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Our ref KPMG Senate Submission Letter

Contact David H Gelb (+61 (3) 9288 6160)

26 May 2010

Dear Sir

Submission to Inquiry into Tax Laws Amendment (Research and Development) Bill 2010 and Income Tax Rates Amendment (Research and Development) Bill 2010

Please find enclosed KPMG's submission in respect of the Tax Laws Amendment (Research and Development) Bills 2010 referred to the Senate Economics Committee for inquiry on 13 May 2010.

Yours faithfully

David H Gelb
Partner

Enclosures:
KPMG Submission

Senate Economics Committee

Tax Laws Amendment (Research and Development) Bill 2010

KPMG Submission

May 2010
This report contains 27 pages
KPMG Senate Submission

Contents

1 Executive Summary

1.1 Overview

The new R&D tax credit as detailed in the Tax Laws Amendment (Research and Development) Bill 2010 ("the Bill") provides some positive encouragement for industry.

KPMG welcomes the Government's policy of improving access to R&D credit for small and medium enterprises. The commitment to increasing the rate of incentive from a base rate of 7.5 cents to 10 or 15 cents per dollar spent on R&D is to be commended.

We note that these increases come at the expense of premium deductions which provided incentives of up to 22.5 cents per dollar.

In particular, we commend the proposed 45% refundable offset for small to medium enterprises.

The removal of the 'multiple sale' rule for software development provides recognition that the R&D activities being undertaken in Australia in the 21st century are not those originally envisaged when the current R&D tax concession was introduced in 1985.

KPMG understands that to achieve a higher rate of benefit to a greater number of businesses that some tightening of the eligibility rules may be required. However, the changes proposed in the Bill will, in our opinion, significantly restrict the ability of all companies, including SMEs to access the new R&D tax credit in respect of genuine R&D.

1.2 Cost to the Government

Over the last decade, R&D expenditure in Australia has significantly increased. This is due to a variety of factors including:

- A buoyant economy during which times companies expend more funds, including on R&D; and

- The availability of 175% premium deductions since 2001.

However, it is unlikely that such economic conditions and spending habits can continue indefinitely. Indeed, beyond 2010, there is likely to be a permanent impact of the global financial crisis as:

- Projects are cancelled or deferred;

- Offshore investment into Australia is reduced due to the constricted economic conditions overseas; and

- Potentially reduced access to finance for Australian companies, particularly start up companies without a proven track record of commercialisation.

If the current R&D tax concession arrangements were maintained (without the175% premium) (i.e. no change to law or definition) the Government's R&D spend is likely to be no more than $1.4 billion per annum.

1.3 Key issues

The key issues with the Bill still remain include:

- why does the definition of "core R&D activities" need to change?
- the 'dominant purpose' test for supporting R&D activities; and
- the revised feedstock provision.

The Government has only recently articulated the mischief which it now seeks to overcome through this Bill. On Tuesday 11 May 2010, Senator Carr stated during a Senate debate that

> "… a mining company that does $20 million worth of R&D is able to claim $500 million for normal mine operations and mineral exploration associated with R&D. They might have a situation under present arrangements where a construction company that does $15 million worth of R&D on air-conditioning systems can potentially claim the $100 million cost of construction of a whole building"

KPMG acknowledges that these types of claims should not be accepted without scrutiny and that given that the Government does not regard such claims as 'genuine R&D', it is appropriate to implement measures to prevent such claims.

In KPMG's experience these types of claims are the exception, not the norm, and represent a very small minority of both the number of claimants and the value claimed. As such, we do not believe that the extensive changes proposed are necessary to target these types of claims. We believe that there are more appropriate measures which will specifically target these activities, such as a 'cap' or other means, whilst not impacting the majority of legitimate claimants.

The proposed changes add complexity and uncertainty to all of the existing 8000 companies accessing the R&D tax concession and may not achieve the Government's aim of reducing claims by the extremely small number of companies which may be making excessive claims beyond the intention of the program.

1.4 Incremental 'Red Tape' and Compliance Costs

It is not clear why the administration regime for the new R&D tax credit needs to be more strict than the normal income tax self-assessment system. Innovation Australia (IA) has been given broader powers under the new R&D tax credit than it currently has under the R&D tax concession regime. These new powers include the power to decide whether to register a company or not to register.

This power is unlike that of the Commissioner of Taxation who accepts a company's statements in its income tax return at the time of lodgement. At a later date, this return may be reviewed/audited by the ATO. However, Innovation Australia, appear to be stepping away from a self-assessment system and review and determining eligibility before registering a company.

KPMG's view is that this will create a disincentive for small and medium sized enterprises (SMEs).

In addition, the requirement to differentiate between core and supporting R&D activities will increase the compliance cost to all businesses. Whether an activity is core or supporting will be a matter of considerable debate between industry and IA.

1.5 Timing

We submit that the introduction of the Bills be deferred to 1 July 2011, to enable appropriate consultation and clarification on the changes and related guidelines.

Companies require additional notice to consider the new rules and adjust their business plans accordingly.

The proposed passing of the Bill in the last week of June, for application on 1 July 2010, without guidelines, will create confusion and are unlikely achieve the desired changes in levels of R&D activity for 2010/11income year.

1.6 Summary

Although there are positive aspects to proposed R&D tax credit KPMG recommends a deferral of the Bill at this time. The hasty and extensive redrafting of Exposure Drafts following concerns raised during the limited public consultation has left unresolved issues and uncertainty as to the application of new definitions.

Given the proposed timing of the passage of the Bill, it is KPMG's view that it will not change company spending on R&D activities for the 2010/11 income year, as there is insufficient time to digest, analyse and apply the new rules to proposed or desired R&D projects. In addition, it is unlikely that the guidelines proposed to be issued by IA will be available to assist with decision making for the 2010/11 income year.

An alternative solution is to amend the Bill so that:

- The 175% premium deductions are removed for 2010 / 2011;
- The proposed tax offsets of 40% and 45% are introduced for 2010 / 2011;
- No change to the definition of R&D activities (as defined under the R&D tax concession) but the insertion of amendments to address areas of concern such as a cap on expenditure or preapproval for projects above a certain level such as over $100million and tighter rules around claiming whole buildings and full scale operational costs of the magnitude outlined by the Minister.
- The proposed exclusion for in-house software be introduced and the multiple sale test be removed.

2 Competitive Alternatives Report 2010

As stated by Treasury representatives at the Senate Economics Committee Hearing on 20 May 2010, KPMG has released as a Report titled '*Competitive Alternatives, KPMG's Guide to International Business Location*' (the Report). A supplement to this report titled '*Special Report: Focus on Tax*' (Supplementary Report) was also released.

The Supplementary Report was referred to during the Senate Hearing as a comparison of Australian R&D regimes with other countries.

However, the key objective of this Report was, to compare business costs for more than 100 cities in 10 countries. The Supplementary Report assesses the general tax competitiveness of 95 cities in 10 countries studied in the main research project. This Report was not prepared as a detailed analysis of the R&D regimes in the various locations but, as indicated by its name, a broad analysis of business costs across 10 countries.

The Supplementary Report includes an R&D section which considers R&D operations, such as university research projects, and the impact of any tax incentives provided . At the time this Supplementary Report was prepared the extent of the proposed changes to the definition were not known. However, the proposed rates of the R&D tax credit had been confirmed in the 2009 Federal Budget.

The R&D section of the Supplementary Report did not purport to rank countries by how well their respective tax systems support commercial entities that undertake R&D as part of their wider operations, but rather, how well the tax system supports pure R&D entities. In the detail provided on Australia, the report stated; "For many R&D operations, such as spin-offs from larger firms or university research projects, the potentially refundable nature of these tax credits will represent a powerful incentive..." The Supplementary Report gives a high weighting to the refundable nature of the tax credit, but does not factor in the proposed changes to definition, as this is likely to have less impact on pure and academic research. For the types of pure R&D operations mentioned above, the Supplementary Reports states that Australia will significantly improve its support for R&D with the introduction of a refundable tax credit.

As stated above, KPMG agrees that the proposed increased rates of credit and the restructure from a tax deduction to a tax credit, which may, in certain circumstances be refundable, are positive features of the proposed R&D program. The encouragement of foreign investment in R&D activities in Australia is another positive element of the proposed R&D tax credit system.

However, when comparing commercial businesses such as Manufacturing and Corporate & Information Technology, the Supplementary Report states that Australia's ranking has either not changed or has fallen, despite the increased rate of incentive in the R&D scheme being factored into the evaluation.

3 Recommendations

If the Bill is to give practical effect to the Government's stated policy objectives, KPMG recommends the following amendments:

3.1 Core activities

- Clarification should be provided, by examples in the EM, that the definition of core activities is satisfied by a combination of activities not merely by a single activity;
- Section 355-25(1) should be amended to refer to 'science or technology';
- The creation of new or improved materials, products, devices, processes or services should be retained as a separate and alternate qualifying purpose;
- The inclusion of a determining point in time, such as the commencement of an R&D project, with sole reference to which the question as to whether knowledge is new or not should be posed;
- Knowledge must be available on terms commercially acceptable to the company, not merely commercially available; and
- Explicit acknowledgement should be made that experimental / core activities are more than the "experiment". This experiment is merely part of the systematic progression of activities which meet the definition of R&D activities.

3.2 Supporting activities

- The requirement to distinguish between core and supporting activities is unnecessary and adds significant complexity and uncertainty to the R&D tax incentive;
- The dominant purpose test should be removed as it imposes an unnecessarily high threshold as evidenced in the EM, and does not target the minority of excessive claims which the Government purports are occurring;
- Alternative solutions to target the specific mischief should be investigated, - for example, expenditure caps, time limits for trials, pre-approval for projects above certain values etc.

3.3 Feedstock

- The application of the feedstock rules should be limited to mass production activities as was intended when introduced in 1996;
- In addition, they should not apply to core R&D, or small-scale activities.

3.4 Administration

- Remove the requirement to distinguish between core and supporting activities;
- Remove the ability of Innovation Australia to not register an application;
- Employ a self-assessment system in alignment with all other income tax assessment/governance;
- Require Innovation Australia to notify all decisions with stated reasons for such.

3.5 Not at risk

- These sections should be removed. The rules were originally included in 1990 for a specific purpose, namely syndicated R&D arrangements, which are no longer an issue. Other provisions adequately protect Government revenue.

3.6 Other

- Grouping rules should be retained at 50% ownership not the 40% threshold proposed;
- In principle, the revised clawback mechanism on recoupment has merit. However, as drafted in the Bill, it results in all R&D credit being eliminated if any grant of 10% or more is received. These provisions must be revised to correct their application.

4 Analysis of key issues

Limited recognition of applied research and experimental development

The inconsistency of the EM with the Bill 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 companies being placed at a competitive disadvantage, as a nation, Australia will be at a disadvantage in attracting R&D expenditure of multinational companies at a time of increased tax competition. This is 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 the application of the dominant purpose rule for both supporting and production-related activities contained in the second Exposure Draft has been retained in the Bill. As a result, this highly impractical test is likely to exclude any large scale production related activities from supporting activities.

As we noted in our previous submissions, 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 these enterprises are less likely to undertake R&D without a commercial imperative.

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.

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

Whilst we acknowledge that limitations are necessary 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 the Bill and EM

KPMG notes with concern a number of aspects of the Bill and in particular, the policy intent behind its drafting as evidenced by the EM.

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.

At paragraph 2.16, the EM appears to explicitly acknowledge that the requirement for the generation of new knowledge can be satisfied in cases where the knowledge in question might already exist but not be readily accessible to the company conducting the R&D.

However, Example 2.6, "Mimic Mining", then contradicts this principle by suggesting that because such knowledge could have been acquired for a "commercially reasonable sum" the activities carried out by Mimic Mining are not Core R&D activities since the requirement for new knowledge is not met.

KPMG submits that simply because a company does not choose to pay a "commercially reasonable sum" for existing knowledge held by a third party does not prevent the pursuit of such knowledge by that company from representing bona fide core R&D activity.

For example, were a company to be offered full knowledge of the algorithm driving the world's most popular search engine for a *commercially reasonable sum*, that sum might be in the billions of dollars. If a company cannot (or chooses not to) take up this offer but instead attempts to develop this knowledge, why should such activity be precluded from eligibility as core R&D?

Similarly at paragraph 2.17, the EM states explicitly that the requirement for generation of new knowledge can be satisfied through the application of existing technology in a novel context giving rise to improved materials, products, devices, processes or services.

However, the examples in the EM only evaluate knowledge which is not known or attempted before.

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 submits that without significant alteration, the combination of the Bill and the EM is unworkable as it presents a contradiction to the law and stated policy.

Feedstock

Whilst we comment below on the proposed feedstock rules contained in the Bill, KPMG submits that these rules are unlikely to have any material application in practice.

This is because, in a commercial context, following the application of the dominant purpose test to both supporting and production activities, the quantum of any feedstock input is likely to be negligible.

Software

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

As we have noted previously, software development is prevalent across virtually all modern economic activity with companies 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.

4.1 Core R&D activities

As an overarching comment, we note that the drafting of the definition of core R&D in 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.

Combination of activities

KPMG, however, has identified issues with the interpretation of that definition as evidenced in the EM which appears to be inconsistent with the common ordinary meaning of the proposed 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.

Established science

Section 355-25(1)(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 (1)(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 recommend that the word ‘established’ is removed and ‘science’ be extended to ‘science or technology’.

Generation of new knowledge

Whilst section 355-25(1)(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 by 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 company"[3].

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.

In this regard, we note that whilst paragraph 2.16 of the EM would seem to concur with this view, Example 2.6 ("Mimic Mining") then suggests that the mere availability of that knowledge at any price – whether or not acceptable to the company conducting the R&D – is sufficient to render the company's activities ineligible as core R&D.

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 companies 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 companies at a marked competitive disadvantage.

[3] Paragraph 2.16

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[4] 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.

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, nor its theoretical availability for consideration does not preclude its being new to the company 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.

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.

Determining New Knowledge

The definition of core R&D activities requires that the activities are undertaken for the purpose of "generating new knowledge (including 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 and Communication technologies sector, but is also true of most areas of technological advance in industry.

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.

[4] Frascati Manual, OECD 2002, Paragraph 63

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 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 available on terms commercially acceptable to the company.

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 a potential confusion in this regard when it says, without further clarification or justification, that:

> *"…Nor will an activity fall within the scope of the experiment merely because the experiment cannot take place without it."*

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. (paragraph 2.19)

The EM continues to focus on "an experiment" as the sole determining factor of core R&D activity. However, the legislation drafted in the Bill clearly states that core R&D *activities* are experimental activities including:

- hypothesis;
- experiment;
- observation and evaluation; and
- logical conclusion.

All of these steps, not merely the experiment, form part of the experimental or core activities.

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 2.19, 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 Bill.

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

4.2 Supporting activities and production

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

As noted in our submission on the second Exposure Draft, 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[5]."

Production related activities

Whilst the augmented feedstock rule of the 1st ED has not been retained in the Bill 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;

[5] KPMG Submissions on Exposure Draft of 18 December 2009 & Second Exposure Draft 31 March 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 stated 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.

In particular, Examples 2.3 suggest that the determinant as to the application of the dominant purpose rule to production activities would appear to be the prospect of financial receipt for outputs of the R&D activities.

Excluded activities

Whilst we note the list of exclusions has been reduced in the Bill, we reiterate that the list of excluded activities has not been highlighted by independent reviews or by the Government as being an area of concern for excessive claims.

In our experience, there is also no justification for the application of dominant purpose to the activities listed in section 355-25(2) ('excluded activities').

4.3 Feedstock

As noted above, KPMG submits that the re-written feedstock rules at subdivision 355-H are unlikely to have any material application in practice as a result of the application of the dominant purpose rule to production activities.

However, where and to the extent that the new feedstock rules might have application, we make the following observations.

Current practice has been for the rules to be applied largely in cases of mass production activities. Indeed, as noted by the Guide to the R&D Tax Concession published jointly by the ATO and AusIndustry and ATO Interpretative Decision 2007/122:

> "The ordinary meaning of processing includes situations where no new or different product is produced, and where no physical alteration of any goods or materials occurs. However, 'processing' ordinarily involves a substantial degree of uniformity of treatment, and does not cover the case of a good or materials being the subject of individual treatment[6]."

In the majority of mass production cases, the valuation of the feedstock output is reasonably ascertainable since the scale of production is warranted by an established market (and hence value) for that product. Such a market value would be constant regardless of whether the output was sold to a third party or held for internal use.

However, neither the Bill nor the EM appear to conclude that this would be the case under the new rules. If the rules are intended to have application to all R&D activities including for internal use, we question the practicality of establishing market valuations for such outputs.

The impact of the recognition of additional assessable income in a future income year, separated from the R&D activities may have implications on other aspects of a company's operations and tax affairs which given the short time frame for review cannot be fully analysed at this time. Whilst, the EM indicates that this deferral is seen as a positive measure the impact on distributions of income or franking accounts has not been considered.

[6] Vibroplant Ltd v. Holland (Inspector of Taxes)

4.4 Administration

We note that the Bill appears to give greater powers to 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 Bill.

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"[7]. However, there is no specified timeframe by which it must make, or be deemed to have made, this decision.

Further, section 355-705 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 process which deem assessment to be made by the Commissioner on the date of lodgement of its income take return.

The administration of tax laws require certainty in application, which is currently substantially undermined by the proposed administrative procedures. Companies without a confirmed registration, for any length of time, may be unable to recognise the benefit in financial statements pursuant to Accounting Standards 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[8]. 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.

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

Innovation Australia 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.

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.

Notification of Findings and Decisions

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

We acknowledge that it is likely to be an unintentional oversight for the Board 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 27C, 27K and 28F should be removed.

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.

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.

4.5 Not at risk

KPMG 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 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.

KPMG's recent experiences indicate that the provision 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.

4.6 Grouping & Recoupment rules

Grouping

The grouping rules within the Bill 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% 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.

To achieve the policy objectives of providing increased benefits to small and medium enterprises, we recommend 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.

Recoupment

The object of the recoupment provisions is that "an entity must pay extra income tax on its recoupments from Government of expenditure on R&D activities for which it has obtained tax offsets under this Division."[9] Whilst this indicates that the extra tax would be paid on the grant received from the Government, the application of the provisions actually applies to the total R&D expenditure incurred, regardless of the level of grant received.

The proposed legislation can lead to manifestly unjust results and leave a company worse off than if it had not received a grant or recoupment in some cases that we have analysed.

It is submitted that qualifying self-funded or net R&D expenditure should properly be eligible for the standard rates of tax offset, as would normally be the case for such expenditure. This should be effected by very simply prescribing a 10% rate of additional income tax payable under the Subdivision on all or part of any amount of monies actually recouped (i.e. the amount of the grant or reimbursement actually received). Furthermore, it should not make any difference to the tax outcome whether that "recoupment" is by way of grant or reimbursement.

The object of the provision should be to neutralise or claw-back any potential concession for expenditure on R&D activities effectively or substantively funded by a Government body, whether the form of that funding/recoupment is by way of grant or reimbursement.

[9] Section 355-430 Tax Laws Amendment (Research and Development) Bill 2010

However, the provision, as it is currently proposed to apply to grants received on the basis of matched funding by entities, potentially denies the concession in relation to R&D expenditure which is never actually or even effectively "recouped" by the entity in any normal sense of that word.

The EM tries to rationalise this by postulating that, in such cases, those entities potentially enjoy three distinct Government benefits (a so-called "triple benefit"):

1 The incentive for the R&D expenditure *not* matched by the grant (i.e. the entity's self-funded or net expenditure);

2 The amount of the grant; and

3 The tax incentive in relation to the spending that was funded by the grant.

Accordingly, the clawback of the tax incentive on the expenditure *not* matched by the grant is sought to be justified on the assertion that it is a duplication of the benefits for that expenditure because the grant itself was intended to be a benefit of having incurred that expenditure.

Unintended results from the operation of the Subdivision

The adverse results from the proposed operation of the clawback, in this case, is not limited to denying the tax incentive to an entity for R&D expenditure which it incurs and *never actually recoups.*

It also means that, for example:

- an entity will lose the entirety of the tax incentive in respect of the R&D expenditure it incurs, regardless of whether it recoups 100% of that expenditure or 10%; and

- an entity entitled to a recoupment in respect of R&D expenditure that it will be required to incur, could even be worse off than if it had not received a recoupment at all. For example:

$	**Expenditure**	**Deduction/ Offset**	**Recoupment**	**Tax Payable**	**Net Cash**
No recoupment	(100)	40			(60)
10% recoupment	(100)	40	10	(13)*	(63)

*Comprises: $3 (30% tax on $10 assessable recoupment) plus $10 (10% "additional" tax on 100 required expenditure)

This applies even for companies with aggregate turnover of less than $20,000,000. For example:

$	Expenditure	Deduction/ Offset	Recoupment	Tax Payable	Net Cash
No recoupment	(100)	45			(55)
10% recoupment	(100)	45	10	(13)*	(58)

The cap (subsection 355-450(3)) has no operation until the recoupment is less than 10% of the total expenditure.

Parity is only achieved if it the recoupment which is assessed at 10% not the total R&D expenditure.