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Board of Taxation Secretariat
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Dear Board of Taxation

Review of Research and Development Tax Incentive (R&DTI) dual-agency administration model

Ernst & Young (EY) makes this submission in response to the review of the R&DTI dual-agency administration model by the Board of Taxation. The review is particularly focused on identifying opportunities to reduce duplication between the two administrators, the Australian Taxation Office (ATO) and the Department of Industry, Science, Energy and Resources (DISER), or more specifically, AusIndustry. It is also focused on simplifying the administrative process and reduce the compliance costs for applicants.

Ensuring that Australia remains relevant on a global scale in regard to its investment in R&D is critical. Current figures published by the ABS show that Australia's overall spending on R&D (GERD) as a percentage of GDP has fallen dramatically from 2.11% in 2011-12 to 1.79% in 2019-20¹. This is despite Australia already significantly underspending comparable OECD nations, with countries like Germany, South Korea and Switzerland spending more than 3 per cent of GDP on R&D, and outlier Israeli spending nearly 5 per cent. The reasons for this decline are varied and complex but include a range of policy issues as well as support and access to programs such as the R&D tax incentive.²

The purpose of the R&DTI program needs to be kept in mind at all times. It is an expansive program designed to encourage R&D with industry deciding where its priorities lie, rather than a grants-based program which only targets specific industries. It is important that the focus of both administrators be on making decisions based on law, rather than driven by policy. This has been an issue historically as the interpretation of the law has changed as evidenced by the replacement of guidance or even complete removal, providing the taxpayer with less certainty about any future interpretations.

The dual agency model provides a balance between revenue protection (ATO) and promotion of industry and innovation within Australia (DISER). This approach complements each administrators' strengths, with the ATO employing taxation and finance experts, and conversely DISER employing technical and scientific experts. We note that there are a number of different global models which we touch on in the below analysis.

¹ <https://www.abs.gov.au/statistics/industry/technology-and-innovation/research-and-experimental-development-businesses-australia/latest-release>

² https://www.innovationaus.com/business-spending-on-rd-has-flatlined-in-australia/?utm_medium=email&utm_campaign=Newsletter%20541%20-%206%20September%202021&utm_content=Newsletter%20541%20-%206%20September%202021+CID_d6c7ca17c8978a79f7457eb3949c0d9b&utm_source=Email%20marketing%20software&utm_term=Business%20spending%20on%20RD%20has%20flatlined&cnme=Newsletter%20541%20-%206%20September%202021&cmid=d6c7ca17c8978a79f7457eb3949c0d9b&utm_term=Business%20spending%20on%20RD%20has%20flatlined

We are however very concerned about the lack of certainty within the R&DTI program with claimants uncertain about both the administrative process as well as risks associated with ongoing liabilities due to change of interpretation or approach by the regulators. There has been an excessive amount of both proposed changes and enquiry activity conducted over the past few years in relation to the R&DTI. This has included:

- Board of Taxation Review 2021
- Review of the R&D Tax Incentive 2019 – Australian Small Business and Family Enterprise Ombudsman
- Treasury Laws Amendment Bill 2019 – Senate Committee
- Treasury Laws Amendment Bill 2018 – Inquiry
- Review of the R&D Tax Incentive 2016 – 3F Review

The above has left claimants worried about the future of the program and whether they should continue to conduct their R&D activities within Australia or shift to other jurisdictions with more stable and attractive programs. It is disappointing to see dramatic decreases in the R&D tax concessional spend (the non-refundable spend dropping from \$14bn to \$5.5bn in last six years) along with corporates increasingly looking to migrate their IP offshore (refer ATO Taxpayer Alert 2020/1). Our analysis on this significant downwards trend in R&D tax spend is at Appendix 1.

Therefore, it is our recommendation that improvements be made to the administrative process to provide claimants with a consistent approach and increased certainty regarding the eligibility of their R&D activities and expenditure. These include:

- Legislative delineation between the roles & responsibilities of the two administrators, including greater certainty on which body determines R&D activity eligibility, and a shifting of the eligibility requirements from ITAA 1997 to the IR&D act.
- Improved communication and collaboration between both the ATO & DISER, including joint visits, sharing of information and a reduction in the duplication of questions and reviews.
- Provision of official guidance material which carry administrative weight, including positive examples of eligible R&D as well as apportionment methodologies and “incurred on” R&D concepts.
- A materiality approach needs to be incorporated into the review of R&D tax eligibility and expenditure.

If you have any queries in relation to this submission, please contact any of:

- Our R&D tax and government incentive partners Jamie Munday on (02) 9276 9087 or Ezra Hefter on (08) 9429 2293
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Yours sincerely,



Jamie Munday – Partner

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?

Comments - Roles and Responsibilities Delineation

The roles and responsibilities have historically been distinct in that there was a clear demarcation between the eligibility of R&D activities (DISER) versus the eligibility of expenditure and related information (ATO). As per Section 27J of the Industry Research and Development Act 1986 (IR&D Act 1986), DISER is the only body able to determine if all or part of a registered activity is an eligible or ineligible activity, with the ATO provided the power to request DISER to undertake a review of an R&D applicant. This restricts the ATO from undertaking any technical assessment of the R&D activities themselves.

However, in more recent times, it has been observed that the ATO have begun to blur the lines between the responsibilities of the two administrators. The ATO has begun to ask very specific eligibility questions in relation to R&D activities conducted by applicants. This is concerning, as it can create double up in the questions that are asked by the regulators, causing additional work (and expense) for claimants. Furthermore, as the ATO does not have the required technical and scientific skillset (like DISER), it can create confusion for claimants and in helping the regulators in understanding an R&D activity.

Furthermore, a very recent opinion by the courts seen in the *Commissioner of Taxation v. Auctus Resources Pty Ltd [2021] FCAFC 39* included observations made in passing that the Commissioner may form his own views about the eligibility of a taxpayer's R&D activities on the basis of the Commissioner's general powers to administer the tax laws (section 166 of the Income Tax Assessment Act 1936 (ITAA36)). These comments are concerning, as decisions about the eligibility of R&D activities have historically only been determined by AusIndustry. This has the potential to result in taxpayers having to justify an activity's eligibility to both bodies, rather than solely AusIndustry, leaving taxpayers without certainty as to whom is responsible for this critical component of the incentive.

As a matter of tax principle and public policy the ATO has as its core focus the preservation of the revenue base and, as is appropriate, it seeks to raise revenue. Given the incentivising nature of the R&D tax program this can sit at odds with the ATO's core focus area and provides the potential to undermine the dual regulatory model.

Finally, it is also not immediately clear within the legislative instruments that there exists a segregation of duties between the two bodies. As per Section 355-25 Income Tax Assessment Act 1997 (ITAA 1997), the definition of a Core R&D activity resides within the tax legislation, rather than the IR&D Act 1986. This gives the impression to taxpayers that the ATO is responsible for determining that a core R&D activity "is based on principles of established science"³ and "proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions"⁴. There is no reference as to which body enforces or assesses whether a core R&D activity meets the definition defined in the ITAA, other than

³ Section 355-25 (a)(i) Income Tax Assessment Act 1997

⁴ Section 355-25 (a)(ii) Income Tax Assessment Act 1997

“for which the R&D entity is registered under section 27A of the Industry Research and Development Act 1986 for an income year”⁵.

Our Recommendations

It is our recommendation that the definition of eligible R&D activities which includes both core, supporting and excluded activities be located within the relevant authorities act, in this case the IR&D Act 1986, to provide more clarity to claimants as to whom is responsible for its administration.

It is our recommendation that further legislative instruments be put in place outlining that only DISER has the ability to find an R&D activity ineligible or eligible, rather than DISER or the ATO having that power.

Comments - Guidance Material

Upon visiting the relevant administrator website there is no clear messaging outlining the role of each administrator, and the guidance material provided can also create confusion. As an example, from the ATO website R&D Tax section:

*“The ATO and the Department of Industry, Innovation and Science (on behalf of Innovation and Science Australia) jointly administer the R&D tax incentive. Your R&D activities must be registered with the Department of Industry, Innovation and Science before the tax offset is claimed, and we determine if the expenditure claimed in your tax return for your R&D activities is eligible for the tax offset.”*⁶

The above statement taken from the ATO’s website outlines that the R&D activity must be registered with DISER but fails to provide critical information including that DISER is responsible for determining the eligibility of activities. It is unclear that DISER is the scientific body with the required expertise to make these decisions, and it is our suggestion that this be enhanced by clearly articulating that DISER is responsible for reviewing the eligibility of R&D activities.

Furthermore, statements regarding the eligibility of R&D activities are frequently found throughout the ATO’s publications, and these publications do not make it clear that DISER is responsible for determining if an activity is an eligible core R&D activity. As such there is a risk that it may be misconstrued as the ATO’s responsibility.

Our Recommendations

It is our recommendation that guidance material be updated appropriately including websites and documentation to outline the segregation of duties more clearly between the two administrators.

It is our recommendation that better delineation and clarity be provided in regard to which administrator is responsible for which components of the R&D Taxpayer Alerts as they cover both expenditure and eligibility concerns.

⁵ Section 355-205 (a)(i) Income Tax Assessment Act 1997

⁶ <https://www.ato.gov.au/Business/Research-and-development-tax-incentive/About-the-program/>

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?

Comments – Broad Statements of Ineligibility & Imprecise Language

From our experience, there have been observed frustrations within the current administration model and in particular attempts to make broad statements on eligibility. These statements have often been made without full consultation with the relevant scientific or technical representatives of the registrant as well as the registration form often being used as the primary risk assessment instrument, which without context or the relevant scientific experience, can be misconstrued. Detailed reasons for the regulator's conclusions on eligibility (in particular gaps in evidence) is often not given or glossed over. For example, a statement that activities are not experimental without saying why, or simply referring to generic statements (e.g. insufficient hypothesis). This is particularly important when looking at the available evidence and any gaps that exist to further educate claimants.

This has also led to the introduction of new nomenclature including business as usual (BAU) R&D which has openly⁷ been outlined as ineligible but is not defined in legislation. For claimants whose regular business is to conduct R&D activities this leaves doubt as to whether the activities are eligible. Broad statements have also been made in relation to eligibility of expenditure without providing any further substance to why.

Our Recommendation

It is our recommendation that if the regulators request an examination of all or part of an R&D entities claim, that they undertake reasonable due diligence in understanding the activities by consulting with appropriate scientific representatives including those of the applicant and independent third parties. This would reduce the occurrence of large in-depth reviews.

It is our recommendation that the administrators stop using business as usual activities as a blunt instrument for activity ineligibility, and instead reflect back on the position taken in TA 2017/3 that states "Ordinary business activities are not generally carried out for the purpose of generating new knowledge", rather than the current interpretation that they are ineligible. These should be assessed on a case-by-case basis and with an open mind as to why the claimant has included the activities.

Comments – Justified Trust and Assurance Reviews

It appears the starting position for any Justified Trust or Assurance Review is that R&D is considered high risk. Currently there is little consideration for the taxpayer's overall risk rating to be considered in the context of R&D. As an example, even for those taxpayers considered low risk of non-compliance, the position for R&D tax is often starter at the position of high risk, and the onus is on the Taxpayer to prove otherwise. As a result, taxpayers with high levels of Justified Trust (low risk of non-compliance) in

⁷ Taxpayer Alert TA2017/3

other areas of tax are often left with high or medium risk of non-compliance in R&D tax areas and/or detailed reviews of the R&D tax claim.

Our Recommendation

It is our recommendation that a low risk of non-compliance for tax equate to a starting position of low risk of non-compliance for R&D tax. R&D tax should not be treated any differently from any other area of tax and the ATO should be able to make a Justified Trust decision regarding a company's R&D tax position.

Comments - Lack of Materiality Focus

The DISER and the ATO's compliance approach is often focused only on considerations of eligibility (of activities and expenditure), even when it is not material to the tax matters of the claimant. As an example, a company with over \$1 billion in tax obligations will receive a disproportionately high number of R&D questions or concerns with a net cash impact of under \$2 million. The ATO appears to only look at the overall deduction amount, rather than the net R&D benefit, when in most instances the expenditure is otherwise deductible. While we are conscious this is public taxpayer money and any expenditure needs to be challenged, materiality must be used to guide the compliance process, as a large amount of time and resources are required to respond to these reviews. It has also been observed that on the ATO's side there has been a high level of referrals to the innovation cluster when a number of these matters can be resolved, or otherwise by raising issues directly with the claimant.

Our Recommendation

It is our recommendation that materiality form part of the ATO's approach to compliance in regard to the R&DTI, including the net R&D benefit rather than the total deductible amount.

It is our recommendation that the ATO first raise issues identified with the claimant before referring through to their innovation cluster.

Comments – Communication between ATO & DISER

There is often a lack of communication and collaboration between both the ATO and DISER when undertaking the review of registered R&D activities. For example, there have been occurrences where the ATO has formed an opinion that activities are most likely ineligible and have subsequently referred these activities to DISER for review. Throughout the DISER review, little to no communication between the two parties was observed. It would be beneficial for the ATO to be an active observer in reviews which they have initiated in order to form a better understanding of the activities that have been conducted, but also to improve their scientific understanding for reviewing activities into the future.

Another example of this lack of communication is evidenced where DISER requests from a new R&D tax claimant with a Substituted Accounting Period (SAP) (or an existing R&D tax claimant which changes to a SAP) the ATO's confirmation of this SAP. It would be beneficial for DISER to request this information from the ATO directly to show a level of coordination between the two regulators.

Our Recommendation

It is our recommendation that where possible visits to claimants should occur jointly with an educational prerogative rather than an adversarial view. Before requesting in-depth documentation and written responses, face-to-face discussions should be conducted jointly (respecting confidentiality) to provide both administrators with an understanding of the R&D and activities conducted.

It is our recommendation that both bodies are involved in any compliance or review activity in respect to the Taxpayer Alerts, as the alerts suggest that both *“The ATO and AusIndustry”*⁸ are involved in applying these rules. It is not appropriate for either administrator to be assessing the risk of non-compliance to Taxpayer Alerts as they pertain to both expenditure and activity eligibility.

It is our recommendation that the ATO be actively involved with any review they refer to DISER to improve their understanding of the registered activities, ultimately improving their ability to determine the nexus of the expenditure. We also recommend that DISER should more frequently share and update the ATO on the progress of ongoing reviews prior to making any determinations in respect of the outcomes of their reviews.

Furthermore, it is our recommendation that DISER request directly, and that the ATO share its confirmations of Substituted Accounting Periods directly with DISER for all R&D tax claimants.

Comments – Timeliness

The timeliness of review outcomes from DISER have historically been prolonged and lengthy, providing the taxpayer with limited confidence in regard to activities they are conducting in the present. Reviews typically cover activities registered historically (sometimes over a 4-year period), meaning that whilst a review is being undertaken, the applicant is continuing their R&D activities. The length of time taken to receive the outcomes of these reviews means that applicants are not provided any certainty as to whether their current activities are eligible and may result in the cessation of the R&D until the matter is resolved. As an example, it’s not unusual to get a 30-day request with an option for a 30-day extension, but not hear anything further over a 90 to 180-day period.

We are also of the opinion that a reduction in the threat of a referred review by either administrator should be investigated as it reduces the certainty for the taxpayer. It has been observed that at the cessation of a review by one administrator, the matter is then referred to the other, creating a ‘two bites at the apple’ approach. This creates an unnecessary burden on the taxpayer to comply after having undergone an already significant review.

Our Recommendation

It is our recommendation that the outcomes of reviews by both the ATO and DISER be provided to taxpayers within 30 days, in line with the requirements placed on the taxpayer to provide information in response to said review.

⁸ <https://www.ato.gov.au/law/view/document?DocID=TPA/TA20175/NAT/ATO/00001&PiT=99991231235958>

It is our recommendation that reviews be conducted collaboratively, rather than sequentially, to provide claimants with more certainty about their R&D activities and expenditure incurred.

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.

Comments - Improvements to DISER Approach

DISER appears to be improving its review process as of recent by implementing a more front ended approach with a focus on using a more educative approach by putting the taxpayer on notice on areas to evaluate and improve upon, specifically for those falling into the 'getting it right' and 'trying to get it right' categories.⁹ It has also been observed that there is a greater willingness to meet claimants to understand both the R&D activities, as well as the business at large, resulting in less requests for wholesale documentation and a more targeted approach.

In the UK (see comments below at question 11), a sample-based approach is also taken, which could potentially be a model for future compliance in Australia.

Our Recommendations

It is our recommendation that DISER continue with its approach around talking with new claimants, and a more targeted approach.

Consideration should be given to a UK-style sample-based approach, especially for claimants with multiple R&D activities, with materiality leading this approach.

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

Comments - Avoiding "One Size Fits All" Approach

In short, we would agree with the position expressed by the ASBFE Ombudsman that both the ATO and DISER:

*"appear to take a 'one-size-fits-all' approach to companies in examining and auditing the R&DTI registration/claims. Their requirements do not differentiate between large and small companies – or the size of the offset."*¹⁰

The cost (both monetary and time) of compliance on the taxpayer must be carefully considered in the administration of this program. The review of an entities R&D claim requires more input's than a typical tax review as it comprises of both a scientific and financial component. The preparation of in-depth

⁹ The Australian Small Business and Family Enterprise Ombudsman Review of the R&D Tax Incentive, December 2019

¹⁰ The Australian Small Business and Family Enterprise Ombudsman Review of the R&D Tax Incentive, December 2019

presentations and responses by technical staff who are heavily involved in R&D activities is not conducive to encouraging accessing the R&D tax incentive system to support R&D activities, but rather creates a resistance as the time and cost required to undertake compliance activities can outweigh the benefit provided. In particular in our experience this is particularly the case for technical personnel in companies who are not used to dealing with regulator on a regular basis and this should be considered as part of the approach by both administrators. It is a commonly expressed view in industry that technical staff should be involved in R&D, rather than preparing tax incentive claims or conducting R&D tax reviews.

It has also been observed that substantiation required by the taxpayer to evidence the R&D activities has to be very specific and often is not prepared as part of the day to day activities - this is particularly true in software R&D. Taxpayers are required to put in place significantly complex systems and processes in order to record both the expenditure incurred and activities that have been conducted, that otherwise would not form part of the taxpayer's ordinary R&D processes, increasing the cost and time required and subsequently eroding the benefit received.

Our Recommendations

It is our recommendation that a tailored approach be utilised which is appropriately scaled to the size of both the company and the R&D claim being examined, rather than utilising a "one size fits all" approach. There can be a phased approach, with a reduction in scope of a review if upon initial investigation and review, no obvious adverse findings appear to be made.

It is our recommendation that the substantiation required to evidence both the expenditure incurred and R&D activities conducted reflect standard industry practices rather than the stringent 'laboratory' based approach currently being adopted. DISER and ATO guidance should be reflected to demonstrate the different documentation requirements and best practice in different industry sectors with samples provided where possible.

It is our recommendation that an approach of looking at industry best practice for documentation for R&D activities is conducted across multiple industries and awareness is provided to both ATO and DISER. We would suggest that rather than creating documentation for R&D claims that instead the R&D tax process flex to represent the documentation kept in industry.

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?

Comments - Real-Life Examples

As EY works with a number of clients across multiple industries in the R&DTI sector, we are sensitive around disclosure of client information without prior authorisation. As such, the real-life examples below will be high level.

1. Length of Review

- a. Claimant went through a desktop review with significant information requests requiring a large amount of effort and time to meet requested deadlines. After providing the documentation, DISER did not provide any outcomes for a prolonged

period of time, only to then issue an adverse finding for all activities. This subsequently went through an internal review where 90% of the activities were found to be eligible.

- b. Claimant went through a large advanced finding process which took over 18 months by which stage the R&D had largely been concluded.
2. Certainty for Claims
 - a. R&DTI claim which was prepared with guidance available at the time of lodgement, however the guidance was subsequently adjusted to include amendments made to the Frascati manual. Throughout the review of these activities the amended version of the guidance was applied, rather than the information available to the claimant at the time of lodgement.
 3. Materiality of Claims
 - a. The ATO has undertaken in-depth reviews and questioning in relation to apportionment where this forms less than \$2,000 (0.1% of total claim).
 - b. Positive examples have been observed with the ATO willing to take a materiality approach to the review of R&D activities. For example, only reviewing the largest “x” number of projects/activities.

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

Comments - Changes to Guidance and Application of Guidance at Time of Review

Frequent changes to guidance material, as well as the application of guidance material that was not available at the time creates a lack of certainty surrounding the application and review process which can act as a disincentive for some claimants. As an example, claimants are required to use available guidance and materials at the time of lodgement, however when reviewed recent guidance is used by the administrators to counter any arguments made by the claimant. In our opinion it is unreasonable to expect claimants to adhere to guidance that was not released at the time of lodgement. This has also led to more guidance being published via the relevant administrator websites rather than as official documentation, making it difficult to detect any changes, as well as archive historical guidance.

Our Recommendation

It is our recommendation that only guidance and administrative processes that were available/active at the time the lodgement was made be used throughout the review of an R&DTI claim.

It is our recommendation that guidance material be published in an alternative format that has administrative weight and delineates a point in time, rather than the replacement of tax rulings with non-specific guidance on websites and generalised alerts.

Comments - Potential Barriers in the New Portal Application Process (DISER)

Recent changes in the application process have resulted in taxpayers becoming more uncertain about the eligibility of their R&D activities and impacting their decision to apply negatively. We are conscious that this is the first year under the new portal system and there is wide ranging consultation being conducted to improve this system and note the large amount of effort being put into this by the AusIndustry team.

We provide the below as some examples of the areas, but note that improvements are being targeted already, including:

- Generic “ineligibility risks”- It has been observed that upon submitting an application, an acknowledgement that the taxpayer is “aware of the potential ineligibility risks” appears depending on the entities primary industry of operation. The primary industry of operation is not an indicator of a high likelihood of ineligibility. For example, an entity operating under ANZSIC Division “J – Information Media and Telecommunications” may be developing new hardware for radio transmission of 5G, however they are alerted to taxpayer alerts covering software development, unrelated to the R&D activities they have registered. The strong wording used at the end of the registration form in response to the claimant’s sector is introducing unnecessary uncertainty and ‘fearmongering’. These warnings are causing claimants unnecessary concern and for those that self-prepare this may cause them to withdraw their application due to fear of ineligibility.
- In regard to the new application system, it has been observed that it is highly restrictive in terms of character limits and pictures, and because of the limitations, claimants can’t fairly represent their R&D activities. For example, the inclusion of symbols such as ‘°’ to symbolise degree Celsius cannot be used, which is commonly found within certain experimental activities. Claimants have found that with large R&D activities and projects, they are unable to clearly articulate and provide the level of detail to respond to the questions being asked.
- Lack of feedback where there is a desktop review and no issues are found- Claimants that prepare successful claims that are reviewed as part of the internal application review process by DISER, and are found to have no issues, are never provided any acknowledgement that their R&D activities lodged are eligible. Previously (under the R&D Tax Concession) applicants were made aware if their application was reviewed and fell into the “getting it right” category, however this is no longer the case.

On a more positive note, EY encourages DISER to continue to use technology and tools to improve the registration process. The implementation of pre-populated activities from prior years is a welcomed improvement which will enable applicants to better keep track of the R&D activities. The implementation of evidenced based checklists and questions have also been well received, allowing claimants to better identify gaps in their documentation processes. Lastly, the breakdown of the core activities into the relevant scientific process (e.g. Hypothesis) provides more clarity to claimants as to what DISER requires in the application form.

Our Recommendation

It is our recommendation that the character limits within the application scale with the expenditure registered in the application. For example, for each \$100,000 included in the core activity, provide the applicant with 1000 characters. This will allow the correct amount of detail to be provided to match the size of the activity.

It is our recommendation that the warning at the end of the application be modified so that rather than it being linked to the sector/industry of the claimant, it instead be presented to all applicants more generally in a less “fearmongering” manner. This would then serve as a reminder to all applicants to review the relevant taxpayer alerts and declare that they have read and understood, rather than simply stating there is a high risk of ineligibility.

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

Comments – Advanced Finding Process

Historically the Advanced Finding process has been difficult for claimants due to the length of time required to undertake the review of the activities. More recently, the implementation of a new model which involves a third-party assessor has been observed to run a lot more efficiently and smoothly. The level of communication was appropriate, and information was exchanged effectively.

It has however been noted that whilst the Advanced Finding process provides applicants with certainty in respect of the overseas R&D activities, it does not provide any certainty about the expenditure that can be included within the claim. This leaves applicants in a position where they receive approval to undertake overseas R&D activities but can still lack certainty about the benefit they will receive from the program.

There are also a number of barriers when using the advanced finding process including complexities such as a lack of certainty, as well as claimants not wanting to ‘go out on a limb’ and subsequently be denied the R&D claim in its entirety. There is also a large cost associated with the process including detailed documentation requests which can extend for months, or even in some circumstances longer than a year. Lastly, it is difficult for claimants to plan and anticipate their R&D activities 3 years in advance, as many R&D activities depend on the outcomes of current or short-term experiments.

Our Recommendation

It is our recommendation that the ATO implement a similar process of approval in regard to overseas expenditure in conjunction with the DISER approval process.

It is our recommendation that a more streamlined advanced finding process be implemented, with a view to reduce the time and complexity to claimants wishing to gain approval.

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?

Comments – Materiality and Settlement/Mediation

We believe a risk adjusted review process that incorporates materiality is essential to the administration process which will both simplify and maintain the integrity of the program. The risk to revenue and misclaiming should be applied and used to guide the level of review that should be undertaken from both an activity and expenditure perspective. For example, activities including research organisations such as universities inherently contain less risk of ineligibility than those of an unknown contractor. Materiality of expenditure incurred must be considered after having observed large disputes over minor amounts. An important measure of this is the concept of R&D expenditure compared to total expenditure, and a careful examination of this should be conducted prior to issuing large data acquisition requests from claimants.

The introduction of a mediation and settlement process with DISER would provide claimants with another avenue to resolve issues of eligibility. Currently, it is often the case that disagreements with DISER result in a ‘no settlement approach’ (especially on partial eligibility) and claimants having to go through the AAT to get a verdict, an expensive process involving legal and other additional costs. It is our recommendation that a mediation process be implemented to allow disagreements to be resolved through an independent 3rd party in cases where the eligibility of R&D activities is being challenged.

Our Recommendation

It is our recommendation that reviews be approached with materiality front and centre, including the claimants R&D expenditure compared to its total expenditure and turnover.

It is our recommendation that activities involving research organisations be approached with a lower risk profile, considering they are collaborating with research professionals.

It is our recommendation that DISER implement a similar settlement and mediation process to the ATO which would allow for intelligent discussion about eligibility and a clearer process for resolving disputes.

Comments – Review Periods

There currently exists a misalignment between the ATO and DISER review periods. Claimants are not provided any certainty to whether historical activities can be reviewed as different time frames exist for different administrators. DISER is able to review any of the 4 most recent claims, with the ATO able to review anytime in the 4-year amendment window (i.e. the amendment reactivates the review period). This results in the ATO having a longer period of review if the claimant makes an amendment. The 4-year window creates unnecessary liabilities for claimants, with some opting not to claim due to the risk of review and penalties (even if they have made best efforts using all relevant guidance and materials).

Our Recommendation

It is our recommendation that the review period be limited to the 2 most recent applications, similar to the small business rules and consistent to the other areas of the tax act. This would exclude cases of fraud.

It is our recommendation that the review periods for both DISER and ATO be aligned to give greater certainty to claimants around the R&D tax claims that remain open to review at any given time.

Comments – Charter Improvements

The ATO's Taxpayer's Charter¹¹ is useful as it outlines the taxpayer's rights and obligations, explaining what they can expect from the ATO in administering the tax and superannuation systems. This includes:

- ▶ Treating the taxpayer fairly and reasonably
- ▶ Treating the taxpayer as being honest
- ▶ What to expect if you are selected for a review or audit
- ▶ Helping the taxpayer to get things right

Our Recommendation

It is our recommendation that DISER implement an R&D Tax Charter to assist Taxpayers in understanding their rights and obligations as well as explain what they can expect when being examined. The current DISER Charter¹² is focused on customer service and does not sufficiently explain or outline their attitude or behaviour towards review and compliance activity.

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

Comments – Reduce duplication through clearer delineation

Duplication and a 'blurring of the lines' have been observed frequently, with the ATO delving deeper into the eligibility of R&D activities. As DISER maintain the relevant technical and scientific expertise, it is our opinion that they be responsible for all issues involving eligibility, including the relevant aspects of the taxpayer alerts. Similarly, the ATO maintain the relevant taxation expertise, and it is our opinion that they be responsible for all issues involving expenditure and its nexus to the R&D activities.

It has been observed that the ATO has begun asking questions as part of their various risk reviews and audits in relation to the R&D taxpayer alerts, however these questions pertain to the eligibility of activities, rather than the expenditure incurred on said activities. It is our recommendation that the ATO defer to DISER in relation to the components of the taxpayer alerts that relate to eligibility. This includes questions such as "What is the new knowledge being generated" and "How have you

¹¹ <https://www.ato.gov.au/about-ato/commitments-and-reporting/taxpayers--charter/>

¹² <https://www.industry.gov.au/data-and-publications/customer-service-charter>

distinguished between technical risk and business or commercial risk". These same questions have then been asked by DISER, resulting in the taxpayer having to respond to both administrators, and creating a point of frustration.

Our Recommendation

It is our recommendation that data sharing between the two administrators be improved in order to reduce the overlap of review and compliance activities.

It is our recommendation that changes be made to the legislative instruments further separating the administrative roles of the ATO and DISER.

It is our recommendation that a memorandum of understanding (MOU) between the two administrators be put in place, similar to New Zealand, to further delineate the responsibilities.

It is our recommendation that both the ATO and DISER attend meetings and site visits to reduce the duplication of review questioning and information requests.

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)?

Comments – Positive Guidance

Currently there is a lack of positive examples of eligibility. Claimants are wanting to adhere to the rules and 'swim between the flags', but in order to do so they require examples of eligible R&D activities. Due to this lack of available guidance a level of uncertainty has developed amongst claimants. Existing guidance also does not provide any examples of documentation required, but rather only lists them as generic titles such as "Records of literature reviews" or Design and scoping documents". The above also extends into evidence and acceptable processes of accounting for R&D expenditure, as there currently does not exist positive examples of acceptable methodologies and evidence that is required to meet the ATO's expectations making it confusing and difficult for taxpayers to 'swim between the flags'. For example, there is no guidance as to whether project-based costings from an accounting perspective is an acceptable methodology, likewise, the ATO's expectations around if invoices should specifically state R&D activities is currently unknown.

Our Recommendation

Is it our recommendation that positive examples of both eligible R&D activities and acceptable expenditure methodologies/processes/evidence be provided for each major industry and/or R&D sector.

It is our recommendation that documentation examples be provided to claimants which are specific to each major industry and/or R&D sector (Software, Mining etc).

Comments – Expenditure Guidance

There is a poor level of guidance provided by the ATO in relation to apportionment and its application to R&D expenditure. The ATO has been ‘prosecuting’ taxpayers on apportionment methodologies and positions without providing clear guidance (such as IT2552¹³) or expectations. Despite the fact that the ATO is taking certain positions, these positions have not been shared publicly, especially in relation to apportionment. Currently the only guidance that exists in relation to apportionment methods is located on the ATO website¹⁴, which lacks the level of detail and granularity to understand the expectations of the ATO. There are instances where the guidance cannot realistically be applied to particular R&D activities or industries leaving claimants with no avenue to incorporate overhead costs incurred (such as those where floorspace is impracticable to calculate due to the size of operation). This guidance material also does not contain any audit trail, meaning that claimants are unable to be alerted when changes are made.

Expenditure “on” R&D activities has also been a area of focus for the ATO in which there currently exists limited binding guidance published by the ATO. As this concept forms a critical component of the ATO’s compliance activities taxpayers require appropriate guidance to enable them to make the right decisions when calculating their R&D expenditure.

Our Recommendation

It is our recommendation that the ATO publish more formalised guidance (e.g. taxpayer alert) in relation to apportionment of R&D expenditure as it forms a critical part of their compliance process.

It is our recommendation that the ATO provide official guidance with administrative weight relating to expenditure “on” R&D activities.

Comments – Delineation of Guidance

Recent guidance documents published by both the ATO and DISER, including the Draft Software Guide¹⁵ and Draft At Risk Ruling¹⁶ have been welcomed by taxpayers. We would recommend that further guidance documentation be provided by both bodies, including any internal guidance documents to allow claimants to understand and conform with requirements. It should also be made clear in the guidance the appropriate body responsible for administering and undertaking any compliance activities. Where guidance is jointly administered, there should be a clear delineation outlining which components belong to the ATO and DISER. An example includes Taxpayer Alert TA 2017/5¹⁷ in which it

¹³ Taxation Ruling IT2552 – Income Tax: Research and Development (R&D) – costing of expenditure

¹⁴ <https://www.ato.gov.au/business/research-and-development-tax-incentive/in-detail/guides/keeping-records-and-calculating-your-notional-deductions/?page=2>

¹⁵ <https://business.gov.au/grants-and-programs/research-and-development-tax-incentive/sector-guides-for-r-and-d-tax-incentive-applicants/software-development>

¹⁶

https://www.ato.gov.au/law/view/document?src=qa&pit=99991231235958&arc=true&start=1&pageSize=10&total=1&num=0&docid=DTR%202021D3%2FNAT%2FATO%2F00001&dc=false&qaid=qa_pbr&stype=find&cat=E%2BF&tm=phrase-docref-TR%202021%2FD3&anchor=H125#H125

¹⁷ <https://www.ato.gov.au/law/view/document?DocID=TPA/TA20175/NAT/ATO/00001&PiT=99991231235958>

is not clear and thus creates instances where it is inappropriate for particular bodies to be undertaking compliance activities.

There are a number of Taxpayer Alerts published on the ATO's website which outline various arrangements and behaviours that are inappropriate. For example, TA 2017/5¹⁸ describes arrangements of companies that are claiming the R&D Tax Incentive on software development projects where some (or all) of the expenditure incurred is on activities which are not eligible R&D activities. Throughout various compliance activities undertaken by the ATO, explanations to how particular Taxpayer Alerts have been reviewed and assessed as being not applicable to an entities R&D application have been requested by the ATO but are subsequently not reviewed by DISER. These alerts cover both the eligibility of R&D activities as well as the expenditure incurred, and it is inappropriate for the ATO to be solely making determinations or assessing the risk of registered R&D activities.

Our Recommendation

It is our recommendation that both the ATO and DISER be involved when assessing the risk of non-compliance in regard to taxpayer alerts as per the alerts.

¹⁸ <https://www.ato.gov.au/law/view/document?DocID=TPA/TA20175/NAT/ATO/00001&PiT=99991231235958>

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?

Comments – New Zealand

One of the more recent R&D incentives to be introduced is in New Zealand, which has been available since the 2019/20 tax year. An independent review¹⁹ into the early implementation of the scheme to identify how it was working and areas for improvement was recently released in which many of the learnings can be leveraged. Importantly, the administration of the incentive utilises a two-body approach, similar to Australia, with Inland Revenue responsible for the assessing the eligibility of R&D claims, and Callaghan Innovation responsible educating and engagement update of the incentive.

Furthermore, New Zealand has a core and dedicated team which comprises of representatives from both parties, with the expectation that they will engage and collaborate as one team rather than as distinct teams from each of the agencies. It is our suggestion that the ATO and DISER enter into a Memorandum of Understanding (MoU) that formally acknowledged the collaborative approach between the agencies, as well as facilitates a more communication between the two agencies. We would also recommend that increased focus on the education and encouragement of companies to apply for the R&D incentive be undertaken by DISER to alleviate concerns and worries held by companies wanting to apply that their activities may be ineligible.

Our Recommendation

It is our recommendation that a MoU be entered into between the ATO and DISER.

Comments - Canada

The Canadian system also employs a dual agency system; however, they utilise a proxy calculation for overhead expenditure using a formula-based approach. Claimants are provided the option of either using a traditional based approach or the proxy method (55% loading). This is similar to the ATO's working from home allowance of 80 cents per hour, or the direct method. It is emphasised that if claimants want to use the traditional method documentation must be maintained to evidence the nexus of these costs.

The Canadian system also contains various consultation processes, including pre-claim meetings, first time advisory services, outreach programs and the ability to request a visit from both administrators.

Our Recommendation

It is our recommendation that a proxy-based approach be introduced as an alternative option to allocate a % of costs based on total salaries claimed. (e.g. Canada uses 55%).

¹⁹ <https://www.mbie.govt.nz/about/news/research-and-development-tax-incentive-pwc-report/>

It is our recommendation that more consultation processes and mediation options be made available for claimants to help them in “getting it right”.

Comments - UK

Other jurisdictions such as the UK have significantly reduced the requirements to provide detailed substantiation and instead are more open to aligning the requirements for documentation to industry standards. For example, the software industry uses an agile approach to documentation, and aligning the requirements for the program to accept this level of documentation would be a welcomed change.

Moreover, other jurisdictions have successfully incorporated software into their existing R&D programs, rather than establishing a separate incentive. It would be overly complex to introduce a separate framework for software activities, given some taxpayers undertake R&D in both software and other sectors, meaning that they would have to submit separate applications, costing both additional time and expenditure to lodge and comply.

Our Recommendation

It is our recommendation that the current R&DTI framework be maintained for software activities and instead provide additional guidance and clarity around specific activities, as well as adjusting the expectations on the type of evidence that is acceptable for software activities as they are not undertaken in the same ‘laboratory’ based approach of more traditional R&D activities.

Consideration should be given to a UK-style sample-based approach, especially for claimants with multiple R&D activities, with materiality leading this approach.

Appendix 1 – Analysis of R&D Tax Expenditure in Australia (2014/15 – 2019/20 (est.))

Current state of R&D activity in Australia

The numbers reported by Treasury and the ATO²⁰ show a sharp decline in corporate R&D expenditure claimed via the R&D Tax Incentive Program. The value of claims processed for the non-refundable R&D tax offset equated to \$14.2 billion in total in 2014-15.²¹ We estimate that this value was down to \$5.5 billion in 2019-20.²²

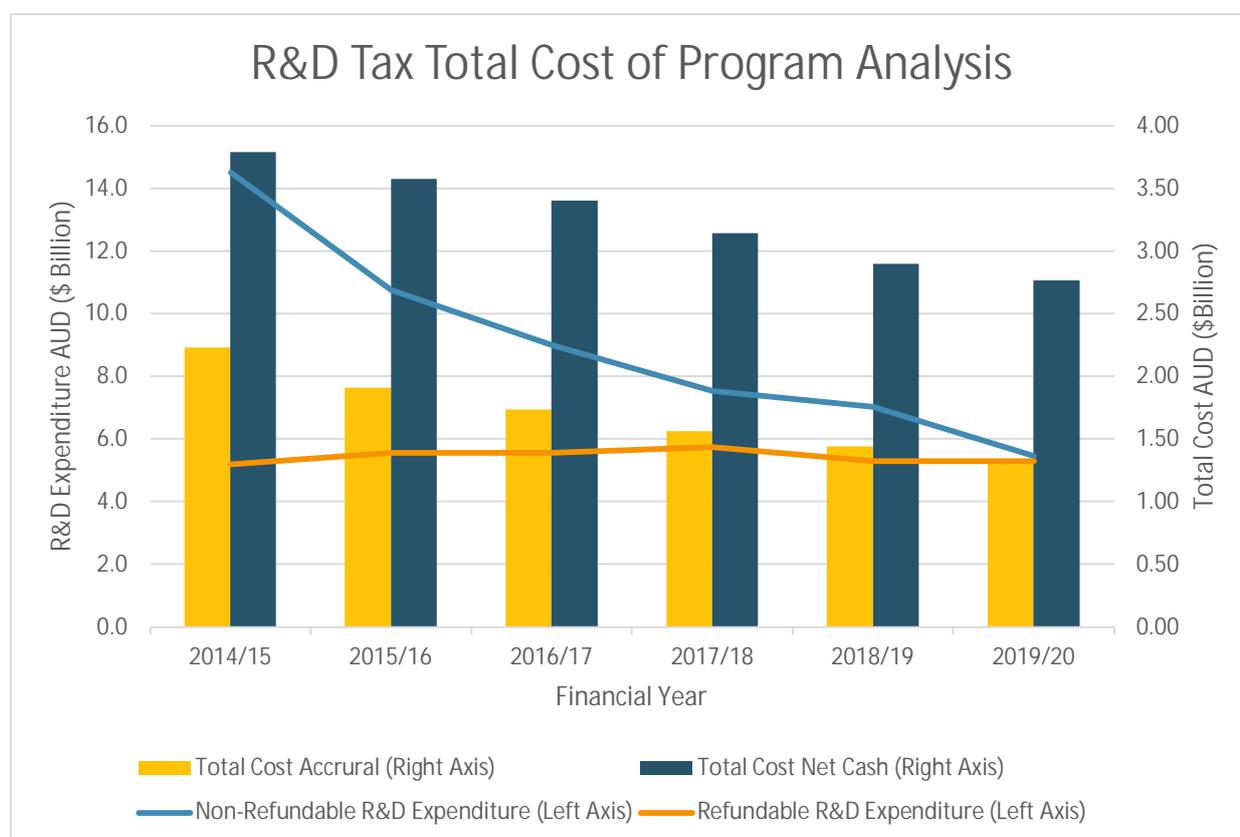


Table 1 below compiled by EY, based on the ATO and Treasury data, shows the precipitous decline in R&D expenditure in the non-refundable (large companies) sector with the R&D expenditure in the refundable (small companies) sector remaining relatively constant. The reporting of the cost of R&D moved from a regular forecasting model to one where the actual offsets paid as administered by the ATO became the focal point.

The methodology used to derive the numbers (with the input data referenced below) is as follows:

²⁰ Tax Offsets paid out through the R&D Tax Incentive split in total refundable offset and total non-refundable offsets are currently reported in the *ATO Corporate Plan* and the *Treasury Parliamentary Budget Statement (PBS) Tax Office Budget Statement* and a three-year trend is now reproduced in the *ATO Annual Report*. <https://www.transparency.gov.au/annual-reports/australian-taxation-office/reporting-year/2018-2019-16>

²¹ Treasury PBS 2016-17 (page 180) Tax Office Budget Statement

²² This calculation is based on total non-refundable offsets in 2019-20 of \$2.1 billion reported on page 55 of the ATO Annual Report 2019-20 https://www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf divided by the offset rate of 38.5% (\$2.1 billion / 0.385 = \$5.5 billion)

1. For 2014/15 income years the actual R&D expenditure reported was used to determine input data for Columns 1 and 2.
2. For other income years the actual offsets paid are shown at Column 3 and 6. These offsets were grossed up using the offset factors of 40%/ 38.5% or 45%/43.5% (dependent on year, given changes in the level of R&D tax offsets) to derive the underlying R&D expenditure in Columns 1 and 2.
3. The R&D expenditure in Columns 1 and 2 was tax effected to estimate the value of notional deductions foregone by companies to claim the offsets in Columns 4 and 7. The reason is that under the R&D Tax Incentive the claimants give up their tax deduction otherwise available for the relevant expenditure.
4. For non-refundable offsets the net tax cost is shown in Column 5 by deducting from the total offsets paid in Column 3 the value of the deductions foregone in Column 4.
5. Column 8 estimates the total cost on a net cash basis as we understand this is used for Budget calculation purposes. In particular, this includes for non-refundable tax offsets the total of the net cost in Column 5. For refundable tax offsets, we understand that the Budget practice is not to reduce the cost by reference to deductions foregone, so in calculating the budgetary (cash) cost in Column 8 we add only the full cost of offsets provided, as shown in Column 6.
6. The Budget practise is, for refundable tax offsets, not to reduce the cost by reference to deductions foregone. We do not believe this adequately accounts for the normal tax deductions forgone, and therefore estimate in Column 11 the total cost on a consistent basis, by showing for both refundable and non-refundable claims the total offsets in Column 9 and the offset by total deductions foregone in Column 10.

Table 1 (all amounts in \$AU billion)

Table by EY	R&D Expenditure		Non-refundable offset			Refundable offsets		Total cost	Total Cost		
Column	1	2	3	4	5 (3-4)	6	7	8 (5+6)	9 (3+6)	10 (4+7)	11 (9-10)
ATO Data	Large	Small	Tax offset	Deduction	Net	Tax Offset	Deduction	Net Cash	Offsets	Deductions	Accrual
2014/15	14.5	5.2	5.80	4.35	1.45	2.34	1.56	3.79	8.14	5.91	2.23
2015/16	10.8	5.6	4.30	3.23	1.08	2.50	1.67	3.58	6.80	4.89	1.91
2016/17	9.0	5.6	3.60	2.70	0.90	2.50	1.67	3.40	6.10	4.37	1.73
2017/18	7.5	5.7	2.90	2.26	0.64	2.50	1.58	3.14	5.40	3.84	1.56
2018/19	7.0	5.3	2.70	2.10	0.60	2.30	1.45	2.90	5.00	3.56	1.44
2019/20	5.5	5.3	2.10	1.64	0.46	2.30	1.45	2.76	4.40	3.09	1.31

Table 1 uses the following data:

1. Actual R&D expenditure for 2014/15 reported in Treasury PBS 2016-17 (page 209) Tax Office Budget Statement. The non-refundable offset paid is calculated as \$14.4b * 40% = \$5.76b; refundable offsets paid = \$5.2b * 45% = \$2.34b (offset rates were reduced from 40% to 38.5% for non-refundable offsets and from 45% to 43.5% for refundable offsets with application for income years starting on or after 1 July 2016).
2. Latest results of offsets paid for 2015/16 reported in 2017-18 ATO Corporate Plan²³
3. Latest results of offsets paid for 2016/17 reported in 2018-19 ATO Corporate Plan²⁴

²³ <https://www.transparency.gov.au/annual-reports/australian-taxation-office/reporting-year/2018-2019-16>
https://www.ato.gov.au/About-ATO/Managing-the-tax-and-super-system/In-detail/Corporate-plan---current-and-previous-years/ATO-Corporate-plan-2017-18/?page=23#Appendix_C___Administered_programs

²⁴ <https://www.transparency.gov.au/annual-reports/australian-taxation-office/reporting-year/2018-2019-16>

4. Latest results of offsets paid for 2017/18 reported in 2019-20 ATO Corporate Plan²⁵
5. Latest results of offsets paid for 2018/10 reported in 2019-20 ATO Annual Report²⁶
6. Offsets for 2018/19 reported in 2018/19 ATO Annual Report²⁷ - please note numbers for 18/19 are estimated amounts per ATO figures.

The total cost to the Federal Budget on a cash basis in 2019/20 was \$2.76 billion comprising:

- \$2.3 billion thereof relating to the refundable sector; and
- \$460 million to the non-refundable sector comprising companies with turnover of \$20 million and more.

The bulk (83% of \$2.76 billion) of the total net cash cost to the Federal Budget relates to refundable sector where the value of offsets claimed in 2019-20 matched the value in 2014-15 with temporary modest increase in between.

Overseas R&D investment by Australian taxpayers

The Australian Bureau of Statistics numbers for 2017-18 show the Business Enterprise Expenditure on R&D (BERD) incurred overseas recorded the largest increase in % terms over any other category of R&D spend, up \$534 million (66%).²⁸ This trend started before the damaging impact caused by policy uncertainty. We are concerned that the flight of activity can only be expected to get worse. The notion that Australia can afford to lose R&D activities seems at odds with other countries continuing to position themselves to compete in the knowledge economy and to attract R&D investment.²⁹

https://www.ato.gov.au/About-ATO/Managing-the-tax-and-super-system/In-detail/Corporate-plan---current-and-previous-years/ATO-Corporate-plan-2018-19/?page=30#Appendix_C___Administered_programs

²⁵ <https://www.transparency.gov.au/annual-reports/australian-taxation-office/reporting-year/2018-2019-16>

<https://www.ato.gov.au/uploadedFiles/Content/CR/downloads/ATO%20corporate%20plan%202019-20.pdf>

²⁶ https://www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf

²⁷ https://www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_report_2018-19/n0995_2018-19_Annual_Report.pdf

²⁸ <https://www.abs.gov.au/ausstats/abs@.nsf/mf/8104.0>

²⁹ <https://www.ey.com/gl/en/services/tax/worldwide-r-d-incentives-reference-guide---country-list>