of activities to test and trial that hypothesis (therefore, by definition, also all experimental activities in their own right), followed by observation and evaluation of outcomes, before determination of a final conclusion, which will represent new knowledge.

Everything done within that systematic progression of work must then, by definition, be an experimental activity because it comprises part of that experiment.

However, the EM raises the serious concern (or potential confusion) in this regard 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."* [EM paragraph 2.23]

That statement then raises the question as to why an *activity*, which is not only part of an *experiment* but is an absolutely essential part of it, "will not fall within the scope of [that] experiment".

1.7 Language and Terminology used in the EM

As an aid to clarification, the EM should not use language and terminology which is defined in a particular way in the ED, in a contrary or confusing manner. For instance, the definition of core activities includes the phrase "hypothesis to

experiment, observation and evaluation, and leads to logical conclusion". The definition clearly implies that an experiment is part of the core activities. However the EM continually implies that an "experiment" is the whole of a core activity.

In particular at paragraphs 2.11 and 2.22, the EM describes the core activities as being part of an experiment. The use of the term experiment in the EM in this manner, and as a subset of core activities within the definition does not aid in the interpretative clarity of the ED.

It appears that, the EM is using the term 'experiment' instead of the term 'experimental activities'.

2 Supporting activities and production

KPMG notes with disappointment that despite the widespread concern expressed by industry and practitioners in response to the 1st ED, the dominant purpose rule in respect of supporting activities has been retained in the 2nd ED.

As noted in our submission on the 1st ED, we submit that the practical application of this rule will lead to restriction of otherwise worthy claims, and increased complexity and compliance burdens – particularly for SMEs:

> "The need to distinguish between core and supporting activities adds an unnecessary layer of complexity to the R&D tax credit. Where an activity is undertaken for both R&D and another purpose it will be difficult to differentiate. However, it is reasonably straightforward to determine if the activity was necessary for the conduct of the R&D, e.g. if it was required to enable testing activities to be conducted.
>
> There is a commercial reality which is not contemplated with the concept of dominant purpose. With limited resources, businesses will often undertake tasks for more than one purpose to maximize their return. In particular, small and medium sized companies do not have the luxury to undertake R&D activities in isolation from their operational activities.
>
> The dominant purpose test focuses on pure research typically seen in a university setting, where production trials are far less common, and research is done in isolation. During the course of industrial R&D it is imperative to gauge the limitations or needs of the production environment. The dominant purpose concept does not allow for the commercial and R&D realities that companies operate under and in fact, penalizes good business practice[4]."

2.1 Production related activities

Whilst the augmented feedstock rule has not been retained in the 2nd ED, it appears that the government has chosen to achieve a similar outcome through the extension of the dominant purpose rule to production related activities.

In addition to the abovementioned difficulties of applying the dominant purpose test, the production related activities rule will give rise to still greater uncertainty for taxpayers.

- "Goods" and "services" are very broad terms with potentially limitless meanings - as the case law relating to the Goods and Services Tax (GST) will attest;

[4] KPMG Submission on R&D Tax Credit Exposure Draft Legislation 5 February 2010

- There is little direction as to the nature or extent of the required nexus between the activity and the production in question to determine whether an activity might be 'directly related' to the production of goods and services; and

- The rules may operate to exclude activities that are truly part of the "logical progression" of the scientific method from being claimable as a result. For example, pre-production trialling.

KPMG submits that the application of the dominant purpose rule to production related activities will only further penalise R&D carried out in anything other than a pure research context. This is consistent with the apparent bias of the EM toward an interpretation of core R&D which provides very limited recognition of applied research and experimental development and is likely to be counter-productive to the government's policy objectives.

If the policy objective is to prevent the inclusion of 'business as usual' costs in supporting activities then a more specific limitation such as restrictions to the time-scale of long term production trials should be considered. We would be happy to explore this further with you.

We are also concerned that the interaction of the dominant purpose test and the proposed feedstock provisions will eliminate any support even for those activities which satisfy the dominant purpose test and yet still result, perhaps fortuitously, in a product with some value.

2.2 Excluded activities

There is also no justification for the application of dominant purpose to the activities listed in section 355-30 ('excluded activities').

The list of excluded activities has not been highlighted by independent reviews or by the Government as being an area of concern or excessive claims.

The listed activities are either unlikely to be related to eligible R&D activities (e.g. making donations), or clarifications of activities which are necessary to the undertaking of R&D activities (e.g. collection of information as part of another R&D activity).

As these listed excluded activities are more likely to be undertaken within a commercial environment, the dominant purpose test will adversely impact those activities more than others. The fact that these activities are directly related to core R&D activities should suffice to ensure that 'genuine' R&D activities qualify for the R&D tax credit.

3 Software

KPMG welcomes the removal of the multiple-sale test and the rules proposed in the 1st ED. We agree with the principle espoused in the EM that R&D activity involving software development should not be treated any differently to any other form of R&D activity. Firms recognise economic returns from software development in a variety of ways, often in an indirect manner which does not involve licensing of intellectual property rights to third parties.

We also note that 355-30 (o) has been drafted in simple terms and agree that this is necessary given the pace of change in software technology. However, given the relative lack of guidance in the EM, we are concerned that further guidelines are required for taxpayers and administrators to have reasonable certainty as to the law's application. These should be written in consultation with industry associations who deal with a range of companies

In addition, we question the use of the term 'primarily' as the threshold for ineligibility. This would appear to be something less than a 'dominant' purpose but the EM provides little guidance in this regard. In any event, the concept introduces a further element of subjectivity and therefore uncertainty and complexity to compliance.

We submit that 'primarily' should be removed from paragraph 355-30(0) of the ED.

4 Feedstock

Whilst KPMG welcomes the removal of the 'augmented' feedstock rules proposed in the first ED, it is difficult to comment fully on the proposal to retain the existing feedstock provisions as the interactions with the revised definition of R&D activities is not clear.

KPMG remains concerned that the requirement for a dominant purpose for both core R&D and many supporting R&D activities in conjunction with feedstock provisions will still penalise successful R&D activities.

Clear guidance as to how these provisions will operate and interact with each other is sought. We reserve any further comments in respect of this until the materials on the proposed feedstock provisions have been released.

5 Not at risk

KPMG submits that the legislation to address "expenditure not at risk" in sub-section 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 we are 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 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 arms 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.

We also have some concern, in view of recent experiences, 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 Administration

We note that the ED appears to give greater powers to Innovation Australia (IA) to unilaterally reclassify activities and reject registrations. We are 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 difficult to decide what constitutes scientifically or technically new information or knowledge, without recourse to the applicants or to industry experts.

The procedures in the past have been to undertake monitoring visits, post self-assessment, 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 the proposed section 27A of the Industry Research and Development Act 1986 (IR&D Act), 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"[5]. However, there is no specified timeframe by which it must make, or be deemed to have made, this decision.

Further, section 355-700 states that only findings made within 4 years after the end of a year of income are binding on the Commissioner, yet 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, until the IA makes a decision to register for the R&D Tax Credit the applicant is at risk of losing its deduction for R&D activity altogether. This is not in line with other income tax assessment processes which deem an assessment to be made by the Commissioner on the date of lodgement of its income tax return.

The administration of tax laws require certainty in application, this certainty is currently substantially undermined by the administrative procedures. Companies without a confirmed registration, for any length of time, may be unable to recognise the benefit in their accounts, as until formal registration there would be no certainty of obtaining a tax benefit.

The registration process should align with the income tax self assessment process. For income tax a company is deemed to have received an assessment of its taxable income upon lodgement of its income tax return[6]. Under a self-assessment regime, a company should also be deemed to be registered in respect of R&D activities upon lodgement of its Application for Registration. IA would then have 4 years to review, and amend this registration, similar to the powers that the Commissioner has in respect of assessments of taxable income.

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[5] Section 39J of the *Industry Research and Development Act* 1986
[6] Section 166A of the Income Tax Assessment Act 1936

An open-ended timeframe for making a decision in relation to registration is not equitable to the R&D claimant, and unworkable in practice.

The capability to reclassify activities as core or supporting R&D activities at the time of registration is, we submit, also unnecessary in a self-assessment regime. The Commissioner does not reclassify repairs and maintenance expenditure as capital expenditure upon lodgement of a company's income tax return. Instead a risk assessment and audit program should be implemented to ensure that registered activities qualify as R&D activities.

Aside from such questions of procedural fairness, it is submitted that these extensions of power undermine the attractiveness of the R&D tax credit as an incentive to undertake eligible R&D activities. A process so complex, difficult and involving the exercise of subjective opinions of AusIndustry staff, would, in our opinion, be a disincentive, particularly to the SME sector, contrary to the stated policy objective of encouraging that sector's access to the tax credit.

6.1 Notification of Findings and Decisions

We are concerned that whilst IA is required to notify the company and the Commissioner of its findings or decisions, its failure to do so does not affect their validity.

We acknowledge that it is likely to be an unintentional oversight for IA not to provide such notification, however it is impossible for either the company or the Commissioner to comply with such findings or decisions if notification is not made.

In addition, where reasons are required to be given, the decision should not remain valid if reasons are not provided.

The relevant paragraphs in sections 27J, 28C and 30B should be removed.

6.2 Single Entity – Registration requirements

We welcome the alignment of the tax and R&D registration treatment of tax consolidated groups The provision of a single registration for the head entity of a consolidated group covering all entities whilst they are subsidiary members of that group is acknowledged as a simplification of the R&D Registration process.

6.3 Approved Forms and Substantiation

Given the significant changes to the definition of R&D activities, our clients would welcome increased guidance on the level of acceptable substantiation, particularly in respect of distinguishing between core and supporting R&D activities and satisfaction of dominant purpose, if retained.

In addition, public review of the proposed approved forms would be welcomed.

7 Other

7.1 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 a 40 percent or higher control of that entity. The current R&D tax concession grouping rules require that control be greater than 50 percent.

This can result in a company being connected with two companies who each have 40 percent 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 percent R&D tax credit.

To achieve the policy objectives of providing increased benefits to small and medium enterprises, KPMG recommends that the grouping rules be retained at the greater than 50 percent 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.

7.2 Overseas Activities

The ability to claim R&D activities overseas is currently dependent on satisfying the conditions for a preliminary certificate which is issued by IA. This involves a lengthy inquiry into the reasons for the activities being done offshore as well as the nature of the activities themselves.

Even when all the conditions for the issue of a certificate are met the overall claim for overseas R&D activities is limited to the 10per cent of the overall onshore R&D expense. This cap no longer exists in the new rules, being replaced by a limit on overseas expenses up to the amount of Australian R&D expenses. That is, overseas expenditure must be less than the Australian R&D expenditure.

Whilst it appears at first reading that up to 49 percent of the total R&D activities may be performed overseas, the limitation itself is listed as a condition in sub-section 28BA(5) of the IR&D Act.

The position therefore needs to be clarified. Whether it is a condition for eligibility that the R&D done offshore is less than the Australian R&D, or whether this is intended to be the proportion of offshore activities which qualifies for the R&D Tax Credit, therefore being effectively capped at 49 percent of the total experimental activities.

We recommend that the EM should provide clear guidance as to the intent of the provisions dealing with overseas R&D activities, including clear examples of the calculations required.

7.3 Recoupment

The policy underlying this provision is unduly penal and, in some cases, enterprises can be left worse off than if they had received a grant or recoupment in a totally non-concessionary tax environment.

It is submitted that qualifying self-funded R&D expenditure should properly be eligible for the standard relevant rates of tax offset, as applicable in the usual case. This should be effected by prescribing a rate of additional income tax payable under the Subdivision on all or part of a recoupment to be 10 percent instead of the proposed 20 percent.

The object of the provision should be to neutralise or claw-back any potential concession for expenditure on R&D activities funded by a government grant or recoupment.

However, the provision goes further. It denies the concession not only for R&D expenditure incurred up to the amount of any grant or recoupment, the tax concession will be denied until an enterprise spends at least double the amount of any money it effectively recoups.

The EM attempts to rationalise this by arguing that, if $2 is spent on R&D activities and $1 is received as grant or subsidy, that $1 grant or recoupment nevertheless represents a benefit in respect of the entire $2 of expenditure – i.e. therefore, representing an initial "benefit" for the $1 that the enterprise has funded itself.

It is on this questionable premise that the EM goes on to conclude, that to allow a tax offset for that self-funded component of R&D expenditure (as would normally be available), would then be tantamount to actually providing a secondary benefit for that expenditure, in order to justify clawing back that benefit. Any tax offset for the $1 of recouped expenditure, itself, is then said to amount to a 'triple benefit', which also then needs to be clawed back.

The unreasonable effect of this Subdivision is not limited to clawing back of the normal tax offset available to an enterprise for qualifying, self-funded R&D expenditure.

In the event that an enterprise spends less than double the amount of any grant or recoupment, it appears to be left worse off than if there was no R&D tax concession at all. For example:

$	**Expenditure**	**Deduction/ Offset**	**Recoupment**	**Tax Payable**	**Net Cash**
No Concession	(100)	30	100	(30)	0
R&D concession (ED)	(100)	40	100	(50)*	**(10)**

*Comprises standard 30 percent tax plus 20 percent "additional" recoupment tax

Under the existing 'clawback' provisions the claimant is not penalised for receiving a grant but is set to a new trial position.

Contact us

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