Australian Government

Australian Small Business and Family Enterprise Ombudsman

Review of the R&D Tax Incentive

DECEMBER 2019

Manager
Media and Communications
Australian Small Business and Family Enterprise Ombudsman
Ph: 02 6121 3000
media@asbfeo.gov.au

This paper is intended to facilitate and encourage discussion on issues related to the Research & Development Tax Incentive and the recent experiences of a number of small businesses registering their R&D activities. The report looks at audit and review policies and practices by the Australian Taxation Office and AusIndustry and considers ways in which these policies and practices might be improved to assist small businesses.

Contents

Executive summary

Following a detailed investigation of the experiences of small businesses and family enterprises that have claimed the Research and Development Tax Incentive (R&DTI), my office is recommending that this important incentive be retained and a suite of reforms are made to the way the system is administered.

This report details how small and family business taxpayers have been subjected to review, examination and audit by the two agencies responsible for the delivery of the program – the Department of Industry, Innovation and Science (AusIndustry) and the Australian Taxation Office (ATO). In all cases, this compliance activity was retrospective and commenced several years after the relevant research and development (R&D) activity was undertaken and the R&DTI refund received. In almost all of these cases, the R&DTI claims were rejected in total.

This has had a devastating impact on the companies, with some saying they face financial ruin. Others have scaled down their R&D efforts in Australia and reduced their R&D staff. For small business, particularly startups, cash flow is critical and access to finance can be challenging. Small businesses undertaking R&D rely on the R&DTI to help fund the development of their innovative new products and services, particularly in the often unprofitable early years.

It is therefore critical that wherever possible the program is improved for small and family businesses and that R&DTI risk and compliance activities are conducted as close as possible to when they register their R&D activities and before they claim the benefit with the ATO.

We have found that many small businesses experienced untimely, inconsistent and in many cases targeted action by both the ATO and AusIndustry, often at the same time. We identified an overall "shift" in the way the R&DTI legislation has been interpreted over the last three to four years; a narrowing of focus leading to a rejection of claims, which in previous years had been regarded as low risk. The way the program has been administered has created uncertainty amongst companies and their advisors and has undermined the policy intent of the R&DTI legislation.

There appears to have been a broad-brush approach to program integrity with a view to recouping Government expenditure on the R&DTI. Valid claimants have been swept up along with those who have been badly advised by unscrupulous R&D "consultants".

Our findings and recommendations are the outcomes of consultation with a wide range of stakeholders, in-depth research and a review of relevant material provided to us. Stakeholders include companies who have accessed the R&DTI; representatives from the agencies responsible for the program; the Tax Practitioner's Board (TPB); R&D Consultants (small, medium and large); industry associations and academics in the field of innovation. Our recommendations relate to the conduct and governance of the program, as well as the important role that R&D consultants play.

The ATO and AusIndustry tell us that they are revising their approach to R&DTI compliance, which we welcome. We have, however, pinpointed the need for better guidance, the application of modernised approaches to compliance, and improvements in respect of the R&D consultant industry and the responsibility that industry also carries. It is important that the improvements are implemented quickly and applied consistently throughout the networks of both agencies. It is also critical that there is a mechanism by which those businesses adversely affected by past poor processes can seek redress.

Since the report was written, the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019* was introduced into the House of Representatives on 5 December 2019. While the Bill primarily deals with law, it will require good governance and administration as the measures outlined in the Bill, assuming the Bill passes through Parliament, commence on 1 July 2019 – that is this financial year. Companies who are currently conducting R&D will need clear guidance so that they are aware of the implications for them and plan accordingly.

Kate Carnell AO
Australian Small Business and Family Enterprise Ombudsman

Recommendations

In our consultation with small business, we found that the premise that the R&DTI '*significantly improves the incentive for smaller firms to undertake R&D*'[1] is sound and the program should be retained for this purpose. However, as a result of that same consultation, we have grave concerns that the administration of the program does not provide sufficient certainty for small business and that compliance activity by the regulators can and does negatively impact the continued viability of small businesses. The potentially devastating impact on the business is primarily due to audit activity coming years after an Incentive has been invested back into the business – with many businesses having relied on expert professional advice. Small businesses simply do not have the cashflow or retained earnings to repay the R&DTI together with accumulated interest and penalties. Given that AusIndustry and the ATO are changing their approaches to the R&DTI, the following recommendations should be built into this modernisation.

The program requires a fairer, more consistent, educative and customer-focused approach by both the Department of Industry, Innovation and Science (AusIndustry) and the Australian Taxation Office (ATO) embedded consistently throughout both networks. Our recommendations are based on the importance of the characteristics of good governance including transparency, clarity and certainty to ensure that companies are encouraged to undertake research and development and claim the R&DTI. The recommendations have the following key themes:

- Where compliance examinations/audits are necessary, they should take place as close as possible to the first year of registration of a project. Statutory examinations by AusIndustry should not be retrospective beyond one year unless fraud or intentional disregard of the law is reasonably suspected.
- Guidance material needs to be comprehensive, clearer and up-to-date and developed in consultation with small business.
- Substantiation and recordkeeping requirements should reflect commercial practicality with regulator personnel fully equipped to understand and collaborate with small business.
- Small business must be assisted to help identify and retain professional and responsible R&D consultants.

1. ATO and AusIndustry administration of the R&DTI should be seamlessly integrated:

The understanding and intrepretation by the ATO and AusIndustry of the operation of the law and their approaches to compliance needs to be consistent.

2. Clear joint ATO and AusIndustry guidance must be provided and maintained, particularly:

a. The ATO and AusIndustry should provide joint specific guidance about the type and detail of contemporaneous documents required to demonstrate eligibility of registered activities and how expenditure on the R&D activities should be apportioned and substantiated. This should be developed in consultation with companies and experienced, reputable stakeholders.

b. All software guidance material should be rewritten to fully align with the Frascati Manual (or to discard references to it). The guidance should be positive and focus on what is eligible, instead of what is ineligible. It should provide examples about how the use of Agile can allow a company to demonstrate that software development is, or includes, R&D activities within the systematic progression of work.

c. Guidance material should be updated to reflect current case law including the *Moreton Resources Limited v Innovation and Science Australia [2019] FC AFC 120* decision and provide certainty about what the decision means for each industry sector.

[1] Tax Laws Amendment (Research and Development) Bill 2010, Explanatory Memorandum, 1.10.

3. The approach to compliance should be:

Proactive

a. AusIndustry should concentrate significant resources to assist a company to comply in the first year of registration of a project, allowing them to adjust subsequent registrations as necessary. Statutory examinations by AusIndustry should not be retrospective beyond one year unless fraud or intentional disregard of the law is reasonably suspected.

b. Innovation Science Australia (ISA) should better utilise advance findings through their wider promotion, expediting processes and publicising decisions.

c. ISA should emulate the ATO Test Case Litigation Program to test contentious areas of eligibility where there is no judicial authority, such as disputed software registrations.

Professional

d. AusIndustry's new R&DTI Service Commitment should be reinforced by a set of rules for staff to follow to ensure the words in the Service Commitment are translated into action.

e. ATO and AusIndustry should ensure that staff reviewing/auditing/examining companies are properly trained and experienced in both the technical aspects of the legislation and how to apply it to industry sectors (particularly when R&D is underpinned by software using Agile and Rapid development methods). The focus should be on the process and the evidence that the process creates rather than time sheets and additional documentation.

f. ATO and AusIndustry staff training should cover how R&D works in commercial reality particularly with start-up companies. This should be delivered in a practical way in conjunction with start-up companies.

g. The ATO debt recovery and dispute resolution areas should co-ordinate their work to ensure a small business is not subject to continuing recovery action, including application of interest charges while a debt is in dispute.

Collaborative

h. AusIndustry's statutory examination process should include as standard a meeting with the company to allow it to explain the registered activities and work through the company's documentation.

Proportionate

i. Companies who are currently in the AusIndustry statutory examination phase or in the internal review phase should have the new R&DTI Framework retrospectively applied.

j. Both the ATO's and AusIndustry's requirements for supporting evidence should be proportionate to the size and complexity of the business and the amount of the claim.

k. The new AusIndustry R&DTI Integrity Framework should make provision for companies that have been subject to previous compliance processes and that will not otherwise have access to, or benefit from the new Framework.

4. Advisors should be skilled and responsible for their advice:

a. Small business taxpayers who rely on specialist advice and use all reasonable endeavours to comply with that advice should not be subject to general interest charges and/or penalties.

b. Like the company tax return that includes a declaration by the tax agent, the R&DTI schedule should include a declaration by the R&DTI adviser.

c. The ATO should swiftly and effectively co-ordinate with the TPB regarding consultants under investigation so that companies are alerted of disqualified R&D "Consultants" on the TPB's online register.

d. The TPB should allocate further resources to speedily investigate R&D consultants who, as registered tax agents, have breached the Code of Conduct or Tax Agent Services Regulations 2009.

e. Registered tax agents who prepare or lodge R&DTI claims should meet specialised further education criteria that demonstrates understanding of the requirements of the R&DTI.

f. Additional Continuing Professional Education (CPE) opportunities through structured courses should be provided by the ATO and AusIndustry to support registered R&D consultants achieve their CPE requirements.

g. AusIndustry should adopt the Austrade "Quality Incentive Program Consultants Register" model to provide assurance to companies that use a consultant to claim the R&DTI.

h. Where enforceable voluntary undertakings are used by the ATO, advisers should still be referred to their professional association or registration body for investigation and possible disciplinary action.

i. The ATO/AusIndustry/TPB should provide further guidance to help companies understand what to look for in selecting an R&D Consultant.

The Policy Landscape

The R&DTI was announced in the 2009-10 Budget to replace the R&D Tax Concession.

Legislation	Purpose
Tax Laws Amendment (Research and Development) Act 2011; and *Income Tax Rates Amendment (Research and Development) Act 2011*	Amends the law relating to taxation and research and development, and for other purposes. Supersedes the R&D Tax Concession program.
Industry Research and Development Act 1986. (IR&D Act)	Sets out the legislative basis for the administration and functions of the R&D Tax Offset including registration, findings and review of decisions.
Industry Research and Development Decision-Making Principles 2011	Sets out the principles that Innovation Australia must comply with when considering R&DTI matters

The Object of the Tax Laws Amendment (Research and Development) Act 2011 is:

> (1) *… to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.*
>
> *(2) … to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form (including new knowledge in the form of new or improved materials, products, devices, processes or services).*[2]

In introducing the Tax Laws Amendment (Research and Development) Act 2011, the case for public support included a statement that the R&DTI '*significantly improves the incentive for smaller firms to undertake R&D*'.

The object in (1) refers to additionality, where increased private investment in R&D occurs due to the program, and to the spillover effect of benefits flowing through to the wider economy. Both additionality and spillover benefits are difficult to quantify. Determining whether or not a business would undertake R&D activities because of uncertain returns to them [3] is problematic – and quantifying benefits to the wider economy, in most cases, takes years to determine.

The R&DTI provides a tax offset to companies conducting eligible R&D activities when the eligible expenditure exceeds $20,000. Tax offsets of 43.5 or 38.5 per cent are available for costs incurred on eligible activities depending on a company's annual aggregated turnover. The 43.5 per cent benefit is a refundable tax offset. Refundable tax offsets can reduce the amount of tax a business is liable to pay to an amount less than zero, which results in a cash refund. The R&DTI is an open-ended Budget initiative; there is no set limit to the amount which will ultimately be expended by the Federal Government.

The *Treasury Laws Amendment (Research and Development) Bill 2019* (the Bill), introduced into the House of Representatives on 5 December 2019 – since this report was written. The Bill provides for a number of changes to the R&DTI legislation. Measures for small businesses include:

- a proposed $4million p.a. cap on the refundable component of the tax offset for companies

[2] *Tax Laws Amendment (Research and Development) Act 2011 paragraph Section 355-5 Object.*
[3] *Tax Laws Amendment (Research and Development) Act 2011, Explanatory Memorandum, 1.9.*

with clinical trials exempted;

- R&D entities with aggregated turnover of less than $20 million entitled to an R&D tax offset rate equal to their corporate tax rate plus a 13.5 per cent premium;
- complex clawback and recoupment technical amendments; and
- extending the R&DTI to the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936* so as to ensure the ATO can act to prevent what they perceive are tax schemes.

The Bill largely reflects the contents of the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018*, which fell when the last Parliament was dissolved for the last Federal election.

The Regulatory Impact Statement attached to the Explanatory Memorandum to the Bill suggests that the changes will impose an increase of average annual regulatory costs to business (from business- as-usual) as $26.3 million.[4]

In our review, we focused on key characteristics of good program governance. In particular: transparency, professionalism, collaboration, proportionality and proactivity in approaches to compliance. These measures, assuming the Bill's passage through Parliament, commence on 1 July 2019 – that is, this financial year. They will require good program governance and administration as SMEs:

- will need to be aware that $4 million cap will apply as from this financial year and plan accordingly;
- will need to be aware that the amendment to clawback provisions will apply to this financial year and the need to understand the new calculations; and
- may need to ensure relevant documentation is available to show the dominant purpose of investing in R&D was not just to obtain the tax offset.

Part 2 of Schedule 3 to the Bill amends the IR&D Act so as to permit the Innovation and Science Australia Board to make a 'determination' as to how it will exercise its powers or perform any of its functions and duties. The proposed 'determinations' have the same legal effect as an ATO ruling. This measure aligns with a recommendation in the report. However, the benefit conferred by publishing a 'determination' is only as good as the clarity of the document.

In addition, Part 3 of Schedule 3 amends the IR&D Act to extend the class of person to whom the ISA Board may delegate powers to a member of the staff of ISA. Currently, only Senior Executive Service officers may receive delegations. This may help alleviate some of the existing bottlenecks. Much will turn, however, on how many public servants can be characterised by being 'staff' of ISA if the idea is to provide more resources to make decisions. The trade-off is that more junior officers may make poorer decisions as a result of less experience.

The R&DTI is a self-assessment program – a company self-assesses the eligibility of their R&D activities based on available guidance. They must understand the legislative requirements and structure their R&D activities accordingly to be able to claim. They are required to document their R&D activities and keep expenditure records relating specifically to the R&D undertaken (as distinct from business-as-usual activities).

A number of OECD countries use tax credits in various ways to support R&D investment.[5] Australia, Canada, and more recently New Zealand, use tax as a principal way to support R&D and in those systems such a tax credit may provide a cash refundable component.

[4] Explanatory Memorandum:68

[5] https://www.oecd.org/sti/rd-tax-stats-compendium.pdf

Two Agency Delivery

The R&DTI is jointly managed by two agencies;

- the Department of Industry, Innovation and Science (through AusIndustry), on behalf of ISA
- the Australian Taxation Office.

ISA's role is to provide independent advice to Government on the R&DTI and may seek the further advice of technical experts to assist with more complex compliance assessments.[6]

AusIndustry manages the process of companies registering their R&D activities, determines whether R&D activities are a risk of non-compliance with the legislation and determines the eligibility of R&D activities. Its role is also to educate R&DTI claimants and publicise the program.

The ATO determines whether the R&D expenditure being claimed in the entity's annual income tax return is directly related to the eligible R&D activities and is substantiated by documentary evidence. They also check that the company is an "eligible entity".

Program Governance

Governance of the R&DTI program should reflect the policy and legislative intent of the program. Good governance of any government program is characterised by:

- Transparency, consistency and clarity of operation and a reciprocity of behaviour expectations (the agencies should engage with small business in the same way and within the same timeframes that they expect of small business).
- Fairness (intuitively sensible, with a culture of a level playing field).
- A proportionate approach (providing a nuanced response to the particular circumstances of the small business taxpayer).
- Value for the customer/taxpayer experience.
- An educative approach to the program's integrity.
- A modern approach to compliance is also proactive and involves professionalism and industry collaboration.

The ATO and AusIndustry are updating their approach to R&D compliance activities. However, during our consultations we heard of circumstances and have seen evidence where companies' interactions with the ATO and AusIndustry have not demonstrated the attributes associated with good program governance. Some of the cases span many years with a number still being considered either by the ATO or AusIndustry. These are discussed in our key findings.

[6] Ferris B, Finkel Dr A, Fraser J, Review of the R&D Tax Incentive, April 2016, p 5.

Changes to R&DTI Compliance Approaches by AusIndustry and the ATO

ASBFEO met with a wide range of stakeholders during the inquiry, including two meetings with AusIndustry (the Department of Industry, Innovation and Science), the ATO and the TPB.

Both AusIndustry and the ATO in the second meeting, in October 2019, and in subsequent correspondence have advised that they have changed their practices in relation to R&DTI compliance.

AusIndustry in late November announced the implementation of a revised R&DTI Integrity Framework which takes into account integrity risk and behavioural factors that influence program participants.

Under the new Integrity Framework each company (R&D entity) will be grouped in particular risk categories.

- Those considered as 'getting it right' are in the lower risk category, receive a registration letter and support is made available as required.
- Those that are 'trying to get it right' are medium risk entities and and would also receive a registration letter, however targeted education and advice would be available to them.
- R&D entities who 'do not comply' are considered a higher risk would receive correspondence and meet with AusIndustry to discuss eligibility issues – the company may withdraw their application or AusIndustry may commence a statutory assessment with ensuing processes of AusIndustry discontinuing if evidence provided by the company reduces the issues. A review process is available if activities are found to be ineligible.[7]

The Framework is intended to support the program to achieve its objectives of encouraging additional R&D, including spillover effects, and ensuring integrity. It is not clear how AusIndustry will determine that the company would have chosen not to undertake the R&D activities due to uncertain returns without the R&DTI. In addition, quantifying spillovers in most cases takes years to determine.

AusIndustry has released a Service Commitment outlining the level of service their customers can expect. In addition, AusIndustry has told ASBFEO that they will undertake training for staff in stakeholder management and customer experience.

Stakeholders and companies have told ASBFEO that AusIndustry did not consult their Roundtable members about the contents of the new compliance material prior to its publication. Consultation and collaboration need to be built into the approach to the R&DTI education and compliance to capture a more effective customer focussed outcome.

The ATO responded to a number of issues raised by ASBFEO in a letter dated 18 October 2019 (a revised letter is at Attachment E). The ATO advise they have updated their approach to R&D compliance activities and are developing additional guidance material to assist companies maintain records of their R&D expenditure. The letter also highlights the review and appeal mechanisms available to companies.

[7] https://www.business.gov.au/Grants-and-Programs/Research-and-Development-Tax-Incentive/Help-guides-and-resources/Navigating-the-Tax-Incentive

Value of the Program

Participation in the R&DTI program has grown since its inception in 2011. Overall, the number of companies which claimed the R&D tax offset increased from 6,475 in 2013[8] to 13,156 in 2017-18.[9]

There was, however, a reduction of $700 million (or 13 per cent) in tax offsets paid in 2017-18 from the previous 2016-17 year. This is despite a slight increase in the number of companies claiming (85 companies or 0.7 per cent).

This reduction in tax offsets paid could be attributed to increased compliance activities, clawing back prior years claims. Also, the ATO has a high risk refund review process to identify 'at risk' claims before refunds are paid, undertaking 151 high risk reviews in 2017-18.

Of particular note is that software claims on the program have increased[10] *(Software R&D expenditure represents 25-30 per cent ot total claimed expenditure)* [11] and that SME expenditure claims on the program have increased significantly. Approximately one third of the 13,000 companies registered for the R&DTI are undertaking software development. The companies are in a wide range of industry sectors.[12]

The cost of the program should acknowledge that Australia's business expenditure on research and development (BERD) is an important indicator of business commitment to generating value and new ideas. OECD research shows a correlation between R&D spending and productivity growth. Australia's BERD decreased by 12 per cent from $18.8 billion (2013-14) to $16.7 billion (2015-16). In addition business resoures devoted to R&D decreased by 11 per cent from 2013-14. According to the Global Innovation Index, Australia has recently fallen out of the world's 20 most innovative economies, now at 22nd.[13]

Additionally, discussions about the cost of the R&DTI program do not take into account the flow through to increased employment and resulting PAYG(W) deductions. The figures are often quoted before offsetting deductions and before feedstock is calculated. Thus, there is not a true account of the 'net' cost of the R&DTI.

The Federal Government flagged concerns about the cost of the program in the 2018-19 Budget announcement in May, 2018 which included measures to cut the cost of the program, saying:

> *"We are cracking down to ensure that R&D tax incentives are used for their proper purpose, with enhanced integrity, enforcement and transparency arrangements, saving taxpayers $2 billion over the next four years".*[14]

The 2019 Federal Budget cut the R&DTI a further $1.35 billion over the budget forward estimates. The total budget cuts to the R&DTI program over the last two budgets is more than $4 billion.[15]

There is therefore an assumption that a percentage of claims are fraudulent or that the cost of the program will be reduced in another way.

The subsequent reforms were included in the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* which was introduced to the lower house on 20 September, 2018. The Senate Economics Legislation

---

[8] ATO website page at https://www.ato.gov.au/Media-centre/Media-releases/$4-million-fine-for-company-promoting-R-D-tax-schemes/ reporting $4m fine for company promoting R&D tax schemes 21 March 2018
[9] ATO Second Commissioner Brief to Senate Economic Committee, February 2019.
[10] AusIndustry, ASBFEO Meeting, June 2019.
[11] AusIndustry workshop as quoted in website article by Michael Johnson Associates https://mjassociates.com.au/journalpost/software-rd-untwisting-the-pretzel/
[12] ATO Second Commissioner Brief to Senate Economic Committee, February 2019.
[13] https://www.globalinnovationindex.org/Home
[14] The Hon Scott Morrison, then Treasurer, Budget Speech delivered 8 May, 2018
[15] Patrick Durkin and Ben Potter reporting in the Australian Financial Review on 2 April, 2019 "Federal budget 2019: Turnbull's innovation agenda dropped as $1.35b squeezed from R&D"

Committee handed down its report on the Bill in February, 2019 (recommending further examination and analysis of the impact of the proposed reforms) and the Bill lapsed when Parliament was prorogued on 11 April, 2019. As discussed earlier, the measures relating to the R&DTI were reintroduced to the House of Representatives on 5 December 2019 as *Treasury Laws Amendment (Research and Development) Bill 2019*.

The Treasury consultation paper of 28 June 2018 accompanying the 'Better Targeting the Research and Development Tax Incentive – Exposure Draft Explanatory Materials' said:

> *"The 2016 Review of the R&D Tax Incentive (the Review) found the cost of the Incentive had exceeded initial estimates. The cost of the Incentive was expected to be $1.8 billion per annum when it was introduced in 2011-12. In 2016-17 it cost around $3 billion".* [16]

Also:

> "*The Government's response acknowledges these reports' findings with a package of reforms to enhance the additionality, integrity and fiscal affordability of the R&DTI."* [17]

The assumption of fraud in the system appears to have driven the apparent poor regulatory behaviours uncovered through our consultation.

[16] Better Targeting the Research and Development Tax Incentive – Exposure Draft Explanatory Materials accompanying Treasury Consultation Paper released 28 June, 2018 para 1.13 p5

[17] Consultation on the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials June 2018 p2.

Approach / Methodology

ASBFEO has investigated the effect of the R&DTI legislation, policies and practices on small businesses or family enterprises as a result of a number of companies approaching ASBFEO about the treatment and outcomes of their R&DTI audit/examinations by the ATO and AusIndustry. They reported that the interpretation of the legislation by AusIndustry and the ATO regarding the eligibility and substantiation of software R&D claims, has shifted to become more rigid. Companies that are not software related, raised concerns with ASBFEO where the ATO had retrospectively ruled that their R&D Incentive activities were not eligible R&D even though Ausindustry advised they were.

In addition we were alerted by press articles from 2018 about the R&DTI compliance processes of both agencies, their retrospective nature and the impact on companies. These included:

Date	Publication	Article
May 2018	AFR	Federal Budget 2018: warnings R&D could move ofshore as incentives slashed.
October 2018	AFR	Tax Office 50 secret agent agreements stop advisers promoting exploitation schemes
December 2018	AFR	AirTasker hit by R&DTI tax crackdown that threatens tech firms
December 2018	SmartCompany	Will Aussie startups be dissuaded from taking advantage of tax incentive
2018	Crossroads Report, StartupAus	R&DTI
December 2018	AFR	PwC slashes R&D staff after being targetted by ATO
December 2018	AFR	How CBA, Deloitte triggered the R&D incentive crackdown
February 2019	InnovationAus	Oursourcing the innovation crackdown
May 2019	InnovationAus	R&D audits are killing startups

In undertaking this investigation ASBFEO:

1. Examined how small businesses typically use the R&DTI;
2. Determined if there had been a change in what activities were considered eligible by AusIndustry and the ATO pre and post the 2019 software guidance material published by AusIndustry and how this had been conveyed to small businesses.
3. Determined the impact on a small business of the ATO and AusIndustry being able to audit/examine R&DTI claims going back four years.
4. Identified the circumstances in the legislation where the ATO can decide that the registered activities are not eligible activities.
5. Examined the liability a R&D consultant incurs where the ATO and/or AusIndustry has audited/examined their client's R&DTI claim, ruled the claim ineligible and ordered the benefit be paid back to the ATO.

To understand the policy landscape surrounding the program ASBFEO's research has included a review of the following:

- *Tax Laws Amendment (Research and Development) Act 2011;*
- *Industry Research and Development Act 1986*;
- Australia 2030: Prosperity through Innovation, Innovation and Science Australia;
- Review of the R&DTI 2016 by Mr B Ferris B, Dr A Finkel and Mr J Fraser;

The ASBFEO conducted extensive consultation and interviews with a broad range of stakeholders that included:

- Government bodies
- Small businesses that had been subject to R&DTI compliance activities
- R&DTI consultants with both small and large consulting firms
- Academics and industry bodies.

To understand the approach of the agencies involved in the administration of the program ASBFEO consulted with the following:

Agency	Date	Interaction
AusIndustry (Department of Industry, Innovation and Science)	June October	Meeting and correspondence Meeting and correspondence
Australian Taxation Office	July October	Meeting Meeting and correspondence
Innovation Science Australia	August September	Meeting Correspondence
The Tax Practitioner's Board	July November	Teleconference Teleconfence

In August 2019 a briefing was made to the Treasurer's office and to the office of the Minister for Industry, Innovation and Science, the Hon Karen Andrews MP.

ASBFEO interviewed and received communications regarding over 20 small business R&DTI claimants who had been reviewed/audited/examined by the ATO and AusIndustry to understand the agencies process and the impact they had on the businesses, with a 'deep dive' into eight of these companies. ASBFEO examined the ATO and AusIndustry correspondence/decisions/position papers from the agencies to these companies.

An academic with years of experience in the innovation environment was interviewed and two teleconferences with an industry association representing small companies were held.

Six small and medium R&D consultants were interviewed, as well as with eight R&D consultants from the major firms.

The R&DTI guidance material issued by the ATO and AusIndustry was examined. ASBFEO contributed to the review of the TPB by participating in a workshop and making a submission to the review.

The findings and recommendations of this report are based on the outcomes of the research, consultations and interviews, and material received during the investigation.

Key Findings
Summary of Findings

- Overall, the program is exceedingly complex.
- The operations of the ATO and AusIndustry are not properly integrated.
- The ATO and AusIndustry have critical roles to play in providing further clarity of operation and administraton of the law.
- The ATO and AusIndustry guidance material is fractured and incomplete.
- Compliance activities have been reactive, lack the commercial understanding of how small businesses operate, assume guilt, are resource intensive and result in long lag times for decision-making so that the vialbility of the scruitinised businesses is threatened.
- Many companies are scaling down their R&D efforts in Australia and have reduced R&D staff due to their experience with both agencies' compliance activities and the uncertainty surrounding eligibility and the substantiation of the R&D and its expenditure.
- The program complexity and issues with the administration of the program results in the R&D advisor role being critical to the company. While the R&D consultants we spoke to operate professionally, there are those who are incentivised to increase claims and are not held responsible for their advice. Unscrupulous operators are able to continue to advise businesess for long periods of time.

The Department of Industry, Innovation and Science (AusIndustry)

The Retrospective Nature of Program

AusIndustry has the ability to make a finding that is binding on the ATO for four retrospective years. Statutory examinations undertaken years after the R&D has been undertaken has created an uncertain environment for innovative companies undertaking R&D in Australia.

AusIndustry advise that R&D projects and activities can span across multiple years. Businesses are required to register their activities annually. As such, an examination being undertaken in one year on R&D activities for a project covering previous years may require examination of those earlier years, particularly, if the core activity was conducted in a previous year.

It is however unfair to adversely affect a company at such a late stage following the incentive payment, particularly when they had, for several years, self-assessed using the guidance material that was available at the time and which they believed they could rely upon. The majority of the companies spoken to had registered R&D activities which they genuinely believed were eligible, on the information provided to them by AusIndustry and the ATO. Many had reinvested the offset back into the business.

AusIndustry's contention is that '*the legislation has not changed*'. There is evidence however that the current AusIndustry software guidance, in particular, has an effect of narrowing their intrepretation of the legislation. An analysis of the R&D legislation and application of the 2015 Frascati Definition to R&D in the development of software is at Attachment B.

Anecdotal evidence suggests that some companies are reporting their R&DTI estimated refund as a liability in their financial records, to recognise the potential of the company having to repay the funds accessed in previous years. This has an impact on possible investment into the company.

In July 2018 AusIndustry announced the implementation of a new statutory examination process for selected registration applications (pre-registration examinations). This was in addition to post-registration examinations. Under the July 2018 process a company is sent a letter notifying them of the statutory examination. An example of the statutory examination letter, which also examines the previous three years registrations is at Attachment D. The letter places an emphasis on the company

withdrawing their registration and does not provide specific eligibility concerns beyond stating that the various eligibility criteria have not been met. AusIndustry ceased the previous risk based compliance continuum.

A finding about the eligibility or otherwise that is applied as close as possible to when the R&D is undertaken has the potential to be fairer to a company, especially for first time registrants. AusIndustry has said that, in practice, this is difficult as a high percentage of registrations occur close to the 30 April cut-off date and it would be very resource intensive to reach a high number of those.

AusIndustry, will have additional resources to assist in their integrity functions early in 2020. A procurement process was advertised in early 2019 to engage a third party provider to assist with a range of R&DTI integrity functions. When questioned, AusIndustry said that this was as part of the reform measures to the R&DTI announced in the 2018-19 Budget, where the Government committed additional resources to support program integrity and administration.

All decision making will be retained by AusIndustry, however the contractor will assist with integrity activities and provide recommendations for review and decision. The expectation is that there will be a contract in place in late 2019 with activities commencing in early 2020. A significant proportion of these new resources should be directed to pre-registration examinations, particularly for first time registrants to 'help to get it right'.

AusIndustry Integrity Measures

Under the process implemented after July 2018, once an application for registration is received, companies may be chosen for pre or post registration statutory examination activity.[18]

At the completion of a statutory examination of eligibility, AusIndustry issue a certificate of finding stating that the activities are either ineligible or, as is current practice, the company is notified that AusIndustry is discontinuing the statutory examination if sufficient contemporaneous evidence is provided.

The IR&D Act states that 'a finding can only bind the ATO if the finding is made within four years after the end of the income year'.[19] The ATO has two years from the date of receiving the certificate that activities are ineligible to amend the assessment of the R&D entity – if giving effect to the finding would increase the R&D entity's liability.[20] Where activities are found to be ineligible, the company would need to amend their tax return (if the examination is pre registration, the registration may be denied).

The company has a right of an internal review with AusIndustry.[21] If the internal review is unsuccessful, the company can appeal to the AAT. If the original finding is upheld by the AAT, the company may take their case to the Federal Court.

The AusIndustry Fact Sheet dated July 2018 (released in November 2018), announced that an application for registration may be examined for compliance with the eligibility requirements of the program (as well as the continuance of post-registration examinations). These statutory assessments can result in a finding that activities examined are ineligible. AusIndustry will discontinue the statutory examination if sufficient evidence to support eligibility is provided. AusIndustry say, however, that discontinuing an examination is not a confirmation that activities are eligible, just that they have been deemed a low-risk to pursue further compliance activities. This is despite the IR&D Act providing AusIndustry with the means to make a positive finding. A finding that activities are eligible would provide greater certainty to the company.

[18] Conducted under the *Industry Research and Development Act 1986*.
[19] Section 355-705(1) of the *Income Tax Assessment Act 1997*
[20] Section 355-710(2) of the *Income Tax Assessment Act 1997*
[21] *Industry Research and Development Act 1986,* s.30

The 2018 Fact Sheet announced that the new compliance process '*will change the way we interact with claimants and their R&D Tax Incentive advisors*' and promises a reduced compliance burden for companies and improved timeframes. Stakeholder feedback to ASBFEO is that the compliance burden was not reduced and timeframes for AusIndustry to respond to the company were not improved, with long periods elapsing prior to the company hearing back from AusIndustry. There was no stakeholder consultation in designing and implementing this measure.

As discussed earlier, AusIndustry is implementing a revised R&DTI Integrity Framework which takes into account integrity risk and behavioural factors that influence program participants and has greater interaction with the company. In addition to this process, AusIndustry say that they will undertake training for staff in stakeholder management and customer experience. ASBFEO has heard from stakeholders that little or no consultation was undertaken in developing this framework.

Although customer service/customer experience and compliance/integrity activities should not be mutually exclusive, we have received many complaints from companies about the fairness and transparency of the statutory examination process and the cultural mindset of AusIndustry assessors. These include:

1. The summary of key issues in the statutory examination letter is a generic list and provides little specific information relating to the company's registered activities (a copy of the letter is at Attachment D).
2. The letter contains little guidance regarding the type and volume of contemporaneous documents that would meet the program requirements (a copy of letter is at Attachment D).
3. AusIndustry has been very reluctant to meet with companies during the examination process. Evidence is required in writing and many companies are concerned about the correct interpretation of the documents.
4. Long timeframes for AusIndustry to respond to the company and to make a decision during the statutory assessment process.
5. We have been advised that there have been instances where the AusIndustry assessor's attitude is that the registration is ineligible and it is up to the company to prove differently.
6. We have been advised that an AusIndustry assessor often says 'A Google search shows me that this existed [at the time of the project] and therefore the core R&D activities cannot be eligible', thus trivialising the R&D effort and not recognising or acknowledging the fast moving nature of R&D in many sectors.

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

AusIndustry Guidance Material

> *"Clear and consistent guidance and uniformity in its application by administrators are essential to preserve the integrity of the programme and the tax system through which it is delivered."*[22]

AusIndustry has issued a range of guidance material over the period of the program. Some of that material has evolved over time, as is the case with software guidance material.

The ATO issued a Taxpayer Alert in 2017 (TA 2017/5) 'Claiming the R&D Tax Incentive for software development activities' outlining concerns about software claims which were not eligible R&D activities. The document was developed in conjunction with AusIndustry. When TA 2017/5 was released, an addendum (TA 2017/5A) was required to correct the statement in the original TA that certain software activities would not be eligible – when in fact they may be eligible as supporting activities. This incorrect interpretation of the legislation caused confusion for companies.

AusIndustry released updated software guidance 12 months later in February 2019 (Software Activities and the R&D Tax Incentive and Guide to Common Errors). The software guidance material makes reference to the 2015 Frascati Manual as a basis to assess software R&D eligibility. The Frascati Manual was not referenced in any AusIndustry or ATO's guidance material released prior to February 2019, including R&D Tax Incentive ICT Guidance September 2017, ICT and the R&D Tax Incentive, January 2017, Getting Software development R&D Tax Incentive claims right - Specific Issues Guidance (undated on website), and the 2017 ATO Taxpayer Alert.

The Frascati Manual is published by the OECD as a methodology for collecting and using R&D statistics and for science and innovation policy makers. The Frascati Manual is not referenced in the Tax Laws Amendment (Research and Development) Act 2011 which sets out the object of the Act and outlines the meaning of R&D activities. Nor is the Frascati Manual referenced in the Explanatory Memorandum to the Act.

Successive software guidance material has had the effect of narrowing the interpretation of the R&DTI definition in the legislation. The AusIndustry 2019 Software Guidance material refers to the Frascati Manual, however it makes selective use of the wording in the manual, which in effect, restricts the interpretation of the legislation. Attachment B addresses AusIndustry's use of the Frascati Manual in the 2019 Software Guidance.

The 2015 Frascati definition needs to be considered as a whole and in how it applies to software development in a conceptual way. That is, it should be applied based on the principles it expresses and not as a prescriptive list. This principle based methodology is consistent with the general methodology used in writing and interpreting the Income Tax Assessment Act 1997. The definition relies on the application of the principles with some specific examples, but the guidance only quotes the examples and it quotes them inconsistently.

AusIndustry's response to the paper at Attachment B is that:

> *"It is important to note that Frascati is not applied when assessing eligibility of R&D activities, this is done in line with the definitions of core and supporting activities provided in legislation".*
>
> *"Our overarching comment is that the Frascati Manual has practical guidance and a principles based approach which can be helpful in providing guidance in certain circumstances and in certain cases. However only the criteria as set out in legislation for core and supporting activities is used to assess the eligibility of R&D activities, not Frascati or any of its elements."*
>
> *"The test for what is an R&D activity for the purposes of the R&DTI is not the same as the test*

[22] Ferris B, Finkel Dr A, Fraser J, Review of the R&D Tax Incentive, April 2016.

for an R&D activity as set out in the Frascati Manual."

"The R&DTI guidance is not intended to imply that an activity will be an R&D activity for the purposes of the program simply because it would meet the Frascati definition of an R&D activity."

"The R&DTI guidance is intended to identify that some examples of R&D activities in the Frascati Manual would also meet the test for an R&D activity under the R&DTI program."

The application of the R&DTI to software development activities, particularly those using the Agile method is uncertain.

> *"Software is developed in Agile teams, which try things and discard things, it doesn't map well to the structure that the Frascati model tries to create."*
>
> Daniel Petre, Co-founder of Airtree Ventures, quoted in the AFR article of 3 December, 2018

However, software development using the Agile method can demonstrate that the development is, or includes, R&D activities within the systematic progression of work. See Attachment A, discussion on Agile, Rapid and R&D.

At the July R&DTI Rountable (a forum co-administered by the ATO and AusIndustry and with a rotating attendance of stakeholders) attendees said that the eligibility of software activities in the R&DTI is considered to be one of the biggest issues facing the Technology Start-up and Fintech sectors. The AusIndustry response was that the '*eligibility of the program has not changed*'. While panel members were invited to consider how they can work with AusIndustry and the ATO on clarifying and understanding the eligibility of software activities in the program, they said that the offer was not about revisiting the current guidance material.[23] AusIndustry has also advised ASBFEO that they do not intend to revisit the 2019 software guidance material, despite widespread criticism of it.

The first Federal Court decision in relation to the eligibility of the R&D activities was made on 25 July 2019 in *Moreton Resources Limited v Innovation and Science Australia [2019] FCAFC 120.*

The Court found that application of existing technologies or methods to a new site will not be precluded from meeting the definition of a "*core R&D activity*". The Court found that nothing in the words of the law would suggest these types of activities are excluded. Equally as significant, the requirement that core R&D activities must be experimental was applied much more broadly than earlier administrative Administrative Appeals Tribunal (AAT) decisions.

The case confirmed that the process of statutory interpretation must always lead back to the text of the legislation, regardless of the wording in any other extrinsic materials. This finding is critical, given the apparent over-reliance on other materials such as the Explanatory Memorandum in recent decisions by the AAT. An analysis of the Moreton Resources decision is at Attachment C.

The decision in *Moreton Resources* has a significant bearing on the statutory interpretation of the legislation underpinning the R&DTI and the use of other materials. AusIndustry has welcomed the decision on *Moreton Resources*, saying that any judgment from the AAT or Federal Court assists with the interpretation of the R&DTI legislation, and that the matter has been sent back to the AAT for further consideration.[24] AusIndustry has not provided further information regarding their ISA's position going forward.

---

[23] Minutes: R&D Tax Incentive Roundtable, 23 July 2019.

[24] www.business.gov.au/Grants-and-Programs/Research-and-Development-Tax-Incentive/External-appeals/ATT-decision-Moreton-Resources-Ltd-v-Innovation-and-Science-Australia

The Federal Court decision has provided clarity – and it is important that AusIndustry proactively advise and provide detail of what this means for companies regardless of the referral back to the AAT.

In summary, there are a number of issues with the new AusIndustry software guidance material which include:

1. It is written in a prescriptive way when referencing the principles in the Frascati definition;
2. Its focus is largely on why activities are not R&D with little focus why it would be R&D. For example there is no guidance on how software development using the Agile method can demonstrate that the development is, or includes, R&D activities; and
3. When it quotes the Frascati Manual it has made changes that affect how the definition is understood.

> *"AusIndustry, by relying on their own interpretation of the Frascati Manual have added an additional layer of confusion, instead of providing the required assistance and clarification."*
>
> Nicola Purser, BDO.
>
> https://www.bdo.com.au/en-au/insights/tax/articles/software-activities-and-the-r-d-tax-incentive

At the inception of the R&DTI, AusIndustry conducted a number of positive education activities such as information sessions in capital cities and regional areas; a joint AusIndustry/Australian Information Industry Association roadshow in 2012 in capital cities[25]; and 'Registration Readiness' workshops in each state and territory for companies and R&D consultants.[26] These were in a large part, positive activities designed to demonstrate to companies undertaking R&D could access the program under the legislation, including R&D involving software.

The Australian Taxation Office (ATO)

The ATO review and audit process.

Under the established system of "self-assessment", the ATO initially accepts the claims and disclosures in an income tax return on face value and issues the Notice of Assessment including any tax offset.

A subsequent ATO review may be triggered by one or more of a number of events including;

- A new or revised "finding" by AusIndustry which affects the registration of the entity's eligible R&D activities;
- ATO data analytics identifying significant or unusual claims in a company's tax return;
- ATO industry wide reviews;
- ATO targeted reviews of perceived aggressive tax behaviours;

Should a review reveal compliance issues, the ATO will commence an audit. Most audits are escalated from a review. However, where it is warranted, the ATO may proceed straight to audit without first conducting a review. This may happen in cases where the ATO suspects fraud or evasion, where a transaction is considered high risk or where a R&D entity has not self-amended their claim after a revised finding by AusIndustry.

During the latter stages of an audit, the ATO's usual practice is to provide the taxpayer with a

[25] Joint AIIA/AusIndustry National Seminars, 6 cities, July and August 2012, in AIIA Reponse to Business Tax Working Group, September 2012, p4.
[26] Innovation Australia, Annual Report 2011-12, pp 34-35.

"position paper" that intends to clearly explain the ATO's position on the available facts, the issue in question, the taxpayer's contentions, the ATO's application of the relevant law to the facts and details of any proposed adjustments or amended assessment to arise out of the audit.

The ATO affords the taxpayer the opportunity to comment on their position paper before making their final decision.

If a Notice of Amended Assessment is issued by the ATO as a result of a review or audit AND that Amended Assessment *increases* the taxpayer's liability in respect of a year, further charges are applied under the penalties and interest regime. The stated purpose of the penalty provisions is to encourage taxpayers to take reasonable care in complying with their taxation obligations. The base penalty is a percentage of the shortfall amount – that is, the increase in tax assessed.

- Failure to take reasonable care attracts a base penalty of 25 per cent
- Recklessness attracts a base penalty of 50 per cent
- Intentional Disregard attracts a base penalty of 75 per cent.

The ATO assesses a taxpayer as "Reckless" if "a reasonable person in your circumstances would have been aware that there was a real risk of a shortfall amount arising and they disregarded, or showed indifference to, that risk".[27]

In determining whether a penalty should be applied, paragraph MT 2008/1 provides that the decision will take into account the personal circumstances of a taxpayer (or responsible individual of a taxpayer entity) such as age, health and background, the level of their knowledge, education, experience and skill and their understanding of the tax laws"[28]

ATO Integrity Measures

As discussed earlier, the ATO has recently advised that it has changed its approach to R&DTI compliance activities and is developing additional guidance material to assist companies maintain records of their expenditure which meet the substantiation requirements.

Throughout our consultations however, companies reported that the ATO staff involved in reviews and audits were aggressive in their interactions, exhibiting poor client engagement skills. Some interactions were reported to have demonstrated a lack of respect and disregarded the taxpayer's representation.

We have seen a ruling by the ATO disallowing the apportionment of a startup company director's fees due to 'other director requirements'. This demonstrates a lack of commercial understanding of how early-phase start-up companies work. It is not the mandate of the ATO to determine how a business entity operates and in the facts of this case, one employee was engaged wholly on R&D activities but was also a company officeholder on the statutory register. Many statutory officeholders are not remunerated in startup companies and their salary reflects their work as a company employee. The time spent on duties as a statutory officeholder are often minimal and executed out of normal business hours.

We have seen a number of examples where there has been a lack of advice from the ATO to the company about the type and volume of documents that would demonstrate the nexus between the registered R&D activities and the notional expenses. When there is a change in the ATO staff assigned to the taxpayer's case, further requests for information are issued, duplicating earlier requests. When challenged to outline the *exact* documentation needed, the ATO has been known to advise they cannot provide confirmation as they may give the wrong advice.

Taxpayers are given strict time frames in which to produce documents or answer questionnaires.

---

[27] www.ato.gov.au/general/interest-and-penalties/penalties/statements-and-positions-that-are-not-reasonably-arguable/

[28] Miscellaneous Taxation Ruling MT 2008/1 "Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard" first issued on 12 November, 2008 consolidated version dated 1 April 2015.

While the ATO will consider applications for extensions of time in which to provide the evidence, once lodged, there is no equivalent response time limit applicable to the ATO. Taxpayers are left to wait for months for a response and in cases we have seen, another request for information.

Both AusIndustry and the ATO appear to have taken a 'one-size-fits-all' approach to companies in examining and auditing the R&DTI registrations/claims. Their requirements do not differentiate between large and small companies – or the size of the tax offset.

ATO Guidance Material

The ATO has advised ASBFEO that it is currently preparing additional guidance material to assist companies to maintain records for their R&D expenditure. However they say that while they will provide broad guidance on record keeping requirements, the diversity of companies from start-ups to large multinational companies will result in different record keeping practices and that the sophistication of a company's financial systems and their approach to governance will affect the quality of records maintained.

A discussion on the keeping of records is at Attachment A, Brief Overview of R&D project methodology using Agile and Rapid

The ATO issued five Taxpayer Alerts in 2017; three of which specifically addressed claims under the R&DTI program. These Taxpayer Alerts provided an 'early warning' of their concerns about software-based R&D activities.

It has been suggested that the level of ATO guidance is not equal to guidance provided to other areas of tax. For example, we have heard that a public ruling on building expenditure has been pending for 18-24 months with the long delay creating continued uncertainty for companies conducting R&D and requiring this advice.

ATO Penalties

Penalties for incorrect or problematic claims are applied to taxpayers, not R&D advisers. Companies suffer the consequences when they receive bad advice from an R&D consultant who charges a fee, often calculated as a percentage of the tax offset received. The ATO has ruled in some cases that a company did not demonstrate 'reasonable care' as the tax advice it received was not considered 'independent' because the R&D consultant charged a commission based on the value of the tax offset (not a fee-for-service).

The ATO then considers that this 'conduct' is a factor in determining that the company displayed a lack of genuine effort to comply and ultimately that the company's actions amounted to 'reckless behaviour'. Recklessness attracts a base penalty of 50 per cent of the tax shortfall amount.

It is objectively unfair that the government imposes a tax system on small businesses that is so complex that registered agents are required to provide advice (for a fee) but still leave small business vulnerable to penalty for a failure by those agents to exercise reasonable care. This is particularly so when the R&D consultant is a registered tax agent and is therefore required to comply with the Code of Professional Conduct and Tax Agent Services Regulations 2009.

As part of our ongoing consultations, we held a second meeting with the TPB in November, 2019. One role of the TPB is to regulate and supervise the conduct of registered tax agents across Australia. The existence and operations of R&D Consultants in the market place, who are not registered tax agents, is difficult to identify and control. There is an activity termed "harvesting" whereby a consultant will target a company and offer to create a claim for the R&DTI offset by reviewing the expenditure in the company's financial report. They "harvest" a claim out of the historical data.

Small business owners are susceptible to poor advice when it is delivered with confidence and promises technical expertise beyond the existing capabilities of the company. While some companies may, in hindsight, have acted in a complicitious way or in a way that suggests they

disregarded the law, we found some companies were targeted via their reputable accountant and regular tax agent and believed they were entitled to the R&DTI offset.

We understand the ATO maps the activities of these consultants, including the high risk R&D registered tax agents but only now in late 2019 is the TPB receiving advice from the ATO.

We are aware that one form of action available to the ATO in its efforts to deter undesirable practices by professional advisers is an Enforceable Voluntary Undertaking (EVU). The use of an EVU is most prevalent in the area of promotor penalty provisions. An EVU serves to bring about a swift change in the behaviour, actions and practices of the adviser without a time-consuming and expensive civil action in the courts. EVU's are confidential and the practitioner is not, to our knowledge, exposed to reporting or sanctions or other disciplinary action. This does not serve the business community well. There is some opinion that EVU's are not a strong deterrent and the legislated confidentiality and lack of appropriate sanctions by the professional's registration or licensing authority is not considered to be best practice.

ATO Debt Recovery

The ATO continues debt recovery action while a debt is in dispute. The ATO system raises a debt when a Notice of Amended Assessment is issued. At this point, there is still an ATO internal review process and formal objection process available to the company. Once the debt has been raised, if the full amount is not paid, the balance attracts the General Interest Charge (GIC) compounding daily. The consistent compounding of interest charges may put undue pressure on a taxpayer to move towards clearing the debt while they dispute the liability. Interest should only be charged once all avenues of objection are finalised.

We have previously identified that any of the stronger forms of debt recovery action by the ATO (garnishee notices, Director's penalty notices, statutory demands or winding up applications) can directly cause the failure of a small business.[29]

While acknowledging that the ATO is the primary collector of revenue for the Federal Government, we have concerns over the fairness of a system which allows a large and powerful agency to continue debt recovery action against small business taxpayers when the underlying debt is in dispute.

ATO Ruling on Eligibility of R&D Activities

We have heard from companies, and have sighted correspondence, that the ATO has ruled that the R&D entities' activities are not eligible R&D activities. For example:

> *'…. Testing carried out by …….. would not be considered R&D.'*[30]

The ATO's role is to verify the nexus between the registered R&D activities and the notional costs claimed – and assess the quantum and substantiation of those costs. There is no legislative basis for the ATO to determine whether or not the activities are eligible under the legislation

There would be occasions where an activity is clearly not eligible, such as an excluded activity, and where it would be administratively efficient for the ATO to make that judgement. There is however, a problem when the area is grey and where the matter requires investigation. In these cases, the ATO and its officers do not have the authority or the training to make determinations on the eligibility of the R&D activities.

[29] Australian Taxation Office – Enforcement of disputed debts before the AAT, Australian Small Business and Family Enterprise Ombudsman, published 8 April, 2019

[30] ATO position paper provided to ASBFEO.

The Tax Practitioner's Board (TPB)

The R&DTI legislation is complex for taxpayers to understand. Specialist advice is necessary because the program is one of self-assessment and the company's regular accountant or tax agent is unlikely to have the expertise to understand and advise on how best to comply with the requirements of the legislation. AusIndustry state that more than 80 per cent of companies who register for the R&D Incentive have used the services of a specialist R&D consultant at some time.[31]

The TPB is the national body responsible for the registration and regulation of tax practitioners and their compliance with the Tax Agent Services Act 2009 (TASA) including the Code of Professional Conduct.

The TPB regulates 80,000 registered tax agents. Of these, around 200 tax agents are registered with a 'research and development' condition. This category of tax agent has partial qualifications (a degree other than accounting and to the satisfaction of the TPB, and experience working with a registered tax agent). Many of the fully registered tax agents also specialise in R&D consulting.

A tax agent with an R&D condition may register R&D activities with AusIndustry on behalf of a company. However a tax agent must be fully registered (without conditions) with the TPB to lodge a company's tax return with the ATO.

The TPB provides a search facility of registered tax agents allowing the public to:

- Ensure the person or firm they have engaged is registered under the relevant Act;
- Identify any suspensions, sanction or disqualifications on the tax agent's record;
- Have some confidence in the professional competence and independence of the tax agent and their adherence with the Code of Conduct, including "Independence: You must act lawfully in the best interests of your client" and "Competence: You must take reasonable care to ensure that taxation laws are applied correctly to the circumstances in relation to which you are advice to a client".

ASBFEO would expect that the fact that a company sought specialist tax advice from a registered tax agent is sufficient proof of reasonable care, (see discussion regarding penalties and tax agent's commission). Companies would also expect that because there is a regulatory framework around a registered R&D consultant, that the R&D consultant would give advice that has a certain level of quality and is independent.

Mr Ian Klug AM, Chair of the TPB in a keynote speech to the Tax Institute in October, said:

> *"The Review of the TPB supports a recommendation from the Hayne Royal Commission that information sharing between agencies should be formalised through legislation to make it mandatory rather than discretionary.*
>
> *The review also notes that the abundance of regulatory bodies places a huge and unnecessary regulatory and compliance burden on practitioners, and multiple points of entry for consumers of tax services.*
>
> *Again, borrowing from Hayne's recommendations, the review suggests looking to the Government's new Modernising Business Registers program of work as an avenue to cut red tape.*
>
> *This would benefit consumers by providing a 'one-stop-shop' of professional registers, and ease the burden in maintaining separate registers.*
>
> *To ensure that consumers are better informed and there is a 'level playing field' of all tax practitioners, the review also suggests the TPB Register should be expanded.*
>
> *This includes further detail about tax practitioners, such as detailed reasons of any sanctions*

[31] AusIndustry in meeting with ASBFEO, October 2019.

or terminations, reasons for rejections of renewal, and a list of known unregistered providers." [32]

We agree whole-heartedly with these suggestions and wait with interest for the final recommendations of the TPB review and Government's response.

Given the complexity of the legislation, the R&D consultant should be an expert in the legislative aspects of the program; however there is no guarantee that a tax agent with the R&D condition understands the rules of the R&DTI and has experience in assessing the validity of a company's claim. There is also value in the R&D consultant understanding the broader tax landscape.

R&D Consultants

During our investigation, we spoke with a number of R&D consultants, both large and small. Our interest is not only in their work with small and family enterprises who claim the R&DTI but, for the smaller firms, in their experience as a small business operating in the current environment. The role of an R&D consultant may include any number and combination of these activities:

- initial assessment of the eligibility of the company's R&D activities
- assistance with or preparation of any Advance Finding application
- preparation and lodgment of the Registration form with AusIndustry
- provision of systems and documentation to support the company's contemporaneous record keeping – indeed, sometimes managing the documentation on site each month
- calculation of the notional deductions from the company's financial records
- preparation of the R&D schedule forming part of the company's income tax return including calculation of the tax offset
- continuing support in the event of a subsequent review or audit by either or both agencies.

R&D consultants may be registered with the TPB as tax agents operating without any limitations on their scope (usually professional accountants) or they may be registered with the TPB with a 'condition' of being qualified to work only in the R&DTI space.

This latter group encompasses consultants from other professions including, but certainly not limited to, engineers and scientists. These professionals use their technical experience to assess a company's R&D activities and craft a registration application aligned with the legislative requirements. This skill-set is not held by many of the professional accountant tax agents. All agents registered with the TPB are bound by a Code of Professional Conduct and subject to disciplinary review.

Long standing and well respected R&DTI Consultants are frustrated with what they see as a change in approach and attitude by the ATO and AusIndustry toward companies; there has been a presumption of ineligibility which has replaced the previous relatively open and communicative style. The R&D consultant's role is impeded by a lack of clarity in the interpretation of the legislation.

This is apparent when under review or audit, AusIndustry and the ATO will seek further information, evidence and responses from the company, often within a short time frame, without providing specific guidance or direction as to how the taxpayer may fulfil those requirements. Once evidence is provided, there can be a long time lag before a response is received. The R&D consultant's role in this process is hampered by a lack of clarity and certainty in the guidance provided to intrepret and apply the legislation.

We heard from R&DTI consultants who are working with stressed small business clients, some of

[32] Ian Klug AM Chair of the TPB Keynote speech to the Tax Institute – Tasmanian State Convention, 17 October 2019

whom are experiencing depression as a result of their interactions with both agencies. The staff of the R&DTI consultant businesses are also facing the personal challenge of maintaining pride in their work in the current environment.

It is the common belief that any open-ended Budget incentive or refund will be susceptible to unscrupulous operators in the market. There is evidence that there has been "mischief" in the R&D consultant sector with some operators aggressively marketing promises of cash tax refunds to businesses. This behaviour has not been limited to small scale consultants, with suggestions of enforceable voluntary undertakings being negotiated between the ATO and larger firms. It has been however the small business R&D entities who have borne the stress and cost of subsequent review and audit action by both AusIndustry and the ATO.

A number of R&D consultants are being asked to assist R&D entities who are under audit or review and whose previous consultant can, or will, no longer assist. Much of this work is pro bono or at reduced rates.

R&D Consultants say that they experience difficulty in meeting the continuing professional development milestones set by the Tax Practitioners Board relevant to the R&DTI.

Many of the R&D consultants who spoke with the us have seen a downturn in work. Existing clients who have been reviewed or audited are reluctant to register further R&D activities; some are adamant they will never apply again.

R&D Consultants have identified that the value of the resources required to conduct retrospective audits and reviews of a number of years is misplaced and could be better directed to the front-end of the process. Also R&DTI consultants often also work in the Government Grants space and have suggestions for improvement to the management and integrity of the current R&DTI program. Suggestions include:

- Austrade whose "Quality Incentive Program Consultants" register provides reassurance to a small business of their consultant's experience and competence in the field.
- Enhanced and additional "front-end loading" of the education, advising and assessment processes within AusIndustry to reduce the compliance cost and burden of retrospective audits and reviews – for both the small business, their professional advisers and the Government Agencies including judicial review mechanisms.
- A return to proactive site visits by experienced and technically relevant AusIndustry staff is viewed as a practical method to eliminate applications for ineligible R&D activities before the company incurs the costs or budgets for receipt of a cash refund through the tax system.
- All agents registered with the TPB are required to undertake continuing professional education (CPE); those with the R&D condition must achieve a minimum of five hours each year with a total minimum of 45 hours over a three-year registration period. The consultants who spoke with the Ombudsman commented that CPE in R&D is difficult to find. Additional structured guidance and professional development activities by AusIndustry and the ATO could support the CPE needs of the consultants, concurrently providing a useful feedback function to both agencies.

We have previously mentioned seeing written opinions from the ATO that the ***basis*** by which an R&DTI consultant charges for their services directly influences the "category of behaviour" (failure to take reasonable care, recklessness or intentional disregard) in respect of false or misleading statement penalties imposed by the ATO. We heard from R&DTI consultants that often client companies elect to pay a percentage of the tax incentive as a fee for the service so they have certainty of the cost and are not required to fund the expense from current cash flows. Under this model the R&DTI consultant completes at least some part of the work and "carries" the cost of that work for months before being paid.

Attachment A

Brief Overview of R&D project methodology using Agile and Rapid

The necessity to verify R&D activities and expenditure on R&D in software

The development of new or improved software can, and must be, able to be considered R&D where this is appropriate, and it meets the objectives of the R&D tax incentive legislation[33]. As with all R&D under this legislation, the objective is to encourage activities to create new knowledge including new products, processes and services. This is confirmed by the legislation in s 355-25-(1) and in s 355-25(2)(h):

355-25 Core R&D activities [Extract]

(1) ***Core R&D activities*** are experimental activities:

…

(b) that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).

(2) However, none of the following activities are ***core R&D activities***:

…

(h) developing, modifying or customising computer software for the dominant purpose of use by any of the following entities for their internal administration (including the internal administration of their business functions):

(i) the entity (the ***developer***) for which the software is developed, modified or customised;

(ii) an entity *connected with the developer;

(iii) an *affiliate of the developer, or an entity of which the developer is an affiliate.

The first section clearly states the purpose as including new knowledge in the form of new products, processes and services. The corollary of the exclusion in the second part is that developing, modifying or customising ***can*** be a core R&D activity if it is for a different dominant purpose. This would include:

Newly developed, modified or customised software for internal use by the R&D entity, a connected entity or affiliate that is for production or any other non-administration purpose, or

Any newly developed, modified or customised software that is created primarily for external users even if it is internal administration software.

This eligibility would be limited to the degree the development, modification or customisation includes, or is reliant on, the new knowledge created by the core R&D activities conducted for the R&D entity.

[33] Division 355 *Income Tax Assessment Act 1997* (Cth)

The R&D Tax Incentive is not a scientific research program. However, it does require that the experimental development activities needed (if any) to create, or enable the creation of new, modified or customised software for most purposes must be conducted in a scientific and verifiable way.

Whilst there is no separate statutory requirement in regard to the substantiation of expenditure on these R&D activities, the general provisions on record keeping from section 262A[34] would apply:

262A Keeping of records **[extract]**

(1) Subject to this section, a person carrying on a business must keep records that record and explain all transactions and other acts engaged in by the person that are relevant for any purpose of this Act.

(2) The records to be kept under subsection (1) include:

(a) any documents that are relevant for the purpose of ascertaining the person's income and expenditure; and

(b) documents containing particulars of any election, choice, estimate, determination or calculation made by the person under this Act and, in the case of an estimate, determination or calculation, particulars showing the basis on which and method by which the estimate, determination or calculation was made.

When seeking to apply this section to what is needed to readily verify the R&D expenditure, S 262A(2)(b) only requires that the documentary evidence to stand alone in regard to whether the R&D entity has made an election or a choice, i.e. whether they have accessed the R&D tax offset by registering the activities. In regard to the estimation, determination or calculation of expenditure on that election or choice, the allocation between R&D and non-R&D expenditure needs documentation and a readily verifiable explanation with the particulars showing the basis of the estimate, determination or calculation to allocate the costs between the two areas. This is no different to what is required to allocate costs between capital and non-capital or to different trading stock or project cost valuations. It does not mean that each invoice or document must state the details of why a portion of it was incurred in conducting R&D and how the reasonable proportion was estimated, determined or calculated to have been incurred on the R&D. This can be by any of the accepted allocation methods under GAAP or in how costs are otherwise estimated, determined or calculated to meet taxation requirements for capital or trading stock allocations.

Outside of this, there is no additional requirement for any documentation on R&D expenditure over any other tax estimate, determination or calculation. The R&D entity must be able to justify how they calculated the expenditure on R&D activities, including any calculations and estimations in allocations between R&D activities and non-R&D activities. The R&D entity will need to show the basis on which, and method by which, this allocation is estimated, determined or calculated and this need only be readily verifiable by a third party as a reasonable basis of allocation.

Application to Agile and Rapid based software development processes

The method of allocation for much of the R&D in creating new or modifying and customising existing software is on the basis of Agile or Rapid software development management processes. Agile and Rapid are similar in structure and methodology and they share the common goal of systematically managing the development processes in lean, but effective ways. From an R&D perspective they can be problematic when determining eligibility.

Along with engineering project management processes, Agile and Rapid use exactly the same processes whether they are a systematic progression of work that is an experimental activity or just a management methodology. This can create conflict and misunderstandings when verifying the

[34] s 261A *Income Tax Assessment Act* 1936

allocations of software development activities and tasks to the R&D tax incentive.

A common error by R&D entities is that the creation of a new piece of software or a new function within an existing software product is R&D because it is a systematic progression of work to create a new or improved product. This may be incorrect because it ignores the rest of the tests in s 355-25(1). It elevates the methodology over the purpose.

Equally, another common error is that the use of Agile or Rapid means that the development process is not an eligible R&D activity. This argument is justified either on the basis that the mere use of the methodology is not proof that the activity is R&D or that the methods do not adequately demonstrate that the development is R&D.

Methodology Does Not Determine Eligibility

In both cases the assessment of whether an activity is R&D based on the use of a standard process is incorrect. The criteria in the eligibility tests are clear: The experimental activity must:

Be necessary because the outcome cannot be determined in advance on the basis of available knowledge or experience. That is, by case law, there needs to a more than insubstantial purpose to resolve uncertainty in outcomes in the conduct of the activity,

This uncertainty must be being resolved by answering the hypothesis in the systematic progression work. That is, the development cycle must be being applied to conduct the experiments and they must measure the outcomes so the R&D entity can determine the logical conclusion to the questions raised in the hypothesis,

This must be on the basis of principles of established science. In the early drafts of the bill to introduce this legislation computer science was one of the specifically listed sciences targeted for support by this program,

The purpose of the activity must be to create new knowledge and this new knowledge can by in the form of a new or improved product, process or service. That is, there is no impediment at all if the activity is the creation of a new or improved product, so the R&D can be how to overcome uncertainties in the development of the new functionality or the integration of functionality or the aggregation of components or a mix of these

There is no requirement that the development process, itself be more than a standard development process, just that it is necessary to resolve the uncertain outcomes.

For Agile and Rapid, this cuts in both directions:

If the development method is being used to implement a generally understood solution in known ways and circumstances (e.g. introducing a common internationalisation library to a software package to enable a pre-existing product to be exported to Germany) will be reliant on applying an Agile or Rapid development process. However, it will be unlikely to have any significant uncertainty.

On the other side, just as the application of internationally prescribed and regulated clinical trial processes must be used to conduct experimental development activities in Phase 1A and Phase 2 pharmaceutical clinical trials without the standard development methodology precluding R&D eligibility, the use of Agile or Rapid should not either. A standard development methodology is not an indication that no R&D has occurred.

How Agile and Rapid Can Demonstrate R&D Eligibility

The philosophy behind the development of modern software development processes is to optimise these processes so they are a complete development management system, but the process does not get in the way of, or needless delay, the deployment of good and tested products. It has allowed the compression of the cycles of development to the extent that at the extreme the time between public release sprints can be weekly instead of the traditional once a year release or less. This has resulted in a sharp decline in the creation, and need for, systematic development documentation. With the

emergence of SaaS (Software as a Service), Insider programs to outsource testing and Hacker style development processes where bug fixing is handed down to un-associated external parties in a community, the creation of development documentation will be restricted further.
This can create a difficulty for the administrators of the Program to readily verify that the R&D entity has allocated costs reasonably to the sum of its eligible R&D activities. Note: the ATO does not require allocations to each individual R&D activity nor individual tasks or experiments within these activities. However, it may create these difficulties if the R&D entity does not apply Agile in line with good software development practices and use available tools.
From a structure point of view, the ideals and philosophy of Agile is ensure that the development process is managed, controlled and conducted in a way that overcomes any uncertainty or impediment in delivering what the client needs. The traditional stages of:

Set requirements → Design → Develop → Test → Maintain

are replaced by a process of many short sprints managed through Scrums or alike:

- The Requirements stage is broken down into a list of required features known as the Backlog.
- These Backlog features are deliberately at smaller level than the Requirements so the development can be more iterative, responsive and quicker.
- To manage the overall project, these backlog features are described and grouped into User Stories that may be grouped at a higher level into Epics for larger or complex overall goals. These Stories and Epics can identify and describe the things that will make a software development project be, or otherwise involve R&D because they will identify the uncertain outcomes that need to be resolved by all the grouped backlogs in that group.
- The development effort, uncertainties and risks are estimated at the story (or Epic) level and the effort to create these outcomes is estimated. This process directly allows the development team to identify those outcomes that are not able to be determined in advance without doing experimental development (Core R&D Activities) from those that are a simple application of what is known or determinable in advance on the basis of current and reasonably knowledge and understandings.
- The Backlog features are ranked and weighted in order of importance. This process allows for the planning of resolving the uncertainties identified above by iterative developments in grouped Backlog features that are conducted to resolve the uncertainties in the hypotheses. It will also identify which of the backlog features are necessary to be created to allow the resolution of these uncertainties where these backlogs are either a step within the uncertainty or a directly related supporting activity to enable development of that step. These latter back log features are the Supporting R&D activities. The remaining backlog features are non-R&D activities.

Where a piece of new software is being developed and the project is before the creation of the Minimum Viable Product (MVP) few, if any, of the backlog features that are not part of the Core R&D Stories will not be Supporting R&D activities because the development process would be largely limited to just what is needed to be done to get the product to the phase where its key uncertainties are resolved.

Where this is a modification or customisation, then it is likely that many of the backlog features that are not part of Core R&D stories will not be necessary to enable the development of resolutions for the uncertain functional improvement or new features. These should be excluded.

In all cases the application of the Scrum process can enable the identification and tracking processes needed to readily verify the split between R&D and non-R&D activities.

Once the features in the backlog are ranked and weighted (and able to be classified between R&D and non-R&D), the process of daily or weekly Scrum meetings are used to manage the experiments (if any) in the experimental development process. At these meetings people discuss what was done, what is to be done and what obstacles were or will be encountered. These steps are about the conduct of the experiments and the measure and evaluation of their results. It would be up to the project manager to document the discussions of the obstacles and the development progress, performance and results.

The overall results of each of the backlog features successfully completed are combined and analysed by the project manager to determine if, or what, features can be released in the next sprint release. In this, the overall plan is updated to reflect results and address newly identified uncertainties. This is the equivalent of the reaching valid conclusions of the experiments and it is based on the principles of established science. This normally be computer science or data science, but it could be other sciences as well depending on the purpose of the new, modified or customised application.

If a software developer is following this process and documenting the critical uncertainties and their conclusion, then there is no reason to argue that the use of Agile means that the business is not able to demonstrate that the development was, or included, R&D activities within the systematic progression of work.

A difficulty will be where the time allocation method used to track the completion of the backlog features is disputed by the ATO on review. This will be especially where the project is by a small team and it is prior to MVP. Under these circumstances, the allocations are going to be at high level and reflect that the development team is solely (or virtually solely) focused on development activities and they will be charging 95 to 100 per cent of their time to R&D activities. Whilst this may be considered a failure to properly allocate time by an ATO review, it will often reflect the reality of the situation and the work of the development team.

To readily verify that the method of development is reasonably allocating development people's time on R&D using Agile, the ATO needs to better understand the Agile processes used by the R&D entity. It should not focus on time sheets and additional documentation but on the process and the evidence that process creates. As the verification of the R&D split is dependent on the R&D entity providing justification of how its application of Agile is consistent with this split, the R&D entity needs to properly tag and group the backlog features into well-defined stories or epics and track the allocations and completion of these features to demonstrate the allocation of these people's time reflects the actual R&D activities conducted, the eligibility of these activities and the need for them. This can be done easily and systematically by software packages like ActiveCollab, Agilo For Scrum, Jira + Agile, Pivotal Tracker, Prefix and Retrace.

Summary

The use of Agile and equivalent methods can be an effective tool to manage R&D software development activities. So long as the ATO compliance reviews seek to merely readily verify the calculation of estimates, determinations and calculations, then these styles of methodologies should not prevent the R&D entity from providing documentation and the particulars showing the basis and method of these allocations between R&D and Non-R&D activities. This would meet the requirements of s 262A.

Equally, a review by AusIndustry should be approached from an understanding of how the R&D entity applies the Agile process. This would include a judgement of d whether the project manager and development team properly group backlog features into stories that separate the core,

supporting and non-R&D activities and how the conduct of development tasks, processes of managing progress and obstacles and determinations of results and conclusions demonstrates the R&D. They should not expect each ticket against each individual backlog feature to be individually demonstrable as an R&D experiment.

To focus on each individual development ticket and expect each invoice to individually demonstrate the eligibility of the activity and the nexus of the expenditure to that experiment is missing the point of seeking to encourage more businesses to do more R&D. It takes a business' focus off the R&D to create documentation that is not required by the law and will fail to encourage businesses to better manage their new knowledge creation processes. It is not needed to readily verify what R&D a business did and whether it is reasonably calculated.

Attachment B

The current R&D Legislation[35] and application of the 2015 Frascati Definition[36] to R&D in the development of software

The R&D legislation was passed into law in 2011. In its preparation it borrowed from the experiences of the old program, the R&D tax concession[37] and from the Frascati Manual definition at the time it was written. This was the 2002 version of the definition. The legislation enacted a very significant broadening of what is eligible R&D compared to the old definition. Firstly, the definition only requires that the outcomes not be able to be determined in advance without there being experimental core R&D activities to systematically create new knowledge including new knowledge in the form of new or improved products, processes or services etc. It previously required these activities to be necessary to create new innovation or resolve high levels of technical risk. The second point of expansion is that the previous legislation restricted experimental development of software to being for sale to two or more external customers. This exclusion was reduced to only eliminating experimental development of software if it is primarily for own or related party use to on internal business administration tasks. This was as a result of the public engagement process with software developers in the formation of the new legislation.

Naturally and intentionally, this created an incentive to conduct software R&D activities in Australia to the point that a very sizable proportion of the increase in R&D activities in Australia is attributable to the expansion of software development. In addition to succeeding in encouraging these types of R&D activities, this, together with the increased net R&D benefit and the increased availability and size of refundable tax offsets has caused concerns for the program. This has resulted in a rolling series of guidance materials and taxpayer alerts on R&D in software. The latest version of this is the February 2019 releases of "Software Activities and the R&D Tax Incentive" and "Software Development Guide to Common Errors". These are highly dependent on the updated 2015 Frascati definition and its application to software development.

The key issues with the new guidance are:

- It is written in a prescriptive way when referencing the principles espoused in the Frascati definition,
- Its focus is largely on why activities are not R&D with little focus why it could be R&D,
- When it quotes the Frascati Manual it has made changes that affect how the definition is understood,
- What it fails to quote from the Frascati is consistent with Innovation and Science Australia's misinterpretation of the legislation as highlighted in the full Federal Bench decision on Moreton Resources.

The new definition needs to be considered as a whole and in how it applies to software development in a conceptual way. That is, it should be applied based on the principles it expresses and not as prescriptive list. This principle based methodology is consistent with the general methodology used in writing and interpreting the Income Tax Assessment Act 1997 as opposed to the prescriptive based methodology in Income Tax Assessment Act 1936. This creates tension in the guidance because the definition relies on the application of the principles with some specific examples, but the guidance only quotes the examples and it quotes them inconsistently.

An example of this is the principle by which a software development project can be R&D is expressed in parts of paragraph 2.68 and 2.70:

[35] Tax Laws Amendment (Research and Development) Act 2011 to amend the Income Tax Assessment Act 1997 and related Acts assented to 8 September 2011.
[36] OECD, Frascati Manual: Guidelines for collecting and reporting data on research and experimental development 2015
[37] The former Sections 73B to 73Z Income Tax Assessment Act 1936 and related Acts

> 2.68 … For a software development project to be classified as R&D, its completion must be dependent on a scientific and/or technological advance, and the aim of the project must be the systematic resolution of a scientific and/or technological uncertainty.
>
> 2.70 … Software development is an integral part of many projects that in themselves have no element of R&D. The software development component of such projects, however, may be classified as R&D if it leads to an advance in the area of computer software. Such advances are generally incremental rather than revolutionary. Therefore, an upgrade, addition or change to an existing program or system may be classified as R&D if it embodies scientific and/or technological advances that result in an increase in the stock of knowledge.

These principles are missing from the guidance. This is despite the fact that they are broadly consistent with the Australian legislation: The dependency for the completion of the development activity being that it is reliant on the creation of an advance is consistent with the need for the experiment to have outcomes that cannot be determined in advance. The systematic resolution of a scientific or technical uncertainty is consistent systematic progression of work requirement under the Australian legislation. The resulting outcome being an advance that could be an incremental upgrade, addition or change to a program or system so long as it embodies the scientific or technical advance is consistent with the new knowledge being in the form of new or improved software products, processes or services. Instead of these principles we have a list of the examples of when there is R&D in software development is taken from paragraph 2.71:

> 2.71 The following examples illustrate the concept of R&D in software and should be included in R&D:
> - the development of new operating systems or languages
> - the design and implementation of new search engines based on original technologies
> - the effort to resolve conflicts within hardware or software based on the process of re-engineering a system or a network
> - the creation of new or more efficient algorithms based on new techniques
> - the creation of new and original encryption or security techniques.

There are three key changes that have been made to this paragraph.

Firstly, the list is presented as projects that should be included in R&D by the definition but in the AusIndustry, this is reduced to "The following examples are given in the Frascati Manual of software development activities that may involve R&D:" This is significant because the Frascati definition states the examples should be R&D but this is reduced to may be. This gives no certainty and the guidance gives explanation of why they may be R&D. It only claims that being highly innovative may not mean that the software development project are core R&D experimental development activities.

The second change is that the Frascati definition states unequivocally that these activities should be R&D, but this is reduced by AusIndustry to "may involve R&D". This seeks to reduce the activity to sub-activities within the project. This reflects the new AusIndustry approach to subdivide core R&D activities into "granular" parts of what is necessary to resolve the uncertain outcome that is the new knowledge that may be in the form of a new or improved product.

The third change is the removal of "and implementation" from "the design and implementation of new search engines based on original technologies." This continues the granular focus as above. This seek to impose a requirement on when an activity is R&D that is not in the law. The uncertainty in software development is often in the implementation or integration of new features into an existing system. This is discussed in paragraph 2.73 of the Frascati Definition but ignored by AusIndustry. This paragraph recognises that R&D can be in the implementation/integration/aggregation phase of a

change to software or a system:

> 1.73 In the systems software area, individual projects may not be considered as R&D, but their **aggregation** into a larger project could generate some technological uncertainty, the resolution of which will need R&D. Alternatively, a large project can be aimed at developing a commercial product by adopting available technologies and not include R&D in its planning, but there may be some elements in the project that would need some additional R&D activity to assure the smooth **integration** of different technologies.

Paragraph 2.73 clearly allows for part of a software development activity to be R&D by the same broad considerations that recognise activities as R&D under the Australian law. However, the guidance material is silent about this due the policy within AusIndustry to restrict R&D activities to granular sub-activities that may be below the area that is the key area of uncertainty.

This error is, ironically, in the guidance on common errors in software applications. This states:

When conducting R&D, companies tend to think in terms of projects and project outcomes rather than in terms of the specific activities that the company conducts within a project. However, the eligibility criteria under the R&DTI require eligibility to be assessed at the level of specific activities.

If a specific area of uncertainty is the integration of new functionality or capability to a system and not just the creation of that new functionality or capability, then the activity is all the experimental development required to resolve this implementation issue.

Paragraph 2.72 includes the reasons why activities are not R&D and examples of where this will occur. Here the guidance melds the principles with the examples and makes two fundamental changes to the principles to expand its application. The principles from the Frascati Manual are:

> *Software-related activities of a routine nature which do not involve scientific and/or technological advances or resolution of technological uncertainties are not to be included in considered R&D. Such activities include work on system-specific or program-specific advances that were publicly available prior to the commencement of the work. Technical problems that have been overcome in previous projects on the same operating systems and computer architecture are also excluded. Routine computer and software maintenance are not included in R&D.*

This is clarifying that the routine software related activities are not R&D. It establishes key principles about when these are routine:

- they do not involve scientific or technical advances,
- they are not to resolve any technological uncertainty,
- they are applying an already known program-specific or system-specific advance to that program or system,
- they are reapplying a previous developed solution in known ways, or
- they are computer or software maintenance activities.

These are consistent with the Australian law and need to be applied as principles not examples. In these the corollary of the principles is that if:

- they do involve scientific or technical advance,
- they are necessary to resolve technical uncertainties,
- they are developing an unknown solution,
- they are necessary and uncertain improvements to apply an existing solution to significantly different software or systems, or
- the application of a known solution in a new and unknown way, and

- these are not the standard application of computer or software maintenance activities, then these can be R&D activities (subject to the application of the Australian law).

The Guidance is deceptive in that it adds these principles as if they are examples of exclusions from the Frascati Definition. The opening principle in first line is changed from "Software-related activities of a routine nature" to "Software-related **development** activities of a routine nature". It is shortened to remove "which do not involve scientific and/or technological advances or resolution of technological uncertainties are not to be included in considered R&D." To keep the list consistent with the addition it removes "Routine computer and software maintenance are not included in R&D". These additions and exclusions to the Frascati Definition changes the nature of these principles and implies that there is international agreement and support for the concept of routine experimental development activities being able to be excluded as not experimental development activities. The introduction of the concept of routine R&D being excluded by the Australian law on the basis of an edit of the Frascati Definition is a very serious concern. This guidance is being used by AusIndustry assessors as if it applies the Frascati definition as it is written, and it does this in a way that is consistent with the Australian law. This has the effect of seriously reducing what is assessed as eligible under the programme.

In practice these changes have a dramatic effect on the size and eligibility of R&D claims resulting in a complete or near complete rejection of the R&D expenditure.

Case Study – the Company, the ATO and AusIndustry

Company (R&D Entity)

1. The company properly tries to consider the application of law in determining what parts of the software development is eligible for R&D. This will require determining:
    a. That this is a development that meets the rules in the legislation
    b. That it is done in Australia or is limited to the parts done in Australia
    c. That the activities are conducted for the company i.e. the management is by the company, the risks and benefits are being largely or exclusively borne by the company and the resulting new knowledge is owned and controlled by the company.

2. Where the project is an entirely new application/system and it is prior to the creation of a Minimum Viable Product (MVP) then the majority of the project will likely be core R&D developments and the supporting setups, frameworks, libraries etc. It is possible that a small proportion of the activities will be neither core R&D experiments or supporting R&D tasks directly required to enable these experiments to be conducted. Typically, this will require a very high percentage of the development activities to be either core or supporting R&D activities

3. Where the project is an upgrade or improvement to an existing system, the portion of the development costs will be much lower. The functional changes that are not creating improvements requiring experimentation, have no real impact on the aggregation, integration or implementation and are not required to directly support the core R&D activities and will be excluded. These will be the routine software-related activities that are excluded by the Frascati Definition. Typically, the Core and Supporting R&D activities will drop to around 30 per cent of the development, maintenance and support costs.

Examinations/Reviews by AusIndustry and the ATO

4. Once the company is selected for a review by AusIndustry or the ATO, the current processes will seek to exclude 100 per cent of the activities for the maximum time allowed (typically 4 years) as the starting point. This will be either because:
    a. AusIndustry has rejected the whole of the claim because it considers the claim to be the whole of the project. Examples have been given of cases where:
        - the claimant has already demonstrated that the claim is limited to only specific areas of improvement or new capabilities.
        - AusIndustry then seeks to exclude any experiments on aggregation, implementation or integration and then breaks down the functional improvements to such a granular level that the R&D is missed.
    b. The competent professional test is often misapplied:
        - would a competent professional consider the outcome should be possible – instead it is applied as –
        - would a competent professional consider that the method to reach the outcome can be known in advance – so no experimental development activity is required.
    c. The ATO will reject the totality of the expenditure claim because the contract developer costs or the Jira time and task tracking data does not demonstrate the nexus between the expenditure and the activities they are for.
    d. The ATO will expect a level of documentation that is not available or reasonable to expect. This has seen a progressive ramp up in previously acceptable

documentation based on reasonable estimates and allocation methodologies based on previous guidance from the Commissioner of Taxation. Today there is an expectation that all businesses will have highly accurate and separately verifiable timesheets (whilst admitting that the AAT has stated for internal employees timesheets are not required) and overhead allocations based on counting emails and envelopes, rejecting invoices from suppliers that only contribute to R&D activities for not detailing the R&D activity and accurate calculations of percentages of office space excluding walkways and amenities.

e. The ATO will increasingly rely on its own determination of whether the R&D entity is conducting R&D unless an assessment has already been by a delegate of Innovation and Science Australia.

5. The impact of this on R&D entities has been that businesses undertaking eligible R&D activities are having these rejected by both AusIndustry and the ATO to the point that they make up a sizable proportion of the $200 million correction in 2018. The follow on effect of this is that Business Expenditure on R&D in Australia has been declining since this process started and economic growth in Australia, for this and other reasons is declining to the point we are on the verge of a recession. In the meantime, we are aware of a number of software development businesses that have shifted development activities overseas or ceased R&D development completely.

Attachment C

The implications of the Moreton decision

The Tax Laws Amendment (Research and Development) Act 2011 sets out the object of the legislation and the definition of core activities. The legislation requires a test that relies on the uncertainty in outcomes that are only able to be determined by the conducting experimental activities. It also accepts that R&D includes the experimental development of new and improved materials, products, devices, processes or services. That is, it recognises that business enterprise expenditure on R&D (BERD) is about the development of new knowledge as defined and grouped in the Frascati definition as Pure and Basic Research, Applied Research and Experimental Development:

> the systematic "*Experimental development*" work that draws on the experiments that developed the new knowledge and/or practical knowledge to produce new or improved materials, products, devices, processes, systems and services[38].

The Explanatory Memorandum to the final Bill describes by principle and example several times R&D projects that are experimental development projects. This has been replicated and enhanced with the preparation of the first software guidance material produced by AusIndustry[39].

This consistency and understanding was, seemingly enhanced, protected and supported by the 2016 Review of the R&DTI[40]. The very first key recommendation was

> *"Retain the current definition of eligible activities and expenses under the law, but develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses."*

This was to build on the existing understanding of what is BERD eligible for the Tax incentive within the business and consulting community but improve the spread and understanding of this knowledge and practice:

> *"Consistent with the panel's finding that the definition is close to international best practice, has only been in place for less than five years and does not appear to have major flaws, revisiting the concepts of eligible activities or eligible expenses is not recommended as a high priority by the panel. Other recommendations from this review are more prospective in achieving greater effectiveness and integrity within the programme. These include, importantly, additional efforts in administrative guidance and compliance activity to engender better understanding of the scope of eligible activities and expenses prescribed under the current law."*

However, since around January 2017, the application of the definition by ISA and AusIndustry has been a sharply different understanding of the legislation seen by:

- examples in the Explanatory Memorandum, to the point that AusIndustry advises R&D entities that the examples are no longer considered applicable,
- guidance material produced by AusIndustry,
- previous R&D reviews by AusIndustry, and
- positions taken by ISA in reviews of R&D through the AAT.

[38] From the Frascati definition 2002

[39] R&D Tax Incentive: ICT Guidance, September 2012

[40] Review of the R&D Tax Incentive April 2016, Mr Bill Ferris AC, Chair, Innovation Australia Dr Alan Finkel AO, Chief Scientist Mr John Fraser, Secretary to the Treasury

A key AAT decision was the first Moreton Resources Ltd case[41]. The AAT supported the administrative processes undertaken by or for ISA to apply a narrow scientific research-based interpretation of the definition and reject the eligibility of the R&D activities. The R&D entity believed that this position was based on ISA and the AAT making a mistake at law and this was appealed through the Federal Court in 2019.

The Full bench of the Federal Court decided in favour of Moreton Resources and agreed that the application of the law by ISA was incorrect. This was because ISA was incorrect on the nature of the tests to determine what is R&D and it was wrong on limiting the purpose of R&D to ignore that the new knowledge can be in the experimental development of materials, products, devices, processes or services.

ISA errors in R&D tests

It was found that there were two errors in the application of the tests to determine if the activities are R&D. The first is that it is incorrect to consider that the first line in s 355-25(1) of the legislation creates a distinction between experimental activities and other R&D development activities that meet the requirements in s 355-25(1)(a) and (b). This line is:

355 25 Core R&D activities

*1) Core R&D activities are **experimental activities**:*

The Federal Court's decision was to reject the ISA position that these two highlighted words create an additional test or requirement over:

a. whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:

i. is based on principles of established science; and

ii. proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and

b. that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).

That is, the term experimental activities are those that meet the tests in a. and b., not that eligible activities are a subset of activities that meet the tests in a. and b.

The second place that ISA was found to be incorrect is its application of whether the definition restricts R&D to excluding experimental development activities because they are seeking to apply current technologies. The R&D entity was seeking to generate energy from mine gases by using an existing gas turbine generator. Both mine gas power generation and generation using gas turbines are known technologies. However, the R&D entity identified clear and significant uncertainties requiring experiment development activities to use these technologies under the planned circumstances. The Federal Court agreed with the R&D entity that there was uncertainty in determining the outcome in advance of any experimentation on the basis of current knowledge, information or experience.

ISA errors in the purpose

The application of the purpose test by ISA since January 2017 has been to sharply reduce this to more of scientific research support program. This means that they have largely ignored that the new knowledge can be in the form of new or improved materials, products, devices, processes or services. This has often seen the rejection of R&D activities on the basis that they are project outcome focused, not knowledge research focused. The Federal Court decision rejected this

[41] Moreton Resources Ltd v Innovation and Science Australia (Taxation) [2018] AATA 3378

interpretation and recognised that this interpretation is incorrect. This reflects the progress of the development of the Bill in that its intent is to encourage R&D and not just research.

The application of this decision on software development is that the errors identified in the case are very applicable to R&D in software development. Most software development is incremental development to improve existing functionality, processes and services. It is seldom to undertake scientific research into areas such as quantum computers. Just as with the development of improved power generation at a mine, the development of improved software applying existing technologies (e.g. current knowledge on database design, applying different Artificial Intelligence or machine learning processes etc.) in new and uncertain ways that does produce uncertainties should not be rejected as R&D. The test should be significance of the uncertainties as demonstrated by the systematic progress of work from determining or finding the uncertain outcomes to identifying potential solutions that cannot just be simply applied and developing these to the point that they solve the problem or prove the problem is not currently solvable.

The rejection of sets of R&D experimental activities because they are project oriented or are a substantial part of the software development project ignores that the purpose test included that the purpose can be new knowledge in the form of new or improved products, processes or services. This is often the only purpose of different phases of development of software development. This would apply to the development of a completely new item of software up to the MVP (minimum viable product) for testing by alpha and beta testers. It would also apply to a project to create new functionality to an existing product or improve the operating processes of that product.

Attachment D – AusIndustry letter to company notification of examination

[redacted]

Sensitive

Australian Government
Department of Industry, Innovation and Science

Business

Innovation and Science Australia

Level 18, Darling Park Tower 3 201 Sussex Street
Sydney NSW 2000

GPO Box 2013
Canberra ACT 2601

Phone: (02) 9226 6068

Email: [redacted]
Web: www.business.gov.au

ABN: 74 599 608 295

Our Ref: 1617T33865

NOTIFICATION OF EXAMINATION OF REGISTRATION UNDER SECTION 27F OF THE *INDUSTRY RESEARCH AND DEVELOPMENT ACT 1986*

This letter is to notify you that the Department of Industry, Innovation and Science (the Department), on behalf of Innovation and Science Australia (the Board), will commence an examination of the Company's 2013/14, 2014/15, 2015/16 and 2016/17 financial years R&D Tax Incentive registrations. This involves assessing the eligibility of all activities within the registrations. Our concerns are outlined in the attached Statement of Issues. To prove the eligibility of registered activities, you are required to provide records you kept during the time you conducted your R&D which you used to self-assess your eligibility (known as contemporaneous records). The examination may lead to a Finding being made by the Board.

What you need to do:

1. **By 23 November 2018**
   Acknowledge receipt of this letter and Statement of Issues
2. Read the Statement of Issues and consider the evidence you have to demonstrate eligibility
3. **By 18 December 2018**
   Tell us that you wish to vary or withdraw your registration, or provide evidence that you used to self-assess your eligibility for the program

You can contact us by emailing [redacted]

What happens next?

We will assess the evidence you provide in response to the Statement of Issues and determine whether to discontinue the examination or make a Finding. If a Finding is made that activities are not eligible, you will be provided with a Certificate of Finding and the Company's registrations will be varied. All activities found to be ineligible will therefore be taken as not registered, and a copy of the Certificate of Finding will be provided to the Commissioner, Australian Taxation Office.

Australian Government
Department of Industry, Innovation and Science | Business

R&D Tax Incentive: Statement of Issues

Purpose

The purpose of this *Statement of Issues* is to outline issues of eligibility associated with activities in Discovery Technology Pty Ltd (the Company)'s 2013/14, 2014/15, 2015/16 and 2016/17 R&D Tax Incentive registrations. It is based on information provided in the Company's registrations.

Your registrations has been selected for examination. You are required to provide records that you kept during the time you conducted your R&D, which you used to self-assess your eligibility (known as contemporaneous records). These records must demonstrate eligibility of the registered activities.

Evidence provided by the Company in response to this *Statement of Issues* will be used to assess eligibility of the activities in the Company's 2013/14, 2014/15, 2015/16 and 2016/17 R&D Tax Incentive registrations. If no evidence is provided, or evidence provided does not demonstrate eligibility against all of the legislative criteria, this examination may lead to a Finding that activities are not eligible.

If a Finding is made that activities are not eligible, the Company will be provided with a Certificate of Finding and the Company's registrations will be varied to be consistent with the finding/s outlined in the Certificate of Finding. All activities found to be not eligible R&D activities will therefore be taken as not registered.

Please note that if an entity is not registered in respect of an income year, subdivision 355-D of the *Income Tax Assessment Act 1997* operates so that deductions under the R&D Tax Incentive are not allowable for that year. A copy of the Certificate(s) of Finding will be provided to the Commissioner, Australian Taxation Office.

After receipt of this *Statement of Issues*, the Company has thirty (30) days to either:

- Request a variation to its registrations to withdraw activities, or
- Provide evidence to demonstrate eligibility of registered R&D activities, as defined in the *Income Tax Assessment Act 1997* (the Act).

If the Company wishes to vary its registrations, it can do so by completing the attached variation form. The Company must also advise the Australian Taxation Office that it wishes to make an adjustment to its tax return (if already lodged), setting out the nature of the adjustment to remove the tax incentive claim from relevant years' tax returns. A copy of this letter should also be provided to the Department.

Summary of Key Issues

Information provided in the Company's 2013/14, 2014/15, 2015/16 and 2016/17 R&D Tax Incentive registrations, in relation to all registered Core and Supporting Activities does not describe activities that meet the definition(s) of *core and supporting R&D activities* as defined in the Act, as:

- The Company has not described an experiment or set of related experiments. The claimed experimentation described by the Company in its registrations refer to standard software development activities (such as the design of bespoke solutions using known methodologies, techniques and tools) undertaken to achieve technical objectives in the absence of unknown outcomes.
- The Company has not described a systematic progression of work proceeding from hypotheses to experimentation, observation and analysis in order to arrive at logical conclusions regarding the validity of stated hypotheses.
- Stated hypotheses do not identify technical knowledge gaps, expressed in terms of causal relationships between technical variables, which directed claimed experimental activities. The stated hypotheses refer to desired technical objectives, evaluating the capabilities of the Company/solution and/or technology.
- The Company has not described experimental activities carried out for the purpose of generating new scientific or technical knowledge based on the principles of established science.
- The Company has not described how the outcomes of an experiment/s cannot be known or determined in advance on the basis of current knowledge, information or experience. The claimed unknown outcomes refer to commercial risks, the feasibility of known software/hardware solutions and technical challenges which were complex but could be resolved using available software development methodologies, techniques and tools.
- The Company has not demonstrated that registered Supporting Activities have a direct, close and relatively immediate relationship with one or more *core R&D activities.*

Please refer to the definitions of core R&D activities and supporting R&D activities in the *Income Tax Assessment Act* 1997 - SECT 355-25 (and attached for reference).

Core R&D Activities

Income Tax Assessment Act 1997 - SECT 355-25

(1) Core R&D activities are experimental activities:

(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:

(i) is based on principles of established science; and

(ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and

(b) that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).

(2) *However,* none of the following activities are *core R&D activities*:

(a) market research, market testing or market development, or sales promotion (including consumer surveys);

(b) prospecting, exploring or drilling for minerals or * petroleum for the purposes of one or more of the following:

(i) discovering deposits;

(ii) determining more precisely the location of deposits;

(iii) determining the size or quality of deposits;

(c) management studies or efficiency surveys;

(d) research in social sciences, arts or humanities;

(e) commercial, legal and administrative aspects of patenting, licensing or other activities;

(f) activities associated with complying with statutory requirements or standards, including one or more of the following:

(i) maintaining national standards;

(ii) calibrating secondary standards;

(iii) routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things;

(g) any activity related to the reproduction of a commercial product or process:

(i) by a physical examination of an existing system; or

(ii) from plans, blueprints, detailed specifications or publically available information;

(h) developing, modifying or customising computer software for the dominant purpose of use by any of the following entities for their internal administration (including the internal administration of their business functions):

(i) the entity (the developer) for which the software is developed, modified or customised;

(ii) an entity * connected with the developer;

(iii) an * affiliate of the developer, or an entity of which the developer is an affiliate.

Supporting R&D Activities

Income Tax Assessment Act 1997 - *SECT 355.30*

(1) Supporting R&D activities are activities directly related to * core R&D activities.

(2) However, if an activity:

(a) is an activity referred to in subsection 355-25(2); or

(b) produces goods or services; or

(c) is directly related to producing goods or services;

the activity is a ***supporting R&D activity*** only if it is undertaken for the dominant purpose of supporting * core R&D activities.

Attachment E – ATO letter to the ASBFEO

GPO Box 9990 IN YOUR CAPITAL CITY

Australian Government
Australian Taxation Office

Ms Kate Carnell AO
Australian Small Business and Family Enterprise Ombudsman
GPO Box 1791
CANBERRA ACT 2601

Dear Ms Carnell AO

I am writing to thank you for the opportunity to meet with your Office on 16 October 2019 and the ongoing discussions we have had subsequent to the meeting. The meeting enabled us to discuss the draft summary of findings from your review of the Research and Development Tax Incentive (R&DTI) program.

The meeting was very much a collaborative discussion between ASBFEO, the ATO and AusIndustry and provided the opportunity for the co-regulators to provide some clarity to the draft findings.

A number of action items were agreed upon during the meeting, with the ATO committing to provide:

- feedback on the draft summary of findings,
- information in relation to advice that the ATO provides to clients about alternative dispute resolutions, and
- decision making guidelines for the application of the penalties.

The following are comments the ATO makes on the draft summary of findings document that was provided to the ATO on 15 October 2019. The comments are made under the headings of the draft summary of findings and are limited to ATO comments only, unless otherwise stated.

R&D Consultants
You have advised that R&D consultants have raised concerns of an apparent change in approach by both the ATO and AusIndustry, with a presumption of ineligibility replacing an open and communicative style.

We have always maintained an open and collaborative approach to any interactions we have with companies and their representatives. Whilst we undertake compliance activities that may result in adjustments, we also provide education to clients to assist them to get their claims correct in future years.

The ATO aims to operate in a professional manner with our clients, including no preconceived assessment of guilt. As evidence is gathered, case officers will form an understanding of the case before them and will make enquiries that may focus on specific areas of concern.

Clients are provided multiple opportunities to provide evidence and information to support their claims and where adjustments are to be made, they are provided with position papers explaining any proposed adjustments based on the evidence provided.

We can contemplate that some of the R&D consultants may have commented on an apparent increase in R&D compliance activities by the ATO. The ATO has increased compliance activities since the inception of the R&DTI. As the program has matured from inception, so has our approach from education; to education and some compliance; to now a more balanced education and compliance approach.

The ATO and AusIndustry are committed to assisting R&D consultants to getting R&D claims correct for companies. However, where we find R&D consultants behaving inappropriately, the co-administrators will take appropriate action.

The ATO has undertaken action against R&D consultants and tax agents who have engaged in egregious behaviour through the application of the Promoter Penalty legislation and criminal sanctions for engaging in fraudulent behaviour.

ATO Integrity Measures

You have advised that some companies have reported that ATO staff have been aggressive in their interactions with small business taxpayers, including views of a lack of commercial understanding and poor client engagement skills.

If companies experience unacceptable behaviour from an ATO officer, they are able to escalate the matter to their manager. When the ATO commences a compliance action, a letter will be issued which includes the contact detail of the case officer and their manager.

Where the facts of the case are in dispute between the ATO and the taxpayer, the taxpayer can apply for alternative dispute resolution (ADR). Each application is considered on its merits by an independent officer.

The ATO promotes the use of ADR, including the use of in-house facilitation and the independent review process for small businesses. The independent review process for small businesses has been extended to include research and development claims. The ADR processes are conducted by independent officers not connected to the case.

The ATO is currently preparing additional guidance material to assist companies to maintain records for their R&D expenditure. The ATO will provide broad guidance on record keeping requirements, but the diversity of companies from start-ups to large multinational companies will result in different record keeping practices. The sophistication of a company's financial systems and their approach to governance will affect the quality of records maintained.

In our updated approach to R&D compliance activities, we do work with companies and will seek secondary source documents which may assist in substantiating R&D expenditure where they are unable to provide primary evidence. We will also work with the company (and R&D consultant) to educate them what is required for future claims.

If, following all of the above, there is still an adverse assessment to a taxpayer, they retain all objection and dispute rights that are outlined in the following section.

ATO Penalties

The application of penalties by the ATO is guided by a number of products, including:

- Miscellaneous Taxation Ruling MT 2008/1 *Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard*.
- Law Administration Practice Statement PSLA 2012/5 *Administration of the false or misleading statement penalty – where there is a shortfall amount*.

Prior to the application of a penalty, the taxpayer will initially receive a position paper outlining any proposed adjustments based on the facts of the case through the application of the information and evidence of the case. The taxpayer is able to respond to the position paper, correcting any factual errors. There may be an exception to this in rare circumstances where the matter involves more egregious behaviours.

Following any response to the position paper, the ATO will consider the application of any penalties and will issue a penalties position paper, once again outlining the reasons for any proposed application of penalties. The taxpayer is once again able to respond to the penalties position paper outlining any factual errors and provide arguments for consideration of why a penalty should not apply or seek a reduction in the rate of penalty.

All decisions made have to be approved by a senior officer from the case officer.

Taxpayers have objection rights to any amendment to a primary tax position or penalty that has been applied. Taxpayers are advised of their objection rights in the finalisation letter. Objections are determined by independent officers in the ATO.

ATO Debt Recovery Process

The ATO generally does not continue debt recovery action while a debt is in dispute. In rare circumstances, for example where there is evidence of serious tax evasion, fraud, phoenixing, criminality or active dissipation of funds and assets, the ATO may continue debt recovery action even while a dispute is in place.

To minimise the impact of compounding of interest charges placing undue pressure on a taxpayer to move towards clearing the debt while they dispute the liability, the ATO can offer a 50/50 payment arrangement to taxpayers which include significant concessions on interest payable on a disputed debt. The ATO is also happy to discuss other avenues by which a taxpayer may minimise the risk of not being able to make a payment of amounts due on finalisation of a dispute.

The ATO will work with companies who may have a debt due to an adverse AusIndustry finding decision. Taking into account the individual financial circumstances of a company, the ATO may defer debt recovery action until the company has had an AusIndustry decision independently reviewed through AusIndustry and AAT/court procedures.

In the event a taxpayer pays a debt which is later overturned, the ATO would refund any overpaid amount as well as paying interest to the taxpayer on that amount.

Other Observations

We thought it relevant to also highlight other activities in which the ATO is presently engaged.

Internally we have completed a review of our web material regarding the R&D program and the ease in which clients may be able to find guidance material relating to R&D. We will soon be in a position to release updated webpages for the purposes of increasing content on pertinent issues and making it easier for clients to understand the different aspects of the R&D incentive.

Finally, we continue to look at new ways in which we can provide additional education to clients and advisors involved in the program. We look forward to sharing the concepts with you in the new year.

We remain committed to assisting the ASBFEO in your review.

Please contact Brett Challans on (08) 7422 2382 if you have any queries.

Yours sincerely

Tim Dyce
Deputy Commissioner
Australian Taxation Office

4 December 2019