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Board of Taxation Secretariat
The Treasury
Langton Crescent
Parkes ACT 2600
By Email: RandD@taxboard.gov.au

Dear Sir/Madam

Review of RDTI Dual-Agency Administration Model: Deloitte feedback

Deloitte welcomes the Board of Taxation review of the dual-agency administration of the R&D Tax Incentive and the opportunity to contribute.

Our detailed comments in response to the questions raised in the Consultation Guide that was published are set out in the attached Appendices.

If you have any questions in relation to our comments, please call me on (07) 3308 7215.

Yours sincerely

Greg Pratt
Partner

Encl.

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Appendix 1

The stated objective of the R&D Tax Incentive (**RDTI**) program is to encourage businesses and industry to conduct R&D activities that may otherwise not be conducted, particularly where the new knowledge gained is likely to benefit the wider Australian economy.

The current administration of the RDTI is undertaken jointly by the Australian Taxation Office (**ATO**) and Industry, Innovation and Science Australia (**IISA**) and the Department of Industry, Science, Energy and Resources (**DISER**) (referred to collectively herein as **IISA**).

As recognised, these joint administration roles have presented challenges and can result in duplicate compliance efforts and cost for participants in the RDTI program over time which have both served to undermine the purpose and intent of the RDTI program. This has ultimately resulted in the withdrawal of funding from the conduct of valuable R&D activities.

As such, Deloitte welcomes the formal recognition of this issue with the Board of Taxation's review of the dual administration of the RDTI, and this opportunity to contribute.

Our detailed comments and suggestions are as follows.

Current administration model

1. *Do you consider that the roles and responsibilities of the two administrators (ATO and IISA/DISER) are distinct and clearly understood? If not, how might they be enhanced?*

We believe that this question should be considered in two parts, addressing it as follows:

- Are the roles understood? We suggest that the answer to this question depends upon the person being asked:
  - We consider that the roles and responsibilities of the two bodies are largely well understood by tax agents and RDTI advisers.
  - We would suggest that the roles are less well understood by some SMEs who make claims without use of RDTI advisers, but this is not likely to be due to the dual administration model itself.
- Are the roles themselves distinct?
  - Despite the law providing sufficient clarity, we view the distinction between the lines of responsibilities as having become blurred over time, with even the regulators themselves demonstrating a lack of understanding of each remit. This has become increasingly evident with some recent case law and what appears to be the changing practices of both IISA and the ATO.
  - In practice, advisers are increasingly seeing ATO queries on activity eligibility related issues, and IISA queries related to expenditure issues.

One of the key arguments in support of the continuing dual administration model is that the ATO and IISA have two unique but differing skillsets, with IISA employing persons with the science and technical skillsets to understand the nature of potential R&D activities to assess their eligibility, and the ATO employing persons with the accounting and tax skillsets required to review the related expenditure claims.

However, two appeal decisions in the past five years have highlighted that it may not only be participants or claimants in the RDTI regime that have difficultly discerning the separate roles of the ATO and IISA in administering the RDTI program. It seems that the regulators have also at times sought to blur the lines where expedient to do so.

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In *JSLP v Innovation Australia* [2016] AATA 23, IISA (the respondent) submitted that there was little practical point in making an advance finding as to the eligibility of the activities if the expenditure of the R&D entity would otherwise be excluded under the eligible expenditure regime.[1]

The Administrative Appeals Tribunal (**AAT**) found that IISA engaged in overreach, stating at [57]:

> "*When the respondent submits, as it does in [2.9] of its written submissions, that "there is little practical point in making an advance finding if the expenditure of the R&D entity is excluded by the eligible expenditure provisions", it engages in overreach. That is because the question whether expenditure is excluded by the eligible expenditure provisions is a question for the Commissioner of Taxation, not the respondent. Whether an entity's expenditure is, or might be, excluded by those provisions has no role to play in the assessment of whether the target activities are "core R&D activities"*."

More recently, the comments of the Full Federal Court (**FFC**) in *Commissioner of Taxation v. Auctus Resources Pty Ltd* [2021] FCAFC 39, whilst persuasive and not binding, have the unwelcome effect of judicially blurring the roles of the regulators. The case opens the door to extending the ATO's responsibilities to include questions of activity eligibility, but it is yet to be seen how this will impact the ATO's approach to RDTI compliance activities.

In this regard, the FFC stated at [32]:

> *"Registration by an R&D entity of particular activities as being "core R&D activities" or "supporting R&D activities" under s 27A of the IRD Act, whilst a necessary requirement to be eligible for the tax offset refund, is not conclusive of such activities having the character of being "R&D activities".* ***Either the Commissioner or the Board might conclude that they are not****. The Board might do so by making findings under ss 27B or 27J. If the Board has not made findings (which is often the case),* ***the Commissioner might form his own views about whether a taxpayer's activities are R&D activities****. As the legislation currently stands (tax offset refunds being part of the process of assessment),* ***if the Commissioner took the view that particular activities were not R&D activities and there was no binding finding about that, then the Commissioner would have to act on his view*** *in performing his assessment obligation under s 166 of the ITAA 1936. In fulfilling his duty, the Commissioner is bound by a finding made by the Board if one happens to exist (s 355-705), but is otherwise responsible for administering the tax laws according to their terms. The Commissioner is not bound by the taxpayer's self-assessed view that their activities are "R&D activities". If it were otherwise, the taxpayer's opinion about their activities constituting R&D activities would, in the absence of a finding by the Board, be determinative of this aspect of the taxpayer's eligibility to the tax offset refund."*
> [***Emphasis added.***]

As a result of these comments, we suggest that, at a minimum, there is a need for the two regulators to agree and clearly communicate to all stakeholders their defined roles and responsibilities, whether they continue to administer the incentive in a formal dual role, or alternatively whether they commence to operate from within a single regulatory body.

Considering the recent judicial commentary, it may also provide greater certainty and clarity for taxpayers if the responsibilities of, and the limitations of, each of the joint regulator's roles were articulated further in a more formal context within the law or associated regulations.

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[1] Refer to *JSLP v Innovation Australia* [2016] AATA 23, at [43], which references the Respondent's Outline of Submissions, at [2.9].

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Dealings with the current administration model

2. *From your experiences, are there any aspects of the current registration, eligibility review and compliance arrangements which impede or hinder your dealings with the current administration system? What works well?*

Aspects that impede or hinder:

Registration

- The registration process under the former SmartPDF system effected the actual registration process reasonably, although on occasion some problems with the registration portal were experienced close to registration deadlines.
- However, there are several issues associated with the new RDTI web-based Portal registration process:
  - The Portal is largely untested at this point although early usage has indicated some problematic areas. These include pop-up boxes inappropriately advising registrants that their application is "likely to be ineligible", and some language used in the template responses not properly reflecting self-assessment processes.
  - Whilst we appreciate the intent of the character limitations which significantly confine responses to registration form queries on activities, these limits are problematic in the registration process, especially for larger claimants or those with projects based on complex technology. Often the small character limits act to prevent the claimant from adequately explaining the activity to IISA in the registration process, and are likely to have the potential to cause unwarranted registration reviews or "requests for information" after lodgement of information as part of the registration process.
  - Furthermore, the character counts do not appear to align with character counting indications in programs such as Word, which are commonly used to prepare and review draft applications. This has the potential to create significant problems if the revision of wording is needed at the point information is inserted into the Portal system, particularly where information is inserted close to the registration deadline.
  - There is a new requirement to allocate eligible R&D expenditure to all the registered activities which will likely be problematic because businesses do not generally account for expenditure based on the RDTI definitions of core and supporting activities.
- The lack of a proper transitional period prior to the new web Portal going live hindered claimants which were due to register around that time. We recommend that significant changes to processes – such as the need to register expenditures prior to lodging ITR for large taxpayers – should be communicated well in advance of implementation to enable taxpayers to adjust to new systems and avoid the need to substantially rework claims that have already been substantially prepared.
- Our comments regarding the increased costs of the new Portal to taxpayers are discussed below at Question 4.

Eligibility Reviews

- The time taken for IISA to make a finding decision is frequently excessive. Finding requests are often handed over to different IISA staff repeatedly, which delays the process, resulting in activities having to be explained in detail to more than one person. This is of particular concern when technical staff are made available for workshops, which may include travel to another State, and the team changes without adequate handover of knowledge from those meetings.
- As discussed in more detail in Appendix 2, it is common for the ATO to rate RDTI claims as a high-risk issue during ordinary review processes on the sole basis that the activities and expenditure *may* be ineligible, without detailed reasons for the finding.
- In our experience, the delays are not generally contributed to significantly by time taken by taxpayers to respond. Rather, the delays from IISA can be quite significant.

- We believe that there is a need to find an appropriate balance between allowing taxpayers to provide information that allows IISA to properly understand the technical basis of the project and enabling quicker IISA response times.
- From the perspective of the ATO, there is a significant focus on the nexus of expenditure to activities (the 'on' test) as well as confirming use of appropriate apportionment methodologies. However, no formal guidance on what the ATO considers acceptable practice has been provided, despite it being anticipated and its importance discussed for several years.
- We note that it is more common for the ATO to raise issues with IISA, with few examples of the reverse – this process or the lack of should be clarified.
- Compared to the ATO, there is a lack of public transparency for IISA decisions, which should be addressed by requiring publication of data on the details of IISA reviews and adjustments. This may increase taxpayers' certainty and understanding.

Compliance Arrangements

- As with review processes, there is a stark difference between the treatment of R&D expenditures and other income tax deductions in the context of streamlined assurance reviews and justified trust conclusions. In our experience, the commentary provided regarding R&D claims as part of these compliance arrangements is uniformly either an outright negative conclusion, a fence-sitting 'we have not seen evidence of....' outcome (when no evidence has been requested), or an inconclusive 'we cannot comment on eligibility...' outcome. All outcomes seem to result in either a negative assurance or a high-risk red flag rating. Given that R&D claims are often immaterial to larger taxpayers, in our view these compliance activities should either exclude R&D from these reviews, or commit the proper resources to the making of a realistic risk rating balanced with its often relatively small tax risk.
- We have noted occasions where historic forms of IISA guidance disappear from web resources and cannot be accessed. A specific example of this related to former software guidance that is not available online anymore, but may be critical for claimants to have access to as it provides context of the basis on which earlier claims were made. This contrasts with our understanding of the current ATO processes that generally maintain historic guidance somewhere for taxpayers to access.

What works well:

Registration

- Receipt of the registration confirmation with the annual registration number have generally been prompt.
- Errors in registration applications are generally notified quickly and resolved quickly via an approach that allowed provision of email-based supplementary information.

Eligibility Reviews

- The current process of reviewing project eligibility does allow taxpayers an appropriate opportunity to clarify / provide further information on project activities at various points during the IISA review process.
- IISA are generally welcoming of workshops involving technical staff to better understand the business context and technical aspects of the relevant activities.

Compliance Arrangements

- We welcome the proposed new determination powers for IISA as a beneficial development.

A more detailed explanation of some of the problematic processes and compliance related challenges we have dealt with on behalf of certain clients is outlined in Appendix 2.

3. *Have you experienced any difference in the way the program has been administered in response to previous reviews? We would like to hear what has been improved and/or any additional challenges that have been experienced.*

We have no specific further detail to add to this point.

However, we acknowledge our general impression that recent dealings with IISA have improved as the new "customer journey" and education processes have started to evolve. In the past, we have experienced less than ideal examples of behaviours by IISA officers who struggled to understand the technical information, would not accept additional information, suggested they would not take into account all information provided in making a decision despite being bound to do so at law, and took positions despite obviously not being supported by the facts.

4. *What is the cost to businesses in claiming the R&DTI? Where have businesses encountered complexity in the process?*

As indicated elsewhere, the eligibility review and compliance processes undertaken by the ATO and IISA, and the approach adopted by some officers in the regulatory bodies during reviews, can significantly increase the costs associated with making an RDTI claim. The anticipation of these potential additional costs by business can form a significant disincentive to participation.

More specifically, where a taxpayer is selected for review, the compliance processes undertaken by the ATO and IISA can result in significantly disproportionate costs and resources for taxpayers. In some cases, the approach of the regulators during reviews significantly increases the cost of participating in the RDTI regime. Our observation is that it can result in unjust outcomes for taxpayers who acted in good faith when making claims, because they can be forced to abandon valid claims as a result of the perceived cost of providing information for the purpose of compliance-based reviews. Although the risk of enduring a compliance process is a recognised disincentive to participation in the incentive, we recognise that compliance processes are a necessary part of ensuring that claims reflect the intended areas targeted for support under the incentive and welcome any new or improved approaches that have the effect of reducing compliance costs whilst maintaining the integrity of the tax system.

We also note that:

- New Registration Portal – the new Portal registration system is more difficult to use (set up of application, nomination of tax agent adviser, character limits etc.), and the format of the new information required to be provided as part of the registration is significantly more complex and time consuming to create and provide. We expect that it will substantially increase the cost to business of applying for RDTI registrations. Specifically, this will be due to factors including:
    - The stricter requirement for activity-based information, rather than project-based information. We acknowledge that this structure of information is in line with the eligibility criteria contained in the relevant sections of the tax legislation. However, the activity-based format will make it significantly more costly to break down and provide the requested information.
    - There is increased work required to provide an activity-based expenditure breakdown for all core and supporting activities – taxpayers, particularly SMEs, do not have processes in place that can account for costs at this level of detail, and the cost of adapting accounting processes to meet the requirements would be prohibitive. An estimated "allocation" based approach will be used, but even this streamlined approach will involve additional cost to taxpayer claimants.
    - It is now more difficult for advisers to act on behalf of clients, as the process to permit the web-based application to allow advisers to act on behalf of clients is more complex to progress.

  - The character-based limits for the fields taxpayers must use to provide information regarding their R&D activities are unduly short. This will result in iterative redrafting of relevant information to permit character limits to be complied with and will prevent claimants from adequately describing the activities in respect of which they seek to make claims.
- Overseas finding processes – the application process for these findings is excessively onerous and therefore expensive. The time taken for the issue of a finding is excessive – please refer to specific comments below in Question 7.
- Supporting documentation – clarity and further consideration are needed regarding the supporting documentation that IISA will accept as evidencing claims:
  - At present there is a significant difference between what the AAT or a Court would accept as evidence regarding the conduct of R&D activities, and what IISA requires in its compliance activities. We hold this view notwithstanding that we accept the principle (espoused by AAT and Court decisions) that contemporaneous documentation is a necessary requirement for making a claim.
  - Our experience is that IISA routinely requests documents in formats and levels of detail that typical companies do not create during R&D activities, and reject documentation that would, in all likelihood, be recognised as supporting eligibility propositions by the AAT or Courts. Companies can incur significant additional costs simply to create documentation specifically to support RDTI claims, despite the documentation having limited product development related benefits.

5. *Would you provide any real-life examples of businesses that have recently navigated the R&DTI application process? Were there issues, challenges or frustrations encountered in the process?*

Please see the discussion of "real life" examples in Appendix 2 which encompasses examples covering the whole process, rather than focused on the narrower application process.

In our experience, the real-life issues and challenges faced by taxpayers participating in the RDTI program are focused in the review process and include:

- The significant length of time (and effort) required to resolve eligibility related queries.
- IISA and the ATO not efficiently exchanging or sharing taxpayer information and regulatory actions of the other body.
- Duplicated expenditure reviews by the ATO pre- and post IISA reviews, despite initial low-risk assessments before receipt of a positive finding.
- An ATO perception that RDTI claimants must be adopting broad aggressive tax positions in comparison to other taxpayers.
- A lack of available guidance on ATO expectations to show a relevant nexus of expenditure to R&D activity, or what would constitute evidence of this nexus.

6. *Does the current administrative process impact the decision to apply for the R&DTI? How has it affected the decision to apply?*

In our experience, the existence and requirements of the dual administrative process is not of itself a source of taxpayer decisions not to participate in the program.

Rather, as outlined in detail above, a decision not to apply for the incentive is largely driven by the anticipated duration and disproportionate costs of potential compliance activities. It is possible this expectation could be exacerbated by knowledge that a combination of IISA / ATO reviews may be experienced in resolving compliance activities. These issues may undermine certainty that a taxpayer has in the program.

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Until a review has been completed (which can take years) there is no certainty for the taxpayer that their claims are accepted by regulators as satisfying the legislative eligibility criteria (with few exceptions such as the safe harbours for certain clinical trials). In our experience, taxpayers under review may not lodge claims again until the outcome of a current review is known, and may defer the commencement of relevant activities accordingly. This issue has been particularly apparent in the software space in recent years.

That said, for smaller taxpayers with lower expenditure on claimable activities, the requirements of IISA registration can impact on the decision to apply for the RDTI. Often, clients make a decision not to make a claim because of the expectation of a limited return and the need to comply with burdensome compliance registration and supporting documentation requirements.

7. *How easy or otherwise have applicants found the Advanced Findings process and the Overseas Findings process with DISER?*

The process of obtaining an overseas advance finding is lengthy, complex and costly, despite reviews now being outsourced to third parties. We have found the eligibility confirmation related aspects of the overseas finding process to be frustrating, in the same way that normal registration related compliance processes are problematic (discussed above and in further detail at Appendix 2).

In our experience, taxpayers very commonly elect not to claim overseas expenditure based on the potential compliance delays and costs alone. In many cases, clients can be advised that the resource costs required to request and progress a finding that would permit the inclusion of costs related to overseas activities are prohibitive.

The two-stage approach taken by IISA, being eligibility findings and then compliance with overseas activity requirements, significantly contributes to the length and effort required in the finding process. To address this, we suggest that:

- The eligibility issues of the core and supporting activities could be self-assessed, in line with all other activities; and
- The overseas finding process could be restricted to the legislative issues related specifically to requirements for overseas related expenditure – specifically, the required link to the Australian core R&D activities, the need for R&D activities to be unable to be conducted in Australia, and the limits related to the amount of overseas expenditure compared to total reasonably anticipated expenditure on the solely Australian activities.

Further guidance would also be welcomed on the interpretation of what we believe are somewhat contradictory aspects of the legislation relating to the requirement that an overseas activity have a significant scientific link to one or more core R&D activities conducted solely in Australia. This application of this provision is problematic and can be difficult to argue and substantiate in practice.

In practical terms, there is a misalignment of the existing application form with the legislative requirements for domestic and overseas core and supporting activities. This adds frustrations to the process for both assessors and claimants alike, which is a matter for urgent assessment.

Notably, the recent outsourcing by IISA of some advanced and overseas finding applications to third party providers has also, in our recent experience, resulted in additional compliance complexity for claimants who have been assessed through this process.

Improvements and efficiencies

8. *What changes could be made to simplify the administrative and compliance obligations for taxpayers, whilst maintaining the integrity of the program?*

A single point of administration and source of information accessible to taxpayers such as exemplified in the New Zealand model could be considered, even if the back end of these functions was conducted by the two regulatory bodies in line with their specific areas of responsibility.

To address the increased cost of making claims, we suggest a simplified registration process requiring reduced detail could be implemented for smaller entities or claims below a threshold level of expenditure. A key feature of this streamlined version of claims could be a reversion to the past approach of providing information on a project rather than an activity basis, without need to cost on an activity-by-activity basis. Expenditure compliance formulaic shortcuts could also be considered to reduce the burden where claims are below set expenditure thresholds.

Use of a streamlined approach could be linked to a defined aggregated turnover threshold, a concept which is becoming an increasingly common threshold mechanism in recent years, and which is already a familiar concept within the RDTI program.

It may also be useful to align the IISA compliance framework with the approach used by the ATO, where smaller claims with lower risks to the revenue are subjected to less intensive compliance activities.

We also foreshadow here recommendations we have made in more detail in Appendix 2, being essentially:

- Concurrent reviews (ATO & IISA) if requested by the taxpayer;
- Amended assessments being issued only when activity related eligibility compliance activities (and appeals/internal reviews) are fully concluded;
- Providing IISA the capacity and legislative mechanisms to mediate and ‘settle’ disputes with taxpayers where the need arises; and
- Processes permitting exchange of certain information between IISA and the ATO, rather than requiring taxpayers to duplicate the provision of the information or update each regulatory body about what the other is doing.

9. What opportunities can you identify to reduce duplication between the two administrators?

The single point of administration and source of information accessible to taxpayers alluded to above would assist with many elements of duplication, and could operate effectively regardless of whether the review functions were conducted by two regulatory bodies in line with their specific areas of responsibility.

Duplication could be avoided by retaining the requirement that reviews of scientific and technical eligibility issues are conducted by appropriately IISA qualified staff members, whilst the ATO is restricted to expenditure issues. It is essential that this delineation be maintained as the skills required to determine issues differ greatly between eligibility and costing reviews. This matter has been discussed above in relation to the roles and responsibilities.

In our view, ATO staff with skills in costing and tax legal areas will generally not have the qualifications and background required to evaluate claim eligibility from a technical, scientific perspective. Similarly, it is our experience that IISA staff often do not understand the complexities of RDTI expenditure issues (capitalisation of costs, tax concepts such as decline in values, the impact of franking debits, etc.).

On the issue of whether a single or dual administration model is preferred, we believe it to be important that the different policy objectives underlying the roles of the ATO and IISA administrators be considered with appropriate separation of duties, regardless of whether the staff are contained in one or two regulatory bodies. We note that the ATO role to collect and protect the revenue is necessarily ideologically at odds with the IISA objective of providing financial support for and encouraging business to make claims to increase innovative activity in the economy.

As such, if a decision to encompass both roles in single entity model is made, we suggest that it will be necessary to continue to clearly separate the administrative roles, as well as the staff involved in them.

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Robust rules would be required to enforce the required separation of roles, and to ensure staff in both administrative roles have the skills needed for their functions even if they work within the same organisation.

10. *Reflecting on recent updates to guidance provided by the administrators, we would like to hear about its effectiveness/usefulness. What improvements could be made (if any)?*

Additional regulatory guidance is always welcomed from regulators.

However, the examples in guidance materials recently issued tend to illustrate obvious and non-contentious outcomes – such as eligibility issues that most taxpayers are likely already aware of. However, the guidance products often fail to provide information about the regulator's position on more complex or contentious technical issues that can arise in practice. As such, more examples illustrating the impact of subtle variations between factual patterns could help to better inform taxpayers, and align taxpayer claims with regulator positions.

Guidance on technical issues appears to take a long time to be prepared and issued to taxpayers. Furthermore, when it is issued, the language and wording used in guidance materials is sometimes not well drafted or logically presented. An example of this was the recent Draft ruling on the "Expenditure at Risk" clause, which appeared to need substantial rewording of initial sections.

Although guidance should be easy to read, more recent guidance products are often too far removed from the legislative requirements or do not reflect the practical format and structure of the RDTI application form (e.g., recent draft software guidance could provide guidance within the context of the new Portal questions).

Urgent guidance is also needed on key technical issues including the required degree of nexus between R&D activities and expenditures (the "on" test), appropriate R&D apportionment methodologies, and the building expenditure exclusion in s.355-225 of the *Income Tax Assessment Act 1997* (**ITAA 1997**). It would also be helpful to clarify the application of the activity provisions to less traditionally scientific industries.

Overall, given the RDTI provisions have now been in operation for a decade, we believe that it could be useful for both IISA and the ATO to progress some funded test cases cooperatively with taxpayers to clarify the interpretation of some key aspects of the RDTI legislation in Division 355 ITAA 1997.

International models and experience

11. *Our review includes an examination of the international R&D administration models. From your international experiences with similar programs abroad, is there any jurisdiction in particular that you consider to be appropriate for us to focus on for further analysis?*

We understand that the Board has explored this issue directly with other relevant countries after the release of the consultation document, so we have not sought to address this aspect of the consultation.

Appendix 2

The following comments reflect the substantial practical challenges that our clients face as a direct result of the dual administration of the RDTI program.

1. Timing of IISA and ATO Reviews

It is common for the ATO to raise RDTI claims as a risk during ordinary review processes (**First ATO Review**). The outcome of the First ATO review is often a high-risk rating for the RDTI claim on the sole basis that the activities and expenditure *may* be ineligible, without detailed reasons for the finding.

This First ATO Review often prompts IISA review activity (**IISA Review**) in relation to the eligibility of the activities, which generally commences during or soon after the First ATO Review. Once the IISA Review has commenced, the ATO typically will not undertake further review activity in relation to the eligibility of the expenditure claimed until IISA has issued a finding in relation to the eligibility of the activities (subject to comments below in section 2, below).

Where IISA issues a finding under section 27J of the *Industry Research and Development Act 1986* (**IRDA**) that some or all of the registered activities are ineligible (**Finding**) and the taxpayer seeks an internal review by IISA of the Finding pursuant to section 30C of the IRDA (**IISA Internal Review**), the ATO typically will not consider the eligibility of expenditure until the IISA Internal Review and any subsequent AAT review or appeal has been finally determined.

Whilst the basis for the ATO's approach to delay further review work is understood and is preferred by some taxpayers (i.e., if all activities are found to be ineligible by IISA then all the expenditure is ineligible), some taxpayers would prefer to finalise the ATO's review of their expenditure claims concurrently with eligibility reviews.

In this regard, the staggering of ATO and IISA reviews in relation to the eligibility of activities and expenditure has the following implications:

(a) Reaching a final resolution in relation to the eligibly of both the activities and expenditure under review can take several years, a process which could be expedited if the ATO reviewed the eligibility of expenditure concurrently with the IISA review of the eligibility of activities;

(b) Taxpayers are unable to make a proper assessment of whether to continue an eligibility related review or appeal without considering any specific concerns of the ATO in relation to the eligibility of expenditure. This is particularly the case given the lack of public ATO guidance or judicial consideration of key risks that attract the ATO's attention, as further discussed in Appendix 1. The processes associated with successfully challenging an IISA finding can be lengthy and costly. Taxpayers should be fully informed of the regulators' positions when deciding to pursue their review and appeal rights; and

(c) Where taxpayers are wholly or partly successful at internal review or in subsequent reviews/appeals, the ATO then takes considerable time to review the eligibility of expenditure claims, which can prompt yet another lengthy objection, review and appeal process.

Recommendation: The current approach is fair and reasonable in most circumstances. However, taxpayers should be able to request that the ATO continue their review concurrently with any IISA review activities where it is appropriate in their circumstances.

2. Commissioner raising amended assessments to give effect to a finding that is the subject of an internal review

Pursuant to section 355-705 of the ITAA 1997, the Commissioner is bound by an IISA Finding. In this regard, section 355-710 of the ITAA 1997 extends the statutory period of review that applies under section 170 of the *Income Tax Assessment Act 1936* (**ITAA 1936**) to enable the Commissioner to amend an R&D entity's assessment to give effect to a finding that increases the entity's liability by two years from the date the Commissioner is given the certificate of finding.

Notwithstanding the Commissioner has two years to increase an R&D entity's liability to give effect to an IISA Finding, on receipt of an IISA Finding, the ATO's approach has typically been to immediately give effect to the IISA Finding by raising amended assessments (**Amended Assessments**), even in circumstances where the taxpayer has requested an internal review of the Finding by IISA pursuant to section 30C of the IRDA.

To enable the raising of the Amended Assessments, once the ATO receives an IISA Finding, the ATO will typically commence a specific issue risk review (**Second ATO Review**) to quantify the adjustments required to give effect to the IISA Finding and to consider the imposition and remission of administrative penalties under the *Taxation Administration Act 1953* (Cth) (**TAA**). This may result in the issue of '**Penalty Assessments**'. The approach of individual compliance teams to this review can vary, which has been problematic in some cases (refer to response to question 5, above).

We acknowledge that the Commissioner raising Amended Assessments and Penalty Assessments to give effect to the Finding whilst the taxpayer seeks a review of the Finding is analogous to raising amended assessments at the end of an income tax audit which the taxpayer can object to. However, due to the dual administration of the RDTI we submit that the raising of the Amended Assessments before the activity eligibility review and appeal process is concluded is too early where the ATO has not otherwise completed a review of the eligibility of the expenditure claimed.

Recommendation: If a taxpayer exercises its right of internal review under section 30C of the IRDA, the Commissioner should not raise Amended Assessments to give effect to the Finding before the later of:

(a) the date that is 22 months after the date the Commissioner was given the Finding; or

(b) the date that is two months before the expiry of the statutory period of review for the relevant income year pursuant to section 170 of the ITAA 1936, taking into account any extensions provided by the Taxpayer pursuant to subsection 170(6) of the ITAA 1936.

The practical reasons for this Recommendation are as follows:

2.1. Solvency and payment arrangements

The Amended Assessments give rise to a debt that is due and payable by the R&D entity within 21 days of the issue of the assessment. Given the financial profile of many R&D claimants, this outcome can create significant solvency concerns, impact debt covenants attached to their funding arrangements, and impact their ability to exercise their review and appeal rights in relation to the IISA Finding due to funding constraints.

Where the Amended Assessments are paid in whole or in part by the due date and the taxpayer exercises its review and appeal rights, if the taxpayer is ultimately successful and the amounts paid by the taxpayer are refunded in full, the interest that will be paid on the amounts refunded is less than the market return on those funds had they been employed in the taxpayer's business or prudently invested.

Where the Amended Assessments are not paid in full by the due date, the general interest charge (**GIC**) is imposed at a rate that is 7% above the 90-day Bank Accepted Bill rate, compounded daily. To mitigate the financial impact, taxpayers that are unable to pay the full amount of the Amended Assessments would typically seek to enter into a payment arrangement with the Commissioner.

In the ordinary course, when a taxpayer objects to an assessment, the taxpayer can apply for a 50/50 payment arrangement as contemplated by paragraphs 26 to 28 of the ATO's *Law Administration Practice Statement PS LA 2011/4: Collection and recovery of disputed debts* (**PS LA 2011/4**). In summary, this requires the Taxpayer to pay 50% of the "disputed debt" until the dispute is finally resolved, and the Commissioner commits to remit 50% of the GIC imposed.

"Disputed debt" is defined in PS LA 2011/4 to "describe a tax-related liability, which is subject to an objection, a tribunal review or an appeal".

Where Amended Assessments relate solely to a decrease in an RDTI claim as a result of a negative IISA Finding, there are no grounds on which to object unless and until the taxpayer is wholly or partly successful during a review or appeal. In our experience, ATO debt teams struggle to understand the interaction between ATO and IISA review activities. Whilst 50/50 arrangements are entered into in these circumstances, our experience is that the process takes longer than negotiating a standard 50/50 arrangement thereby resulting in further increased costs for taxpayers.

Recommendation: If the recommendation above is not adopted regarding the deferred dates for raising Amended Assessments, PS LA 2011/4 should be amended to specifically deal with payment arrangements relating to disputed RDTI amounts.

2.2. Administrative penalties

Administrative penalties are often imposed and assessed at the same time as the Amended Assessments to give effect to the IISA Finding. It is important to note that there are no statutory limitations on when the Commissioner can raise a penalty assessment.

The basis for the penalty is often that the taxpayer made a statement to the Commissioner or to an entity that is exercising powers or performing functions under a taxation law that is false or misleading in a material particular (subsection 284-75(1) of Schedule 1 to the TAA) or that the taxpayer treated an income tax law applying to a matter in a particular way that was not reasonably arguable (subsection 284-75(2) of Schedule 1 to the TAA).

Since the ATO has not, at this point, conducted a review of the eligibility of expenditure, the sole basis for the penalty is the IISA Finding. That is, the R&D entity is no longer registered for the R&D activities under section 27A of the IRDA as required by Division 355 of the ITAA 1997.

This practice poses several issues, as further described below.

Recommendation: Penalty Assessments should not be raised on the sole basis of an IISA Finding where the taxpayer has sought an internal review until the eligibility of the activities has been finally determined.

(a) The grounds for the imposition of administrative penalties in these circumstances is not well understood by taxpayers, their representatives and ATO officers

Where the sole basis for the Amended Assessments is an IISA Finding, there is a concern that the purported imposition of administrative penalties by the Commissioner pursuant to Division 284 of Schedule 1 to the TAA is not authorised by law. In respect of the grounds for imposing an administrative penalty outlined above, the basic requirements are:

(1) Subsection 284-75(1) of Schedule 1 to the TAA:

   a. The relevant statement must be made to the Commissioner or an entity exercising powers or performing functions under a tax law; and

   b. The relevant statement is false or misleading in a material particular.

(2) Subsection 284-75(2) of Schedule 1 to the TAA:

a. The relevant statement must be made to the Commissioner or an entity exercising powers or performing functions under a tax law; and

b. The relevant statement treated an income tax law applying to a matter in a particular way that was not reasonably arguable.

The relevant statement relating to the Amended Assessments and Penalty Assessments is the statement made by the taxpayer in its income tax return that it was eligible to claim the RDTI. Where the sole basis for the Amended Assessments is a IISA Finding, notwithstanding it has retrospective effect for other purposes, the existence of a IISA Finding does not change the correctness or reasonableness of the statement at the time that the statement was made.[2]

If it were accepted that the Commissioner has the power to impose an administrative penalty in these circumstances, the basis for the penalty is often flawed. In this regard, in our experience, ATO teams treat the mere existence of an IISA Finding as conclusive evidence that the taxpayer took a position that was not reasonably arguable. However, in making a finding, IISA does not conclude whether the taxpayer's position as to the eligibility of the activities was reasonably arguable or not.

The threshold for a reasonably arguable position is not whether the position is correct or incorrect, but whether what was argued is as likely to be correct as incorrect and could be argued on rational grounds. This is a lower threshold than that required under section 27J of the IRDA for the making of a finding. In this regard, subsection 27J(1) of the IRDA provides that IISA may make one or more findings about an R&D entity's registration under section 27A for an income year, including that all or part of a registered activity <u>*was not*</u> a core R&D activity or a supporting R&D activity.

Therefore, it is erroneous for the Commissioner to rely on the mere existence of a finding as conclusive evidence that a taxpayer has taken a position that was not reasonably arguable.

Recommendation: We request that the Commissioner further consider whether it is appropriate to apply penalties under Division 284 in the circumstances described above.

Recommendation: We recommend the Commissioner issue a law administration practice statement, following public consultation, to guide ATO officers in making decisions in relation to the imposition and remission of administrative penalties in relation to RDTI claims.

<u>*(b) If a Taxpayer disagrees with the Penalty Assessment they have 60 days to object within time*</u>

Whilst there is no basis to object to the Amended Assessments whilst an IISA Finding is in effect, the taxpayer may disagree with the Penalty Assessment. A notice of objection must be given to the Commissioner within 60 days of the Penalty Assessment. This initiates another engagement point with the regulators, increasing the cost of compliance.

In addition, whilst the Commissioner's decision to raise Penalty Assessments immediately enlivens the taxpayer's review and appeal rights, ATO officers are often reluctant to decide penalty objections until the outcome of the IISA Internal Review is known.

The stated basis for this is that the Commissioner is bound by a finding made by IISA. However, and as outlined above, this confuses the threshold applicable to the making of a finding and assessing whether a

[2] See *Walstern v Federal Commissioner of Taxation* [2003] FCA 1428 at [105]-[106], *Orica Ltd v Federal Commissioner of Taxation* [2015] FCA 1399 at [44], and *Miscellaneous Taxation Ruling MT 2008/2 Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable* MT 2008/2 (see [31], [34],[52] and [53]).

taxpayer has taken the requisite level of care when making a statement or a position that is not reasonably arguable.

Recommendation: We recommend that the Commissioner issue a law administration practice statement, following public consultation, to better guide ATO officers in making decisions in relation to the imposition and remission of administrative penalties in relation to RDTI claims.

(c) A debt becomes due and payable

As with Amended Assessments, a debt becomes due and payable on the issue of a Penalty Assessment. Refer to comments in section 2.1 above. The length of time it takes for some RDTI reviews to be finally determined coupled with the ATO's reluctance to decide penalty objections until a final determination has been made can give rise to unwarranted outcomes for taxpayers. This is particularly the case given the Commissioner is not subject to a statutory deadline for issuing Penalty Assessments.

Recommendation: If the Commissioner is not willing to stay the issue of Penalty Assessments until the final resolution of the issues, ATO officers should be directed to determine penalty objections in the ordinary course.

2.3. Shortfall interest charge

Depending on the quantum of shortfall interest charges (**SIC**) imposed on Amended Assessments, the taxpayer may request a review of the ATO's decision not to remit all or part of the SIC, or object to the SIC remission decision (**SIC Review**).

One generally accepted ground for the remission of SIC is where there has been a delay in the ATO commencing or completing a review of the taxpayer's affairs (refer to *Practice Statement Law Administration 2006/8* (**PSLA 2006/8**)).

This is consistent with paragraph 280-160(2)(b) of Schedule 1 to the TAA, which provides that, "…in deciding whether to remit, the Commissioner must have regard to … the principle that remission should occur where the circumstances justify the Commonwealth bearing part or all of the cost of delayed payments", and the *Explanatory Memorandum to Tax Laws Amendment (Improvements to Self-Assessment) Bill (No. 1) 2005* (Cth), which states that:

> "*Remission should occur where the circumstances justify the Commonwealth bearing part of the cost of delayed receipt of taxes… Such cases would usually entail delay, contributory cause or fault on the part of the ATO or others. Where the Commissioner is aware that these circumstances arise, the Commissioner should initiate remission.*"

The ATO Review and Dispute Resolution Business Line, in consultation with the ATO's R&D Technical Team, have previously stated that delays by IISA were not relevant to the remission of SIC on the basis that those delays were outside the control of the Commissioner and PS LA 2007/8 only references any delay by the ATO. This remained the decision notwithstanding escalation of the issue by the ATO objection team.

This decision ignores the fact that the legislation refers to circumstances that warrant the *Commonwealth* bearing the cost of the delayed payments of tax, IISA is a Commonwealth entity and IISA performs adjacent functions to that of the ATO in relation to the RDTI. Taxpayers should not be penalised by imposition of SIC for delays of this kind which they are unable to control.

Recommendation: PS LA 2007/8 should be amended to specifically reference the relevance of delays on the part of IISA for SIC remission decisions.

3. Multiple ATO reviews of the same issues

On occasion, the Second ATO Review referenced above includes a review of the eligibility of the expenditure claimed, rather than just the ascertainment of the expenditure claimed that relates to the First Finding for the purpose of raising Amended Assessments. Where this is the case, the ATO review team often request that detailed information be provided to satisfy the ATO that the expenditure is not otherwise ineligible, and the ATO concludes on the risk that the expenditure would otherwise be ineligible.

We are aware of circumstances where, notwithstanding low risk ratings obtained as part of the Second ATO Review and the fact that taxpayers ultimately receive a positive IISA Finding, the ATO has sought to undertake a third review of the same expenditures and material. This leads to yet further significant duplications of cost and effort, with no real reasons apparent for the third review being undertaken by the ATO.

4. Alternative dispute resolution methods

Mediation and settlements are an important feature of alternative dispute resolution with the ATO. The ATO Code of Settlement contained in *Law Administration Practice Statement PS LA 2015/1* (**PS LA 2015/1**) acknowledges that settlements are an important element of good administration where the decision to settle is a fair, effective and efficient means of resolving the matters in dispute.

In this regard, the ATO has stated that "Settling disputed matters is consistent with good management of the tax system, overall fairness and best use of ATO and other community resources. This has become known as 'the good management rule', which has been endorsed by the courts."[3]

IISA has advised taxpayers that it has no legal authority to mediate and settle disputes. We submit that this adversely impacts the proper administration of the RDTI regime and undermines IISA's ability to administer the law in an efficient and effective manner. As a Commonwealth agency, IISA has obligations under Appendix B to the Legal Services Direction 2017 made under section 55ZF of the *Judiciary Act 1903* (Cth). Those obligations, which extend to Commonwealth agencies involved in merits review proceedings, include (without limitation):

(a) making an early assessment of the Commonwealth's prospects of success in legal proceedings that may be brought against the Commonwealth;
(b) endeavouring to avoid, prevent and limit the scope of legal proceedings wherever possible, including by giving consideration in all cases to alternative dispute resolution and by participating in alternative dispute resolution processes where appropriate;
(c) keeping the costs of litigation to a minimum by monitoring the progress of litigation and using methods that it considers appropriate to resolve the litigation, including settlement offers, payments into court and alternative dispute resolution; and
(d) not relying on technical defences unless the Commonwealth's or the agency's interests would be prejudiced by the failure to comply with a particular requirement.

Furthermore, the functions performed by IISA in administering the RDTI regime are analogous to the functions performed by the ATO, and IISA should be equally bound by the "good management rule" and the principles which the Commissioner has adopted in the Taxpayers' Charter and ATO Code of Settlement.

Recommendations: If IISA does not have the legal authority to settle disputes, we urge the Board of Taxation to make a recommendation to Government to address this via legislative reform. We would also strongly urge consideration of tripartite mediation processes or settlements between taxpayers, the ATO and IISA. *VDRZ and Innovation Australia* [2017] AATA 123 is an example of one such settlement in the AAT context.

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[3] Practical Guide to the ATO Code of Settlement, available at ato.gov.au.