Australian Government

The Treasury

The new research and development tax incentive

Consultation guide — second exposure draft

March 2010

ISBN 978-0-642-74592-7

TABLE OF CONTENTS

CONSULTATION PROCESS

The Government is seeking feedback and comments on a revised version of the exposure draft legislation for the new R&D tax incentive. This document is intended to assist readers in navigating the second exposure draft but they should refer to the explanatory materials to the draft legislation for explanation of how the legislation works.

Making a submission

Submissions on the revised exposure draft are requested by: **Monday, 19 April 2010**

Submissions can be sent to:

General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Or emailed to: **rdtaxcredit@treasury.gov.au**

For inquiries, please call:

Gerry Antioch
Business Tax Division
The Treasury
02 6263 4382

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

Confidentiality

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

INTRODUCTION

1. In light of the feedback received on the exposure draft legislation for the new R&D tax incentive released in December 2009, changes have been made to ensure that the legislation is clearer and to remove unintended consequences.

2. A second exposure draft is now available for public comment. Submissions are requested by 19 April 2010. To assist you in navigating the second exposure draft, this document provides:

   – a brief summary of the differences between the second and first exposure drafts; and

   – responses to some frequently asked questions.

3. The Government recognises that the new R&D tax incentive is important to Australian businesses and that is why extensive consultation is being undertaken in developing the new incentive.

Background

4. In the 2009-10 Budget, the Government announced it would replace the existing research and development (R&D) tax concession with a new, more streamlined R&D tax incentive from 1 July 2010.

5. On 18 September 2009, the Government released a consultation paper on the design of the new R&D tax incentive. A number of public forums were held around Australia during September and October 2009. Treasury received 197 submissions in response to the consultation paper. All public submissions are available on the Treasury website.

6. On 18 December 2009, the Government released draft legislation for public comment. Treasury received 131 submissions in response to the exposure draft legislation. Public submissions are available on the Treasury website.

7. On 24 February 2010, the Treasury wrote to all parties who made a submission on the exposure draft. That letter:

   – identified five issues attracting a majority of concerns;

   – invited stakeholders to provide additional examples of 'genuine R&D' excluded from the new incentive by the exposure draft legislation; and

   – undertook to provide a second exposure draft of the legislation for further comment.

8. On 31 March 2010, the Government released revised exposure draft legislation for the new scheme. Submissions on the second exposure draft are requested by 19 April 2010. Once this process is complete, the Government intends to finalise the legislation for introduction in the next sittings of Parliament.

CHANGES TO THE DRAFT LEGISLATION

9. This section outlines where the second exposure draft takes a different approach to the first exposure draft. References to the relevant provisions and the associated explanatory materials are provided.

CHANGES SINCE THE FIRST EXPOSURE DRAFT

A clearer definition of core R&D

10. The revised definition of core R&D uses clear language instead of ambiguous concepts such as 'considerable (or appreciable) novelty' and 'high levels of technical risk'. It also streamlines the overlapping tests that were associated with these concepts and the requirement that experimental activities also be systematic and investigative.

11. To give effect to the new tax incentive, the first exposure draft attempted to adapt the language from the existing law into the framework of the new law. However, feedback on the first exposure draft indicates that this approach caused considerable confusion.

12. In essence, the revised definition requires that you need to be seeking new information (to solve a problem, develop a new product or improve a process) and that you need to do an experiment to uncover that knowledge.

Second exposure draft	First exposure draft
Schedule 1, item 1, section 355-25	Schedule 1, item 1, section 355-25

Lifting exclusions on supporting R&D

13. The second exposure draft does not apply the exclusions list to supporting R&D. We have concluded that it is not necessary to apply the exclusions list to supporting R&D in conjunction with the dominant purpose test.

    – The current exclusions list will still apply to core R&D. The treatment of software is dealt with in more detail below.

Second exposure draft	First exposure draft
Schedule 1, item 1, section 355-30	Schedule 1, item 1, subsection 355-30(2)

A refined dominant purpose test for supporting R&D

14. The new definition of supporting R&D takes a more refined approach to applying a dominant purpose test. In general, the risk of the new R&D tax incentive inappropriately supporting 'business as usual activities' is greatest when production is involved. The second exposure draft applies the dominant purpose test only to production activities (and activities on the exclusions list). Non-production activities will only need to meet a 'directly related' test similar to the existing law.

Second exposure draft	First exposure draft
Schedule 1, item 1, section 355-35	Schedule 1, item 1, subsection 355-30(1)

A less technical objects clause

15. The objects clause for new Division 355 of the *Income Tax Assessment Act 1997* (ITAA 1997) has been revised in light of the changed terminology for core R&D and to remove references to technical terms (such as 'spillovers'). Both the legislation and the explanatory materials make it clear that the objects clause is not an operative test that taxpayers will need to satisfy, although it does provide important context.

Second exposure draft	First exposure draft
Schedule 1, item 1, section 355-5	Schedule 1, item 1, subsection 355-5

A more targeted approach to software

16. The second exposure draft adopts a more principles-based approach to software R&D. The first exposure draft included both a multisales test and broad-based exclusions. Under the second exposure draft, most software R&D will be subject to the same rules as all other kinds of R&D. However, certain in-house software activities will be excluded from core R&D and will therefore be subject to the dominant purpose test for supporting R&D.

Second exposure draft	First exposure draft
Schedule 1, item 1, subsection 355-30(o)	Schedule 1, item 1, subsections 355-35(o) to 355-35 (r)

Streamlined treatment of Cooperative Research Centres (CRCs)

17. The second exposure draft implements the simplified treatment for R&D entities making contributions to a Cooperative Research Centre (CRC). The key change from the existing law is that monetary contributions made by program participants, rather than expenditures out of those contributions, are eligible for a tax offset. Program conditions will require that participant contributions be spent on R&D activities (as defined in the legislation for the new R&D tax incentive).

   – Work on the appropriate treatment of expenditure on R&D activities out of Commonwealth contributions to a CRC is continuing.

Second exposure draft	First exposure draft
Schedule 1, item 1, section 355-580	Schedule 1, item 1, section 355-500

Improved administration

18. The second exposure draft includes additional administrative powers to help ensure that AusIndustry and Innovation Australia have the tools necessary to implement an effective system of advice-giving and enforcement. In addition to providing taxpayers with private findings, the Board will issue public findings.

Second exposure draft	First exposure draft
Schedule 2	Schedule 2

Provisions to manage the transition

19. The second exposure draft contains provisions to deal with a variety of transitional issues. For example, how to approach a balancing adjustment for a depreciating asset used for R&D activities in an income year that commences before 1 July 2010, but where the balancing adjustment event occurs in an income year commencing on or after 1 July 2010. The first exposure draft contained only the basic application rules for expenditure and depreciating assets.

Second exposure draft	First exposure draft
Schedule 4, items 1-18	Schedule 4, items 1-3

Technical changes

20. The second exposure draft contains technical refinements to various provisions, most notably the partnership provisions, which have been substantially reworked. The revised draft also corrects two technical errors.

- The first exposure draft unintentionally 'repealed' the deduction rules for expenditure on scientific research in section 73A of the *Income Tax Assessment Act 1936* (ITAA 1936). These deduction rules are independent of the existing R&D Tax Concession and will not be repealed.

- The first exposure draft left out an existing exception to the 'expenditure not at risk' rule, where an Australian corporation performs R&D for a related foreign company. This exception will be retained to ensure that the new incentive is available to the Australian corporation.

21. The 'expenditure not at risk' rule has also been clarified to align with the Australian Taxation Office's interpretation of the corresponding existing rule. The second exposure draft explicitly limits the rule to circumstances where an R&D entity (or an associate) reasonably expects to receive an amount of consideration as a result of incurring expenditure, regardless of the results of the activities on which the entity incurs the expenditure.

Second exposure draft	First exposure draft
Deductibility of expenditure on scientific research Schedule 3, item 44	Deductibility of expenditure on scientific research Schedule 3, item 41
Expenditure not at risk: Schedule 1, item 1, section 255-405	Expenditure not at risk: Schedule 1, item 1, subsection 255-405

Material not included in the first exposure draft

22. Provisions for a number of issues were not included in the first exposure draft, but are dealt with in the second exposure draft.

A simpler approach to government grants

23. The second exposure draft clarifies how the new incentive will treat grants from an Australian government where all or part of the grant is spent on eligible R&D activities. A taxpayer will be ineligible for the R&D tax incentive on expenditure equal to twice the amount of grant money that is acquitted on eligible R&D.

24. This approach is consistent with the objective of making the new incentive easier to comply with and administer, while ensuring that the incentive does not provide a double benefit to grant recipients.

Second exposure draft	First exposure draft
Schedule 1, item 1, subdivision 355-G	N/A

Issues not covered by the second exposure draft

Retaining, but not augmenting, the feedstock provision

25. The new tests for core and supporting R&D and the new administration arrangements outlined above have led us to conclude that the augmented feedstock rule, contained in the first exposure draft, should not be necessary. A redrafted provision along the lines of the existing feedstock provision will be retained.

FREQUENTLY ASKED QUESTIONS

How is the new R&D tax incentive more generous?

26. The new R&D tax incentive will provide higher base rates of assistance. For smaller firms, the rate of assistance will effectively double.

27. Further, more small companies will be able to access a cash refund in respect of their R&D activities.

    – Currently, only those with a turnover of less than $5 million and R&D expenditure of less than $2 million can claim a refundable tax offset.

    – Under the new R&D tax incentive, companies with a turnover of less than $20 million can access a refundable tax offset for all of their eligible R&D; no expenditure cap will apply.

The tax benefits of tax offsets and deductions*

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

*At the current company tax rate, the equivalent to a 100 per cent tax deduction is a 30 per cent tax credit.

Will the new incentive still start from 1 July 2010?

28. The Government still intends that the new R&D tax incentive start from 1 July 2010. Legislation for the new incentive should be introduced in the next sittings of Parliament.

When will additional guidance material be available?

29. AusIndustry and the Australian Taxation Office are working to ensure that updated guidance material is available as soon as possible after the legislation for the new incentive is passed by the Parliament.

    – It is also expected that the new guidance material will be more extensive than under the current scheme. In particular, more industry-specific guidance will be made available.

    – The Government provided $38 million in the 2009-10 Budget to ensure that both agencies are equipped for this task.

30. In the meantime, the explanatory materials for the second exposure draft provide more examples than were included for the first exposure draft.

The legislation is still long — can it be shorter?

31. The draft R&D provisions are simpler than the existing R&D provisions, mainly because the four different benefits available under the existing law are replaced with an entitlement to a tax offset. The second exposure draft is about 30 per cent of the length of the corresponding provisions in the existing tax law.

32. Unlike the existing tax law, the draft provisions have a clear structure and have been written in the clearer style and structure used in the ITAA 1997. Provisions relating to the administration of the new R&D tax incentive have also been rewritten with a clearer structure and in a plain English style.

How does the new incentive cut red tape?

33. Balancing administrative simplicity for taxpayers with appropriate integrity measures is always a difficult task in the tax law.

34. The Government has eliminated the ongoing compliance concern for companies by removing the statutory requirement for them to maintain and submit an R&D plan.

35. As provided for in the first exposure draft, any agency involved in administering the incentive will only have a maximum of four years to revoke a finding or amend a taxpayer's claim for the R&D tax incentive.

36. However, taxpayers will be required to differentiate between their core and supporting R&D when registering their R&D activities. While the eligibility criteria for the R&D Tax Concession have always made this distinction, it has not been required at the registration stage.

    – The compliance costs associated with this change will be highest during the early stages of the new incentive, but should reduce as taxpayers adjust their practices.