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EXPOSURE DRAFT

TAX LAWS AMENDMENT (RESEARCH AND
DEVELOPMENT) BILL 2010

EXPLANATORY MATERIALS

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Chapter 1

Introduction to the new research and development tax incentive

Outline of chapter

1.1 This exposure draft amends the law to provide a new tax incentive for research and development (R&D). This chapter provides a high level introduction to the new R&D tax incentive.

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

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provisions in the *Income Tax Assessment Act 1936* (ITAA 1936) that govern the existing R&D Tax Concession will be repealed.

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

Context of amendments

1.5 In the 2009-10 Budget, the Government announced it would replace the R&D Tax Concession with a new, streamlined tax incentive. The Government issued a consultation paper titled *The new research and development tax incentive* in September 2009.

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

The case for subsidising R&D

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

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

1.9 Knowledge produced by firms as they perform R&D often has beneficial impacts on other firms or the economy as a whole (often referred to as spillovers). A firm may choose not to undertake R&D because of technical uncertainty in cases where the knowledge generated would spillover to the benefit of other firms and the wider economy. In such situations, less R&D may occur than would be optimal for the economy as a whole.

1.10 A public subsidy that appropriately targets such spillovers can be beneficial for the economy as a whole and improve productivity. To this end, the new R&D tax incentive redirects assistance to those activities most likely to generate spillovers. It also tilts assistance in favour of smaller innovative firms as they are more likely to respond to fiscal incentives.

Summary of new law

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

R&D activities

1.12 R&D activities are defined as either ‘core’ or ‘supporting’ R&D activities.

- Core R&D activities are experimental activities that are systematic and investigative and:
 - involve considerable novelty and high levels of technical risk; and
 - are conducted for the purpose of acquiring new knowledge or information, including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services.
- Supporting R&D activities are activities undertaken for the dominant purpose of supporting core R&D activities.
- Some activities are excluded from being either core or supporting R&D.

1.13 Previously, the core R&D activities involved innovation (defined as involving an appreciable level of novelty) or high levels of technical risk. Supporting R&D activities were undertaken for a purpose directly related to conducting core R&D activities. Strengthening and clarifying both tests ensures taxpayer funded support is directed at those activities that are most likely to generate an additional benefit for the economy as a whole.

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

- there are physical limitations on an R&D activity being conducted in Australia;
- the activity to be conducted overseas makes a significant scientific contribution to related R&D activities conducted in Australia; and
- the related R&D activities to be conducted in Australia will be significant relative to the activity to be conducted overseas.

1.15 Chapter 2 provides further information about the concept of eligible R&D activities.

R&D entities

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

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

1.17 This represents an expansion on the kinds of entities eligible for the R&D Tax Concession. Expanding access for foreign corporations will strengthen Australia's negotiating position in future tax treaties and act as an inducement for more companies to conduct their R&D activities in Australia.

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

R&D expenditure

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

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

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

1.22 As an integrity measure, R&D entities are only able to obtain the tax incentive for expenditure incurred to an associate entity when they actually pay the amounts incurred. In addition, more robust feedstock rules ensure that the value of any direct outputs of R&D activities is offset against the cost of producing those outputs before the tax incentive is claimed.

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

The R&D tax offsets

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

- A 45 per cent refundable tax offset is available to R&D entities with an aggregated turnover of less than \$20 million (unless they are a tax exempt entity or majority owned or controlled by tax exempt entities).
- A 40 per cent non-refundable tax offset is available for all other R&D entities.

1.25 The new refundable tax offset provides more generous and timely support to smaller innovative firms, regardless of whether they end the income year in tax profit or loss. R&D entities accessing the non-refundable tax offset can carry forward any unused offset amounts, under the tax offset carry forward rules.

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

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

Worked examples

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

Example 1.1

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

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

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

Example 1.2

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

Based on its turnover and R&D expenditure, Big Ideas would previously have missed out on the R&D tax offset. While the company meets the turnover test it has exceeded the expenditure cap.

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

Example 1.3

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

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

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

Administration

1.29 The new R&D tax incentive operates largely on a self-assessment basis. Innovation Australia continues to have a significant role in registering and assessing whether an activity is eligible R&D; providing advance findings to increase certainty to companies; and registering research service providers. The ATO will continue to determine whether an amount of expenditure is validly incurred on that R&D activity.

1.30 Chapter 4 provides further information on the role of the Innovation Australia Board in relation to the new R&D tax incentive.

Chapter 2

Meaning of research and development activities

Outline of chapter

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

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

Context of amendments

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

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

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

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
A distinction is made between core R&D activities and supporting R&D activities.	A distinction is made between core R&D activities (without that term being used) and supporting R&D activities (termed directly related activities).
Core R&D activities must involve considerable novelty and high levels of technical risk.	Core R&D activities must involve innovation (defined as an appreciable degree of novelty) or high levels of technical risk.
Supporting R&D activities must be undertaken for the dominant purpose	Supporting R&D must be carried on for a purpose directly related to the

of supporting core R&D activities.	carrying on of core R&D activities.
Listed activities are specifically excluded from being R&D activities (either core or supporting).	Listed activities are specifically excluded from being core R&D activities.
In-house software is excluded from being an R&D activity by a requirement that software development activities be for the purpose of making a commercial return directly from supply to at least two other entities.	In-house software is excluded from being a core R&D activity by a requirement that software development activities be for the purpose of supply to at least two other entities.
Software services other than software development are explicitly excluded from being R&D activities.	Software services other than software development are not explicitly excluded from being R&D activities.
Integrating off-the-shelf computer software is explicitly excluded from being an R&D activity.	Integrating off-the-shelf computer software is not explicitly excluded from being an R&D activity.
Where R&D activities directly produce outputs, a feedstock adjustment applies to reflect the extent to which the value of those direct outputs offsets the cost of the related R&D activities. Certain R&D activities are quarantined from this adjustment.	Where goods or materials are produced or acquired in order to be the subject of processing or transformation in R&D activities, a feedstock adjustment applies to reflect the extent to which the value of the outputs from the processing or transformation offsets the cost of the goods or materials.

Detailed explanation of new law

Object of new law

2.6 The rationale behind the new R&D tax incentive lies in the combination of the potential for technical uncertainty to discourage R&D activities and the potential for the knowledge gained from the conducting of R&D activities involving novelty to ‘spill over’ to the benefit of the wider Australian economy. This means that a subsidy that causes such R&D activities to proceed has the potential to provide a public benefit (in the form of additional spillover of knowledge) that exceeds the cost of the subsidy. *[Schedule 1, item 1, subsection 355-5(1)]*

2.7 Accordingly, the definition of R&D that is eligible for the tax incentive centres around the activities that are most likely to produce spillover benefits that, in the absence of the incentive, might not go ahead because of technical uncertainty. The R&D tax incentive is not intended as a subsidy for innovation in general. *[Schedule 1, item 1, subsection 355-5(2)]*

2.8 For the targeted R&D activities to occur, supporting activities will generally be required. As a complementary measure, where the dominant reason for conducting activities is to support R&D, those supporting activities can also be recognised as R&D activities and qualify for the tax offset. In contrast, where the necessary supporting activities would have been undertaken anyway, for normal operational reasons, they do not impose an additional cost on the company that arises from its R&D activities and so the R&D tax incentive is not intended to subsidise them. *[Schedule 1, item 1, subsection 355-5(3)]*

2.9 The object of the law is also reflected in an augmented feedstock rule, which modifies the amounts attributable to certain R&D activities that directly produce marketable outputs.

Meaning of R&D activities

2.10 The new law retains a distinction between ‘core’ and ‘supporting’ R&D activities *[Schedule 1, item 1, section 355-20]*. For R&D activities to be considered to be occurring, there must be an activity — or more typically a set of related activities — that satisfies the criteria for core R&D. Once core R&D has been identified, certain supporting activities can also be considered to be R&D activities.

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

2.12 The examples also illustrate the operation of the augmented feedstock rule, which is outlined in the section preceding the examples.

Core R&D activities

2.13 Core R&D activities are first and foremost experimental activities *[Schedule 1, item 1, subsection 355-25(1)]*. Those experimental activities must have the attributes of being systematic and investigative *[Schedule 1, item 1, paragraph 355-25(1)(a)]*. Together, these requirements are referred to below as the ‘experimental, systematic, investigative’ (ESI) test. That is, what principally defines the occurrence of R&D is the conduct of activities that are experimental, where the experimentation is systematic and with an investigative purpose.

2.14 Accordingly, the experimentation must be conducted for the purpose of acquiring new knowledge or information or, at a more practical level, creating new or improved materials, products, devices, processes or services. This is referred to below as the ‘purpose of knowledge/improvements’ (PKI) test. *[Schedule 1, item 1, paragraph 355-25(1)(c)]*

2.15 Additionally, to be eligible as core R&D, the experimental activities need to involve threshold levels of novelty and technical risk. *[Schedule 1, item 1, paragraph 355-25(1)(b)]*

2.16 Identifying the scope of core R&D therefore amounts to:

- identifying the scope of the experimental activities;
 - this ‘scope of experiment test’ applies to each individual activity claimed as core R&D;
 - being part of the experiment is what links the activities together as a set of related (potentially) core R&D activities; and
- establishing that those experimental activities collectively meet the related tests for:
 - ESI;
 - novelty;
 - technical risk; and
 - PKI.

2.17 The meaning of these interlocking tests is elaborated on below.

ESI test (experimental, systematic, investigative)

2.18 The existence of core R&D depends firstly on establishing that an experimental process is occurring — that is, a method of investigating causal relationships among variables to test a hypothesis or determine the efficacy of something previously untried.

2.19 The scope of the experimental activities then needs to be identified. These will be the activities that form part of the experimental process itself — rather than merely being directly related to it. An activity will not fall within the scope of the experiment merely because it is considered a ‘legitimate’ or ‘necessary’ part of what the firm might view as its R&D ‘project’. Where such an activity falls outside the scope of the experiment, it can still qualify as an eligible R&D activity if it meets the requirements of supporting R&D.

2.20 The requirement for the experimental activities to be systematic and investigative reinforces the need for a scientific process to be underway. That is, the scientific method is being applied in a systematic

progression of work, from hypothesis to experiment, observation and evaluation, followed by logical conclusions. Further, the experimental process will have a sound basis in scientific principles.

Novelty test

2.21 Novelty means the development of technology or a new use of existing technology, by comparison with knowledge of the technology that is publicly available on a reasonably accessible worldwide basis.

2.22 The degree of novelty needs to be considerable, rather than a mere logical progression from existing knowledge. It is this higher degree of contribution to knowledge that is likely to produce spillover benefits that would not arise from merely being the first to take the next obvious step.

2.23 Novel activities therefore go beyond something that can be readily implemented without significant risk. That is, the novelty will be of an extent that a scientific approach is required to validate it.

2.24 The actual experiments themselves do not need to be novel. Indeed, the experimental approach taken will often be the obvious method of testing a novel idea developed at an earlier supporting stage.

Technical risk test

2.25 Technical risk exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, is not readily available or deducible by a competent professional working in the field.

2.26 The technical risk of the R&D activities need not reside in the actual experiment, but will often be in the uncertainty that the systematic investigative experiments will seek to resolve.

2.27 The threshold ‘high levels’ of technical risk is set down in terms of uncertainty that can only be removed through application of the scientific method based on scientific principles [*Schedule 1, item 1, subsection 355-25(2)*]. This contrasts R&D from less rigorous ‘trial and error’ or ‘fitting’ that is part and parcel of simply making things work.

PKI test (purpose of knowledge/improvements)

2.28 The PKI test reflects the R&D tax incentive’s rationale of generating spillover benefits that arise from conducting R&D — rather than subsidising the application of that knowledge. The PKI test will not be satisfied by experimental activities that merely confirm what is already

known — even though that knowhow might not exist within the firm conducting the activities.

2.29 The scope of being for the purpose of knowledge/improvements does not extend to the application of R&D for the production or implementation of a specific material, product, device, process or service. Where the line is drawn between the conducting of R&D and the application of R&D will be a question of fact.

2.30 Although the PKI test can be met by the purpose of acquiring knowledge in the practical form of ‘knowledge or information about the creation of new or improved materials, products, devices, processes or services’, the test in essence remains one about the purpose of acquiring knowledge.

2.31 That said, experimental activities will often occur in the context of normal production activities, and the experiments may entail the production or use of an actual material, product, device, process or service. Consistent with the above, these experimental activities can be R&D if they are conducted for the investigative purpose of acquiring new knowledge or information. (However, the feedstock rule would apply to the actual direct output of the experimental activity — see below.)

2.32 For purposes of the PKI test, the ‘purpose’ of experimental activities will be understood to mean the dominant (or sole) purpose for which the activities are undertaken.

2.33 In discerning the dominant purpose for undertaking experimental activities, regard must be had to the overall circumstances within which they are conducted. This can be of particular relevance where repeated or prolonged experiments are conducted in a production context without a sound business case for those experiments. The presence of elements of experimental form — such as documentation and measurement — is not of itself determinative of whether the activities meet the PKI test for receiving a tax offset.

2.34 With very few exceptions, R&D undertaken by companies will have an ultimate commercial objective. This is not of itself relevant when determining whether experimental activities are conducted for the purpose of knowledge/improvements — the R&D tax incentive is not targeted at ‘R&D for R&D’s sake’.

Supporting R&D activities

2.35 Supporting activities are those undertaken for the dominant (or sole) purpose of supporting core R&D activities. [*Schedule 1, item 1, subsection 355-35(1)*]

2.36 Activities that ‘support’ core R&D will be ones that assist the conducting of the experimental activities, but without being part of them. This assistance can occur before, during or after the experimental activities and at a proximate or remote location.

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

2.38 Conversely, the fact that certain activities are necessary in order for core R&D to occur does not suffice to show that those activities are undertaken for the dominant purpose of supporting core R&D. Nor will the test be satisfied merely because the activities occur in close proximity (in time and space) to the experimental activities.

2.39 These qualifications can be particularly significant where core R&D is conducted in the context of normal production. It is not intended that the R&D tax incentive cross-subsidise normal production activities that would occur in the absence of the core R&D activities.

2.40 In discerning the purpose for undertaking an activity, regard must be had to the overall circumstances within which the activity is conducted. Similar sets of activities that might qualify as supporting activities in one context might not in another. A critical factor will be the extent to which the activities in question will also achieve outcomes (such as production or other commercial goals) over and above assisting the conduct of the core activities, and the importance of those outcomes in the context.

2.41 In various contexts, key considerations might include:

- the scale of experimental activities relative to concurrent production activities;
- whether the business case for the future production activities depends on the outcome of the experimental activities; or
- whether the scale or nature of non-experimental work suggests it is being undertaken to support future production.

Excluded from core and/or supporting R&D

2.42 Activities that might otherwise satisfy the respective tests for core or supporting R&D are specifically excluded from qualifying as R&D activities if they appear on the exclusion list. The list also serves to

simplify the R&D tax incentive by clarifying that certain activities would not meet the tests for R&D activities.

2.43 The content of the existing list of exclusions from core R&D is retained (with some modification of wording) and applied to supporting R&D [*Schedule 1, item 1, subsection 355-35(2)*]. Any exclusions applying to supporting R&D also apply to core R&D [*Schedule 1, item 1, subsection 355-25(1)*].

Intended approach to software

2.44 The existing exclusion for ‘in-house’ software is strengthened and incorporated into the exclusions list (rather than being in a separate provision) [*Schedule 1, item 1, paragraph 355-35(2)(o)*]. The exclusion continues to be couched in terms of a ‘multisale’ requirement that, if satisfied, carves an activity out of the exclusion.

2.45 However, the multisale test can only be satisfied where the purpose of the supply is to make a commercial return directly from the supply. This has the effect that the test is not satisfied where software is licensed for zero or a nominal charge — such as where principally made available to enable customers to access other products (for example, software supplied to customers so that they can conduct their online shopping or banking with the supplier of the software).

2.46 In addition, the list now clarifies that software activities are not R&D activities where they consist of integrating off-the-shelf commercial or open source computer software. These activities are excluded from being R&D because they are directed at taking software or pieces of software that are already available and integrating or combining them using known techniques and technology. In addition, these activities are excluded from being core R&D activities because the nature of integrated software output is such that the level of technical risk and innovation of such output is impossible to determine. [*Schedule 1, item 1, paragraphs 355-35(2)(p)–(q)*]

2.47 The terms ‘off-the-shelf commercial’ or ‘off-the-shelf open source’ computer software have their normal meaning as used by the industry.

2.48 Any other computer software services are also excluded. [*Schedule 1, item 1, paragraph 355-35(2)(r)*].

Augmented feedstock rule

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

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

2.51 The new R&D tax incentive extends this feedstock principle to all cases where R&D activities (including supporting R&D activities) produce direct output — termed ‘feedstock output’ — that is of value. This reduces the extent to which the R&D tax incentive provides an unwarranted subsidy to activities that are already directly profitable.

2.52 Outputs covered by the feedstock rule are those produced directly by the R&D activities themselves. These feedstock outputs do not include the knowledge/improvements that are the intended results of core R&D activities, as set out in paragraph 355-25(1)(c) (the PKI test). Consequently, the sale of the intellectual property arising from R&D activities would not be captured by the feedstock rule. Nor would the feedstock rule capture exploitation — in the form of subsequent production — of knowledge or information about the creation of new or improved materials, products, devices, processes or services. [*Schedule 1, item 1, subsections 355-450(1), step 1 and 355-450(3)*]

2.53 However, the feedstock rule would capture an actual material, product, device or service *produced by* the R&D activities that embodies the knowledge or information *arising from* the R&D activities — such as knowledge or information about the creation of new or improved materials, products, devices, processes or services. That is, the feedstock rule would capture a prototype boat, but not an improved boat design.

2.54 Feedstock output is that produced by the R&D activities themselves, rather than by the broader production activities within which an R&D activity might occur. As discussed below, this might mean the feedstock output is not of a marketable state, in which case the output’s value may need to be imputed from a later production stage.

2.55 The feedstock rule applies in relation to both core and supporting R&D activities. Where supporting R&D activities add value

to the direct output of core R&D activities, the feedstock output would be the direct output of the R&D activities inclusive of the supporting activities.

2.56 Feedstock output can be a service produced by R&D activities, including progress toward the completion of contractual obligations.

2.57 The feedstock rule applies on an output by output basis. This means that where R&D activities ‘turn a profit’ with respect to one feedstock output, the surplus of that output’s value over related costs will not carry across to net off amounts relating to other feedstock outputs. In practical terms, where the same set of R&D activities produces a number of substantially identical feedstock outputs (such as ingots of gold produced by a processing experiment), those outputs can be treated as if a single feedstock output.¹

2.58 Certain costs are quarantined from the feedstock rule, to ensure that the R&D tax incentive is always available to key activities that are most likely to produce spillover benefits:

- expenditure on conceptual design [*Schedule 1, item 1, subsection 355-450(1), step 2(a)*].

(Note: the scope of quarantined expenditures is yet to be finalised.)

2.59 To avoid undue complexity, the new feedstock rule does not directly adjust the actual amounts attributable to the affected activities (which would require arbitrary attribution rules to determine the order in which particular amounts were pushed out of the R&D tax incentive provisions into the normal taxation rules). Rather, the approach taken is to subtract a single feedstock adjustment amount from the total of the amounts eligible for an offset [*Schedule 1, item 1, subsection 355-450(1)*]. An equivalent amount is then made available as a new, statutory deduction [*Schedule 1, item 1, subsection 355-450(2)*].

2.60 The total feedstock adjustment is determined in the following manner:

- the direct outputs produced by the R&D activities are identified as ‘feedstock outputs’ [*Schedule 1, item 1, subsection 355-450(1), step 1*];

¹ Strictly speaking, each ingot would be a separate feedstock output and the costs of the related R&D activities would be prorated across each ingot; but, provided the same activities were responsible for the full set of ingots, the total feedstock adjustment would be the same as were the set of ingots treated as a single feedstock output.

- the market value of each feedstock output is determined and ascribed as the ‘output’s value’ [*Schedule 1, item 1, subsection 355-450(1), step 1*]:
 - where multiple outputs are treated as a single output, this will be the sum of the market values of those outputs;
 - the meaning of market value is elaborated on below;
- the activities that produced those feedstock outputs are identified [*Schedule 1, item 1, subsection 355-450(1), step 2(a)*]:
 - these activities connect the feedstock output with the costs attributed to it;
- the cost amounts associated with the non-quarantined R&D activities that produced each feedstock output are attributed to each output as the ‘output’s cost’ [*Schedule 1, item 1, subsection 355-450(1), step 2*]:
 - where activities contributed to more than one feedstock output, a reasonable apportionment is made;
 - ‘cost amounts’ means expenditures and decline in value allowances for depreciable assets [*Schedule 1, item 1, subsection 355-450(1), step 2(a) and (b)*];
- the feedstock adjustment arising from the output is the lesser of the output’s value and the output’s cost [*Schedule 1, item 1, subsection 355-450(1), step 3*]:
 - where the output’s value exceeds the output’s cost, the feedstock adjustment will equal output’s cost (effectively reducing the claimable expenditure to nil because the net cost of the related activities was nil);
 - where the output’s value is less than the output’s cost, the feedstock adjustment will equal the output’s value (effectively reducing the claimable cost to equal net cost);
- the respective feedstock adjustments are added together and the total feedstock adjustment subtracted from the total of the amounts eligible for an offset [*Schedule 1, item 1, subsection 355-450(1), step 4*].

2.61 This has the overall effect that an offset will be available for:

- quarantined expenditures; and
- non-quarantined expenditures to the extent that they are not netted off against the value of direct outputs of the R&D activities to which the expenditures relate.

2.62 The augmented feedstock rule as it appears in the exposure draft will be refined further, by clarifying:

- the scope of quarantined activities:
 - currently, only conceptual design has been designated as a quarantined activity;
- application to R&D undertaken in order to enable completion of contractual obligations (such as civil engineering projects);
- the meaning of ‘market value’: the principle for outputs that are not at a marketable state when produced by the R&D activities is to take the market value when the output reaches a marketable state and use it to impute a value for output at the time of its production. That later market value (such as an arm’s length price at time of sale) would be allocated across the costs attributable to getting the output to that marketable state:
 - all of the non-R&D costs shall be covered before any value is attributed to R&D activities;
 - the residual value is allocated to the R&D activities; and
- inter-year application: two possible approaches for where the feedstock adjustment process straddles the end of the income year are:
 - a trading stock approach, under which claims for the R&D tax incentive would be deferred until the market value of feedstock output can be imputed; or
 - a clawback approach, under which the delayed feedstock adjustment would be clawed back from previous years’ offsets — this is the approach illustrated in the examples.

2.63 The examples in the following section illustrate how the rule is intended to ultimately operate.

Examples illustrating the R&D activities tests

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

2.65 The examples also illustrate (where relevant) the intended operation of the augmented feedstock rule outlined above.

EcoStartup

2.66 Example 2.1 illustrates a straightforward application of the ESI, novelty, technical risk and PKI tests in a non-production context.

Example 2.1: EcoStartup

EcoStartup was formed to investigate the potential for a chemical known as C23 to be added to petrol to reduce greenhouse gas emissions. The company devises an R&D plan and systematically conducts documented experiments to investigate this idea, by measuring exhaust emissions produced from a range of engines by different amounts of the additive for fuels across a range of octane values.

Core R&D

The idea has a scientific basis, as C23 has several analogous properties to a compound K32 — which is known to reduce greenhouse gas emissions in cars but is only available in limited quantities. C23 is widely available but normally used as a paint additive; its use as a fuel additive to target greenhouse gas emissions would be novel. The related chemistry theory is complex and underdeveloped, so the probable outcome of the experiment is uncertain.

EcoStartup's experimental activities are systematic and investigative. They involve the requisite levels of novelty and technical risk. They are conducted for the purposes of acquiring new knowledge. The activities do not fall within the scope of any items on the exclusions list. EcoStartup's experimental activities are core R&D.

Supporting R&D activities

EcoStartup currently has no revenue or products for sale and conducts no marketing activities. Accordingly, it is straightforward for EcoStartup to show that the activities supporting the experimental activities are undertaken for the dominant purpose of supporting core R&D.

Feedstock rule

EcoStartup's experiments prove successful and the company then decides to manufacture and sell the fuel additive based on C23. The revenue EcoStartup might make from selling its new product is not relevant to its R&D tax incentive claim, as it will not be sales of a product produced by the R&D activities. Were EcoStartup to instead sell its intellectual property rights in the use of C23, the revenue from that sale would also not be relevant to its R&D tax incentive claim. The feedstock rule would only be relevant if the test batches produced by the R&D activities were marketable.

Smartread

2.67 Example 2.2 illustrates the scope of PKI test within the overarching commercial purpose of R&D.

Example 2.2: Smartread

Smartread manufactures tyres. It also conducts an ongoing research program testing new compounds with a view to developing improved products that it can exploit commercially. None of Smartread's sales revenue comes directly from the research program, which does not produce any marketable outputs.

Although the research has an overriding commercial objective, the relevant purpose of its program is to create knowledge and/or product improvements. Accordingly, Smartread's experimental activities satisfy the PKI test, so where they meet the tests for ESI, novelty and technical risk, they will be core R&D.

Feedstock rule

Smartread's revenue from the sale of existing products is not relevant to its R&D tax incentive claim in relation to core R&D.

Boulevard Mining

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

Boulevard Mining I

2.69 Example 2.3 illustrates how the tests apply where existing technologies are modified to apply in a novel application, adjacent to normal production, with the experimental activities incorporating what would otherwise be normal production activity.

Example 2.3: Boulevard Mining I

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

The project utilises existing knowledge about a new truss design developed elsewhere for cantilevered stadium roofs along with existing knowledge about optimal tunnel shaping for black coal. The project investigates the extent to which using the new truss design in various scales with various modifications will allow tunnels to be widened, using measurements of the forces being generated in the supported tunnel structure.

Core R&D

The experimental activities pertain to investigating how the truss functions as a tunnel support, rather than a cantilever roof support, in conjunction with various tunnel widths and shapes. The experiments are systematic and investigative.

The fact that the truss is being used in a different application would not, of itself, satisfy the requirement for novelty. However, in this instance the truss will be subject to forces of a significantly different nature to those in its previous applications, and so the application is a novel, rather than obvious, extension of previous uses.

The approach is also technically risky because it requires experimentation in order to resolve how the truss design interacts with tunnel widths and shapes. These interactions could not be resolved by desk calculations using existing knowledge of the properties of the truss and of tunnels.

The experimental activities therefore involve the requisite levels of novelty and technical risk. They are conducted for the purpose of acquiring new knowledge and/or improved processes and so satisfy the PKI test. They are not listed as excluded activities. Accordingly, the experimental activities constitute core R&D.

Although Boulevard Mining intends to mine the fork regardless of the outcome of the experiments — and the coal extracted in the course of the experiment is mixed with coal extracted from the other fork in the seam and sold — excavating the coal forms part of the experimental activity of making the tunnel.

As the experimental activities meet the PKI test, the overriding commercial purpose of extracting that coal (to sell or use it) is not relevant — the PKI test applies to the experimental activities as a

whole. Accordingly, the costs of extracting coal in the course of the experiment are eligible for the R&D tax incentive.

Supporting R&D activities

Removal of the coal excavated by the experimental activities is an activity supporting the core R&D, in that it prevents the coal from blocking the main tunnel. However, in the context of a working mine — where the coal extracted from the experimental tunnel is mixed with a much greater amount from the main tunnel fork — supporting the experimental activities is not the dominant purpose of removing the coal. Accordingly, it does not qualify as a supporting R&D activity.

Feedstock rule

The feedstock rule applies to effectively net the revenue from the coal off against the cost of the R&D activities that produced the coal. In this instance, the ‘normal’ bulk extraction phase (before the truss becomes involved) and the more considered fine extraction phase (entailing pauses in work to allow the trusses to be installed and adjusted, measurements to be made and analysed, and an overall much slower pace of work) can be treated as separate activities.²

This means that the profit from the bulk extraction is not netted off against the net costs attributable to the fine extraction and to the fabrication, installation and testing of the truss — only the coal extracted in the fine extraction phase would be considered a direct output of those activities. The feedstock adjustment does not apply to the costs associated with the conceptual design of the truss, because these are quarantined.

The pricing point for determining the market value of the coal outputs reflects the scope of the activities claimable for its extraction. In this instance, only the removal of the coal out of the way of the immediate experiment site is eligible, so Boulevard adjusts its ex-mine sale price of the coal down to reflect the costs of intramine movement and storage. For purposes of illustration, were (for whatever reason) Boulevard able to attribute as supporting activities those loading and transport costs to its R&D claim, the relevant market value would instead be the unadjusted ex-mine price, and the feedstock rule would apply to offset the amount claimable for those intramine costs.

² Technically, each lump of coal is a separate output. As noted in the section on the augmented feedstock rule, outputs produced by the same activities can, in practical terms, be treated as one output without changing the resulting total feedstock adjustment. In this case, lumps of coal produced by the bulk extraction activities were not produced by the same activities as lumps of coal produced by the fine extraction activities. Consequently, there are, in practical terms, two outputs.

The feedstock rule would apply similarly were Boulevard to use the coal itself (for example, as fuel or as an input to a coking oven), because coal is a marketable output.

The feedstock rule does not apply to the potential revenue from the exploitation of the knowledge and intellectual property embodied in the finished test tunnels.

Boulevard Mining II

2.70 Example 2.4 illustrates how the tests apply where the knowledge gained from experiments incorporating production activity is implemented in subsequent customised applications that involve trial and error that is systematically conducted and monitored.

Example 2.4: Boulevard Mining II

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

However, the scope of core R&D activities at Evans Range only extends to the amount of experimentation necessary to acquire the new knowledge to create the improved process — not to the determination of all of the various combinations of truss scale and tunnel width used in the mine. Further, although the implementation activities entail a degree of trial and error, they do not entail considerable novelty or high levels of technical risk, given the knowledge gained from the *Boulevard Mining I* activities.

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

These subsequent activities are conducted for the purpose of applying knowledge, rather than acquiring knowledge — even though a degree of trial and error is required and further useful knowledge might be gained in the process. Consequently, the implementation of the technique developed in *Boulevard Mining I* does not constitute R&D activities.

Feedstock rule

The feedstock rule has no application to the implementation phase, as the coal is not produced by R&D activities (of which there were none). Further, the revenue achieved from implementing the technique at Evans Range is an exploitation of the knowledge/improvements gained from the R&D, and so is not relevant for Boulevard Mining's claim in relation to the activities in *Boulevard Mining I*.

Mimic Mining

2.71 Example 2.5 illustrates how the tests apply where the knowledge gained from experiments incorporating production activity is applied in a different location. Although unique circumstances will be faced in different contexts, resolving how to apply known technology in the face of those circumstances will not, of itself, constitute R&D activities.

Example 2.5: Mimic Mining

Mimic Mining learns of the technique developed at the Evans Range mine and applies it to a mine it owns in the Oates Range. Mimic Mining decides to conduct its own experiments, rather than purchase the knowledge from Boulevard Mining.

Mimic Mining's experimental activities would fail the test for novelty. The Evans Range experiments have shown that it is feasible to use the new truss design to widen tunnel sizes.

Consequently, Mimic Mining is not undertaking R&D activities. Rather, the application by Mimic Mining of the Evans Range technique at Oates range would be an example of the spillover benefits that the R&D tax incentive seeks to foster.

Feedstock rule

Were, instead, Mimic to acquire the knowledge from Boulevard, the feedstock rule would not apply to Boulevard's licensing revenue, because it would be the exploitation of the knowledge and information produced by its R&D.

Boulevard Mining III

2.72 Example 2.6 illustrates, by way of contrast with *Mimic Mining*, that resolving how to apply known technology in a fundamentally different location can potentially constitute R&D activities.

Example 2.6: Boulevard Mining III

Boulevard Mining also has a mine in the Bowers Valley where the coal is presumed too crumbly for the approach developed at the Evans Range mine to be usefully applied. However, Boulevard Mining

conducts further experiments to show that the truss can, in fact, still permit significant increases in tunnel width.

The experimental activities for the Bowers Valley mine do involve considerable novelty, as evidenced by disproving the presumption that the truss could not be used to significantly widen tunnel width in seams of crumbly coal. This application could not be foreseen from the Evans Range experiments and its feasibility could only be ascertained by systematic scientific experimentation. It therefore satisfies the technical risk requirement. Because the Bowers Valley experimental activities were conducted for the purpose of producing knowledge, rather than merely to resolve problems in applying knowledge, they satisfy the criteria for core R&D.

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

Boulevard Mining IV

2.73 Example 2.7 illustrates how the dominant purpose test applies to supporting activities where production activities are contingent upon the outcome of the experimental activities and there is no ‘Plan B’.

Example 2.7: Boulevard Mining IV

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

Supporting R&D activities

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

Although the road and access tunnel construction activities would be used for future mining operations, this is not determinative of their

dominant purpose; nor is the fact that they will have no production purpose should the experiments fail.

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

In this instance, it is evident that, although the road and access tunnel will initially be used for the experiment, the company mainly envisaged them as infrastructure for future mining operations. Accordingly, it was found that their construction was not for the dominant purpose of supporting the core R&D and so does not constitute supporting R&D activity.

Feedstock rule

Were, under a different scenario, the construction of the mine infrastructure found to be supporting R&D activities, the feedstock rule would apply to offset coal revenue against the construction costs (to the extent that they were costs of those activities). In that scenario, the construction costs would be apportioned between the bulk and fine extraction phases, on the basis of the quantity of coal derived from each phase (see *Boulevard Mining I* above).

Grandheap Mining

2.74 The following series of Grandheap Mining examples illustrates the practical difference that the context in which experimental activities are conducted can make to the impact of the tests.

Grandheap Mining I

2.75 Example 2.8 illustrates applying the PKI test outside of a commercial context.

Example 2.8: Grandheap Mining I

Grandheap Mining undertakes experimental activities on the ability of new ground vibration sensor technology to assist in optimising slope angles for overburden heaps. The experiments involve considerable novelty as they utilise in a new way technology developed for vulcanology. The ability of this technology to reliably identify incipient heap instability prior to a collapse occurring is uncertain. Grandheap will apply the findings to minimise the land area lost to overburden heaps at a range of mines it operates, by allowing slope angles to safely approach more closely the actual angle at which the heap would fail. The results could also have implications for the economics of other mine sites.

Core R&D

The experiments are conducted at one of its abandoned mine sites, Mined Out Valley, using overburden excavated from old heaps. Accordingly, there are no reasons to suggest the experimental activities are conducted other than for an R&D purpose to gain knowledge about whether the new technology can be used to reduce the redundant safety margin in heap slope angle.

Supporting R&D activities

Similarly, it would be relatively straightforward for Grandheap Mining to establish that the activities it conducts to support its core R&D activities — such as extracting and transporting old overburden — meet the dominant purpose test, due to their physical separation from commercial mining activities.

Grandheap Mining II

2.76 Example 2.9 illustrates applying the PKI test where the experimental activities are linked to live production activities.

Example 2.9: Grandheap Mining II

Rather than conduct the experiments at Mined Out Valley, Grandheap Mining integrates them with its disposal of overburden at a working mine site, Compact Gorge. Due to the restrictive geography of the lease, minimising the number of overburden heaps will be a key factor in maximising access to the minerals there.

Core R&D

At the initial stages it would be fairly straightforward to demonstrate that the activities are being undertaken to test the predictive power of the sensor technology. As the number of experiments progresses, closer scrutiny would be expected as to whether further heaps were still part of the experimental activities related to assessing the technology, or were more appropriately considered to be the application of that technology to determine the optimal slope angle for a particular heap.

Regard would be had to factors such as Grandheap's original plan³ for the experimental activities, the results obtained and the statistical rationale for the number of trials. The nature of the business case for prolonged costly experiments could also be a key consideration in determining whether the activities were primarily for other than the purpose of knowledge/improvements.

³ Although, under the new R&D tax incentive, *ex ante* preparation of an R&D Plan is not a statutory requirement for registration, documented planning will still form an appropriate part of evidencing that experimental activities were systematic and investigative.

Although Grandheap conducted all of the ‘tests’ at Compact Gorge in a similar manner, it was found that the state of knowledge had reached the point that the cost of the ongoing tests could only be justified by the minerals that could be accessed as a result of removing (and storing) the overburden. Accordingly, those latter trials, despite their experimental form and appearance, did not satisfy the PKI test.

Supporting R&D activities

The scope of eligible supporting activities would, in practise, be narrower for the Compact Gorge site compared with had the experiments been conducted at Mined Out Valley. Although testing the vibration sensors at Compact Gorge also requires a supply of overburden, the overburden would be removed regardless of the experiments with the sensors, in order to access mineral deposits. Further, there is no apparent difference between the activity of removing overburden used in the experiments and removing overburden subsequent to the experiments. In the context of Grandheap’s activities at Compact Gorge, the dominant purpose of removing the overburden is to access mineral deposits rather than supporting the core R&D activities.

Feedstock rule

The R&D activities do not produce any direct output; therefore, the feedstock rule has no application. For purposes of illustration, this would apply were (for whatever reason) the removal of overburden to qualify as an R&D activity, as that activity does not directly produce the minerals.

Matryoshkoala

2.77 The following series of Matryoshkoala examples illustrates how the tests apply where experimental activities occur within a normal production run. The extent of the experiment relative to the normal production activities can affect the scope of R&D activities.

Matryoshkoala I

2.78 Example 2.10 illustrates how the tests apply for a small scale experiment conducted within a factory production run.

Example 2.10: Matryoshkoala I

Matryoshkoala operates a factory producing koala shaped Russian dolls. The production line produces the seven sizes of doll halves in sets of bare forms, which it then paints, glazes, assembles in the nested form and packages. The speed of the production line is constrained by the need to allow the paint on the dolls to dry before the set of dolls

can be nested inside each other prior to moving to the packaging stage of the production line.

Matryoshkoala has learned of a new fast drying permeable polymer glaze that is used to protect leather from scratching while still allowing it to breathe. Matryoshkoala conducts experiments on whether, in a production line context, using this glaze would allow the dolls to be nested before the paint has fully dried, such that the paint does not smudge and does finish drying in storage.

An alternative glazing unit with an attached glaze tank is fitted to the production line to allow several sets of test doll to be coated with the permeable glaze in the middle of a normal production run. The test doll halves are diverted to a spare nesting machine at an earlier than usual stage of the production line.

Core R&D

The experimental activities are for the purpose of creating an improved, faster production process. They involve considerable novelty in the application of existing technology and the outcome is uncertain. The experimental activities qualify as core R&D.

The scope of the experimental activities would not encompass the full production run. Operating the production line would only be part of the experiment when the test dolls were on it, and not with respect to the production line stages prior to the application of the glaze and after the diversion of the test dolls.

Supporting R&D activities

Further, although Matryoshkoala's experiment on an alternative glaze can only be done in a production context, most of the activities involved in the production run would fall outside the scope of supporting R&D activities — because they are undertaken for a dominant purpose of producing the normal production run rather than supporting the experiment.

Manufacturing and painting the doll halves used in the glazing experiment would be supporting R&D activities, as these doll halves are additional to or in place of those produced for the normal production run.

Feedstock rule

In principle, the feedstock rule would apply to the production costs claimed by Matryoshkoala for the experimental dolls, including the supporting activity costs of the painted doll halves used for the experiment. However, because the test dolls are arguably not new because they have been subject to considerable handling, Matryoshkoala donates them to the local preschool. The samples have

negligible market value and the feedstock rule has no practical application.

Matryoshkoala II

2.79 Example 2.11 illustrates how the tests apply for an experiment that dominates a factory production run, and the scope of the ‘pre-production activities’ exclusion.

Example 2.11: Matryoshkoala II

Due to concerns over the viscosity and curing properties of the test glaze, the experiment is, instead, run at full scale, to also test whether the glaze will clog the lengthy ducts leading to the glaze applicator.

Core R&D

For this full scale experiment, the scope of the experimental activities would be broader. Operating the production line downstream of the glazing unit (rather than just until a diversion) would now be part of the experimental activities, as would monitoring the glaze ducts from the main tanks (rather than from small tanks attached to a test glaze unit).

Supporting R&D activities

The scope of supporting R&D activities would now include operating the production line upstream of the glazing unit, and the manufacturing and painting of all the doll halves used in the experimental production run.

Exclusions

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

Tabby Marine

2.80 The following linked examples for Tabby Marine illustrate how it is intended the rules should apply where R&D activities are conducted through the production of a marketable product. In all three stages, the experimental activities are conducted on prototypes that are intended for sale.

Tabby Marine I

2.81 Example 2.12 illustrates how the tests apply where normal production components are unsuccessfully matched with experimental ones, increasing the overall cost of what ultimately turns out to be a normal production unit.

Example 2.12: Tabby Marine I

Tabby Marine manufactures catamarans. Generally five boats are under construction at any one time. Tabby experiments with a novel combination of steering rudder and propeller screw, in the hope of increased speed without sacrificing steering control. A prototype catamaran of conventional design is constructed with the test rudder-screw assembly fitted. The boat is fully fitted out as usual for eventual sale. Trials are then conducted on open water.

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

Core R&D

The experimental activities are deemed to satisfy the tests for ESI, novelty, technical risk and PKI.

Designing, fabricating and then removing the test rudder-screw assembly (to allow a conventional rudder and screw to be fitted) would be a part of the experimental activities. As the experiment pertains to testing how the rudder-screw assembly operates with Tabby's standard hull design, the activities of constructing the hull (and other boat elements that are a necessary part of the experiments) would also be part of the experimental activities and therefore core R&D activities.

It is not relevant that many (or most) of the activities are normal manufacturing steps for the company, or whether the dominant purpose of constructing the conventional hull was arguably for the commercial sale of a finished boat — the PKI test only applies to the experimental activities as a whole.

The intention to sell the prototype would, however, be relevant in that the hull would be trading stock rather than a depreciating asset.

Supporting R&D activities

Fit out that goes beyond what is necessary for the experiment is not part of experimental activities. Although such fit out supports the experiments by aiding crew comfort, in the circumstances it was not undertaken for the dominant purpose of supporting R&D (but for the

purpose of the intended sale) and so does not qualify as a supporting R&D activity.

Feedstock rule

There are two direct outputs produced by the R&D activities: the physical rudder-screw assembly and the boat (without experimental rudder-screw assembly, with a standard rudder and screw yet to be fitted). Consistent with the fact that the boat was built as part of the experiment and its construction costs claimable as an R&D expense, the boat is captured by the feedstock rule — notwithstanding that experiments ultimately made no contribution to the boat sold in its purely conventional form.

All the costs associated with the R&D activities are attributed to either the boat or the rudder-screw assembly. As the boat that was ultimately sold did not incorporate any of the ideas that were tested, Tabby attributes the costs of designing and conducting the experiments to the rudder-screw assembly.

The price of the boat is allocated first against the costs of non-R&D activities attributed to the boat and the residual against the costs of R&D activities attributed to the boat, to determine the market value of the output of the R&D activities. The feedstock adjustment then compares that market value with the cost of non-quarantined R&D activities attributed to the boat.

At this stage, the novel rudder-screw assembly is not a marketable output. Had Tabby abandoned further experimentation, the feedstock rule would apply the scrap value of the rudder-screw assembly against the non-quarantined R&D costs attributed to the assembly. Under the clawback approach, because the novel assembly will be used in further experiments, the application of the feedstock rule to the attributed costs is deferred until the assembly's ultimate fate is known.

In these circumstances, the extent to which the non-quarantined R&D costs attributed to the boat ultimately receive a subsidy from the R&D tax incentive would depend essentially on whether Tabby's normal profit margin exceeded the extra costs created by the R&D activities that were attributed to the boat.

In this instance, it turns out that the feedstock adjustment acts to negate any claim arising from the boat itself. This reflected the fact that the commercial risk of the R&D was relatively low, despite the need to build most of a boat, because of the fallback option of reverting the prototype to a conventional product. Further, most of the extra costs (including all the quarantined costs) were attributed to the rudder-screw assembly, for which all of the R&D activity costs are initially claimable (subject to a future feedstock adjustment, contingent upon whether the assembly is sold for scrap or incorporated into a marketable boat).

Tabby Marine II

2.82 Example 2.13 illustrates how the tests apply where modified production components are matched with experimental ones in a follow-up experiment that produces immediate commercial rewards.

Example 2.13: Tabby Marine II

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

Core R&D

This new experiment with the test rudder-screw assembly would still involve novelty, as new technology (the rudder-screw assembly design) is still being developed.

The design and fabrication of the test rudder-screw assembly that were part of the *Tabby Marine I* experiment are absorbed into the scope of experimental activities for the follow-up experiment. Otherwise, the scope will be as for *Tabby Marine I* but with the addition of the hull design modifications.

Feedstock rule

For purposes of the feedstock rule, the direct output of the R&D activities is a prototype boat incorporating the novel rudder-screw assembly and hull segments.

In this instance, even though the boat sold for a premium over Tabby's standard catamaran price, the revenue attributable to the R&D activities proved less than the costs attributed to non-quarantined activities. This was because of extensive sea trials, the challenges of making the modified hull sections for the first time and because the costs of designing and fabricating the rudder-screw assembly were absorbed into this second prototype. Tabby receives a subsidy on that shortfall, as well as on the quarantined conceptual design activities.

The costs claimed for fabricating the rudder-screw assembly for the first prototype would attract a feedstock adjustment that had the effect of negating the previous year's claim for those costs. This is because when those costs are absorbed into the follow-up experiment the rudder-screw assembly is deemed 'sold' at the cost of the R&D activities that produced it.

Under the clawback approach, this feedstock adjustment would first be applied against other amounts that would be eligible for an R&D tax

offset in the income year that the feedstock adjustment arises,⁴ then, to the extent it was not exhausted, applied to undo the R&D tax offset received in relation to the rudder-screw assembly (only) in the previous year.

Tabby Marine III

2.83 Example 2.14 illustrates how the tests apply where a prototype fails and is made from overspecified materials.

Example 2.14: Tabby Marine III

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

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

Core R&D

This new experiment with the rudder-screw assembly would still involve novelty. In this instance, application of what is still only proven as catamaran hull technology to a monohull is a significant step that requires scientific experimentation to assess its feasibility.

Fabricating (but not designing) a further rudder-screw assembly is part of the experimental activities, as is translating the catamaran hull modifications to the existing monohull design and constructing the modified monohull. It is not relevant that the materials used in the experimental activities (such as the planking for the hull) were of a higher standard than necessary to conduct the experiment.

Supporting R&D activities

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

Feedstock rule

⁴ This approach is taken to minimise the compliance costs associated with clawing back prior year offsets. It does not have the effect of applying profits from one direct output against net costs of others.

For purposes of the feedstock rule, the direct output of the R&D activities is a prototype boat incorporating a modified monohull the novel rudder-screw assembly and hull segments.

In this instance, because the monohull prototype was sold at a loss and a significant proportion of that price was allocated against the luxury fit out, the market value attributed to the direct output of the experimental activities was exhausted before all of the relevant costs are accounted for and the R&D tax incentive is available for the shortfall and the quarantined costs.

Whist Constructions

2.84 Example 2.15 illustrates how the rules apply where experimental activities are an integral part of an inherently once-off production task under a fixed price contract.

Example 2.15: Whist Constructions

Whist Constructions enters into a fixed price contract to construct a bridge across River Gorge, which has a deep, unstable sedimentary layer at the bottom of the gorge. Competing tenders had proposed arch-base constructions with deep piles to reach the underlying bedrock. Whist tendered on what it hopes will prove a lower cost approach using a suspension bridge with pylons located on the top of the cliff. Whist's approach is risky because the type of rock to which the suspension cables must be anchored has known weaknesses. Whist hopes to address this weakness by altering an existing anchor design. If successful, the technology may have commercial value beyond the project, but this potential did not materially affect Whist's decision.

The anchor design is tested in situ at the point in the construction schedule that anchors would normally be inserted and load tested. As usual, the anchors are closely monitored as the load increases throughout construction of the remainder of the bridge.

Core R&D

The experimental activities pertain to how changes to the anchor design allow it to be used in the rock type, and therefore include some activities that would normally be undertaken in building a suspension bridge, such as ongoing monitoring of the test anchors as the load increases.

However, the experimental activities do not extend to installing and testing all of the anchors — only to the extent necessary to acquire the new knowledge to create the improved products (the new anchor design) and installation process — beyond this, installing and testing anchors is undertaken for the non-experimental purpose of building the bridge. Core R&D could, however, include any monitoring of those

‘non-test’ anchors beyond what would be normal, where this extra monitoring is justified by the experimental plan.

The relevant novelty lies in the modification of the existing anchor to marry it to the rock type — rather than in the broader engineering strategy of using a suspension bridge instead of a gorge arch. Similarly, the relevant technical risk lies in the uncertainty of how a modified version of the anchor design will interact with the rock type — rather than the risk that Whist will not be able to complete the bridge on the basis of its tendered approach.

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

Supporting R&D activities

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

Feedstock rule

For purposes of the feedstock rule, the direct output of the R&D activities is their contribution to the completion of the bridge. That is, notwithstanding that the experimental activities have the purpose of knowledge/improvements, in the circumstances they were conducted to produce an engineering solution to enable Whist to complete the bridge project within which the experiments were conducted — rather with a view to general commercial exploitation.

The revenue from completing the contract is allocated to the cost of non-R&D activities undertaken to complete the bridge, and the residual applied against the costs of the non-quarantined R&D activities to determine the feedstock adjustment amount.

In this instance, Whist’s novel approach worked and, as they had hoped, the R&D costs were fully funded by the bridge contract. Accordingly the feedstock rule has the effect of confining the claimable R&D cost to the quarantined amounts.

Had things not gone so well, Whist might have spent well over budget on solving the anchoring problem, or had to sell the contact with unresolved problems for a low price. Access to the R&D tax incentive

on the net cost of the R&D partly underwrote the risk that Whist had taken on.

For purposes of illustration, were (for whatever reason) Whist able to claim all of the costs of constructing the bridge as R&D, the value of the direct R&D output would be the full contract price.

Chapter 3

Tax offsets for research and development

Outline of chapter

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

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

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

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

Context

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

- a base 125 per cent R&D tax concession that provides an increased tax deduction for certain expenditure on registered Australian-owned R&D activities;
- a 175 per cent premium R&D tax concession that provides an additional deduction to the base concession for expenditure that exceeds the average of the corporation's previous three years of Australian-owned R&D expenditure;
- an R&D tax offset that allows small corporations to cash out the value of deductions relating to Australian-owned R&D, which is of benefit if they are in a tax loss situation:
 - the tax offset is (broadly) available to corporations with an annual group turnover of less than \$5 million and whose aggregate R&D expenditure is greater than \$20,000 and whose group aggregate R&D expenditure is not more than \$2 million per year; and
 - eligible corporations can choose to receive the tax offset in lieu of deductions available to them under both the base concession and the 175 per cent premium; and
- a foreign incremental tax concession that provides deductions for foreign-owned R&D is as follows:
 - 100 per cent deduction for the base expenditure amount; and
 - an additional 75 per cent deduction for additional expenditure over the three-year average.

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

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

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

Summary of new law

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

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

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

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

The total of the entity's notional R&D deductions is reduced by any feedstock amount.

3.11 The R&D entity is entitled to a refundable tax offset if the annual turnover of the entity (and certain related entities) for that income year is less than \$20 million (and one or more exempt entities do not own

or control more than 50 per cent of the entity). Otherwise, the R&D entity is entitled to a non-refundable tax offset.

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

Comparison of key features of new law and old law

<i>New law</i>	<i>Current law</i>
<p>The two core components of the new incentive are:</p> <ul style="list-style-type: none"> • a non-refundable 40 per cent R&D tax offset; and • a 45 per cent refundable R&D tax offset for (broadly) R&D entities with an aggregated turnover of less than \$20 million. 	<p>An array of deductions and a tax offset (summarised above under the heading 'Context' in paragraphs 3.4 to 3.7) are available for eligible corporations.</p> <p>The primary benefit is an increased tax deduction equal to 125 per cent of certain expenditure on registered Australian-owned R&D activities.</p>
<p>The types of entity eligible for the tax offsets (called R&D entities) are:</p> <ul style="list-style-type: none"> • a corporation that is an Australian resident; • a foreign corporation that is resident of a country with which Australia has a double tax agreement and carries on business through a permanent establishment in Australia; and • a public trading trust with a corporate trustee. <p>An entity that is exempt from income tax is not eligible for the R&D offsets.</p>	<p>The types of entity eligible for the R&D concession are Australian corporations and public trading trusts.</p>

<i>New law</i>	<i>Current law</i>
<p>An R&D entity is entitled to a tax offset if the total of its notional R&D deductions is at least \$20,000.</p> <p>It is also entitled to a tax offset for certain R&D expenditure incurred to a research service provider, regardless of the level of its notional deductions.</p>	<p>Entitlement to a tax offset or a 125 per cent deduction is generally limited to corporations whose aggregate R&D expenditure is greater than \$20,000. There is an exception for certain R&D expenditure to a registered research agency.</p> <p>Entitlement to a tax offset is limited to a corporation with an annual group turnover of less than \$5 million and whose group aggregate R&D expenditure is not more than \$2 million per year.</p>
<p>An R&D entity can notionally deduct amounts under the R&D provisions for the income year for:</p> <ul style="list-style-type: none"> • certain expenditure on registered R&D activities; • a decline in value of depreciating assets used for registered R&D activities; • a balancing adjustment for those depreciating assets used only for R&D activities; • R&D expenditure incurred to an associate in an earlier income year; • R&D partnership expenditure; and • a decline in value of R&D partnership assets. <p>The total of the amounts an R&D entity can notionally deduct is reduced by any feedstock amount.</p>	<p>R&D deductions are available for:</p> <ul style="list-style-type: none"> • expenditure on R&D activities; • a decline in value of depreciating assets used for R&D activities; • a balancing adjustment for depreciating assets used for R&D activities; • R&D partnership expenditure; and • a decline in value of R&D partnership assets.
<p>An R&D entity is entitled to a refundable tax offset if the annual turnover of the entity (and certain related entities) for that income year is less than \$20 million. It is also necessary that one or more exempt entities do not own or control more than 50 per cent of the entity.</p> <p>Otherwise, the R&D entity is entitled to a non-refundable tax offset.</p>	<p>A corporation is (broadly) entitled to choose a refundable tax offset if it has an annual group turnover of less than \$5 million and its group aggregate R&D expenditure is not more than \$2 million per year.</p>

<i>New law</i>	<i>Current law</i>
<p>The quantum of the refundable tax offset is equal to 45 per cent of the notional R&D deductions.</p> <p>The quantum of the non-refundable tax offset is equal to 40 per cent of the entity's notional R&D deductions.</p>	<p>Where a corporation chooses to convert a 125 per cent deduction to a tax offset, that is equivalent to a tax offset worked out as 37.5 per cent of relevant amounts.</p>
<p>The deductions under the R&D provisions are notional deductions. They are worked out as a step in calculating an entitlement to an R&D tax offset.</p>	<p>A corporation can obtain actual R&D deductions. However, where a corporation chooses a tax offset instead of a deduction, it cannot actually deduct any amount under the R&D provisions for that income year.</p>

Detailed explanation of new law

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

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

3.15 The main notional deductions are for certain expenditure on registered R&D activities and the decline in value of a depreciating asset used for registered R&D activities (if certain other conditions are satisfied). The total of the amounts an R&D entity can notionally deduct is reduced by any feedstock amount.

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

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

3.17 The following types of corporation are eligible to obtain an R&D tax offset if they satisfy the relevant conditions:

- a corporation incorporated under an Australian law;

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

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

3.18 A public trading trust that has a body corporate acting as trustee is also eligible for an R&D tax offset. Public trading trusts are broadly taxed like a company for income tax purposes. However, corporate limited partnerships, which can have a partner other than a corporation, are not eligible for an R&D tax offset. *[Schedule 1, item 1, section 355-40 and Schedule 3, item 42, section 94J of the ITAA 1936]*

3.19 This exposure draft extends eligibility for the R&D Tax Concession in that eligibility was previously limited to Australian corporations and public trading trusts. The primary reason for extending eligibility is so that the R&D provisions do not discriminate against foreign corporations from a country with which Australia has a comprehensive double tax agreement where that corporation is an Australian resident or has a permanent establishment in Australia. A tax information exchange agreement, an agreement signed in conjunction with a tax information exchange agreement that only allocates taxing rights over a few, limited categories of income or an airline profits agreement is not a comprehensive double tax agreement.

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

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

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

Entitlement to a tax offset and amount of the tax offset

Work out total of notional deductions reduced by any feedstock amount

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

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

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

3.24 The total of the amounts an R&D entity can notionally deduct is reduced by any feedstock amount worked out under subsection 355-450(1). The concept of feedstock amount is explained in detail in Chapter 2 of this explanatory material. *[Schedule 1, item 1, subsection 355-100(3)]*

Total of notional deductible amounts is at least \$20,000

3.25 An R&D entity is entitled to a tax offset if the total of its notional R&D deductions is at least \$20,000. If the aggregated turnover for the entity is less than \$20 million, its tax offset is equal to 45 per cent of the total deductions. Otherwise, its tax offset is equal to 40 per cent of

the total deductions. Whether the tax offset is a refundable tax offset depends primarily on the aggregated turnover of the entity and is explained below under the heading ‘Is the offset refundable or non-refundable?’ in paragraphs 3.34 and 3.35. [*Schedule 1, item 1, section 355-100*]

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

Aggregated turnover

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

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

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

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

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

As the aggregated turnover of New Thingummies is less than \$20 million, it is entitled to a tax offset equal to \$90,000 (45 per cent of \$200,000). Also, as its aggregated turnover is less than \$20 million, the offset is a refundable tax offset (see detailed discussion below

under the heading ‘Is the offset refundable or non-refundable?’ in paragraphs 3.34 and 3.35).

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

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

Expenditure incurred to a research service provider

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

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

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

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

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

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

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

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

Is the offset refundable or non-refundable?

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

3.35 The rules applying to refundable tax offsets and non-refundable tax offset are explained below under the heading ‘Application of the tax offset rules’ in paragraphs 3.94 to 3.96.

R&D deductions are notional only

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

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

- a provision that prevents some or all of an amount being deducted (for example, Division 26 (about some amounts that an entity cannot deduct, or cannot deduct in full) or the general anti-avoidance provisions in Part IVA of the ITAA 1936);
- a provision that changes the income year in which an amount can be deducted (for example, the prepayment rules in Subdivision H of Division 3 of Part III of the ITAA 1936);
- a provision that includes an amount in assessable income wholly or partly because an amount has been deducted (for

example, the rules about recoupment of deductible amounts in Subdivision 20-A);

- the cost base rules in the capital gains and losses provisions (commonly known as capital gains tax (CGT)) in Parts 3-1 and 3-3; and
- the R&D provisions themselves.

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

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

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

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

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

On 1 June 2012 Upfront Payments incurs expenditure of \$150,000 for services to be provided by a contractor over three years (1,095 days). That expenditure satisfies the conditions for a notional deduction for R&D expenditure set out in section 355-55. For the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936 the deduction under section 355-55 is treated as an actual deduction (section 355-110).

Section 82KZM applies to the deduction under section 355-100 because:

- Upfront Payments is a small business entity (and has not chosen not to apply section 82KZMD to the expenditure);
- the expenditure is not excluded expenditure (as defined in section 82KZL);

- the eligible service period for the expenditure is longer than 12 months; and
- a deduction under section 355-100 would, apart from section 82KZM, have been allowed in the year Upfront Payments incurred the expenditure.

The effect of section 82KZM is that the deduction under section 355-100 is spread over the service period. In the 2011-12 income year Upfront Payments is entitled to a deduction for the expenditure under section 355-55 of \$4,110 $[(30 / 1,095) \times \$150,000]$.

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

Registration

3.40 To be eligible for an R&D deduction — for either R&D expenditure or decline in value of depreciating assets used for R&D activities — the R&D entity must be registered under section 27 of the IR&D Act for the activities for which it uses the asset. The registration rules are discussed in more detail in Chapter 4. [*Schedule 1, item 1, sections 355-200 and 355-300*]

3.41 For the balancing adjustment for depreciating assets used only for R&D activities, it is necessary that the R&D entity be registered for the income year in which the balancing adjustment event happens (see more details under the heading ‘Balancing adjustment for depreciating assets used only for R&D activities’ in paragraphs 3.83 to 3.86). [*Schedule 1, item 1, section 355-310*]

Where activities must be conducted

3.42 An R&D entity is eligible for notional deductions in relation to R&D activities it conducts within Australia or an External Territory. An R&D entity is also eligible for deductions for overseas activities in the following specified circumstances. [*Schedule 1, item 1, section 355-205*]

Overseas activities

3.43 An R&D entity is also eligible for notional R&D deductions for an overseas R&D activity conducted for the R&D entity while a finding by Innovation Australia under section 28B of the IR&D Act is in force for the R&D activity.

3.44 One of the findings that Innovation Australia can make under section 28B is a finding under section 28AA about activities to be conducted outside Australia. Innovation Australia cannot make a finding about an activity under section 28AA of the IR&D Act unless it is satisfied that the activity:

- is an R&D activity;
- cannot be conducted in Australia or an External Territory for one or more reasons prescribed by regulations; and
- meets any other requirements prescribed by regulations.

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

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

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

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

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

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

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

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

Example 3.4: Operation of ‘on own behalf’ rule

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

A is the major benefactor of the R&D expenditure it has incurred on the R&D activities, whereas B is not the major benefactor of the expenditure that it has incurred on those same activities.

Example 3.5: Operation of ‘on own behalf’ rule where activities conducted jointly

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

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

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

Permanent establishments

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

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

R&D activities conducted for foreign corporations

3.51 The new incentive also retains an exception to the 'on own behalf' rule that currently exists for certain activities conducted by the R&D entity for one or more foreign corporations that are related to the R&D entity (called foreign-owned R&D in the existing law). Each of the foreign corporations for whom the activities are conducted must be a resident of a country with which Australia has a comprehensive double tax agreement. *[Schedule 1, item 1, subsection 355-205(1) and section 355-215]*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

3.60 Expenditure that is not at risk is discussed below under the heading of ‘Integrity rules’ in paragraphs 3.110 and 3.111.

Interest

3.61 Here, interest has the same broad meaning as it has in the withholding tax rules in Division 11A of Part III of the ITAA 1936. This

includes an amount in the nature of interest (for example, a discount on security) and a dividend on a non-equity share.

Core technology expenditure

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

Cost of a depreciating asset

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

Buildings

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

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

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

3.66 An R&D entity is entitled to a notional R&D deduction for expenditure if:

- the entity satisfies the conditions (about registration and where activities must be conducted) applying to both R&D expenditure and decline in value of R&D depreciating assets (explained above);

- the expenditure is of a kind eligible for an R&D deduction (also explained above); and
- the entity incurs expenditure during the income year (other than an amount it incurs to an associate but does not pay until a later income year) on one or more registered activities.

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

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

- an amount of expenditure is incurred to an associate (which has its normal broad meaning in the income tax law); or
- the rules about prepayments of expenditure for services to be provided over a period apply (explained further below under the heading ‘Prepayments of expenditure for services’ in paragraphs 3.146 to 3.148).

Expenditure incurred to an associate

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

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

3.69 However, if the R&D entity does not pay the amount incurred until a later income year, the entity has a choice. The entity can choose to deduct an amount (or, if relevant, obtain a non-R&D tax offset) under the normal income tax provisions (for example, the general deduction provision, section 8-1). It would do this by claiming a deduction (or a non-R&D tax offset) in its income tax return. If it does so, the choice has been made and cannot be revoked (for example, by the taxpayer requesting an amendment of an assessment to disallow the deduction previously allowed). *[Schedule 1, item 1, sections 355-200 and 355-480]*

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

Example 3.6: Expenditure incurred to an associate but not paid until a later income year

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

Ingenious Plans is registered for the activities in the income year in which they were conducted. The expenditure also satisfies the various conditions in section 355-100 for the expenditure to be deductible. Nevertheless, Ingenious Plans cannot deduct the expenditure to the associate in the 2011-12 income year because the amount was not paid in that income year.

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

Ingenious Plans can deduct the expenditure for the 2012-13 income year.

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

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

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

- the entity would be entitled to deduct an amount under the depreciation provisions (Division 40) if those provisions applied with certain changes.

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

3.72 The entity cannot deduct an amount if the asset has been pooled with other assets for working out deductions for depreciating assets. Conversely, the entity cannot allocate a depreciating asset to a low value pool or one of small business pools after the R&D depreciation provisions have applied to the asset. *[Schedule 1, item 1, paragraph 355-300(e); Schedule 3, item 24, subsection 40-425(8); Schedule 3, item 91, subsection 328-175(9) of the ITAA 1936]*

Notional application of depreciation provisions

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

Purpose of conducting R&D activities

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

Buildings

3.75 The second change is to assume that Division 40 does not apply to a building (or an extension, alteration or improvement to a building) for which the entity can deduct an amount under the capital works provisions in Division 43. Nor does it apply to a building (or an extension, alteration or improvement to a building) for which the entity could have deducted an amount under Division 43 if the entity had started work before a particular date or used the building for R&D activities. *[Schedule 1, item 1, section 355-305]*

Capital works other than buildings

3.76 An R&D entity can get an R&D deduction (and, therefore, a tax offset) for capital works that are not buildings that it uses in R&D activities. *[Schedule 1, item 1, subsection 355-305(4)]*

Uses to ignore

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

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

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

Effective life

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

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

[Schedule 3, items 17 to 19, subsections 40-95(9), 40-100(4) and 40-105(1) to (3)]

3.79 This applies both for a taxpayer self assessing effective life and for the Commissioner making a written determination of effective life. *[Schedule 3, items 17 to 19, subsections 40-95(9), 40-100(4) and 40-105(1) to (3)]*

3.80 It is also necessary, in having regard to the period within which the asset is likely to be scrapped or abandoned, to disregard reasons attributable to technical risk in conducting R&D activities (if it reasonably likely that the asset will be used for R&D activities). *[Schedule 3, items 17 to 19, subsections 40-95(9), 40-100(4) and 40-105(1) to (3)]*

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

No change in depreciation method

3.82 A taxpayer generally has a choice of two methods — the prime cost method and the diminishing value method — in working out the decline in value of a depreciating asset and cannot change methods. If an R&D entity has previously worked out actual deductions under Division 40 for an asset, it must use the same method in working out notional deductions under Division 40, and vice versa. [*Schedule 3, item 16, subsections 40-65(6) and (7)*]

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

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

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

3.85 If the R&D entity would have been entitled to a balancing deduction under the standard balancing adjustment provision of section 40-285 (assuming the changes discussed above under the heading 'Notional application of depreciation provisions' in paragraphs 3.73 to 3.82), the entity is entitled to an R&D deduction of an equivalent amount.

That R&D deduction is included in the calculation of the entity's tax offset. [*Schedule 1, item 1, section 355-310*]

3.86 Conversely, if an amount would have been included in assessable income of the R&D entity under the standard balancing adjustment provision of section 40-285 (assuming the changes discussed above under the heading 'Notional application of depreciation provisions' in paragraphs 3.73 to 3.82), an 'uplifted' amount is included in the entity's assessable income. The assessable amount is equal to four thirds of the amount that would have been included under section 40-285. The uplift factor of four thirds is based on an offset rate of 40 per cent (rather the higher 45 per cent rate that generally applies to R&D entities with an aggregated turnover of less than \$20 million). [*Schedule 1, item 1, section 355-310*]

Example 3.7: Balancing adjustment for depreciating assets used only for R&D activities

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

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

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

As B only ever used the unit for undertaking R&D activities, it will work out a balancing adjustment under section 355-310. It is entitled to a notional deduction equal to the amount calculated under subsection 40-285(2), which is equal to the termination value less the adjustable value. The termination value is \$15,000. The adjustable value is equal to the opening adjustable value less the decline in value during the 2012-13 income year. The opening adjustable value is \$24,000. The decline in value is \$3,000. Accordingly, the adjustable value is \$21,000.

B is entitled to a notional deduction of \$6,000 (\$21,000 – \$15,000) under subsection 355-310(2). Assuming B has total notional R&D deductions over \$20,000 for 2012-13, B is entitled to an offset of \$2,700 (45 per cent of \$6,000) in respect of the sale of the unit.

Balancing adjustment for assets used partly for R&D activities

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

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

3.89 In working out reductions in the balancing adjustment amount for non-taxable use, use for the purpose of conducting R&D activities is assumed to be use for a taxable purpose. *[Schedule 3, item 23, section 40-292]*

3.90 If the R&D entity is entitled to a balancing deduction under the standard balancing adjustment provision of section 40-285, the amount of the balancing deduction is increased. The amount is increased by half if the R&D entity's aggregated turnover is less than \$20 million and one third in other cases. The factors by which the deduction amount is increased are equivalent to the 45 per cent and 40 per cent rates at which the R&D tax offsets are calculated. *[Schedule 3, item 23, section 40-292]*

3.91 If an amount is included in the R&D entity's assessable income under section 40-285, the amount assessable is increased by one third of an amount worked out under a formula. The factor of one third is concessional for those R&D entities with an aggregated turnover of at least \$20 million but is used for simplicity reasons. *[Schedule 3, item 23, section 40-292]*

3.92 The formula adjusts the amount worked out under section 40-285 so that it does not exceed the asset's total decline in value. It then applies a factor so that the amount being clawed back reflects that proportion of the decline in value of the asset represented by total notional R&D deductions. *[Schedule 3, item 23, section 40-292]*

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

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

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

ordinary business activities and 50 per cent of the time for carrying on R&D activities.

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

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

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

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

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

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

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

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

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

Application of the tax offset rules

Refundable tax offsets

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

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

Non-refundable tax offsets

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

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

3.97 The existing law (section 73C of the ITAA 1936) contains a clawback of the enhancement of deductions (that is, currently the additional 25 per cent) where a corporation receives (or becomes entitled to receive) from an Australian government body:

- a grant in respect of expenditure on R&D activities; or
- a recoupment of expenditure on R&D activities.

3.98 The effect of the existing clawback is that where a project receives a government grant (or recoupment), the taxpayer is disqualified from claiming the R&D Tax Concession in respect of expenditure up to twice the amount of the grant. When introduced in the 1980s, this had the effect that, for the company tax rate and concession rate at the time, the

concession would only be received to the extent that it would be worth more than the after tax value of the grant.

3.99 The new law will restore this outcome. Under the new law, a recipient of a grant (or recoupment) from an Australian government agency will have their R&D tax incentive offset reduced by the after-tax value of their grant, commencing with the year of the grant, then working back through any prior years of the relevant project, then carrying forward any residual amounts to future years of the project, until the clawback is complete. This will ensure that grant recipients receive the R&D tax offset to the extent that it is worth more than the grant. The provisions to implement this outcome are not in the exposure draft because they have not yet been developed.

Integrity rules

3.100 Integrity rules apply to the following:

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

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

Expenditure incurred while not at arm's length

3.102 If the expenditure incurred in a non-arm's length transaction or in a transaction with an associate is not equal to the market value of the R&D activities, the expenditure is instead taken to have the market value. That is, market value expenditure is taken to have been incurred whether the actual expenditure was less than, or greater than, the market value of the R&D activities or if there was no expenditure incurred. *[Schedule 1, item 1, section 355-400]*

Relationship with international transfer pricing provisions

3.103 Section 136AB of the ITAA 1936 is amended to clarify the relationship between the proposed non-arm's length transaction section (section 355-100) and the international transfer pricing provisions in

Division 13 of Part III of the ITAA 1936. If section 355-100 and Division 13 could otherwise apply, the potential operation of section 355-100 is to be disregarded. This leaves Division 13 to apply comprehensively in the international area, subject to the terms of any relevant double tax treaty. *[Schedule 3, item 44, subsection 136AB(2) of the ITAA 1936]*

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

Disposal of R&D results

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

- it is entitled to a notional deduction for expenditure on R&D activities or for using a depreciating asset for R&D activities; and
- it receives, or becomes entitled to receive, an amount:
 - for the results of any of the activities;
 - from the grant of access to, or the right to use, any of those results;
 - attributable to the entity having incurred the expenditure (including an amount that it is entitled to receive irrespective of the results of the activities); or
 - from disposing of a CGT asset, or from granting a right to occupy or use a CGT asset, where the disposal or grant resulted in another entity acquiring a right to access or use any of those results.

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

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

Expenditure reduced to reflect group mark-ups

3.107 If one or more entities connected with the R&D entity incur R&D expenditure for which the R&D entity can notionally deduct an amount and that expenditure was incurred when those entities were

connected or affiliated with the R&D entity, then the amount that the R&D entity can notionally deduct may be reduced. [*Schedule 1, item 1, section 355-415*]

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

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

Expenditure not at risk

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

3.111 Expenditure is not at risk to the extent that, when the expenditure is incurred, the R&D entity (or an associate) could reasonably be expected to receive an amount of consideration as a result of the expenditure being incurred or because of anything that happened before then. [*Schedule 1, item 1, section 355-405*]

R&D partnerships

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

3.113 An ***R&D partnership*** is a partnership in which at least one of the partners is an R&D entity and:

- each other partner in the partnership is either:
 - an R&D entity; or
 - a research service provider; or
- the partnership is a Co-operative Research Centre (under the program known as the Co-operative Research Centre program).

[*Schedule 1, item 1, section 355-500*]

3.114 The existing law contains rules (primarily in subsection 73B(3A)) that deal with these special partnerships. The new rules have a similar effect to the existing rules but have been drafted in a different way. The existing law used several deeming rules whose ramifications were hard to fully appreciate. The new provisions undo much of the deeming in the current law and describe more directly how the tax offset rules apply to partnerships.

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

3.116 In particular, an R&D entity that is a partner in an R&D partnership is entitled to a deduction for expenditure incurred by the partnership if various conditions, corresponding to those for expenditure incurred by an R&D entity, are satisfied. The entity is taken to have incurred so much of the expenditure as the partnership incurred out of money contributed by the entity in the current year or an earlier income year. *[Schedule 1, item 1, sections 355-505 and 355-510]*

3.117 The partnership rules also contain special rules about:

- notional deductions for a decline in the value of depreciating assets of R&D partnerships *[Schedule 1, item 1, section 355-515]*;
- the notional application of the depreciating asset rules in Division 40 *[Schedule 1, item 1, section 355-520]*;
- the application of the integrity rules *[Schedule 1, item 1, sections 355-525 to 355-535]*; and
- the application of the recoupment rules *[Schedule 1, item 1, section 355-540]*.

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

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

this Act' (for example, the rule applies for the purposes of Division 5 (Partnerships) of Part III of the ITAA 1936).

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

Is there a better approach for the treatment of partnerships?

3.120 Currently only a small number of partnerships carry on R&D activities (and few, if any, of these partnerships consist of R&D entities and research service providers).

3.121 The complexity of the rules is out of proportion to the small number of partnerships that we understand conduct R&D activities. Consequently, a simpler approach may be more suitable here. A possible approach could be to treat expenditure incurred by a partnership as incurred by the partners in equal proportions (or perhaps according to how a partnership agreement says that they share profits/losses).

Cooperative research centres

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

3.123 In this exposure draft the tax offset rules apply to a partnership that is a Cooperative Research Centre in basically the same way as they apply to the existing concessions. However, another approach may be able to produce a clearer and more practical application of the tax offset rules.

3.124 Another approach, which is being considered, would be:

- an R&D entity would be entitled to a notional R&D tax deduction based on the contribution they make under a

participant's agreement in the Cooperative Research Centre program;

- to provide a tax concession in the income year an entity makes a contribution, it would need to be certain that the contribution had been or would be expended on eligible R&D activities. One means of achieving this might be through program conditions; and
- an R&D entity's entitlement to a tax offset in relation to a notional deduction for an amount contributed to a Co-operative Research Centre would (like certain R&D expenditure incurred to a research service provider) be regardless of the level of its total notional deductions.

Consolidated groups

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

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

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

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

3.128 Therefore, a head company will be treated as an R&D entity that is registered for certain R&D activities while any subsidiary member of the group is an R&D entity that is registered for those R&D activities.
[Schedule 1, item 1, section 355-600]

3.129 In addition, the new law replicates the existing provisions that clarify the history that is taken into account for the purposes of working out the aggregated turnover of:

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

[Schedule 1, item 1, sections 355-605 and 355-610]

Imputation

3.130 Generally, a franking debit arises in an entity's franking account when, so far as is relevant, the entity receives a refund of income tax (item 2 in the table in section 205-30 of the ITAA 1997). A refund of income tax includes the amount of any tax offset which the entity is entitled to under Division 355, to the extent that the tax offset is refunded to the entity. *[Schedule 3, items 87 and 88, section 205-35]*

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

3.132 To prevent this outcome, a franking debit will not arise in an entity's franking account under item 2 in the table in section 205-30 to the extent that a refund of income tax is attributable to the refund of a tax offset which the entity is entitled to under Division 355. The franking debit is effectively deferred. *[Schedule 3, item 86, subsection 205-30(2)]*

3.133 Generally, a franking credit arises in an entity's franking account when, so far as is relevant, the entity pays a PAYG instalment or income tax (items 1 and 2 in the table in section 205-15). However, where a debit has not been made to an entity's franking account because a refund of income tax is attributable to the refund of a tax offset which the entity is entitled to under Division 355, a franking credit will not arise in respect of the payment of a PAYG instalment or income tax until these deferred franking debits are recovered. *[Schedule 3, items 84 and 85, subsections 205-15(1) and (4)]*

Example 3.9

Radical Innovations Pty Ltd is an R&D entity.

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

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

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

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

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

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

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

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

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

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

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

Other matters

Assessments and objections

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

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

3.136 That means that the amount of a refundable tax offset is covered by a notice of assessment. If a taxpayer is dissatisfied with the amount of a tax offset under an assessment for the taxpayer, the taxpayer may object against the assessment under section 175A of the ITAA 1936.

3.137 For corporations, an original assessment is generally a deemed assessment under subsection 166A(3) of the ITAA 1936. That assessment of the taxable income of the amount of taxable income (or that there is no taxable income) and the tax payable thereon (or that there is no tax payable) is in accordance with what the taxpayer specified in its return. Also, the return is taken to be a notice of assessment served on the taxpayer on the day the return was lodged.

3.138 No amendment to the law is necessary to achieve these results.

Findings of Innovation Australia binding on Commissioner of Taxation

3.139 The Commissioner is bound by the following findings of the Innovation Australia Board where the finding is set out in a certificate given by the Board to the Commissioner:

- a finding about an R&D entity's registration (under section 27A of the IR&D Act), provided that it is made within four years after the end of the income year; and

- a finding about activities yet to be completed (under section 28A of the IR&D Act).

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

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

Amendment of assessments

3.141 Currently the Commissioner has an unlimited period to amend an assessment to increase the liability of a taxpayer to give effect to existing R&D provisions in the ITAA 1936. The unlimited period is repealed, which is consistent with the recommendations in the Treasury discussion paper titled *Review of Unlimited Amendment Periods in the Income Tax Laws*. *[Schedule 3, item 45, subsection 170(10A)]*

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

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

3.144 There will also be special contingent amendment periods where:

- Innovation Australia gives the Commissioner a certificate setting out a finding about registration (and that finding was made within four years after the end of the income year); or
- a decision is made on internal review (under section 30D of the IR&D Act) or by the Administrative Appeal Tribunal or a court about an R&D entity and an income year.

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

3.145 In these cases, the Commissioner has a period of two years from the giving of the certificate, or the decision being made, to amend an assessment to give effect to the certificate, or decision (respectively).

This is consistent with recommendation 3 in the Treasury discussion paper.

Consequential amendments

Prepayments of expenditure for services

3.146 As discussed above under the heading ‘R&D deductions are notional only’ in paragraphs 3.36 to 3.39, the deductions under Division 355 are treated as actual deductions for the purposes of the rules about the period of deductibility of certain advance expenditure (in Subdivision H of Division 3 of Part III of the ITAA 1936).

3.147 To ensure that the advance expenditure provisions can apply to the new R&D provisions in a similar way that they apply to the expenditure under the existing R&D provisions, the exposure draft makes a series of amendments to the advance expenditure provisions. These involve changes in section references and terminology to those used in the new law. *[Schedule 3, items 6 to 13, sections 82KZL, 82KZM, 82KZMA, 82KZME and 82KZMF of the ITAA 1936]*

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

Recoupment of deductible expenditure

3.149 As explained above under the heading ‘R&D deductions are notional only’ in paragraphs 3.36 to 3.39, the deductions under Division 355 are treated as actual deductions for the purposes of the rules about recoupment of deductible expenses in Subdivision 20-A.

3.150 The recoupment provisions in Subdivision 20-A are also amended so that they can apply generally to the recoupment of amounts deductible under the R&D provisions in Division 355. Without the amendment, Subdivision 20-A would apply only where the recoupment was by way of insurance or indemnity. *[Schedule 3, items 64 and 65, section 20-30]*

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

Capital works

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

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

[Schedule 3, items 25 to 40, sections 43-35, 43-70, 43-90, 43-100, 43-140, 43-195, 43-210 and 43-215]

Capital gains and losses

3.153 As explained above under the heading ‘R&D deductions are notional only’ in paragraphs 3.36 to 3.39, notional R&D deductions are treated as actual deductions for the cost base rules in the capital gains and losses provisions (commonly known as CGT). Consequently, the existing provisions that exclude certain deductible expenditure from the cost base or reduced cost base of a CGT asset apply to expenditure that is notionally deductible under the new R&D provisions.

3.154 There are consequential amendments to the CGT provisions to:

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

[Schedule 3, items 68 to 83, sections 104-235, 104-230, 108-55, 110-45, 118-24 and 118-35]

Definitions

3.155 The amendments to the taxation law discussed in this chapter have necessitated the inclusion of various new definitions in the Dictionary to the ITAA 1997 (and the repeal or amendment of some others). The substantive effects of these changes are discussed in the course of this chapter. *[Schedule 1, items 2 to 8, subsection 995-1(1)]*

Checklists

3.156 The amendments to the taxation law discussed in this chapter have necessitated the amendment of various checklists in the ITAA 1997. *[Schedule 3, items 51 to 63, sections 10-5, 12-5, 13-1 and 20-5]*

Other consequential amendments

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

- replace references to the existing R&D provisions with references to the new R&D provisions;
- reflect the terminology used in the new provisions; and
- reflect the repeal of various existing R&D provisions, to the extent that there is no corresponding new provision.

[Schedule 3, items 46 to 50, 66, 67, 89 and 90]

Application and transitional provisions

3.158 The new R&D provisions will broadly apply to:

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

[Schedule 4, item 1]

3.159 The existing R&D provisions in sections 73A to 73Z of the ITAA 1936 are repealed. *[Schedule 3, item 41]*

3.160 The exposure draft only contains the above basic rules. More detailed application and transitional provisions will need to deal with a variety of issues. For example, a balancing adjustment for a depreciating asset used for R&D in an income year commencing before 1 July 2010 but where the balancing adjustment event occurs in an income year commencing on or after 1 July 2010.

Chapter 4

Administrative arrangements for the research and development tax incentive

Outline of chapter

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

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

Context of amendments

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

4.3 A key function of the Board will be to enhance the integrity of the program by registering activities as well as undertaking risk assessment and compliance work. In conducting this risk assessment and compliance work, the Board will confirm or reject an R&D entity's self assessment of certain activities as 'core' or 'supporting' R&D activities as defined under new Division 355 of the ITAA 1997.

4.4 The Board will also have a function in examining and making findings about R&D conducted outside Australia, to enable entities to access a R&D tax offset for certain types of activities that are conducted overseas.

4.5 In order to provide certainty for R&D entities, the Board will also be able to make findings about whether activities are core R&D or supporting R&D activities upon application by R&D entities.

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

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

Summary of new law

Registration of R&D activities

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

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

- the Board may make findings about an application for registration, or activities that have been registered, of its own accord;
- the Board must examine and make findings on activities that have been registered if it is requested to do so by the Commissioner; and
- the Board may make findings on whether registered activities are R&D activities upon application by an R&D entity.

4.10 Findings by the Board that activities are or are not core R&D or supporting R&D activities are binding on the Commissioner of Taxation (Commissioner) when making a decision in relation to whether expenditure associated with the activities is or is not R&D expenditure and claimable under the R&D tax offset rules.

Advance findings

4.11 An R&D entity may request two types of advance findings. As advance findings are in relation to activities yet to be completed, R&D entities will naturally apply for an advance finding before registration of the activities.

4.12 The first type of advance finding relates to activities that are being conducted or yet to be completed. An R&D entity may request that the Board make an advance finding in relation to one or more of the activities that could reasonably be expected to be undertaken in the current or next two income years, or which is or are being undertaken at the time of application for the advance finding. The ability of the Board to provide this type of advance finding is intended to increase certainty for R&D entities in relation to whether the Board considers certain activities to be core R&D activities or supporting R&D activities.

4.13 The second type of advance finding relates to activities to be conducted outside Australia. This type of advance finding is required if the R&D entity wishes to claim a tax offset for those activities. The Board will give a finding in relation to these activities if it is satisfied that certain requirements are met, including the requirement that the activities are R&D activities and also that they cannot be conducted in Australia.

Registration of entities as Research Service Providers

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

4.15 As a transitional arrangement for the 2010 2011 income year, RSPs registered by the Board for the R&D tax incentive will automatically include those entities which were registered as Australian research agencies on the Register of Research Agencies under the existing IR&D Act. These entities, and new entities which are registered in the future, will need to renew their registration on an annual basis.

Review of Board decisions

4.16 Certain decisions by the Board are reviewable decisions and any person whose interests are affected will have the right to request an internal review of the decision. The Commissioner can also request an internal review of these decisions. Applications may also be made to the AAT for a review of an internal review decision.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
The new Part III of the IR&D Act specifies the powers of the Board in relation to the new R&D tax incentive.	The current Part IIIA of the IR&D Act specifies the powers of the Board in relation to the R&D Tax Concession program.
The Board may register core and supporting R&D activities upon application by R&D entities. The Board may revoke an entity's registration in certain circumstances.	The Board may register R&D activities upon application by eligible companies. The Board cannot revoke a registration.
The Board may make findings on whether activities are (or are not) core R&D activities and whether activities are (or are not) supporting R&D activities. Registration may be amended in accordance with the Board's findings. Findings may be made at the discretion of the Board, and must be made at the request of the Commissioner or R&D entity after registration.	The Board may issue certificates in relation to whether registered activities are R&D activities. Findings can be made at the discretion of the Board and must be made at the request of the Commissioner.
R&D entities may request an advance finding to confirm that activities are core or supporting R&D activities if the activities can reasonably be expected to be conducted within three years.	Eligible companies may request an advance registration that provides them with a right to register their R&D activities. Advance registration decisions have effect for up to three years.

<i>New law</i>	<i>Current law</i>
An R&D entity must apply to the Board for an advance finding if it wishes to claim a tax offset for activities conducted outside Australia. The Board must be satisfied that the activities are R&D activities and cannot be conducted in Australia, as well as any other requirements set out in regulations.	An eligible company must apply to the Board for a provisional certificate in relation to overseas R&D activities before the commencement of those activities if it wishes to claim the Tax Concession for those activities. The overseas activity must be part of a larger Australian project and overseas expenditure must not exceed 10 per cent of total project expenditure.
The Board may register RSPs for an income year. All registrations are renewed at the same time every year.	The Board may register Australian research agencies for a period of 12 months.

Detailed explanation of new law

Registration of activities

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

4.18 Supporting R&D activities are connected to specific core R&D activities by the definition in section 355-35 of the ITAA 1997. Consistent with this, where the Board registers a supporting R&D activity, the registration must also specify the core R&D activity or activities to which the supporting activity is connected. Where the connected core R&D activities are not conducted in the same income year as the supporting R&D activities, the registration must identify the income year in which those core activities were registered or are proposed to be registered. That is, the relevant core activities can be undertaken in a past, present or future income year. *[Schedule 2, item 1, subsection 27A(3)]*

4.19 An applicant that wishes to be registered will be required to self assess whether or not it is an R&D entity. If the Board receives an application from a body that is not an R&D entity as defined in section 355-40 of the ITAA 1997 and it purports to register the core and supporting R&D activities of the ineligible entity, the registration would be invalid as the Board only has the power to register activities by R&D entities.

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

Applications for registration of activities

4.21 Applications for registration must be made within:

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

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

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

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

Findings about applications

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

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

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

4.27 In making its findings, the Board is not confined by the manner in which the entity categorises particular actions as ‘activities’. If the Board considers that some part of an activity nominated by the applicant as an R&D activity meets the definition but another does not, the Board may register the activity that it considers does meet the definition.

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

4.29 The Board has no power to make findings as to whether the entity applying for registration is an R&D entity, or whether expenditure in relation to the carrying out of the activities meets relevant tests in the ITAA 1997 (for example, whether activities are carried out by or for the registering entity, and not some other person, or whether the activities are

conducted in Australia). Entities may need to take independent advice on whether they are otherwise eligible to claim for a tax offset.

4.30 The activities in the application may be the subject of an earlier advance finding under subsection 28A(1). In this circumstance the advance finding will prevail over a finding under subsection 27B(1) to the extent of any inconsistency. [*Schedule 2, item 1, subsection 27B(2)*]

Positive findings

4.31 The Board is able to make positive findings in respect of activities within an application; namely, that the activities identified by the applicant are R&D activities. It makes these findings if it is satisfied, on the basis of the information provided, that the activity meets the requirements in section 355-25 or subsection 355-35(1) of the ITAA 1997, as relevant.

4.32 In relation to a finding that an activity is a supporting activity, the Board would ordinarily also make a finding about the core activity to which the supporting activity relates. If the relevant core activity will not be undertaken until a later income year (and hence cannot be registered yet), the Board will need to decide whether, if that nominated core activity were to be carried out in the current income year, it would meet the definition of ‘core R&D activity’.

4.33 A positive finding by the Board in respect of particular activities is confirmation of the applicant’s self assessment that nominated activities are R&D activities. Once the Board has made such a finding, the Commissioner is bound to treat the activities which are the subject of the finding as R&D activities when determining whether expenditure incurred in relation to the activity in question is R&D expenditure for the purposes of Division 355 of the ITAA 1997.

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

Negative findings

4.35 The Board can make negative findings in respect of activities within an application if it is not satisfied that it should make a positive finding; that is, if it is not satisfied that a nominated activity meets the relevant test in the ITAA 1997 as noted above.

4.36 There are a number of reasons why the Board might not be satisfied that the activity meets the appropriate test.

- The Board may be of the opinion that the activity fails one or more components of the test in the ITAA 1997. For example, an activity may have been nominated as a core activity, but the Board may not be satisfied that it carries a sufficient level of novelty, or a sufficient level of technical risk, or it might be an activity of the type specified in section 355-30.
- For supporting R&D activities, the Board might consider that the sole or dominant purpose of the relevant activity was not to support a core activity, or the activity might be of a kind specified in subsection 355-35(2). Additionally, if the Board makes a negative finding in relation to particular nominated core R&D activities, any activities conducted in support of those activities would likewise not be eligible for registration as supporting R&D activities.
- The Board may have insufficient evidence available to it to be satisfied that the activity is an R&D activity. This may be because the applicant did not provide all required information in the application, or because additional information is necessary in the circumstances of the case.

Additional information requests

4.37 The Board has the power to request, in writing, that the applicant provide it with any additional information it requires for the purposes of making a decision. The Board can ask for specific information or classes of information.

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

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

Consequence of findings

4.40 If the findings made by the Board confirm all aspects of the application (that is, the Board makes positive findings about all activities nominated in the application), the Board will register all the activities

nominated in the application for the R&D entity for the income year.
[Schedule 2, item 1, section 27A]

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

4.42 If the findings made by the Board are entirely inconsistent with the application (that is, the Board determines that no activities nominated by the applicant are core R&D or supporting R&D activities), the Board will refuse to register the applicant in respect of any activities.

4.43 The Board must inform an applicant in writing of the Board's decision about an application. Where the Board has registered the nominated activities without making any findings, it is only necessary to provide notice of registration to the applicant.

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

- a description of each finding;
- the Board's reasons for the finding; and
- the activity affected by the finding.

4.45 If the Board fails to comply with this notice requirement, however, it does not affect the validity of the Board's findings. If the Board makes more than one finding in relation to an application, there is no need for the Board to issue separate documents relating to each finding. All certificates can be contained in the same document.

[Schedule 2, item 1, section 27C]

Post registration process

4.46 The Board is able, at its discretion, to examine the registration of an R&D entity with a view to confirming that the registered activities are R&D activities. The Board must examine a registration if requested to do so by the Commissioner. The Board will check whether activities that are the subject of the request are registered activities, and if so, make a finding about whether these activities are core or supporting R&D

activities. This examination can take place at any time, in relation to a current income year or a past year (although if an earlier finding exists about particular activities, the later finding will have no effect to the extent of any inconsistency).

4.47 A finding by the Board only binds the Commissioner for the purposes of an R&D entity's income tax assessment for the income year if the finding is made within four years after the end of the income year (by operation of subsections 355-700(1) and 355-705(1) of the ITAA 1997).

4.48 The Board must also examine a registration if an R&D entity applies (in the approved form, and accompanied by the fee, if any, specified in regulations) for particular findings. The Board must either make one or more findings about the registration or refuse to make a finding, or any findings, in response to the application. The finding made by the Board may differ from that sought by the R&D entity and the Board may make a negative finding (that the activity was not a core or supporting R&D activity) if it has insufficient information to make a positive finding. The Board may also refuse to make a finding that is requested by an R&D entity if, in its opinion, no finding can be made or it is necessary or appropriate that no finding be made. This may occur, for example, if the R&D entity does not provide sufficient information, and does not supply further information requested by the Board under section 27G. [*Schedule 2, item 1, section 27F*]

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

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

definition in subsection 355-35(1) of the ITAA 1997)
[*Schedule 2, item 1, paragraph 27H(1)(c)*]; and/or

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

4.50 The activities may already be the subject of an earlier finding under subsection 27H(1) or findings under subsection 28A(1) (advance findings) or 27B(1) (findings about applications). In this circumstance these earlier findings will prevail over a new finding under subsection 27H(1) to the extent of any inconsistency. [*Schedule 2, item 1, subsection 27H(2)*].

Positive findings

4.51 The Board is able to make positive findings in respect of the activities it examines; namely, that the activities registered in relation to the R&D entity are R&D activities (either core or supporting). It makes these findings if it is satisfied, on the basis of the information provided, that the activity meets the definition set out in section 355-25 or subsection 355-35(1) of the ITAA 1997, as relevant. The Board may also release policy guidance about how it applies this test.

4.52 In relation to a finding that an activity is a supporting activity, the Board would ordinarily also make a finding about the core activity to which the supporting activity relates. The core activity may be undertaken in a past, present or future income year. If the relevant core activity will not be undertaken until a later income year (and hence cannot be registered yet), the Board will need to decide whether, if that nominated core activity were to be carried out in the current income year, it would meet the definition of ‘core R&D activity’. [*Schedule 2, item 1, subparagraph 27H(1)(c)(iii)*]

4.53 A positive finding by the Board in respect of particular activities is confirmation of the applicant’s self assessment that nominated activities are R&D activities. Once the Board has made such a finding, the Commissioner is bound to treat the activities that are the subject of the finding as R&D activities when determining whether expenditure incurred in relation to the activities in question is R&D expenditure for the purposes of Division 355 of the ITAA 1997.

Negative findings

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

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

- The Board may be of the opinion that the activity fails one or more components of the relevant definition in the ITAA 1997. For example, an activity may have been nominated as a core activity, but the Board may not be satisfied that it carries a sufficient level of novelty or a sufficient level of technical risk, or it might be an activity of the type specified in section 355-30 of the ITAA 1997.
- For supporting activities, the Board might consider that the dominant purpose of the relevant activity was not to support a core activity, or the activity might be of a kind specified in subsection 355-35(2). Additionally, supporting R&D activities, by definition, must be conducted in support of core R&D activities. If the Board makes a negative finding in relation to particular registered core R&D activities, any registered activities conducted in support of those activities would likewise not be supporting R&D activities.
- The Board may have insufficient evidence available to it to reach the appropriate level of satisfaction. This may be because the entity did not provide all required information in its registration application, or because additional information to these base requirements is necessary in the circumstances of the case.

Additional information about examinations

4.56 To facilitate an examination, the Board may request additional information about an R&D entity's registration from that entity. The request must be in writing and may specify the period (of at least 30 days) within which the additional information it requires must be provided. The Board may require that the information be given in the approved form.
[Schedule 2, item 5, section 27G]

4.57 If the Board is still unable to reach a positive finding on the basis of information provided, or the entity does not provide the further

information, the Board may reach a negative finding on the basis that it is not satisfied that the activity meets the test.

Consequence of findings

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

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

- a description of each finding;
- the Board's reasons for the finding;
- the registered activity affected by the finding; and
- the effect of the finding on the entity's registration.

4.60 If the Board makes more than one finding in relation to a registration, there is no need for the Board to issue separate notices relating to each finding. All certificates can be contained in the same document. *[Schedule 2, item 1, subsection 27J(2)]*

4.61 The Board must also notify an R&D entity in writing of a decision refusing to make a finding in response to an application by the entity. *[Schedule 2, item 1, subsection 27J(3)]*

4.62 If the Board fails to comply with this notice requirement, however, it does not affect the validity of the Board's findings, or the status of the entity's registration as varied by the Board. *[Schedule 2, item 1, subsection 27J(3)]*

4.63 If the findings made by the Board confirm all aspects of the registration, the Board will make no changes to the registration. Otherwise, the registration will be varied to reflect the findings.

Variations of registration

4.64 If any findings made by the Board are inconsistent with a registration of an R&D entity's activities, the registration is automatically varied. This variation is intended to align an R&D entity's registration in accordance with any findings that are made by the Board. *[Schedule 2, item 1, section 27L]*

4.65 A registered R&D entity may request a variation to its registration by way of application in the approved form, and payment of the fee (if any) specified in the regulations. If the Board is satisfied that the requested variation is consistent with any findings it has made, and is justified in accordance with the decision-making principles, the Board may vary the registration. The Board may request additional information from the R&D entity under the rules contained in section 27E if necessary. *[Schedule 2, item 1, section 27M]*

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

Revoking registrations

4.67 The Board may revoke the registration if an entity was not an R&D entity at any time when a registered activity was conducted, or if where a registered R&D entity requests to have their registration revoked. *[Schedule 2, item 1, section 27K]*

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

4.69 The Board must notify the Commissioner if it revokes a registration. *[Schedule 2, item 5, subsection 27K(5)]*

Advance findings

4.70 An R&D entity may apply to the Board for two types of advance findings. The first type of advance finding relates to activities that are being conducted or yet to be completed. The second type of advance

finding relates to activities that are proposed to be conducted outside Australia.

4.71 Even after receiving an advance finding from the Board, the R&D entity will still need to be registered for the activities that are subject to the advance finding in relation to each income year in which the activities are conducted in order to be eligible to claim an R&D tax offset.

4.72 Applications for advance findings must be in a form approved by the Board and accompanied by a fee (if any) as specified in regulations. *[Schedule 2, item 1, section 28D]*

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

4.74 The Board must notify the R&D entity that has requested an advance finding in writing, of its decision whether or not to make advance findings and, if it does so, details of each of the findings that the Board has made. If the Board makes any findings, the notice must also be provided to the Commissioner, and must include a certificate in respect of each finding, that includes:

- a description of the finding;
- the Board's reasons for the finding; and
- a description of the activities affected by the finding.

4.75 If the Board makes more than one advance finding, there is no need for the Board to issue separate documents relating to each advance finding. All certificates can be contained in the same document. If the Board fails to comply with this notice requirement, however, it does not affect the validity of the Board's findings. *[Schedule 2, item 1, section 28C]*

Finding about the nature of activities yet to be completed

4.76 An R&D entity may request that the Board make an advance finding in relation to one or more of the activities that could reasonably be expected to be undertaken in the current or next two income years, or which is or are being undertaken at the time of application for the advance finding. In some circumstances an R&D entity may already have a finding under subsection 28A(1) in relation to activities being conducted or proposed to be conducted. Where this is the case, a subsequent finding

under subsection 28A(1) has no effect to the extent of any inconsistency between the findings. *[Schedule 2, item 1, section 28A]*

4.77 In applying subsection 28A(2) the Board is not confined by the characterisation of actions by the R&D entity as ‘activity’. If the Board considers that only an activity which is part of the activity nominated by the R&D entity in its application satisfies the requirements set out in subsection 28A(2) the Board may make a finding in relation to the part of the activity it considers meets the requirements. This part then becomes ‘the activity’ for the purposes of the positive finding and the entity’s registration.

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

- that the activity is a core R&D activity (if it is satisfied that the activity meets the definition in section 355-25 of the ITAA 1997);
- that the activity is a supporting R&D activity (if it is satisfied that the activity meets the definition in subsection 355-35(1) of the ITAA 1997) in relation to one or more core R&D activities for which the R&D entity is or could be registered; or
- that the activity is neither a core R&D activity nor a supporting R&D activity (if it is not satisfied that the activity meets the definition of core R&D activity or supporting R&D activity).

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

4.79 The Board may refuse to make an advance finding that is requested by an R&D entity in relation to activities yet to be completed if, in its opinion, no finding can be made or it is necessary or appropriate that no finding be made. Circumstances where the Board may refuse to make a finding include where the R&D entity does not provide sufficient information in its application, and does not supply further information requested by the Board under section 28E.

4.80 Once made by the Board, an advance finding binds the Commissioner. That is, assuming that other requirements for claiming the R&D tax offset are met, if the Board makes a positive finding (that activities are R&D activities) the Commissioner is bound, by operation of subsection 355-700(2) of the ITAA 1997, to treat the activities as R&D activities when making a decision about whether expenditure associated with the activity during the income year or years to which the finding

relates is R&D expenditure for the purposes of new Division 355 of the ITAA 1997.

4.81 An advance finding only relates to the activity nominated by the R&D entity and which is made subject to a finding by the Board. If the R&D entity, having received an advance finding, conducts an activity which differs materially from that described in the advance finding, the advance finding will not apply to the activity conducted.

Findings about activities to be conducted outside Australia

4.82 An R&D entity may only claim a tax offset for R&D activities conducted outside Australia if it has a finding in relation to those activities by the operation of paragraph 355-205(1)(d) of the ITAA 1997. Upon application to it by an R&D entity, the Board must either make a finding that all or part of an activity specified in an entity's application cannot be conducted in Australia, or refuse to make a finding about the activity. The Board does not make negative findings in this context.

4.83 The Board may refuse to make an advance finding that is requested by an R&D entity on activities to be conducted outside Australia if, in its opinion, no finding can be made or it is necessary or appropriate that no finding be made. Circumstances where the Board may refuse to make a finding include where the R&D entity does not provide sufficient information, and does not supply further information requested by the Board under section 28E.

4.84 In order to make a finding the Board must be satisfied that the activity meets certain criteria. First, the Board must be satisfied that the activity is an R&D activity. Second, the Board must be satisfied that the activity cannot be conducted in Australia for one or more reasons to be specified in regulations. Third, the Board must be satisfied that the activity meets any other requirements as specified in regulations. The advance finding in relation to activities to be conducted outside Australia is subject to any conditions specified in regulations. [*Schedule 2, item 1, subsections 28B(2) and (3)*]

4.85 In applying subsection 28B(2) the Board is not confined by the characterisation of actions by the R&D entity as 'activity'. If the Board considers that only some action, which is part of the activity nominated by the R&D entity in its application satisfies the requirements set out in subsection 28B(2), the Board may make a finding to the part of the activity that it considers meets the requirements.

4.86 The Board may refuse to make an advance finding that is requested by an R&D entity on activities to be conducted outside Australia if, for example, in its opinion:

- it is not able to make a positive finding because it is not satisfied that the activity meets the relevant criteria; or
- no finding can be made or it is necessary or appropriate that no finding be made; for example, where the R&D entity does not provide sufficient information, and does not supply further information requested by the Board under section 28E.

4.87 The Board may examine findings which have already been made about activities to be conducted outside Australia in order to determine the entity's compliance with conditions of the finding. To facilitate this examination the Board may request the R&D entity give it specified information or specified classes of information about the R&D entity's compliance with any conditions under subsection 28B(3). The Board may ask that the information be given to it in an approved form and within a period of at least 30 days. *[Schedule 2, item 1, section 28F]*

4.88 A finding by the Board in relation to activities to be conducted outside Australia is valid for the entire period over which the activity is conducted unless the finding is revoked. The Board may revoke a finding in relation to activities conducted outside Australia if it is satisfied that the R&D entity has breached a requirement specified in regulations, or if the R&D entity requests the Board to do so (in the approved form and accompanied by a fee (if any) specified in regulations). A revocation has the effect, for the purposes of the ITAA 1997, that the finding is taken never to have been made. The Board must notify the Commissioner of any revocation. *[Schedule 2, item 1, section 28G]*

Intended content of regulations

Under paragraph 28B(2)(b), the Board must be satisfied that the activity cannot be conducted in Australia for one or more reasons to be specified in regulations. It is intended that the reasons specified in regulation will be as follows:

- (a) *the activity requires access to a population (human or otherwise) not available in Australia;*
- (b) *the activity requires access to a facility, expertise or equipment not available in Australia;*

- (c) *the activity requires access to a geographical or geological feature not available in Australia; or*
- (d) *the activity is prevented from occurring in Australia due to the operation of quarantine law.*

Under paragraph 28B(2)(c), the Board must be satisfied that the activity meets any other requirements as specified in regulations. It is intended that these extra requirements will be as follows:

- a) *the activity conducted overseas makes a significant scientific contribution to related activities conducted in Australia; and*
- b) *the related R&D activities conducted in Australia will be significant relative to the activity to be conducted overseas.*

Under subsection 28B(3) a finding about activities to be conducted outside Australia is subject to any other conditions specified in regulations. No conditions are proposed at this time.

Registration of entities as Research Service Providers

4.89 The Board has a role in the R&D tax incentive to ensure a minimum standard of capability in the provision of contracted R&D by RSPs. It will also make the list of RSPs publically available for the use of R&D entities wishing to access RSP services.

4.90 R&D entities which use the services of an RSP are not required to meet the \$20,000 expenditure threshold requirement for R&D expenditure by operation of subsection 355-100(2) of the ITAA 1997. This is intended to enable R&D entities to access expertise in Australia's public and private R&D organisations, to reduce unnecessary duplication of R&D facilities, and to improve the overall effectiveness of Australia's R&D effort through collaboration.

4.91 The Board ensures this minimum standard by granting registration to entities that satisfy the criteria set out in the regulations. Registration is given in respect of specified fields of research for which the organisation has shown that it is capable of undertaking.

4.92 Entities wishing to become RSPs must apply to the Board for registration as an RSP qualified to provide services in one or more specified research fields to registered R&D entities. An application for registration must be in the approved form and be accompanied by a fee (if any) prescribed in regulations for this purpose. [*Schedule 2, item 1, section 29C*]

4.93 Upon receipt of an application by an entity, the Board must decide whether to register or refuse to register the entity as an RSP. Regulations will specify the criteria the entity must meet to satisfy the Board that it is capable of providing services to R&D entities in one or more specified fields of research. *[Schedule 2, item 1, sections 29A and 29B]*

4.94 The Board may request that further information be provided about an application for an RSP registration or for variation of an RSP registration, and may request that information be provided within 30 days after the request was given. If the applicant fails to comply with the request, the Board can refuse to consider the application. However, the Board will make a decision about whether to accept information outside the period specified in the notice in accordance with the decision-making principles made by the Minister. *[Schedule 2, item 1, section 29D and subsection 29G(3)]*

4.95 The Board may also need to make inquiries for the purpose of determining whether the applicant meets the criteria for an RSP registration in relation to an application for registration or for variation of an RSP registration. It may notify the entity in writing of its intention to do so and may require that the entity pay up to \$1,000 (or any higher amount prescribed by regulations) towards the cost of determining whether the applicant meets the criteria for registration. The Board may refuse to consider the application for registration or variation until this fee is paid. *[Schedule 2, item 1, section 29E and subsection 29G(3)]*

4.96 Registrations are valid up until the end of the financial year in which the application is lodged. However, if an application is lodged within two months of the end of a financial year, then the registration will be valid until the end of the following financial year. *[Schedule 2, item 1, subsection 29E(1)]*

4.97 At least two months before the end of each financial year, the Board must give a notice to each RSP, asking if it wishes to continue to be registered under section 29A, and attaching an approved continuation of registration form. The form will include a statement about whether the RSP wishes to continue and is capable of continuing to be an RSP, and whether there is any variation to the approved fields of research in relation to which it wishes to be registered. The Board may revoke the registration in question if the RSP does not return the completed form within 30 days or any further period allowed by the Board (in accordance with the decision-making principles). Revocation will take effect at the end of that financial year. *[Schedule 2, item 5, subsections 29F(2) and (3)]*

4.98 In certain cases RSPs may wish to vary their registrations. This might occur where an RSP wishes to change the fields of research in relation to which it is registered; for example, by removing one field of

research, but remain capable of contracting research services in relation to at least one other field. In cases like this, the Board may vary a registration, where the RSP applies for the variation and the Board is satisfied that the research service provider would still meet the criteria in the regulations if the registration were varied as requested. *[Schedule 2, item 1, section 29G]*

4.99 The Board may also vary a registration without the request of the RSP if it is satisfied that the RSP does not meet the criteria for registration in the regulations in so far as those criteria relate to a research field for which the provider is registered. *[Schedule 2, item 1, section 29H]*

4.100 The Board may revoke a registration if an RSP requests the Board to do so or where the Board is satisfied that the RSP:

- no longer meets the criteria for registration in relation to any field of research; or
- has breached a requirement of registration prescribed in the regulations.

[Schedule 2, item 1, section 29J]

4.101 The Board is required to notify an RSP in writing of any variation, cancellation or revocation of its registration. The notice must also set out the reasons for the Board's decision in question and inform the RSP of its right to have the decision reviewed. *[Schedule 2, item 1, section 30B]*

4.102 The Board is also required to maintain a register of RSPs, which must include details of registrations, variations and revocations under this Division (current and past). It is intended that the register will contain the name of each registered RSP, the field of research for which it has been approved, and contact details. This register must be made available to the public via the internet, and published in the Board's annual report. The keeping of this register may assist R&D entities in decisions about subcontracting R&D activities. The register is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003* as it is merely an administrative record. *[Schedule 2, item 1, section 29K and item 117]*

4.103 As a transitional arrangement for 2010-11, entities registered as Australian research agencies under section 39F of the current IR&D Act will be deemed to be registered as RSPs, for the fields of research they were registered, from the commencement of this Part. *[Schedule 4, item 35]*

Review of Board decisions

4.104 Many decisions made by the Board in its function relating to the R&D tax incentive can be reviewed through an internal review process. The list of reviewable decisions in this regard is set out in section 30A. Examples of reviewable decisions include:

- decisions relating to applications by R&D entities to register activities as R&D activities;
- decisions relating to registration of R&D activities, including variations and revocations of registrations;
- decisions relating to findings that activities are or are not R&D activities;
- decisions relating to applications or registrations of RSPs (including variation, cancellation, revocation and extensions of time); and
- extensions of time for making an application for review of a decision.

[Schedule 2, item 1, section 30A]

4.105 When the Board makes a reviewable decision, as listed under section 30A, it is required to give written notice of the making of the decision, the reasons for the decision and the entity's right to have the decision reviewed under Division 5. However, a failure of the Board to give such notice does not affect the validity of the underlying decision.

4.106 Some provisions of the Act already require notice to be given of a decision (such as the notices required under sections 27C, 27J, or 28C) which is a reviewable decision. These notices will by themselves fulfil the requirements of section 30B if they include the information listed in that section (that is, a second notice need not be given). Where the provision relating to a particular decision does not expressly provide for the notice requirement, the notice, however, must be given in accordance with section 30B. *[Schedule 2, item 1, section 30B]*

Applications for internal review of reviewable decisions

4.107 An application for internal review of a decision can be made by or on behalf of a person affected by a reviewable decision. This application must be made in the approved form within 28 days after the entity to which the decision relates is notified of the Board's decision unless the Board has allowed an extension to this time period in

accordance with the decision-making principles. The Commissioner may apply for a review of a reviewable decision at any time after the reviewable decision is made.

4.108 The Commissioner may also apply for a review of a reviewable decision at any time after the reviewable decision is made. [*Schedule 2, item 1, section 30C*]

4.109 In reviewing its decision, the Board is not limited to considering only the information it had at the time the reviewable decision was made. It is able to consider new information that has come to light since the reviewable decision was made. Any new information that an entity wishes to be considered as part of the review should be provided to the Board within the 28-day period or any further period allowed.

4.110 If the Board receives an application for review of a reviewable decision, it must review the original decision and make a decision to:

- confirm the reviewable decision;
- vary the reviewable decision; or
- set aside the reviewable decision and make a new one made in its place.

4.111 If the Board does not make a decision within 90 days of receiving an application for review, then the Board is taken to have made a decision confirming the reviewable decision. Where a decision is taken to have been made for this reason, the Board is required to notify the entity that sought the review. However, the deemed decision is disregarded if the Board makes a decision after the expiration of the 90 days, and an application for review of the deemed decision by the AAT has yet to be made.

4.112 Under the *Administrative Appeals Tribunal Act 1975* (AAT Act), notice of an internal review decision must be given to any person whose interests are affected by the decision. Additionally, written notice of an internal review decision, including reasons for the decision, must be given to the Commissioner specifically under subsection 30D(5).

4.113 The Board's decisions determine the entity's registration status or the nature of an entity's activities for a particular year of income. As decisions, and therefore reviews of decisions, have impact for an entire year of income, it is necessary that internal review decisions take effect on the day on which the original reviewable decision took effect. [*Schedule 2, item 1, section 30D*]

Review by the Administrative Appeals Tribunal

4.114 Where the Board has made, or is taken to have made by the operation of subsection 30D(3), an internal review decision, applications may be made to the AAT for review of an internal review decision. Variations or substitutions of internal review decisions by the AAT take effect from the day on which the reviewable decision took effect.

4.115 Where the Board has made an internal review decision, applications may be made to the AAT in accordance with section 29 of the AAT Act. Where the Board is taken to have made a decision because of the operation of subsection 30D(3), applications must be made within 28 days starting on the day on which the internal review decision is taken to have been made. This ensures that the lack of a decision by the Board does not prevent entities having recourse to the AAT.

4.116 Due to the commercially sensitive nature of R&D conducted by entities, hearings of proceedings for review of internal review decisions are to be held in private. The AAT may also give directions as to who may be present during all or part of a hearing of the proceedings and also give directions of a kind mentioned in paragraphs 35(2)(aa), (b) or (c) of the AAT Act, which relate to the publication or disclosure of information. *[Schedule 2, item 1, section 30E]*

4.117 Variations or substitutions of internal review decisions by the AAT take effect from the day on which the reviewable decision took effect.

Approved forms

4.118 There is a requirement for certain things to be in the relevant approved form in several provisions in Part III (for example, applications under section 27D and applications of internal review under section 30C). In order to meet the requirement that something must be in the approved form for the relevant provision, the thing must be in writing in a form approved by the Board, and include the information required by the form and include any other material required by the form (including documents).

4.119 The Board may approve a form in writing. However, the Board must ensure that any form that is approved is consistent with any determinations made by the Minister about information and other material required by an approved form. Determinations of this kind are not legislative instruments as defined by section 5 of the *Legislative Instruments Act 2003* as they are administrative in nature. *[Schedule 2, item 1, section 31]*

Decision-making principles

4.120 Provisions within Part III requires that the Board must make certain decisions in compliance with decision-making principles. These decisions are:

- whether to allow a further period for something to be given other than the specified period in Part III; and
- whether a proposed variation under section 27M is justified.

4.121 The Minister may make these decision-making principles by way of a legislative instrument. [*Schedule 2, item 1, section 31A*]

Consequential amendments

4.122 Part 2 of Schedule 2 introduces the following defined terms to subsection 4(1) of the IR&D Act:

- approved form;
- Commissioner;
- constitutional corporation;
- core R&D activities;
- decision-making principles;
- entity;
- income year;
- internal review decision;
- R&D activities;
- R&D entity;
- research field;
- research service provider;
- reviewable decision;

- supporting R&D activities; and
- disclose.

These terms are required for the operation of the new Part III of the IR&D Act. *[Schedule 2, items 3, 5, 7 to 10, 12 to 19 and 32]*

4.123 Part 2 of Schedule 2 repeals the following obsolete terms from subsection 4(1) of the IR&D Act:

- approved research institute;
- company; and
- finance scheme guidelines.

[Schedule 2, items 4, 6, 11]

4.124 As a consequence of the new Part III, the reporting requirements in the Board's annual report have been amended. The Board will now report on the number of applications for registration under section 27A of the IR&D Act, the amount of offsets involved, an analysis of the R&D tax offset scheme for the financial year, and provide a list of RSPs and their fields of research as at the end of the year. *[Schedule 2, items 26 and 27]*

4.125 Amendments to the information-sharing provisions of the IR&D Act will permit the Board to disclose information to other government agencies, in particular the Australian Taxation Office, to facilitate whole-of-government input, as necessary, for administration of the R&D tax offset. *[Schedule 2, items 28 to 31]*

4.126 Regulations may specify fees for making applications to the Board under Part III and a method for indexing the fees. These fees must not amount to taxation. *[Schedule 2, item 48A]*

Application and transitional provisions

4.127 Part III of the IR&D Act will apply in relation to income years commencing on or after 1 July 2010. Section 29F of the IR&D Act (as inserted by Schedule 2) applies in relation to financial years commencing on or after 1 July 2010. *[Schedule 4, item 34]*

4.128 The R&D Tax Concession will be discontinued from 1 July 2010. However, the Board will still require some powers in relation to the R&D Tax Concession after this date, and some provisions

in Part IIIA will be preserved in transitional arrangements. These arrangements will be finalised at a later date.

4.129 Entities registered as Australian research agencies, immediately under section 39F are taken to be registered under new section 29A as RSPs. *[Schedule 4, item 35]*

