



Australian Government

The Treasury

The new research and development tax incentive

Consultation paper

September 2009

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TABLE OF CONTENTS

- THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE 1**
- Introduction 1
- Implementation..... 1
- The case for reform..... 2
- Access to the new incentive 3
 - Companies incorporated in Australia 3
 - R&D to be conducted in Australia..... 4
 - Location of IP ownership not relevant 4
- The new R&D Tax Credits 5
 - Standard R&D Tax Credit 5
 - Refundable R&D Tax Credit..... 6
 - Non-enhanced deductions 6
 - Payments to associates 7
- Administration..... 7
- Eligible R&D activity 8
 - What is R&D?..... 9
 - Core R&D 9
 - Supporting R&D..... 10
 - Excluded activities 13
 - Software..... 13
- Summary..... 14

CONSULTATION PROCESS

The Government is seeking feedback and comments on options outlined in this paper. The options have not received Government approval and are not law. Feedback and comments received will help to inform the Government's proposed approach on the way forward.

Making a submission

Submissions on this paper are requested by: **Monday, 26 October 2009**

Submissions can be sent to:

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While you may lodge your submission electronically or by post, Treasury prefers electronic lodgement. For accessibility reasons, please email responses in a Word or RTF format. You are welcome to submit an additional PDF version.

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THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

INTRODUCTION

1. In the 2009-10 Budget, the Government announced it would replace the existing research and development (R&D) tax concession with a new, more streamlined R&D tax incentive from 1 July 2010.
2. The two core components of the new incentive are: a non-refundable 40 per cent Standard R&D Tax Credit; and a 45 per cent Refundable R&D Tax Credit for companies with a turnover of less than \$20 million. Accompanying this will be a tighter definition of eligible R&D activity. The Government indicated it would issue a consultation paper on this issue.
3. The Government has identified some high-level principles that will guide the implementation of the new R&D tax incentive. Underneath these principles there are a range of more detailed design features yet to be settled. In relation to these issues, there are questions as to how the Government could proceed which stakeholders are encouraged to consider. Feedback and comments on these principles and questions will inform further decisions.
4. This paper details some aspects of the new R&D tax incentive not canvassed in the original announcement. However, it does not cover every detail that stakeholders may be interested in. Exposure draft legislation will cover this when it is released for comment later in the year. Notwithstanding this, stakeholders can raise issues not covered in this paper if they would like to bring these to the Government's attention.
5. Feedback and comments are invited on elements of the existing scheme that require alteration or clarification as part of the transition to the new scheme.

IMPLEMENTATION

6. Submissions on this paper close on Monday, 26 October 2009. The Government will then prepare exposure draft legislation and explanatory materials that will be released for comment later in the year.
7. The Government intends to introduce legislation into the Parliament in early 2010.¹ The new legislation will apply to all income years commencing after 30 June 2010 and apply to both new and existing R&D activities.

1 Consistent with moving the tax law into a single act, legislation for the new R&D tax incentive will be placed in the *Income Tax Assessment Act 1997* (ITAA 1997). The current R&D tax concession is governed by extensive provisions in the *Income Tax Assessment Act 1936* (ITAA 1936). Any existing provisions in the ITAA 1936 that are retained for the new scheme will be reworded. The *Industry Research and Development Act 1986* (IR&D Act) will be rewritten to accommodate the new scheme and provide a more robust self assessment framework.

THE CASE FOR REFORM

8. The new R&D tax incentive will be more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community.
9. As recommended by the Review of the National Innovation System (the NIS Review), the existing scheme of enhanced deductions will be replaced with less complex and more predictable tax credits. Companies will no longer need to distinguish between their base and incremental expenditure on R&D in working out their claim. It is the location of R&D activity in Australia that will count under the new scheme rather than where the resulting intellectual property (IP) rights reside.
10. As shown in Table 1, both elements of the new R&D tax incentive are more generous than the current 125 per cent R&D tax concession. However, the new R&D tax incentive intentionally redistributes support in favour of small and medium sized businesses which are more responsive to fiscal incentives.
11. The current definition of eligible R&D activity is allowing claims to be made for activities where there is not a strong rationale for public support. In the absence of Government action, these claims are likely to continue and to increase. Attachment A presents some examples, based closely on real cases, which are representative of the sorts of claims of questionable merit that can be allowed under the current scheme.
12. More fundamentally, an effective R&D tax incentive needs to result in firms conducting R&D that they would otherwise not perform because they cannot capture sufficient benefits from the activity to justify an investment. That is, although the benefits of the R&D activity 'spillover' to the rest of the community, it is not commercially sensible for any one individual company to invest.
13. Reviewing the definition of eligible R&D activity, in the context of moving to a tax credit structure, was also a recommendation of the NIS Review.
14. The new R&D incentive will be funded by abolishing the current scheme and by tightening eligibility for the new R&D incentive. On an underlying cash basis, implementation of the new R&D tax incentive is to be revenue neutral over its first four years of operation. It is therefore important, that the different elements of the package should be considered as a whole, rather than in isolation.

Table 1: The tax benefits of credits and deductions

A deduction has the effect of reducing a company's taxable income. The 'tax benefit' from this reduction in liability would be the tax saved. A tax credit, or offset, reduces the amount of tax payable.

At the current company tax rate, the equivalent to a 100 per cent tax deduction is a 30 per cent tax credit. The new R&D tax incentive will decouple the tax benefit from the company tax rate.

A tax credit of ...	Is equivalent to a tax deduction of ...
45 per cent	150 per cent
40 per cent	133 per cent
37.5 per cent	125 per cent

ACCESS TO THE NEW INCENTIVE

Principle 1

The new R&D tax incentive will be available to companies incorporated in Australia for R&D conducted in Australia. Location of ownership of the resulting IP will not be relevant.

Companies incorporated in Australia

15. The Government will support eligible R&D activities undertaken in Australia by Australian incorporated firms.
16. Firms that have a grouped turnover of less than \$20 million will be eligible to access the 45 per cent Refundable R&D Tax Credit. Firms that have a grouped turnover of \$20 million or more will be eligible to access the 40 per cent Standard R&D Tax Credit.
17. This means that both elements of the new R&D tax incentive will be available to:
 - Australian-owned companies incorporated in Australia; and
 - foreign-owned companies incorporated in Australia.
18. Foreign companies will not be eligible for the new R&D tax incentive, consistent with the current scheme. The requirement to establish a local company is not onerous and avoids the need to determine what constitutes the equivalent of an Australian company in various foreign jurisdictions.
19. Only companies will be eligible for the new R&D tax incentive. Generally, an entity that is treated as a company in the tax law will be treated as a company for the new R&D tax incentive. Extending eligibility to other entities would create significant integrity and administrative issues, especially in the area of trusts.

Grouping rules

20. Grouping rules will apply in the context of relevant thresholds for the new R&D tax incentive as they do under the current scheme. References to a 'company' in this context should be read as 'company group'.
21. Grouping rules provide integrity to the provisions by ensuring that company groups do not split up their activities to increase the number of companies that can claim the refundable concession, which is only intended for smaller firms.

Tax exempt entities

22. The new Refundable R&D Tax Credit will be open to companies with up to 50 per cent ownership by exempt entities (such as universities). This is double the 25 per cent cap that exists under the current R&D Tax Offset. This will encourage collaboration between those entities and small firms while still providing some protection against the R&D Tax Credit being used to fund non-business R&D (that receive public support through other programs).

R&D to be conducted in Australia

Question 1

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

23. Under the new R&D tax incentive, the general rule will be that eligible R&D activity must be conducted in Australia. The Government will consider whether the limited exceptions to this rule that apply under the current scheme should be retained.
24. Under the current R&D tax concession, a claim in relation to Australian-owned R&D can include R&D conducted overseas where the activities cannot be conducted domestically and provided it does not exceed 10 per cent of the claimed expenditure. This is intended to provide a balance between encouraging R&D in cases where the activity cannot be undertaken solely in Australia and targeted support at activities that are most likely to generate benefits that spillover into the Australian economy.
25. The current R&D tax concession is not available at all for foreign-owned R&D conducted overseas.² Under the current scheme, if part of an otherwise eligible R&D project is conducted overseas, the core R&D must be undertaken in Australia for any of the Australian-located R&D to be itself eligible. This restriction is intended to help ensure Australia benefits appropriately from foreign-owned R&D that is subsidised by Australian taxpayers.
26. The Government could allow a company to claim expenditure in relation to R&D to be conducted overseas provided some R&D has been undertaken in Australia first. Alternatively, the Government could apply the general rule – that eligible R&D activity must be conducted in Australia – without any exceptions.
27. The merit of retaining any of the existing requirements around the use of Australian products and personnel will be reviewed further in the course of developing exposure draft legislation for the new scheme.

Location of IP ownership not relevant

28. The new R&D tax incentive will not consider whether IP from an eligible R&D activity is owned in Australia or overseas.³ It will only consider where and on whose behalf the R&D is conducted and where the company is incorporated.
29. Australian companies undertaking R&D which results in IP owned overseas currently face restrictions in accessing the current R&D tax concession. For example, although they have access to the 175 per cent International Incremental Concession, they receive only a 100 per cent deduction for expenditure that would receive the 125 per cent R&D Tax Concession if the IP was Australian-owned. Expenditure on foreign-owned R&D is currently also ineligible for the R&D Tax Offset.

² To the extent that foreign-owned R&D is eligible for the current R&D tax concession, it is under the more restrictive rules of the 175 per cent International Incremental Concession.

³ [Attachment B](#) compares the implications of company and IP ownership under the new and existing schemes.

30. Foreign-owned R&D will not be precluded from either the Standard or Refundable R&D Tax Credit.⁴ Further, the definition of eligible R&D expenditure will be the same for Australian-owned and foreign-owned companies.

The 'on own behalf' rules

31. The new R&D tax incentive will retain the rule that a company can only claim eligible R&D activities conducted by the company or on its behalf. This rule enables the appropriate claimant to be identified, and prevents the duplication of claims where R&D is contracted out.
32. An entitlement to claim the current R&D tax concession lies with the company in whose substantial interests the R&D is carried out. This is tested by reference to the weighing up of three key criteria, namely who:
- bears the financial risk associated with a R&D project;
 - has control over the R&D project; and
 - effectively owns the project results.
33. The new scheme will also retain the exception to the 'on own behalf' rules that currently exists for foreign-owned R&D. An Australian company can, subject to certain requirements being met, claim the R&D Tax Concession for R&D carried out on behalf of a grouped foreign associate in a treaty country. Normal transfer pricing rules will apply where the IP is made available to the foreign associate.
34. The new R&D tax incentive will also retain the rule that where R&D is exploited, it must be done so on commercial terms. This prevents firms doing R&D ostensibly on their own behalf, but then transferring the results to an entity that would be unable to claim the incentive.

THE NEW R&D TAX CREDITS

Standard R&D Tax Credit

Principle 2

The Standard R&D Tax Credit will be available at a rate of 40 per cent for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero.

35. The Standard R&D Tax Credit will be available to companies at a rate of 40 per cent for expenditure on eligible R&D activities. It will take the form of a tax offset that can be carried forward under Division 65 of the ITAA 1997. If a company's income tax liability is zero, unused offset amounts cannot be applied to reduce other tax liabilities (such as GST). However, any unused amounts can (subject to integrity rules) be carried forward

⁴ IP ownership may continue to be relevant in the limited circumstances that the R&D is conducted overseas (assuming that an exception to the general rule that R&D be conducted in Australia continues to apply).

to be applied against future income tax liabilities in accordance with Division 65 of the ITAA 1997. Carried forward amounts will result in a similar outcome to a carryforward loss arising from a tax deduction under the existing R&D tax concession.

36. Division 63 of the ITAA 1997 provides a set of common rules for tax offsets, including the order tax offsets must be applied to reduce a taxpayer's income tax liability. The Standard R&D Tax Credit will be applied after 'use it or lose it' tax offsets (such as the tax offset for foreign income tax under Division 770) and before refundable tax offsets (including the Refundable R&D Tax Credit).

Refundable R&D Tax Credit

Principle 3

The Refundable R&D Tax Credit will be available to companies with a turnover of less than \$20 million at a rate of 45 per cent for eligible R&D expenditure.

37. Companies with a group turnover of less than \$20 million will have access to a Refundable R&D Tax Credit at a rate of 45 per cent of expenditure on eligible R&D activities. This will take the form of a 'refundable' tax offset under Division 67 of the ITAA 1997, similar to the treatment of the current R&D Tax Offset under Subsection 67-25(3). If a taxpayer's income tax liability is reduced to zero, the unused refundable tax offset amount can be applied to reduce other tax liabilities (such as GST). Any residual unused amounts can be refunded as cash to the company.
38. Companies can only access refunds after their tax assessment is completed. The Australian Taxation Office (ATO) in conjunction with AusIndustry will apply appropriate risk management procedures before issuing refunds.

Non-enhanced deductions

Question 2

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

39. The Government is yet to decide how the new R&D tax incentive will treat expenditure on R&D that currently receives a non-enhanced (100 per cent) deduction (namely, interest, residual feedstock, allowable core technology and expenditure that is not 'at risk'). One approach would be to provide an equivalent level of support under the new arrangements by allowing companies to access a non-refundable tax credit on these expenditures at the prevailing company tax rate (currently 30 per cent).
40. The current R&D Tax Offset allows companies to cash out expenditure that would be deductible at the non-enhanced rate. Given the significantly expanded access to the new Refundable R&D Tax Credit, it may be inappropriate to continue this practice. That is, a tax credit for expenditure that currently receives a non-enhanced deduction could be non-refundable for all companies rather than refundable for those companies that are able to access the Refundable R&D Tax Credit. However, this approach could also add an undesirable level of complexity to the new scheme.

41. While there is some benefit to handling these expenditures in the R&D system⁵, consideration could also be given to excluding them entirely and leaving these expenses to be deducted under the normal tax rules.

Payments to associates

Question 3

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

42. The Government is yet to decide how expenditures incurred to associate entities will be treated. Under the current arrangements, expenditure on R&D is incurred under accrual accounting principles. Consequently, cash refunds have been paid on amounts for which the taxpayer is yet to make an actual cash outlay. Accrual payments to associate entities can result in tax offsets years before taxable receipts are reported.
43. The Government could mandate that expenditure incurred to associates can only be claimed where they are paid in cash. Alternatively, the Government could allow the amount to be claimed in a later year when paid, with companies having the option to make a permanent election in their initial tax return after the scheme commences to forego the new R&D tax incentive for non-cash expenditure to associates and simply claim tax deductions in accordance with the normal income tax rules. Integrity rules would still apply to ensure that such non-cash expenditures are genuinely incurred.

ADMINISTRATION

Principle 4

Legislation for the new R&D tax incentive will provide support for the scheme's efficient and effective administration.

44. Legislation for the new R&D tax incentive will provide an administrative framework that balances the ability of claimants to self-assess their eligibility and entitlements and the scope for administrators to ensure compliance. The compliance framework will be transparent, consistent and ensure timely service delivery.
45. The joint administration model will continue to apply to the new R&D tax incentive. The Innovation Australia Board (a group of independent experts assisted by AusIndustry) will continue to assess whether an activity is eligible R&D. The ATO will continue to determine whether an amount of expenditure is validly incurred on that activity.

5 For example, in the case of core technology, the deductions are tied more closely to near-term usage of the technology, which will often be a more generous tax treatment than under the normal rules for depreciating assets under Division 40 of the ITAA 1997.

46. Coordination of these roles will be important. Because the new R&D tax incentive will work on a self-assessment basis, Innovation Australia and AusIndustry will be empowered to adopt a more active approach to their role. The administrative rules for the current R&D tax concession will be rewritten to ensure that, in administering the new R&D tax incentive the ATO, Innovation Australia and AusIndustry are together able to:
- provide appropriate levels of guidance and certainty to claimants;
 - receive and share the necessary information to monitor the operation of the program, focus their compliance efforts and assess the validity of claims;
 - respond to questionable registrations and claims;
 - conduct appropriate upfront compliance checks – particularly where cash refunds are involved; and
 - perform their functions in a timely manner.
47. The new R&D tax incentive will require companies to distinguish between core and supporting R&D. However, companies also will be able to draw on more extensive guidance material (from both the new legislation and guidance issued by the administrators) than is currently available.

ELIGIBLE R&D ACTIVITY

Principle 5

The new R&D tax incentive should target R&D that:

- (a) is in addition to what otherwise would have occurred; and
- (b) provides spillovers – benefits that are shared by other firms and the community – that are large relative to the associated subsidy.

48. A public subsidy for R&D should generate additional R&D activity with benefits that spillover to other firms and the community. This ‘additionality and spillovers’ test applies to the new R&D tax incentive as a whole, rather than individual R&D activities.
49. In a broad-based entitlement scheme that allows claimants to self-assess, administrators cannot practically assess whether individual activities provide spillovers and whether the R&D would have occurred in the absence of a subsidy. However, the principle of additionality and spillovers will underpin the design of the rules for what activities will be eligible for the new R&D tax incentive.
50. The Government appreciates that previous attempts at tightening the definition of eligible R&D activity under the current scheme were contentious and that some stakeholders are satisfied with the current definition. However, a new definition of eligible R&D activity is an essential component of the new R&D tax incentive package. Without it, the Government cannot afford to proceed with the incentive at the current rates and turnover threshold and would continue to leave the Budget exposed to lower value-add claims.

What is R&D?

51. Subsection 73B(1) of the ITAA 1936 separates R&D into core and supporting activities.⁶ *Core activities* are systematic, investigative and experimental (SIE), of which experimental is the most significant element. SIE activities involve innovation or high levels of technical risk and are carried on for the purpose of:

- acquiring new knowledge (whether or not that knowledge has a specific practical application); or
- creating new or improved materials, products, devices, processes or services.

Supporting activities are carried on for a purpose directly related to carrying on core R&D.

Core R&D

Principle 6

Eligible R&D activity will be defined as systematic, investigative and experimental activity that:

- (a) involves both innovation and high levels of technical risk; and
- (b) is for the purpose of producing new knowledge or improvements.

52. The definition of core R&D will not alter the SIE or purpose requirements. However, the Government's current intention is that the definition of core R&D will require SIE activities to be both innovative and technically risky. These conditions go more to the heart of why a subsidy for R&D is warranted. The absence of either of these factors reduces the likelihood the activity will produce spillover benefits and be in addition to what would otherwise occur.

53. Innovation is one of the ways in which companies seek to differentiate themselves from their competitors and improve profitability. There is a level of innovation that will occur in the absence of a subsidy. Similarly, companies routinely make commercial judgements about undertaking activities that involve technical risk based on the probability of success, the benefits of success and the costs involved.

54. Subsidising an activity that is innovative but not risky may, at the margins, lead to additional R&D with benefits extending beyond an individual company. However, it is more likely to do no more than subsidise a company for doing what is already commercially sensible. Similarly, a subsidy for activities that involve high levels of technical risk but are not inherently innovative may lead to additional activity but is unlikely to deliver benefits beyond an individual company.

⁶ This definition is predominantly derived from the Frascati Manual which provides a methodology for collecting and using statistics about R&D in OECD countries.

An illustration of innovative and technically risky activity

An Australian company faced a problem that was preventing them from growing their business. Current industry technology and expertise could not provide the solution from available knowledge. The company undertook a program of research and development and created a new device that solved the technical problem. The device was innovative because it was novel. The activities involved technical risk as a solution was not predictable from current knowledge.

The benefits from this innovation will 'spillover' to other companies, by demonstrating what is achievable and through staff moving on with knowledge of how to solve similar problems. However, the company would not have taken those benefits into account when deciding whether the benefits of success justified the risk and outlay in undertaking the R&D.

By subsidising the cost faced by the company, the R&D tax incentive encourages them to proceed with the R&D activities in the face of the financial risk involved, ensuring that the spillover benefits were enjoyed by the wider community.

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

Supporting R&D

Principle 7

Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

56. Companies will continue to be able to claim supporting (or non-core) activities under the new R&D tax incentive. This recognises that some supporting activities are required in order for a company to undertake core R&D. Whatever form it takes, any new approach to supporting R&D will be more stringent than the current rules.
57. Currently, a small amount of core R&D can trigger an entitlement to claim large amounts of supporting activities. These concerns are exacerbated where the amount of supporting activity being subsidised is also a significant part of the cost of a related commercial activity. Companies are not required to distinguish between core and supporting R&D in making a claim under the current scheme. However, it is understood that a considerable portion of the current R&D tax concession subsidises supporting rather than core activities.
58. In some cases, supporting activities could themselves produce additional spillover benefits in their own right. However, under the current rules, R&D activities involving large amounts of supporting activities can attract subsidies that are out of proportion to the public benefit.

Question 4

Should supporting activities:

- (a) be capped as a proportion of expenditure on core R&D?
 - (i) If so, what would be the appropriate proportion (for example, 1:1)?
- (b) only be eligible where they are for the sole purpose of supporting core R&D activity?
- (c) exclude production activities or dual role activities?
- (d) only be eligible on a net expenditure basis?
- (e) attract a lower rate of assistance than core R&D?
 - (i) If so, what would be the appropriate rate be?

Capped as a proportion to core R&D

- 59. Capping eligible supporting activity expenditure at a percentage of core R&D expenditure would help address concerns about the relative size of claims for supporting and core R&D activity.
- 60. This approach would set a limit on claims in relation to supporting activity but a limit determined by the company's expenditure on core R&D. If adopted, an appropriate rate would need to be chosen. For example, claims for support activity could be capped at 100 per cent of core R&D expenditure (or some other rate).

Sole purpose test

- 61. A more direct approach would be to adjust the current definition of supporting R&D activities⁷ from:
 - other activities that are carried on for a purpose directly related to the carrying on of [core activities];
 - to
 - other activities that are carried on for the sole purpose of supporting the carrying on of [core activities].
- 62. This would establish a positive test for activities to meet in order to qualify for the R&D tax incentive. Activities that are undertaken partly for non-R&D purposes – such as current production activities – would not qualify for the incentive.⁸

⁷ Part of the definition of R&D activities at subsection 73B(1) of the ITAA 1936.

⁸ The fact that R&D is ultimately targeted at a commercial benefit from the new products or processes developed would not breach this sole purpose test.

63. A variation on this approach would be to require that the support activity be 'predominately' for the purpose of supporting a core R&D activity (that is, something less than the sole purpose but still the leading purpose). This would make some allowance for supporting activities to serve an incidental production role.

Excluding production and dual purpose activities

64. Rather than prescribe a sole purpose test, activities with a purpose other than R&D could be excluded. The United Kingdom and Canada use this approach, noting that they also have different administration arrangements.
65. Production activities have the prospect of producing goods or services for supply to customers. This includes products such as saleable prototypes. Dual role activities have a role other than R&D, such as production or corporate services. These activities would not be considered R&D.

Net expenditure only

66. A net expenditure or 'recoupment' approach identifies the net cost of an eligible R&D activity, to subsidise R&D in proportion to the company's effective rather than apparent outlay. This is consistent with the principle that core R&D should entail financial risk. Where a company can recover much or all of its R&D outlay directly from the outputs of the R&D process itself, the need for subsidy is reduced.
67. One option would be to apply a recoupment approach to supporting activities, in order to reduce leakage of support to activities that are profitable in their own right and so target activities more likely to be stimulated by the incentive.
68. A recoupment style approach already applies to feedstock expenditure, which receives limited concessional treatment. This could be applied more broadly to expenditure on supporting activity for all types of R&D activity, whether they be conducted in a manufacturing production line or processing environment, a natural product extraction or processing environment, whether they relate to the creation of custom-built trading stock for sale, contracted mechanical or civil engineering contract projects, or novel infrastructure contract projects.
69. Consideration could also be given to applying a recoupment approach to both core and supporting R&D – that is, a total recoupment approach. This would require rules to be developed, including around the extent of the expenditure to be recouped against and whether these rules should be different across industries.

A lower rate of assistance for supporting activities

70. Supporting activities are not the specific activities that the R&D tax incentive seeks to target. It is additional core R&D activity which is expected to provide the highest social benefit from the public investment. Given that the social benefit expected to flow from expenditure on supporting activities is much less than core R&D, it may be appropriate to offer a lower credit for expenditure incurred on supporting activities, with the highest credit (either 45 per cent or 40 per cent) reserved for expenditure on core R&D activities.

Excluded activities

Question 5

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

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

71. A list of activities currently excluded from being considered core R&D is expected to be retained under the new R&D tax incentive. The current list is provided at [Attachment C](#). The primary objective of these activities is considered to be to develop markets, do pre-production planning or to get production or control systems working smoothly. As such, these activities do not add as much benefit for society as core R&D activities. The Government may consider adding activities to the current list. However, this will depend on the response to other options in the paper.
72. Currently excluded activities can be undertaken as a supporting activity and thereby attract assistance. The Government is considering extending the application of the list so that no R&D tax incentive will be available for any activity included on the exclusion list either as core or supporting expenditure. However, taxpayers may still deduct such expenditure through other tax provisions (such as the general deduction provision or the capital allowance provisions).

Software

Question 6

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

73. The Government acknowledges that the treatment of software R&D is a complex area. How the new R&D tax incentive treats software, including the efficacy of the current multiple sales provisions, will require further consideration and consultation with industry. Stakeholders should take this opportunity to suggest alternative approaches to the current treatment of software as part of the new R&D tax incentive.
74. To be eligible for the current R&D tax concession, software activities need to meet a multiple sales test in addition to meeting the normal definition of eligible R&D activity. The multiple sales test was intended to limit government assistance for software R&D to claims where a firm sold the software that was produced, effectively excluding support for in-house software development.
75. However, it is important to note that when the multiple sale provisions were put into place some 20 years ago, the extent of development of e-commerce was not fully appreciated. The Government now considers that the current multiple sales test has become an outdated articulation of policy intent as it relates to software.

76. It is clear that the eligibility of software R&D requires review. The United Kingdom (UK) system may provide a useful starting point for developing a new general approach to software R&D. Under the UK system, software projects considered unlikely to be eligible for tax incentives include:
- the handling of interactions with users (for example, the development of user interfaces and development of data entry procedures);
 - using standard methods of encryption, security verification and data integrity testing;
 - the creation of websites or software using tools designed for that purpose; and
 - creating software that replicates an established paper procedure. That fact that a previously manual task has been automated does not in itself make it R&D.
77. In contrast, under the UK system, software projects that are considered likely to be eligible for tax incentives include:
- developing new operating systems or languages;
 - creating new search engines using materially new search methods;
 - resolving conflicts within hardware or software, where the existence of a problem area and the absence of a known solution have been documented;
 - creating new or more efficient algorithms whose improvements depend on previously untried techniques; and
 - creating new encryption or security techniques that do not follow established methodologies.

SUMMARY

78. The new R&D tax incentive will provide more effective and predictable support for Australian companies conducting R&D in Australia. It will also be better targeted at the underlying rationale for public support so that taxpayers receive better value for money. The Government welcomes feedback and comments on the principles and questions outlined in this paper and summarised below.

Design principles

Principle 1	The new R&D tax incentive will be available to companies incorporated in Australia for R&D conducted in Australia. Location of ownership of the resulting IP will not be relevant.
Principle 2	The Standard R&D Tax Credit will be available at a rate of 40 per cent for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero.
Principle 3	The Refundable R&D Tax Credit will be available to companies with a turnover of less than \$20 million at a rate of 45 per cent for eligible R&D expenditure.
Principle 4	Legislation for the new R&D tax incentive will provide support for the scheme's efficient and effective administration.
Principle 5	The new R&D tax incentive should target R&D that: <ul style="list-style-type: none"> (a) is in addition to what otherwise would have occurred; and (b) provides spillovers — benefits that are shared by other firms and the community — that are large relative to the associated subsidy.
Principle 6	Eligible R&D activity will be defined as systematic, investigative and experimental activity that: <ul style="list-style-type: none"> (a) involves both innovation and high levels of technical risk; and (b) is for the purpose of producing new knowledge or improvements.
Principle 7	Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

Design questions

Question 1	Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?
Question 2	How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?
Question 3	Should payments made to associate entities only be eligible for the new R&D tax incentive where they are paid in cash?
Question 4	Should supporting activities: <ul style="list-style-type: none"> (a) be capped as a proportion of expenditure on core R&D? <ul style="list-style-type: none"> (i) If so, what would be the appropriate proportion (for example, 1:1)? (b) only be eligible where they are for the sole purpose of supporting core R&D activity? (c) exclude production activities or dual role activities? (d) only be eligible on a net expenditure basis? (e) attract a lower rate of assistance than core R&D? <ul style="list-style-type: none"> (i) If so, what would be the appropriate rate be?
Question 5	Should the current list of activities excluded from being considered core R&D be: <ul style="list-style-type: none"> (a) amended in any way? (b) extended to exclude such activities from being considered supporting activities?
Question 6	How should the new R&D tax incentive treat software R&D?

ATTACHMENT A: EXAMPLES OF CONCERN WITH THE CURRENT SCHEME

Example 1: Blended core and supporting activities

A mining company develops a significant new resource project. The project is for the progressive implementation of new mine, mill and waste management processes over a period of 6 years. All of the activities described by the company are somewhat generic in nature and broadly represent project phases. Most activities are claimed to contain a blend of both core and supporting activities.

Taken together these activities account for a significant percentage of the total mining costs in any particular year. The actual cost of the core R&D activity within one of the blended activities is likely to be a small fraction of the total activity. The blending of core and directly related activities makes it difficult to distinguish core activities from supporting activities, or make appropriate expenditure allocations. The claim is expected to be in the order of \$30 million over the life of the project.

The claim illustrates how a small amount of core R&D can be leveraged into a large claim to subsidise a significant percentage of overall costs.

Example 2: Extensive and multiple repetition of trials

A heavy engineering company enters into a contract to develop a series of new transportation modules for a client. The contracted modules are required to meet certain specifications. Many are standard for that type of module, but some elements of the module push the boundaries of known technology.

The design, development and construction of the full series of modules are claimed under the tax concession on the basis that the performance of the modules in relation to the innovative aspects could only be properly tested in a series of completed modules. The supporting activities involved multiple identical trials being claimed after the core activities had been completed. The claim is expected to be in the order of \$200 million over the life of the project.

The claim illustrates how significant claims can be made in cases where the costs of R&D would already have been reflected in the agreed contract price.

Example 3: Software

A company in the finance industry undertakes to provide customers with an enhanced online experience and more simple use of the company's products. The business solution will provide customers with access to an extensive range of on-line facilities. The project provides a common platform for delivery of software-based services over the internet. The project involves internal software development and the integration of a number of existing on-line services with single customer sign-in.

All activities are claimed to involve both innovation and technical risk. The existing multiple sale test provision for software is deemed satisfied, because customers are 'licensed' to access a single sign-on integrated on-line environment. The claim is expected to be in the order of \$15 million over the 4 year life of the project.

This claim illustrates the weakness of the current multiple sale test and the high level of taxpayer subsidy available to activities which largely involve customisation and/or integration of existing systems.

ATTACHMENT B: IMPACT OF COMPANY AND IP OWNERSHIP

Location of ownership		New R&D tax incentive	
Company	IP	Standard R&D Tax Credit	Refundable R&D Tax Credit
Australian	Australian	Eligible	Eligible
Australian	Foreign	Eligible	Eligible
Foreign	Australian	Eligible	Eligible
Foreign	Foreign	Eligible	Eligible

Location of ownership		Current R&D tax concession		
Company	IP	125% R&D Tax Concession	175% Premium R&D Tax Concession	175% International Incremental Concession
Australian	Australian	Eligible	Eligible	N/A
Australian	Foreign	Ineligible	Ineligible	Eligible
Foreign	Australian	Eligible	Eligible	N/A
Foreign	Foreign	Ineligible	Ineligible	Eligible

Note: Assumes the company is incorporated in Australia and that the eligible R&D activity is conducted in Australia

ATTACHMENT C: EXCLUSIONS FROM THE DEFINITION OF R&D ACTIVITY

Subsection 73B(2C) of ITAA 1936 excludes the following activities from being considered core R&D:

- (a) market research, market testing or market development, or sales promotion (including consumer surveys);
- (b) quality control;
- (c) prospecting, exploring or drilling for minerals or natural gas for the purpose of discovering deposits, determining more precisely the location of deposits or determining the size or quality of deposits;
- (d) the making of cosmetic modifications or stylistic changes to products, processes or production methods;
- (e) management studies or efficiency surveys;
- (f) research in social sciences, arts or humanities;
- (g) the making of donations;
- (h) pre-production activities such as demonstration of commercial viability, tooling-up and trial runs;
- (i) routine collection of information, except as part of the research and development process;
- (j) preparation for teaching;
- (k) commercial, legal and administrative aspects of patenting, licensing or other activities;
- (l) activities associated with complying with statutory requirements or standards, such as the maintenance of national standards, the calibration of secondary standards and routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things;
- (m) specialised routine medical care;
- (n) any activity related to the reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information.

