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R&D Tax Incentive

Customer Information Guide (AusIndustry sections)

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Disclaimer

The material in this document aims to provide general guidance only. The intention of the guidance material is to provide useful information that will assist taxpayers seeking to claim the tax offsets available under the R&D Tax Incentive. However, it is by no means exhaustive or in the nature of definitive legal or financial advice. The guidance material cannot and does not purport to extend or supplement the operation of the legislation. Any examples provided in the guidance material are for illustrative purposes only and are not an exhaustive statement of the application of the legislation to any particular fact situation.

It is up to you and your advisers to manage your financial and tax affairs, and to ensure the accuracy of any information that you provide concerning your claims. You are also responsible for keeping yourself informed of any changes to the law that may affect your rights and responsibilities in claiming the R&D Tax Incentive for R&D activities.

R&D Tax Incentive – Customer Information Guide (AusIndustry sections)

The *R&D Tax Incentive* is administered jointly by AusIndustry (on behalf of Innovation Australia) and the Australian Taxation Office (the ATO). This document contains the all information found in the Customer Information Guide on AusIndustry's website. It also identifies information that is provided by the Australian Taxation Office (ATO).

Contents

About the Program

Overview

The *R&D Tax Incentive* replaced the *R&D Tax Concession* from 1 July 2011. It provides targeted research and development (R&D) tax offsets designed to encourage more companies to engage in R&D.

The *R&D Tax Incentive* has two core components. Entities engaged in research and development may be eligible for:

- a 45 per cent refundable tax offset (equivalent to a 150 per cent deduction) if their turnover is less than $20 million per annum provided they are not controlled by income tax exempt entities; or
- a 40 per cent non-refundable tax offset (equivalent to 133 per cent deduction) for all other eligible entities (entities may be able to carry forward unused offset amounts to future income years).

Objectives

The *R&D Tax Incentive* aims to:

- boost competitiveness and improve productivity across the Australian economy
- encourage industry to conduct research and development activities that may not otherwise have been conducted;
- provide business with more predictable, less complex support; and
- improve the incentive for smaller firms to engage in research and development.

Administration

AusIndustry (on behalf of Innovation Australia) and the Australian Taxation Office (ATO) administer the *R&D Tax Incentive* jointly. AusIndustry registers your R&D activities and check that they comply with the law. The ATO determines whether or not the expenditure you are claiming for your R&D activities is eligible.

Legislation

The *R&D Tax Incentive* is administered under the following legislation:

- Division 355 of the Income Tax Assessment Act 1997; and
- Part III of the Industry Research and Development Act 1986.

The *Tax Laws Amendment (Research and Development) Bill 2010 Explanatory Memorandum* provides a guide to the interpretation and intent of the sections of those acts that relate to the *R&D Tax Incentive*.

Two legislative instruments and their accompanying explanatory statements have been developed to support administration of the *R&D Tax Incentive*:

- *Industry Research and Development Regulations 2011*
- *Industry Research and Development Regulations 2011 - Explanatory Statement*
- *Industry Research and Development Decision-making Principles 2011*
- *Industry Research and Development Decision-making Principles - Explanatory Statement*.

Transition from the R&D Tax Concession

The legislation for the *R&D Tax Incentive* contains arrangements for the transition from the *R&D Tax Concession* to the *R&D Tax Incentive*. This document describes transitional arrangements that relate to:

- registering;
- R&D activities;
- assessments by Innovation Australia; and
- Registered Research Agencies.

The Australian Taxation Office (ATO) provides information about transitional arrangements for:

- making a claim;
- assessments and decisions by the ATO;
- situations, relating to claims, that straddle the two programs; and
- existing tax rulings.

Registering - timing of transition

As with the *R&D Tax Concession*, companies are required to register annually with AusIndustry (on behalf of Innovation Australia) before being able to claim under the *R&D Tax Incentive*. Companies need to register eligible research and development (R&D) activities within 10 months of the end of the income year in which the activities were conducted.

R&D activities that are conducted in income years beginning on or after 1 July 2011 must be registered under the *R&D Tax Incentive*. Activities conducted in income years that commenced prior to 1 July 2011 may still be registered and claimed under the *R&D Tax Concession*.

Example 1: A company with a standard income year (1 July to 30 June)

1. **Activities performed between 1 July 2010 and 30 June 2011.** These activities must be registered under the *R&D Tax Concession* with an application for registration submitted before 30 April 2012.
2. **Activities performed between 1 July 2011 and 30 June 2012.** These activities must be registered under the *R&D Tax Incentive* with an application for registration submitted to AusIndustry between 1 July 2012 and 30 April 2013.

Example 2: A company with a substituted accounting period of 1 January to 31 December

1. **Activities performed between 1 January 2011 and 31 December 2011.** These activities must be registered under the *R&D Tax Concession* rules with an application for registration submitted to AusIndustry between 1 January 2012 and 31 October 2012.
2. **Activities performed between 1 January 2012 and 31 December 2012.** These activities must be registered under the *R&D Tax Incentive* rules with an application for registration submitted to AusIndustry between 1 January 2013 and 31 October 2013.

R&D activities

Activities registered under the *R&D Tax Concession* are not equivalent to activities registered under the *R&D Tax Incentive* due to changes to the definition of R&D activities.

However, where the *R&D Tax Incentive* legislation requires a company to identify a relationship (or link) to a core R&D activity, the requirement may be satisfied by a relationship (or link) to an activity conducted before the commencement of the *R&D Tax Incentive* (i.e. in an income year prior to 1 July 2011) if it:

- was registered under the *R&D Tax Concession*; **and**
- meets the *R&D Tax Incentive* definition of a core R&D activity.

This applies in the following situations:

1. Registering R&D activities - When applying to register a supporting R&D activity under the R&D Tax Incentive, companies are required to specify one or more core R&D activities that are related to the supporting R&D activity.
2. Findings about a registration application, findings about registered activities and advance findings – When seeking a finding about a supporting R&D activity, companies need to identify one or more core R&D activities that are related to the supporting R&D activity.
3. A finding about an overseas activity – When seeking a finding about overseas activities, companies need to identify a significant scientific link to Australian core R&D activities.

Assessments by Innovation Australia

Although the *R&D Tax Incentive* replaced the *R&D Tax Concession* for income years starting on or after 1 July 2011, Innovation Australia (assisted by AusIndustry) continues to be able to make decisions under the *R&D Tax Concession* rules where they relate to activities conducted or, expenditure incurred in an income year that commenced prior to 1 July 2011. Innovation Australia continues to be able to amend assessments that they previously made under the *R&D Tax Concession*.

For example, Innovation Australia continues to be able to perform assessments and make determinations under the former section 39L of the *Industry Research and Development Act 1986* about the eligibility of activities performed in an income year that commenced prior to 1 July 2011 and registered under the *R&D Tax Concession*.

Provisional certificates and advance registrations

Advice on transitional arrangements for provisional certificates and advance registrations will be available here in the near future.

Registered Research Agencies

Research Service Providers will replace registered research agencies (RRAs) from 1 July 2011. If your organisation is registered as an RRA on 30 June 2011, it will automatically be taken to be registered as a research service provider for the 2011-12 income year.

If your organisation is automatically registered under this rule it will need to complete a full application for registration as a Research Service Provider prior to the start date of the 2012-13 income year.

Eligibility

Under the *R&D Tax Incentive*, you assess for yourself whether or not your company is eligible to register activities and claim research and development (R&D) tax offsets in any given year.

Generally, your eligibility to claim R&D tax offsets will depend on whether:

- you are a R&D entity;
- you have engaged in eligible activities;
- you can identify eligible deductions.

Information on R&D entities and eligible activities can be found below. The Australian Taxation Office (ATO) provides information about eligible deductions.

Eligible Entities

Definition of an R&D entity

Only 'R&D entities' can register research and development (R&D) activities and claim R&D tax offsets. You are an R&D entity if you are a corporation that is:

- incorporated under an Australian law; **or**
- incorporated under foreign law but an Australian resident for income purposes; **or**
- incorporated under foreign law **and**:
    - a resident of a country with which Australia has a double tax agreement, including a definition of 'permanent establishment'; **and**
    - carrying on business in Australia through a permanent establishment as defined in the double tax agreement.

You are **not** eligible for the *R&D Tax Incentive* if you:

- are a corporate limited partnership;
- are an exempt entity (because your entire income is exempt from income tax)

Trusts are not generally eligible R&D entities. The exception is a body corporate in the capacity of trustee for a public trading trust.

If your company is part of a consolidated group, only the head company should apply for registration for the *R&D Tax Incentive*.

The ATO provides more information about eligible R&D entities.

For whom the R&D activities are conducted

Generally, an R&D entity is only entitled to a R&D tax offset if the R&D activities were conducted for one of the entities below:

- the R&D entity itself; or
- a foreign corporation that is:
    - a resident of a country with which Australia has a comprehensive double tax agreement; and
    - the activities are conducted under a written agreement between the entities.

Additionally, if the R&D entity is a foreign corporation carrying on your business through a permanent establishment in Australia, it may be entitled to an R&D tax offset:

- if the R&D activities are conducted for itself; and
- provided they are not also conducted for that permanent establishment.

You, as the R&D entity, must have written evidence that this is the case.

➲ The ATO provides more information about 'for whom the R&D activities are conducted'.

Eligible Activities

For activities to be eligible under the program they must satisfy the definition of core research and development (R&D) activities. Other activities may be eligible as supporting R&D activities.

As a self-assessment program, you assess for yourself whether your company's activities satisfy the definition. You can seek to register activities that you determine are likely to be eligible.

At registration, you will need to describe your company's core R&D activities and supporting R&D activities. Your company will need to maintain adequate records of it activities.

If your company is selected for a compliance review by AusIndustry, you may need to provide copies of these records or other additional information that supports your assessment that your company's activities satisfied the definition.

➲ The identification of core and supporting R&D activities is illustrated by a number of case studies in Appendix 3.

How do activities qualify as core R&D activities?

The definition of core R&D activities is as follows:

Core R&D activities are experimental activities:

- 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:
  - is based on principles of established science; and
  - proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and
- 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).

Some activities are excluded from being core R&D activities (see section on the core R&D activity exclusions list).

Activities need to satisfy all aspects of the definition to be considered as core R&D activities. In essence, the definition recognises that a company needs new information and needs to do an experiment to discover that knowledge.

In assessing the eligibility of your activities against the definition, you need to consider the following questions:

1. Was an experiment (or set of related experiments) carried out?
2. Could the outcome of the experiment have been known or determined in advance?
3. Did the experimental activities employ the scientific method?
4. Was the purpose of the experiment to generate new knowledge?

An explanation of each of these questions follows:

1. Was an experiment (or set of related experiments) carried out?
An experiment (or a set of related experiments) needs to be taking place.

Experiments involve tests being undertaken to investigate a proposition about something unknown, or the effectiveness of something previously untried. They may take place in a range of settings, from a separate laboratory to a normal production run.

When registering activities, you will need to describe the experimental activities that your company undertook. You will need to retain records that demonstrate that your company carried out the experiments, and provide these to AusIndustry if requested as part of a compliance review. Further details on record keeping and the type of records to be retained can be found in the section on Record Keeping.

2. Could the outcome of the experiment have been known or determined in advance?
The definition requires that the outcome of the experiments could not have been known or determined in advance on the basis of current knowledge, information or experience.

This requirement will not be satisfied if:

- experiments merely confirm what is already known; or
- the outcome of the experiments, or how to achieve that outcome in practice, could be deduced or determined by a competent professional in the field on the basis of current knowledge, information or experience.

'Current knowledge, information or experience' refers to what is available in the public arena on a reasonably accessible worldwide basis at the time the activities were conducted. This gap in the current knowledge is often referred to as the knowledge gap.

You should be able to indicate how your company established that the outcome could not have been known or determined in advance. For example, you may have sought advice from an independent expert or conducted literature searches. If requested as part of a compliance review, your company may need to provide to AusIndustry with supporting evidence that demonstrates what your company did to establish this.

3. Did the experimental activities employ the scientific method?
The definition requires that a systematic progression of work is employed. This work must:

- be based on principles of established science; and

proceed from hypothesis to experiment, observation and evaluation, and leads to logical conclusions, as the only way to address the knowledge gap. This systematic progression of work is often referred to as the scientific method.

The scientific method is required because a knowledge gap exists and a significant level of uncertainty is associated with resolving this gap.

Experimentation involving less rigorous knowledge discovery and problem solving techniques, such as 'trial and error', are unlikely to meet this requirement.

'Systematic' generally means conducted in a planned way, with records kept of the process followed and the outcomes of the process.

A 'hypothesis' is a proposition about something unknown, or the effectiveness of something previously untried. A hypothesis can be an idea, theory or fact about something which is unknown or untested.

When describing the experiments, you should indicate how the scientific method was applied. If requested as part of a compliance review, your company may need to provide AusIndustry with supporting evidence that demonstrates how your company's experiments employed the scientific method.

4. Was the purpose of the experiment to generate new knowledge?
Experimental activities must be conducted for the purpose of generating new knowledge or information. This includes new knowledge in the form of new or improved materials, products, devices, processes or services.

The knowledge sought needs to be more than:

- a simple progression from what is already known; or
- applying existing knowledge in a different context or location.

When describing experimental activities as part of their registration, companies should indicate what new knowledge was generated.

A flowchart and decision tree of the process for identifying core R&D activities is shown in Appendix 1.

The case studies in Appendix 3 illustrate the identification of core R&D activities in a variety of contexts.

Core R&D activities exclusions list

Certain activities are specifically excluded from being core R&D activities. These excluded activities may however be eligible as supporting R&D activities but are subject to the dominant purpose test.

None of the following activities are core R&D activities:

1. Market research, market testing or market development, or sales promotion (including consumer surveys).
2. Prospecting, exploring or drilling for minerals or petroleum1 for the purposes of one or more of the following:
    a. discovering deposits;
    b. determining more precisely the location of deposits; or
    c. determining the size or quality of deposits.
3. Management studies or efficiency surveys.
4. Research in social sciences, arts or humanities.
5. Commercial, legal and administrative aspects of patenting, licensing or other activities.
6. Activities associated with complying with statutory requirements or standards, including one or more of the following:
    a. maintaining national standards;
    b. calibrating secondary standards;
    c. routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things.
7. Any activity related to the reproduction of a commercial product or process:
    a. by a physical examination of an existing system; or
    b. from plans, blueprints, detailed specifications or publicly available information.
8. 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):
    a. the entity (the developer) for which the software is developed, modified or customised;
    b. an entity connected with the developer;
    c. an affiliate of the developer, or an entity of which the developer is an affiliate.

Notes:

1. Petroleum is defined in section 40-730 of the *Income Tax Assessment Act 1997*. Petroleum is any naturally occurring hydrocarbon or naturally occurring mixture of hydrocarbons, whether in a gaseous, liquid or solid state; or any naturally occurring mixture of:
    - one or more hydrocarbons, whether in a gaseous, liquid or solid state; or
    - one or more of the following: hydrogen sulphide, nitrogen, helium or carbon dioxide whether or not that substance has been returned to a natural reservoir.

9. The terms 'connected entity' and 'affiliate' are defined in the *Income Tax Assessment Act 1997*. The ATO provides guidance on these terms.

Core R&D activities in a production environment

Core R&D activities may occur in a production environment. Activities that also serve a production or commercial objective are not precluded from qualifying as a core R&D activity.

If experiments that form part of a production run satisfy the definition, they will be eligible up until the point when the new knowledge has been generated.

The amount of production necessary to acquire this knowledge will depend on the circumstances of the activities being undertaken. The case studies in Appendix 3 are provided to help clarify how the definition applies to activities that are undertaken in the production environment.

Scope of core R&D activities

When describing core R&D activities you should clearly identify the scope of core R&D activities.

Core R&D activities are only eligible up to the point where their purpose (the generation of new knowledge) has been achieved. If the activity is continued after the new knowledge has been generated, it is no longer a core R&D activity. You need to consider how you will separate activities that were conducted as part of the experiment from those that were not.

You may need to identify the number of units to be produced as part of the experiment, or the time when the core R&D activity starts and ends. For example, it may be reasonable to run a production line for a certain period of time in order to test the feasibility of a new process but, once the effect of the new process is known, there is no longer a core R&D activity taking place.

When self-assessing your company's R&D activities, you must make an assessment of the amount of 'testing' that is required in order to attain the new knowledge. Your company's records should provide evidence that supports this assessment.

An activity does not fall within the scope of the core R&D activity merely because the core R&D activity cannot take place without it. For example, the following activities may be essential preparation for a core R&D activity but should not be presented as a core R&D activity:

- literature searches to find a pre-existing solution;
- construction or purchasing of equipment for the experiment;
- the purchase or preparation of materials to be used in the experiment (the case studies EcoStartup I and Matryosh-koala I in Appendix 3 provide an example of this); and
- designing the experiment.

In many cases these activities will be supporting R&D activities even though they are not core R&D activities.

How do activities qualify as supporting R&D activities?

Activities that are not core R&D activities may be eligible as supporting R&D activities.

The definition of supporting R&D activities is as follows:

Supporting R&D activities are activities directly related to core R&D activities. However, if an activity:

a. is an activity referred to in the core R&D activities exclusions list; 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.

In determining eligibility of supporting R&D activities, you need to consider whether:

- the activity is directly related to a core R&D activity; or
- for certain activities, they have been undertaken for the dominant purpose of supporting core R&D activities.

Activities subject to the dominant purpose requirement are those that:

- are excluded from being core R&D activities; or
- produce, or are directly related to producing, goods or services.

The fact that an activity has a production or commercial objective does not preclude it from qualifying as a supporting R&D activity.

The meaning of the terms **directly related** and **dominant purpose** are discussed below. The case studies in Appendix 3 illustrate the application of these terms in identifying supporting R&D activities.

What is the meaning of directly related?

Directly related requires an activity to have a direct, close and relatively immediate relationship with the core R&D activities.

Supporting R&D activities are usually required in order for core R&D activities to take place. They can occur at a different location or time to the core R&D activities so long as they maintain the required relationship.

What is the meaning of dominant purpose?

Activities may be conducted for more than one purpose. Dominant purpose means the prevailing or most influential purpose for conducting an activity.

In identifying the dominant purpose of an activity, you need to consider:

- the extent to which the activities also achieve commercial or production outcomes in addition to assisting the conduct of the core R&D activities; and
- the importance of those non-R&D outcomes.

The factors that need to be considered will vary depending on the particular circumstances of each activity. However, the following questions may be relevant:

1. Is the activity a routine activity that is normally undertaken for non R&D purposes?

If an activity is routinely undertaken for a non R&D purpose, it is likely that the activity is not being undertaken for the dominant purpose of supporting core R&D activities. The Grandheap Mining case study in Appendix 3 includes a consideration of whether a routine production activity is for the dominant purpose of production or for supporting a core R&D activity.

However, where activities required to support an experiment are undertaken in addition to routine activities, they may be for the dominant purpose of supporting the experiment. For example, where additional inspections of outputs are required to support the core R&D activities, these additional inspections may be supporting R&D activities.

2. Would the activity have occurred in the absence of the core R&D activity?
Where an activity would have been undertaken even if no core R&D activity took place, it is likely that it was not performed for the dominant purpose of supporting the core R&D activity. This is an important consideration in the Boulevard Mining I case study in Appendix 3 where a tunnelling activity is found to be for the dominant purpose of mining coal rather than supporting a core R&D activity.

3. To what extent are normal production practices disrupted for the core R&D activity?
Where normal production practices are extensively disrupted in order to accommodate the core R&D activity, those production activities may satisfy the dominant purpose requirement. In the Matryosh-koala II case study in Appendix 3, this factor was important in determining that the dominant purpose of the production run was to support the core R&D activities.

4. How great is the risk that production outcomes will be significantly compromised as a result of the core R&D activity?
Where the experiment affects the saleability of the production outputs, it is likely that the production run activities will satisfy the dominant purpose requirement. In the Matryosh-koala I example in Appendix 3, the quality of the goods used in the experiment is compromised by the experiment and thus their production is considered to be a supporting R&D activity.

5. Was there was a purpose, other than supporting core R&D activities, for infrastructure developed in the activity?
Where an activity produces infrastructure that will be used in both core R&D activities and other activities, the relative importance of the infrastructure to each of these purposes needs to be considered. In the Sanctuary example in Appendix 3, the modification of Sanctuary's customer accounts system is required for the core R&D activity, but it is undertaken predominantly for commercial purposes.

6. Will the activity facilitate future activities that are not core R&D activities?
Where an activity facilitates both core R&D activities and future activities that are not core R&D activities, the relative importance of each of these purposes needs to be considered. In the Boulevard Mining IV example in Appendix 3, the development of infrastructure to be used in the core R&D activity is ineligible as a supporting R&D activity because the dominant purpose of developing the infrastructure is to support future production activities.

However, where it is possible to restrict the scope of the activity so that only actions and expenditure that relate to period in which the core R&D activity is taking place, the dominant purpose is more likely to be for supporting core R&D activities. In the Boulevard Mining IV example in Appendix 3, the maintenance of infrastructure during the period in which the core R&D activity is taking place is found to be eligible as a supporting R&D activity.

The fact that an activity is necessary in order for core R&D activities to occur is not sufficient to show that it is undertaken for the dominant purpose of supporting core R&D activities. Nor will the test be satisfied merely because the activity occurs in close proximity (either time or location) to the core R&D activities.

Companies must keep evidence to support the decisions that they make when self-assessing their activities. It is not adequate for a company to simply assert that the prevailing or most important purpose in conducting an activity was to support core R&D activities. They must retain documentation that supports this assessment.

A flowchart and decision tree of the process for identifying supporting R&D activities is described in Appendix 2.

Scope of supporting R&D activities

The scope of supporting R&D activities must be restricted so that they only include the actions that are directly related to core R&D activities.

For example, an activity such as 'quality inspections of produced goods' may be undertaken in support of both normal production and core R&D activities. The supporting R&D activity would include the inspections that are undertaken in support of core R&D activities but not the inspections that are undertaken as part of normal production activities.

Overseas R&D activities

Generally only R&D activities conducted in Australia qualify for the *R&D Tax Incentive*. However, R&D activities conducted overseas qualify if Innovation Australia makes a finding that the activities meet the conditions specified in section 28D of the *Industry Research and Development Act 1986*.

You must apply for a finding about overseas activities before the end of the income year in which the activities were conducted.

More information about findings about overseas activities can be found in the Guide to Findings (available on the AusIndustry website www.ausindustry.gov.au).

How are software activities treated?

Software is subject to the same eligibility tests as other forms of R&D, with the exception of certain software activities which are excluded from being a core R&D activity and may only be a supporting R&D activity if they are undertaken for the dominant purpose of supporting core R&D activities. This exclusion covers activities related to the development, modification or customisation of software where the software is for the dominant purpose of 'internal administration' by the entity (or connected entities or affiliates) for which it was developed, modified or customised.

Software for 'internal administration' includes management information systems, and enterprise resource planning software that is for use in the day-to-day administration of a business.

The terms 'connected entity' and 'affiliate' are defined in the *Income Tax Assessment Act 1997*. The ATO provides guidance on these terms.

The software exclusion does not apply to software developed in-house that is of an applied nature, forming an integral part of an electrical or mechanical device (such as home appliances or industrial equipment).

R&D projects and R&D activities

The definition of R&D under the *R&D Tax Incentive* is described in terms of 'activities'. However, within your business, R&D activities may normally be grouped into 'projects' rather than activities.

The terms 'activity' and 'project' are not equivalent. An R&D project usually comprises a set of activities with start and finish dates, undertaken to generate a specific piece of new knowledge. Identification of an R&D project does not render all (or any) of the activities within that project eligible for the *R&D Tax Incentive*. Eligibility is determined on an activity basis rather than on a project basis.

Registering

Arrangements for the transition to the *R&D Tax Incentive*

The *R&D Tax Incentive* has replaced the *R&D Tax Concession* for research and development (R&D) activities and expenditure in income years commencing on or after 1 July 2011. Registration for the *R&D Tax Incentive* will commence from 1 July 2012.

- The *R&D Tax Incentive* Application Form for Registration of R&D Activities will be available in 2012.
- The *R&D Tax Concession* still applies to activities and expenditure in income years commencing prior to 1 July 2011.

Find out more about transitional arrangements in the section on the Transition from the *R&D Tax Concession*.

Accessing the R&D Tax Incentive

If your company is a R&D entity and you want to claim the *R&D Tax Incentive* in your company's income tax return, you must first register your R&D activities with AusIndustry (on behalf of Innovation Australia). You must register your R&D activities:

- for every income year you want to claim the offset;
- within 10 months of the end of your company's income year;
- before you lodge your company income tax return in which you are claiming the offset.

Treatment of consolidated groups

Where a group of companies have formed a consolidated group (under the consolidation provisions of the *Income Tax Assessment Act 1997*, Part 3-90), subsidiary members of that group are treated as part of the group's head company for income tax purposes.

Subsidiary members of consolidated groups or multi-entry consolidated groups (under the consolidation provisions of the *Income Tax Assessment Act 1997*, Part 3-90) cannot register R&D activities under the *R&D Tax Incentive*. The R&D activities of the entire group must be registered by the Australian head company of that group.

If a company is a subsidiary member of a consolidated group for only part of an income year, it can register R&D activities only for the period in which it was not part of the group. The head company of the consolidated group needs to register the R&D activities for the period in which the company was a subsidiary member of the consolidated group.

Where a company both joins and leaves a consolidated group during an income period, the company needs to lodge separate applications for each period in which they were not a member of a consolidated group. The separate applications can be lodged together as a bundle within 10 months of the end of the company's income year.

Lodgement of applications

You register R&D activities by lodging an application with AusIndustry. AusIndustry administers registration for the *R&D Tax Incentive* on behalf of Innovation Australia.

Application deadline

Your application for registration must be received by AusIndustry within ten months of the end of your company's income year in which the activities were conducted. If the deadline falls on a Saturday, Sunday or a public holiday, the deadline becomes the next working day.

The deadline for paper forms is 5.00 pm local time at any AusIndustry office. Electronic applications may be lodged via the AusIndustry website at any time on or before the due day.

Late applications

If your application is received after the deadline, it is a late application and will not normally be accepted.

However, in exceptional circumstances, you may make a written request for an extension of the deadline for applications. The written request must give reasons why the extension is required, and provide relevant supporting evidence. AusIndustry will then decide whether to accept the late application.

Where possible, you should submit the application form at the same time as the request for an extension of the application deadline. The request for an extension can be submitted as an attachment to the electronic application form.

It should also be noted that AusIndustry's discretion to accept late applications is a limited discretion. It is not intended to allow retrospective access to the *R&D Tax Incentive* that the statutory application deadlines are designed to prevent.

The *Industry Research and Development Decision Making Principles 2011* describe the circumstances in which AusIndustry may allow an extension of the application deadline.

AusIndustry (on behalf of Innovation Australia) may decide to extend the deadline for an application in cases where the delay has been the result of an act or omission by AusIndustry. In these cases an extension will be allowed that is reasonable in the circumstances to put the applicant in the same position as they would have been in if the cause of the delay had not occurred.

Extensions to the application deadline may also be granted in other situations where an event has occurred that is beyond the ability of the applicant to control. In determining the length of the extension granted, AusIndustry takes into account the severity of the situation that caused the delay, and the strength of the evidence that the applicant provides for that delay. Examples of such situations include:

- unavailability of the company's key personnel
- a breakdown of the company's record keeping system
- a failure of the company's key personnel to perform necessary functions
- a problem that results in a failure of delivery of information
- accidental destruction of key property or records.

If AusIndustry refuses to accept your company's application for registration because the application is late, you will be advised in writing.

Employing a registered Tax Agent

AusIndustry neither discourages nor encourages the use of an agent to assist with the completion of your company's application for registration.

It is, however, a requirement under the *Tax Agents Services Act 2009* that a person be a registered Tax Agent if they are to provide tax agent services for a fee or to engage in other conduct connected with providing such services.

A 'tax agent service' is any service that relates to:

- ascertaining or advising about the liabilities;
- obligations or entitlements of an entity under a taxation law; or
- representing an entity in their dealings with the Australian Taxation Office (ATO) that is provided in circumstances where it is reasonable to expect that a person will rely on it to satisfy liabilities or obligations under a taxation law or to claim entitlements under a taxation law.

Further information on Tax Agents is available from the Tax Practitioners Board at www.tpb.gov.au.

Registration Form

Your company's application for annual registration must be in the approved form. The application must contain all information that is requested in the form and any supporting material that is required must be attached to the form.

Applications for registration for the *R&D Tax Incentive* cannot be made until 1 July 2012. Approved forms will be made available closer to this time on AusIndustry's website.

The application for registration form is an electronic smartform. You should ensure that they use the most recent version of the form.

Applications should be lodged electronically if possible. Instructions for electronic lodgement are contained within the application form.

The form can also be lodged in hardcopy by printing the electronic smartform and mailing it to AusIndustry at any AusIndustry office in State and Territory capital cities and in a number of regional centres around Australia. As AusIndustry Regional Offices are not continuously staffed, companies intending to lodge at a regional office should contact that office to confirm arrangements. Instructions for printing are contained within the application form. Lodgement of hardcopy applications occurs upon receipt of a complete application before the relevant deadline.

You are able to upload data from previous years into the application form. However, this will not be possible in the first year of registration since data from the *R&D Tax Concession* cannot be used to populate the application form for the *R&D Tax Incentive.*

Review of applications

AusIndustry reviews all applications for registration for timeliness and completeness including:

- receipt within the statutory deadlines;
- scrutinising for adequacy of:
    - form completion;
    - description of activities.
- that the application is submitted by an appropriate person; and
- that the registration is consistent with previous findings made by Innovation Australia.

Applicants for the *R&D Tax Incentive* self-assess whether they are an R&D entity and the eligibility of their core R&D activities and supporting R&D activities. In the majority of cases AusIndustry accepts the accuracy of the information provided in the application form and register the activities. However, AusIndustry can choose to examine a registration application and this may lead to a finding by Innovation Australia about some or all of the activities described in the application.

AusIndustry generally makes a decision on registration within 30 days of receipt of a hard-copy application, and generally within 10 days if the application is lodged electronically online. AusIndustry sends a letter advising of the registration decision to all applicants. If approved, the date of this letter is the date of registration. Included in this letter is a registration number to be quoted on the ATO's *R&D Tax Incentive* Schedule. The registration number is unique to the R&D entity for that income year.

Registration of activities does not, by itself, render the activities described in the registration as eligible R&D activities, nor is it an indication of compliance with the requirements of the *R&D Tax Incentive*. After registration, AusIndustry may examine a registration in detail and this may lead to a formal finding by Innovation Australia about the eligibility of all or some of the registered activities.

Your company must keep adequate records to support the assessments you make in your application for registration.

Refusal to register

When you send AusIndustry an application for registration, Innovation Australia must make a decision to register, or refuse to register, R&D activities described in your application. AusIndustry will notify you (or the contact that you nominate) of Innovation Australia's decision to register or refuse to register the activities that you described in the application.

The decision to register R&D activities must be made consistently with any findings that have been made by Innovation Australia about the activities (for example, if there is an advance finding that has already been made about the activities). This means that, for example, AusIndustry cannot register your company's activities if Innovation Australia has already made a finding that those activities are not R&D activities.

Claiming

Before you lodge a claim for the *R&D Tax Incentive* with the Australian Taxation Office (ATO), you must have:

- established that you are an eligible R&D entity;
- determined that your R&D activities and expenditure meet the requirements of the *R&D Tax Incentive*; and
- registered your research and development (R&D) activities with AusIndustry (on behalf of Innovation Australia) and received your unique registration number.

You claim *the R&D Tax Incentive* in your income tax return. When you lodge your income tax return you should ensure you have completed an *R&D Tax Incentive* schedule and included your unique registration number on this schedule. You must lodge this schedule with your company tax return.

You may be able to claim a R&D tax offset under the *R&D Tax Incentive* if you are an eligible R&D entity and you meet one of the following:

- your notional deductions total at least $20,000;
- you use a Research Service Provider (RSP);
- you contribute to a Cooperative Research Centre (CRC) under the CRC program.

http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00287564.htm&page=11 - P266_15934

The ATO provides information about:

- the process for submitting a claim under the *R&D Tax Incentive*;
- what you are allowed to claim under the program.

Keeping Records

If you intend to register and claim the *R&D Tax Incentive*, you must keep adequate records to demonstrate to the Australian Taxation Office (ATO) and AusIndustry that you did carry out eligible research and development (R&D) activities and that you did incur eligible expenditure.

Your records must be sufficient to verify: the nature of the R&D activities; the amount of expenditure incurred on R&D activities; and, the relationship of the expenditure to the activities.

The information below describes the record keeping requirements for R&D activities. The ATO provides information about record keeping about claimed notional deductions.

Keeping records about R&D activities

The *R&D Tax Incentive* program operates on a self-assessment basis. You are responsible for ensuring that your registered research and development (R&D) activities meet the program's eligibility criteria. A formal R&D plan is not mandatory under the *R&D Tax Incentive.* However, as part of a compliance review AusIndustry may ask you to provide records that show that your company's R&D activities were carried out and were eligible.

Your company's records must be sufficient to show that the claimed R&D activities took place and that they met all aspects of the legislative definition for either 'core R&D activities' or 'supporting R&D activities'.

As you self assess your company's eligibility for the program, you should ask yourself:

1. Do my company's activities meet all aspects of the legislative definition for either core R&D activities or supporting R&D activities?
2. Have I retained, and can I access, sufficient records to show that the activities meet all aspects of the legislative definition for either core R&D activities or supporting R&D activities?

Which records should I keep?

In deciding what records are required in order to demonstrate the eligibility of R&D activities, you should consider each aspect of the definitions of core and supporting R&D activity. You should then consider which records are appropriate to demonstrate that your company's activities meet these definitions.

The records that you keep will vary depending on the nature of your business and your R&D activities. Examples of evidence that is likely to assist includes:

- project planning documents;
- design of experiments;
- project records and laboratory notebooks;
- design documents for system architecture and source code;
- records of trial runs;
- progress reports and minutes of project meetings;
- test protocols, test results, analysis of test results and conclusions;
- photographs and videos;
- samples, prototypes, scrap or other artefacts;
- contracts;
- records of resources allocated to the project, eg. asset usage logs;
- staff time sheets; and
- tax invoices.

This list of supporting documentation is not exhaustive, and is not a checklist to determine eligibility of R&D activities. The list is provided in order to show the wide variety of records that may assist in demonstrating the existence and eligibility of R&D activities.

Core R&D activities

Records of core R&D activities should document:

- the state of knowledge or technology that existed when the R&D was undertaken;
- the new knowledge or information concerning the creation of new or improved materials, products, devices, processes or services that was sought through the R&D;
- that the knowledge or information was not publicly available. For example, this might include:
    - literature reviews;
    - patent or other searches;
    - scientific or technological reviews and articles.
- trade journals;
- the proposed hypothesis (that is, the idea, theory or possible solution) being tested;
- the systematic progression of work to test the hypothesis based on the principles of established science, that is, the 'scientific method' that was employed; and
- documents detailing the experiments undertaken, the experiments' results, the analysis of the results, and the subsequent changes implemented to the experiments.

Regular progress reports against the planned milestones are important records. They provide evidence of your R&D project's progression and record decision points.

Any material changes to the purpose of your R&D project, or the hypothesis being investigated, should be documented.

Where use is made of a production line for R&D, you will need to document the proportion and period of use of the production line for the R&D purposes.

Supporting R&D activities

Your company must retain records that demonstrate that its supporting R&D activities were performed, and were eligible. Depending on the nature of the activity, this will either mean demonstrating that the supporting R&D activity was directly related to core R&D activities, or was for the dominant purpose of supporting core R&D activities.

Records about a 'directly related' relationship need to establish that the relationship between the supporting R&D activity and core R&D activities existed and was sufficiently direct, close and immediate.

Records about supporting R&D activities that produce, or are directly related to producing goods or services, need to demonstrate how you determined that the dominant purpose of these activities were to support core R&D activities.

Supporting R&D activities and their target core R&D activities do not necessarily occur in the same income year. Supporting R&D activities may begin before the core R&D activities since they are required in order for the targeted core to take place. Records in support of an application may therefore cover multiple years in which either the supporting R&D activities or related core R&D activities were conducted or are planned.

Maintenance of records

A number of years may elapse between the time when an activity is done and the conduct of any compliance reviews. Unless good records are available, your company may not be able to recall, explain and demonstrate the activities it has conducted in the detail necessary to establish its claims to R&D activities. Documentation of claimed activities is vital insurance against staff turnover and could add value to the sale price of your products, intellectual property, or business as buyers conducting their due diligence are likely to be interested in these documents.

All companies should have a system in place to backup their electronic files. This is a simple, relatively cheap insurance policy for a company. For a company conducting R&D activities to lose all records of their work, the cost to the company may be far more than the ability to substantiate their claims under the *R&D Tax Incentive* program.

Hardcopy documents (including all notes) should be kept in an easily accessible, logical system. Several copies should be made of crucial documents and precautions taken against the risk of fire or other destruction.

Effective research and development planning

Effective R&D planning requires companies to think strategically about their R&D activities as a critical and ongoing part of their business.

Knowledge management is particularly important in R&D projects. Knowledge management includes the management of results, knowledge and lessons learned. Knowledge management improves the quality of results from R&D by the use of systems and tools for tracking, guiding and storing the results of R&D work for future use.

Knowledge management ensures that the use of R&D knowledge is optimised, because information is verified, complete and 'findable'. This results in better uses of systems and management methods that are aligned to the implementation of business strategy and governance.

Good knowledge management enables you to self-assess your company's eligibility, meet its compliance obligations, and identify new areas where it can access the benefits of the *R&D Tax Incentive* program. It also assists your company to conduct its work and re-visit ideas, processes, and solutions in future. If the company seeks to commercialise its work, potential investors will expect to have access to a wide variety of records. A company's 'stockpile' of information is a valuable resource.

Effective (and well documented) R&D planning is a valuable part of a company's R&D activities because it:

- enhances the likelihood of successful outcomes by:
  - encouraging companies to think strategically about their R&D activities as a critical and ongoing part of their business;
  - providing focus and structure to R&D activities;
  - leads to implementation of appropriate systems and management methods from the project's outset (including methods for managing resources, risks, outcomes, and knowledge).

- assists companies to establish the compliance of their R&D activities with the *R&D Tax Incentive's* requirements by:
  - documenting a project's compliance with the some of the program's requirements;
  - clarifying the nature of the records necessary to substantiate R&D claims.

Planning should be ongoing in R&D projects. Throughout an R&D project life cycle, lessons are learned and opportunities for improvement are discovered. Systematically documenting the 'lessons learned' helps project teams discover the root causes of problems that have occurred and avoid those problems in later project stages or future projects.

Your company should prepare and retain documentation of its R&D planning in order to contribute to the success of its R&D efforts, and to assist in demonstrating the eligibility of its R&D activities for the program.

The documentation that your company prepares about its R&D planning should be adapted to the individual circumstances of your company. The actual documents produced will vary for each company. Documents such as business cases or justifications for expenditure, requests for project approval, and work requests can all be valuable R&D planning tools.

Planning documents should be prepared before R&D activities commence and then updated to reflect changes in the R&D activities as the project progresses.

Case studies in research and development planning

The way in which R&D planning, knowledge management, business strategy, and governance may interact is illustrated in these two generic case studies:

1. Small R&D intensive IT business

Small IT Company is a 15-person software developer building a software-based management solution for medium and large companies. It registers and claims the *R&D Tax Incentive* annually for its eligible R&D activities.

The company has generated a healthy enough cash position from an ad-hoc sales strategy and a few large consulting engagements. Up to this point, the company has been essentially a R&D company where most of its activities are considered R&D.

Small IT Company's approach to R&D planning and management has evolved during the project. As the project proceeded through a series of 'tollgates' or milestones, the company considered its 'lessons learned' and re-evaluated its plan for balancing opportunities, and managing risks and resources.

The company uses an IT-based knowledge management system to ensure that information is centralised and available as required, on demand. This tool has been invaluable in evaluating whether tollgate outcomes have been achieved and outputs delivered. The information contained within this tool is also invaluable when the company is applying for registration and claiming under the *R&D Tax Incentive*.

2. IP registry and successful commercialisation

Medium Company is a R&D company established with funding from industry, universities and a Commonwealth grant. Its main focus is on testing a theoretical medical process that could be developed into a new technology if successful. It registers and claims the *R&D Tax Incentive* annually for its eligible R&D activities.

The success of the company will depend on its ability to manage the intellectual property (IP) that they generate in a way that facilitates rapid outcomes through commercialisation and on to utilisation.

A custom IP registry was developed and formed the basis of how the organisation was managed. The IP registry linked key business processes and formal, contractual arrangements to the documents associated with research outputs and outcomes. This allowed for all of the information related to people, confidentiality, IP, content and contract to be viewed or printed at the click of a button.

The clinical trials of the medical process were successful and the company decided to commercialise the process by recruiting an investor from existing industry partners, and creating a spin-off company. To be successful, *Medium Company* needed to be able to work quickly with potential investors to establish the viability of the pain management process.

The IP, research outcomes, and the timesheets and skills of the key people who worked on the project, were all documented in a way that would simplify the formal due diligence process during investor negotiations. Normally, a due diligence clause in an investor agreement takes 30-60 days. The aim of the IP registry was to reduce this time by enabling the company to produce the due diligence documentation on demand.

In this situation, the effective use of an IP registry:

- enabled good management and planning of the company's research effort;
- led to rapid and successful commercialisation of the company's IP; and
- provided the information that the company needed both to acquit their Commonwealth grant, and demonstrate that their R&D activities met the requirements of the *R&D Tax Incentive*.

Compliance and Monitoring

http://syntergy.ausindustry.gov.au/InnovationandRandD/RandDTaxIncentive/Pages/RandDTaxIncentive-CustomerInformationGuide.aspx

AusIndustry and the Australian Taxation Office (ATO) undertake complementary risk assessment and compliance reviews. AusIndustry's compliance work focuses on the eligibility of research and development (R&D) activities while the ATO's compliance work focuses on the R&D tax offsets allowable in respect to those activities.

Making incorrect claims may result in penalties.

More information about AusIndustry's compliance and monitoring is described below. The ATO provides information about their compliance and monitoring activities.

The AusIndustry Compliance Model

http://syntergy.ausindustry.gov.au/InnovationandRandD/RandDTaxIncentive/Pages/RandDTaxIncentive-CustomerInformationGuide.aspx

Introduction to the compliance model

The purpose of AusIndustry's compliance model is to provide a framework to assure the ongoing integrity of the *R&D Tax Incentive*.

It aims to ensure that companies obtain the benefits under the program to which they are entitled and that they receive those benefits with minimal compliance burden.

The framework includes the monitoring of trends and behaviours in the registration of research and development (R&D) activities. This is done to better understand industry

trends, identify issues or gaps that inform the need for additional guidance, and ultimately leads to the increased compliance integrity of the program.

This section provides a simple overview of the rationale and approach that AusIndustry takes to managing compliance. The goal is to assist companies to adopt *compliance ready* practices in relation to your R&D management and record-keeping practices and at the same time to help them to better understand compliance activities that may arise. This information also describes the nature of various compliance activities that AusIndustry typically undertakes.

The perceived risks of non-compliance can change. While there is a framework that guides AusIndustry's compliance work, it is important to understand that AusIndustry's emphasis and effort are also guided by the identification of emergent risks and appropriate mitigation strategies. AusIndustry also undertakes distinct risk management and compliance activities jointly with the ATO.

Principles on which the model is based

AusIndustry is committed to customer service and minimising the compliance burden faced by companies undertaking R&D in Australia. Invariably the compliance burden is also dependent upon the quality and integrity of the business systems that companies implement to underpin their compliance requirements. AusIndustry (and the ATO) provide education and guidance material that seeks to assist companies to better understand what is required of them in meeting their obligations under the program.

In line with the guidance and ongoing education provided to companies, AusIndustry's compliance framework activities are undertaken in accordance with the following general principles:

- *transparency*: companies have a clear understanding of AusIndustry's compliance and decision-making processes and how they apply to their circumstances;
- *consistency*: program legislation is applied and interpreted consistently through sound decision making, internal quality assurance, staff training, and knowledge management;
- *timeliness*: compliance activities are undertaken in a timely fashion
  continuity of management: continuity in the management of companies through their 'compliance journey' until a result is reached; and
- *working cooperatively* with the ATO and other stakeholders so as to minimise the impact on companies.

Compliance management roles and responsibilities

The role of Innovation Australia is to make decisions on the statutory assessment of the more material cases under the program and provides in-principle guidance to AusIndustry in its interpretation of the eligibility of claimed activities.

Innovation Australia has delegated authority to AusIndustry to undertake a range of administrative functions and certain decisions.

One of the key determinants of AusIndustry's compliance approach is the broad categorisation of companies according to the material value of registered R&D activities in any one income year. This means that:

- larger registrations are managed by AusIndustry's National Office; and
- smaller registrations are primarily managed by AusIndustry's State and Territory Offices.

Guidance and compliance assurance activities

Education activities and sources of guidance

Good guidance leads to ease of compliance for companies undertaking R&D, and registering under the program. An effective strategy begins with appropriate education directed at empowering companies to self-assess their eligibility under the legislative criteria. AusIndustry invests considerable effort in ensuring that new and existing companies have sufficient information to understand all of the benefits, requirements and obligations arising from the program.

AusIndustry collects and monitor data from its registration and compliance activities to identify issues and trends at the company, sectoral and regional level that can be addressed through the provision of additional guidance.

AusIndustry's education and guidance materials available to assist companies presently include:

- fact and information sheets; and
- a program overview.

Information channels for providing guidance include AusIndustry's:

- hotline;
- website; and
- Customer Service Managers (CSMs) in State and Territory Offices.

AusIndustry runs seminars to explain the benefits of the program to industry and highlight key administrative requirements to be compliant.

All companies currently registered for the *R&D Tax Incentive* receive a regular electronic newsletter, *The R&D Incentive Bulletin*, which keeps them abreast of trends and developments in relation to the program's administration and articles on innovation more widely.

Together with the ATO, AusIndustry maintains a close dialogue with key industry stakeholders through workshops and consultative forums.

Annual registration of eligible activities

To be eligible for the *R&D Tax Incentive*, companies are required to register annually using the approved application form. This form is available on AusIndustry's website and can be lodged either by post or online. The registration form allows companies to self-assess and describe eligible activities. Importantly, the registration application must contain sufficient information to allow AusIndustry to undertake a basic assessment of a company's eligibility.

Providing a meaningful and insightful description of key activities that were carried out in experiments can greatly assist companies to either avoid or reduce later compliance activity.

Registration documentation is central to AusIndustry's compliance assurance work as it is used for both:

- identifying industry trends that might inform the emphasis of education and compliance activities; and
- case selection of companies for compliance assurance activities.

AusIndustry is working with the ATO to enhance the pre-registration evaluation of applications in line with the timely provision of benefits. This work is also directed at better managing any potential fraud and any other acute risks of non-compliance.

Compliance risk filtering and case selection

AusIndustry regularly selects companies for compliance reviews based on perceived levels of the risk of non-compliance with legislation. Typically this is a function of:

- the scale and complexity of R&D activities being registered and the level of expenditure being claimed as an offset; and
- any other potential indicators of non-compliant behaviour. These can include industry and sectoral intelligence, prior registration information and trends, compliance history, and particular financial ratios, for example the ratios of R&D expenditure to turnover, R&D spend to total project spend.

AusIndustry systematically examines registered R&D activities of the selected companies. Companies making smaller registrations are typically managed through an escalating process of compliance assurance activities called the 'compliance continuum'.

Larger and more complex registrations are typically managed through an 'active case management' process.

The Compliance Continuum

The compliance continuum is a four-tier, escalating process of compliance involving the progressive evaluation of registered R&D activities.

The stages in this process of escalation include:

- registration profile review;
- compliance desk review;
- R&D activity review; and
- R&D eligibility statutory assessment and finding by Innovation Australia.

The National Office of AusIndustry manages the large company claims and the State and Territory Offices of AusIndustry manages the small to medium-size enterprise (SME) claims.

Compliance activity ceases when all identified issues are resolved.

Registration profile review

The registration profile review is a desk-based process that involves a range of activities.

These may include:

- an evaluation of the company's R&D activities against program requirements and tests;
- a comparison of the technology the company is involved with and what is perceived to be the state of the art in the particular industry sector at the time of the registration;
- local knowledge and intelligence of AusIndustry's State and Territory offices;
- information obtained from the ATO relevant to the determination of the eligibility of the company's activities;
- analysis (often web-based) to obtain background information on the company's activities and the industry sector it operates in;
- an analysis of the company's current and previous registration applications and any previous compliance activity; and
- an analysis of the company's history with AusIndustry (for example, other program activity).

The outcome of a registration profile review either will be to:

- finalise the registration profile review with no further action; or
- escalate through to a compliance desk review if there are issues or insufficient information in the registration application.

Compliance desk review

During a compliance desk review further information is requested from the company to address the particular issues identified in the registration profile review.

Where the information requested is provided and resolves outstanding concerns, then the company profile will be updated, compliance processes will cease and the company will be advised accordingly. Otherwise, the case may be escalated to a R&D activity review.

R&D activity review

The R&D activity review will generally include a site visit to further investigate the outstanding concerns around eligibility of the registered activities. The company (and its registered tax agent) will be advised in advance of the particular issues that AusIndustry would like to resolve at the site visit.

Should the R&D activity review resolve all outstanding issues, the compliance process will stop and the company will be advised accordingly. Otherwise the case may be escalated to a R&D eligibility statutory assessment.

Prior to escalating to a R&D eligibility statutory assessment, AusIndustry will again seek to work with the company to mitigate the identified risks by providing the company with the opportunity to amend its registration (and tax claim) to remove the activities in question.

R&D eligibility statutory assessment

A R&D eligibility statutory assessment is a formal examination about a R&D entity's registration.

During a R&D eligibility statutory assessment, a company can expect to receive requests for detailed information about its claimed activities. AusIndustry is also likely to undertake a site visit(s) and may engage an independent technical expert to comment on the novelty and technical risks involved.

At the end of the R&D eligibility statutory assessment, AusIndustry will prepare a report for consideration by a delegate of Innovation Australia which may led to a finding being made as to whether the activities registered have been demonstrated to be eligible R&D activities.

If the outcome of a R&D eligibility statutory assessment is a finding by Innovation Australia about the eligibility of R&D activities, a company is not entitled to claim a tax offset under the *R&D Tax Incentive* in respect of activities listed in the certificate as not being 'R&D activities'. The finding is binding on the Commissioner of Taxation.

If dissatisfied with a finding by Innovation Australia, a company has the right to request an internal review of the decision. Further information about internal reviews is in the section on Getting Advice and Decisions.

If a company is dissatisfied with the internal review decision, it has the option of applying to the Administrative Appeals Tribunal (AAT) to review the decision. Further information about applying to the AAT can be found in the section on Getting Advice and Decisions.

Active case management

AusIndustry undertakes compliance assurance activity in relation to large claimants through a risk review process called 'active case management'. This work, which is undertaken by AusIndustry's National Office team, involves the following:

- early engagement with high revenue-risk companies involving review processes similar to those of the compliance continuum;
- meeting with companies and/or their registered tax agents to develop a clear understanding of the activities being claimed under the program;
- risk assessment based on available information;
- risk identification and mitigation to resolve identified issues where possible (for example, confirmation of eligibility, amendment of claims);
- where compliance issues remain escalation to a R&D eligibility statutory assessment and finding about a registration; and
- where appropriate, managing compliance activities jointly with the ATO.

AusIndustry's compliance assurance activities

ATO referrals

The ATO may identify concerns about the eligibility of R&D activities if they review expenditure claims in company tax returns. The ATO has the ability to refer such cases to AusIndustry for compliance activity. Similarly AusIndustry has the ability to identify issues that may be of concern to the ATO.

Compliance readiness

Companies can work with AusIndustry in compliance activities by ensuring that their records and business processes are in effect 'compliance ready'. For example, it is recommended that companies and their tax agents take the time to:

- be aware of their obligations under the program;
- become familiar with AusIndustry's compliance review processes and what might be required;
- in registering, describing activities in an appropriate manner that provides a meaningful overview and also captures the significant points of the experiments and other activities, that is what was done that was different (in large matters, short examples can provide enormous value);
- maintain good records that will assist to explain the nature and eligibility of claimed activities (for example R&D project plans and milestone reports, documentation on prototypes and project risk management plans);
- work cooperatively with Innovation Australia, the ATO, and ourselves; and
- respond to information requests in a timely manner and in the format requested.

Research Service Providers

Transitional arrangements for Registered Research Agencies
If your organisation is registered as a Registered Research Agency (RRA) under the legislation relating to the *R&D Tax Concession* on 30 June 2011, it will automatically be registered as Research Service Provider (RSP) for the 2011-12 financial year.

RSPs are required to renew their registration annually. AusIndustry will send an Application for Renewal to all RSPs before the end of each financial year.

New registrations of Research Service Providers
Applications to register as a Research Service Provider are now available for lodgement.

What is a Research Service Provider?

A Research Service Provider (RSP) is an organisation that is registered under section 29A of the *Industry Research and Development Act 1986* as a RSP by Innovation Australia has appropriate scientific or technical expertise and resources to perform research and development on behalf of other companies.

Benefits of using Research Service Providers

RSPs help small to medium-sized companies identify and gain access to expert R&D resources in particular fields.

Collaborating with RSPs enables companies to conduct R&D activities without having to invest in the specialist staff or infrastructure needed to support such activities.

Companies can contract R&D activities to RSPs with confidence since all RSPs must meet a set of criterion to qualify for registration.

If a company engages a RSP to perform R&D activities, they can claim a R&D tax offset for eligible expenditure on registered R&D activities, even where their total claim is less than the usual threshold of $20 000 in an income year.

Beneficiary of activity

Note that R&D entities are only entitled to a R&D tax offset for R&D activities that are conducted 'for' the R&D entity. Companies considering contracting research and development to a RSP should review the information that the Australian Taxation Office (ATO) provides on beneficiary of activities to ensure that the activities that they contract to the RSP continue to meet this requirement.

How to find a Research Service Provider?

A public register of RSPs is available on AusIndustry's website and published each year in the Innovation Australia annual report.

The public register provides:

- details of the RSP;

- the fields of research in which the RSP is registered to perform contracted R&D services; and
- contact details for the RSP.

Registration and eligibility

Who can register as a RSP?

Any type of organisation can register as a RSP provided your organisation meets the necessary criteria. Organisations seeking to be a RSP need to meet the eligibility criteria in each of the research fields for which they are seeking registration.

Research fields

A RSP's registration specifies the fields in which it is capable of undertaking research. The research fields that are recognised by the *R&D Tax Incentive* are those that are identified in the *Australian and New Zealand Standard Research Classification 2008*.
For the purposes of claiming the *R&D Tax Incentive*, expenditure is only treated as being 'to a RSP' if it is:

- to an organisation currently registered with Innovation Australia as a RSP; and
- on R&D activities that are in research fields specified in the RSP's registration.

Therefore while a R&D entity with a total claim of less than $20 000 can normally receive R&D tax offsets for expenditure contracted to a RSP, they cannot receive this benefit if the R&D activities are not in research fields specified in the RSP's registration.

Eligibility

In order to qualify for registration as a RSP, an organisation must meet eligibility criteria that relate to the entities:

- staff
- facilities
- capability
- pricing.

Two types of organisations are exempt from some eligibility criteria but are instead required to comply with some alternative criteria. These are publicly controlled organisations and levy collecting organisations.

1. Publicly controlled organisations: are organisations that are owned and controlled by a tertiary education institution or a government research organisation. Note that this category does not include the tertiary education institutions and government research organisations themselves.

2. Levy collecting organisations: are organisations that collect levies from R&D entities within an industry (the contributors) to fund the provision of services in relation to R&D activities, and do so under a contract or memorandum of understanding with government.

Publicly controlled organisations and levy collecting organisations are not required to meet the staffing and facilities criteria that apply to other organisations. However, they are required to meet some other criteria that relate specifically to their capacity to provide research and development services.

More information on eligibility criteria for publicly controlled and levy collecting organisations is provided under subsequent headings:

- Publicly controlled organisations – Eligibility criteria
- Levy collecting organisations – Eligibility criteria

General criteria applicable to all organisations (except publicly controlled organisations or levy collecting organisations)

Staff (employment)

RSPs (other than publicly controlled organisations and levy collecting organisations) must have access to sufficient staff with adequate qualifications and experience for providing research and development services. Specifically, they must employ:

- at least one full-time researcher who has:
    - a degree in science or technology from an Australian university; or
    - tertiary qualifications from an overseas education institution that are recognised in Australia as being equivalent to a university degree in science and technology.
- at least four full-time researchers (or part time employees whose hours are the equivalent to four full time employees) who each have:
    - a degree in science or technology from an Australian university; or
    - tertiary qualifications from an overseas education institution that are recognised in Australia as being equivalent to a university degree in science or technology; or
    - at least five years of relevant research experience in a single scientific or technological field.

The requirement for a degree in science or technology will be applied broadly. Researchers may have degrees in any fields based on science or technology and this includes, for example, medicine or engineering and those that relate to the research fields in which the entity is seeking registration.

If an entity is soon able to meet this criterion, for example if one of the entity's researchers has resigned and they are recruiting to fill that position in the near future, the entity should contact AusIndustry beforehand to discuss their application.

Facilities

RSPs (other than publicly controlled organisations and levy collecting organisations) must have access to research and development facilities in Australia that are:

- suitable for the researchers to carry out their work
- appropriate to the research field or fields in relation to which the entity has applied to be registered.

It is not necessary for this access to be exclusive, provided the access meets the above two requirements. For example, access which is available as part of a lease arrangement would be sufficient.

Capability

The organisation must be able to provide services in the research field or fields in relation to which the entity has applied to be registered. The RSP must also show an intention to provide services to companies that are not a related entity as defined in section 50 of the *Corporations Act 2001*. Registration as an RSP is not available to research and development providers that only work with customers in the same entity or in the same group of companies.

If the organisation subcontracts the provision of services to another organisation, it must be able to:

- manage the subcontracting of the services
- understand and explain the results of the services provided by the subcontractor to the R&D entity.

In order to assess whether an organisation is competent to manage and provide research and development services, Innovation Australia considers information such as:

- objectives and history in providing research and development services
- whether the organisation has appropriate administrative arrangements for planning and managing the provision of the services
- whether the organisation has a management structure that is appropriate for managing the provision of services in relation to R&D activities on a day to day basis (particularly in relation to how research and development policies are set and how performance is supervised)
- the performance of the RSP, including any relevant achievements of the organisation (particularly those that produced commercial results)
- the annual number and cost of research and development services provided
- the main source of income of the organisation.

Pricing structure

If RSPs charge for providing research and development services, the fees and charges must be based on ordinary commercial terms, or they must not be:

- subsidised by government resources; or
- inflated to exploit the *R&D Tax Incentive*.

'Ordinary commercial terms' are those that are set through a commercial mechanism. Examples include:

- market rate
- full cost recovery
- full cost recovery (+ a normal profit margin)

Organisations that do not charge on 'ordinary commercial terms' for their services may still be eligible for registration as a RSP if they are able to show that they are not using government resources (such as appropriations or grants) to subsidise their services, and that they do not inflate their charges to exploit the *R&D Tax Incentive*.
RSPs whose pricing is less than ordinary commercial terms (e.g. market rates) must be able to explain how the applicant ensures that government resources do not subsidise their fees and charges. This explanation might involve a discussion of some or all of:

- whether the organisation receives government funding
- how the organisation calculates their costs
- how the organisation ensures that the cost of delivering services is fully covered from sources other than government funding.

RSPs whose pricing is higher than ordinary commercial terms (e.g. market prices) need to explain why the applicant believes that the higher fees and charges are justified.

If you are in doubt about whether you will satisfy this criteria, please contact AusIndustry for more information.

Publicly controlled organisations - Eligibility criteria

Publicly controlled organisations do not need to meet the same staffing and facilities criteria as other RSPs. However, these organisations must have access to the research and development facilities and research personnel of the controlling institution that will allow them to provide services in relation to R&D activities in their registered research fields.

In addition, publicly controlled organisations will need to meet the above general criteria relating to capability and pricing structure.

Levy collecting organisations - Eligibility criteria

Levy collecting organisations do not have to demonstrate that they meet the same staffing and facilities criteria as other RSPs but they do need to have arrangements for:

- making available to the contributors the results of the services provided that were funded by the levies
- reporting to the contributors about:
    - how much of the levies was used for providing services in relation to R&D activities and how much was not; and
    - a ratio (based on a reasonable estimate) for working out how the levies are to be apportioned between:
        - core R&D activities and
        - supporting R&D activities.

RSPs should provide the information in the second bullet point above in a timely manner to their R&D entities as the entities will need this information when registering for the R&D Tax Incentive.

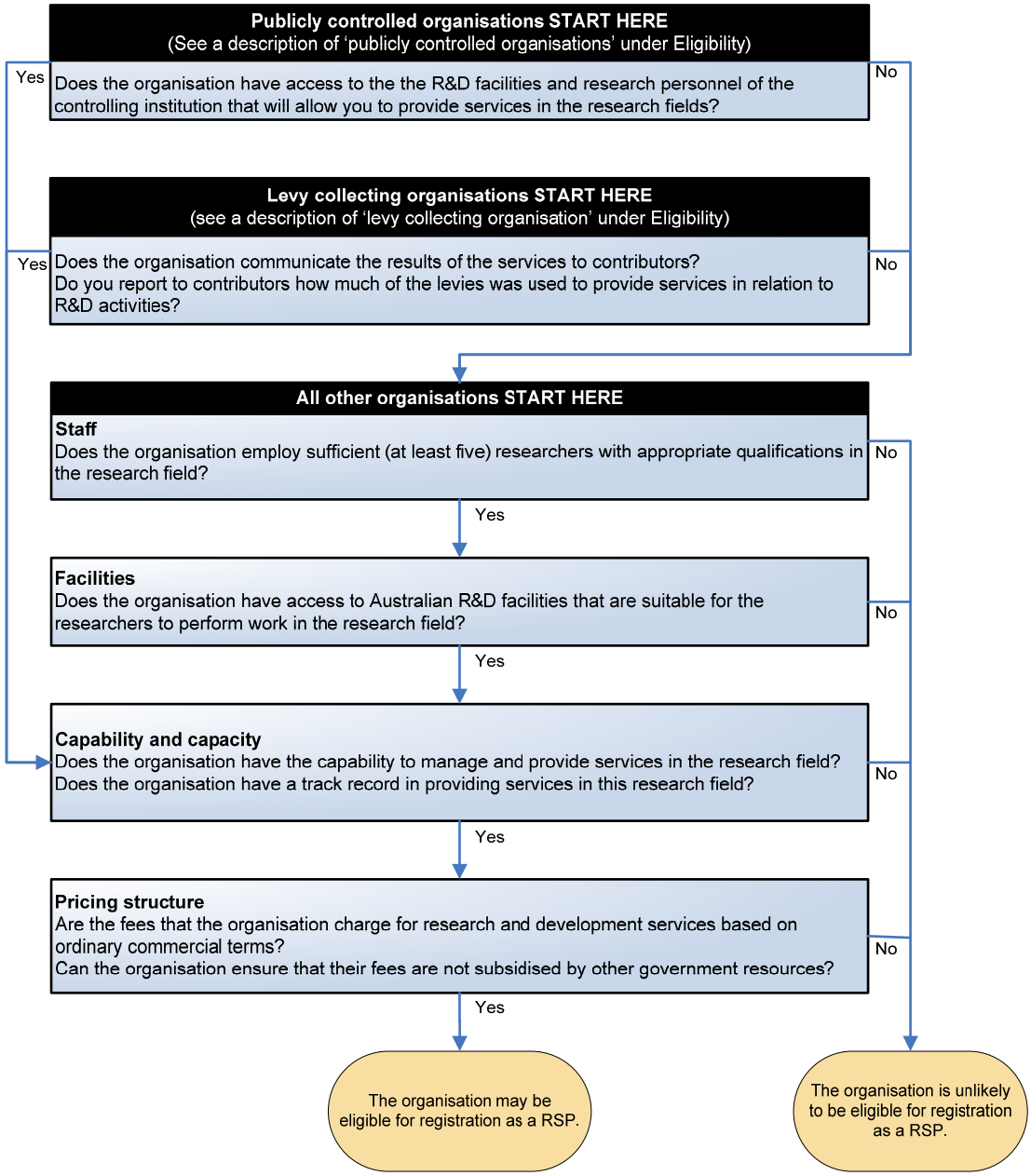

Figure 8.1 Eligibility flowchart for research service providers. (This flowchart is intended to give potential RSPs a quick indication of their eligibility for registration as a RSP. Review the detailed guidance material in this chapter to make a complete assessment)

Registering as a RSPs

Entities wishing to become RSPs must apply to Innovation Australia for registration in one or more specified research fields. An application for registration as a RSP must be made using the form available from AusIndustry's website.

An entity may apply to become a RSP at any time. Registrations are valid up until the end of the financial year in which the application is lodged. However, if an applicant becomes registered as a RSP in May or June of a financial year, then the registration will be valid until the end of the following financial year.

Upon receipt of an application by an entity, Innovation Australia may register or refuse to register the organisation as a RSP. Innovation Australia may also request that an applicant provides further information about their application or may pursue independent inquiries for the purpose of determining whether the applicant meets the criteria for RSP registration. A site visit may be conducted as part of the registration approval process.

Renewal of registration

Two months prior to the end of the financial year, AusIndustry contacts all RSPs, advising that registration is due for renewal. RSPs that wish to renew their registration need to complete and submit a form which requests information about:

- whether the RSP wishes to renew their registration
- whether the RSP is capable of continuing to be a RSP
- whether there is any variation to its registered research fields.

Innovation Australia may revoke a RSP's registration if it does not submit the renewal form within 30 days. Revocation will take effect at the end of that financial year.

Conditions of registration

If a RSP's situation changes so that it no longer meets the eligibility requirements for registration the RSP is required to notify AusIndustry. If the change is related to varying the fields of registration or expertise for part of the RSP registration, it must apply to Innovation Australia for a variation to its registration.

It is a condition of registration that RSPs must:

- be competent to manage and provide services;
- act in the best interests of the R&D entities for whom it provides services;
- ensure that R&D entities control the services provided to them by the research service provider;
- maintain confidentiality of the services it provides in relation to R&D activities, and security of information given to the research service provider by the R&D entity;
- have an appropriate management structure to manage the provision of services on a day to day basis;
- ensure that all results of services provided in relation to R&D activities for an R&D entity are owned or have a right to be used by the R&D entity, including the results of any services provided by a subcontractor of the research service provider in relation to the R&D activities;
- tell the client R&D entity and the Board about services provided outside Australia.

Record Keeping for RSPs

Upon registration RSPs agree to comply with certain record keeping requirements. In particular they must:

- keep separate financial records for services provided in relation to R&D activities for each R&D entity
- maintain records of services provided in relation to R&D activities for each R&D entity (including records of the charges made to the entity and a copy of the contract to provide the services) and makes those records available on request by the Innovation Australia
- provide Innovation Australia an annual report (in a form approved by Innovation Australia) on the services they provided in relation to R&D activities during the period covered by the annual report.

Obligations on levy collecting RSPs

Levy collecting RSPs have several additional conditions of registration. Within 10 months of the end of the financial year, levy collecting RSPs must provide Innovation Australia a written report (or reports) about:

- the services they provided during the registration year for the R&D entities that paid levies to the RSP
- how much of the levies collected in the registration year were used for providing services in relation to R&D activities for all the R&D entities from which the RSP collected levies, and how much was not
- any further information requested by Innovation Australia in relation to the services provided during the financial year by the RSP.

Variation of a RSP's registration

Variation requested by the RSP

In certain cases RSPs may wish to vary their registrations. This might occur where a RSP wishes to change the fields of research in relation to which it is registered:

a. If the RSP seeks registration in an additional field of research, the RSP must show that it meets the same criteria as are required for a new registration in a research field

b. Where the RSP is no longer able to provide research services in a particular field (for example, due to staff changes) it should notify Innovation Australia by requesting a variation to its registration as a RSP. The variation would result in the removal of the particular research field from the RSP's approved fields of research.

Applications for variation of registrations must be made using the same form as is used for registration. This form is available from the AusIndustry website. Innovation Australia may vary the registration where it is satisfied that the RSP would still meet the eligibility criteria if the registration were varied as requested. Innovation Australia may request additional information from the RSP about an application for variation of registration, or make independent inquiries about such an application.

Variation by Innovation Australia

Innovation Australia may also vary a registration without the request of the RSP if it is satisfied that the RSP does not meet the criteria for part of its registration. Innovation Australia will notify the RSP in writing if its registration is varied in this way.

For example, Innovation Australia may become aware that a key researcher in a particular field has ceased employment with a RSP. Upon being made aware of this situation, Innovation Australia may investigate the RSP's ability to continue to provide services in the research fields for which it is registered by requesting information from the RSP, or making independent inquiries. If Innovation Australia concludes that the RSP is not capable of providing services in a particular research field, it will vary the RSP's registration accordingly and notify the RSP.

Revoking a RSP's registration

Innovation Australia may also revoke a registration on request from an RSP, or if it is satisfied that the RSP:

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

Innovation Australia will notify a RSP in writing of the decision and reasons to revoke its registration.

Getting Advice and Decisions

You can get help and advice about the *R&D Tax Incentive* from AusIndustry and the Australian Taxation Office (ATO). The type of help and advice you receive will depend on your specific needs and circumstances and whether or not you want an answer in writing.

AusIndustry manages the registration of your research and development (R&D) activities and conduct compliance reviews related to the eligibility of these activities. The ATO can assist with determining whether or not the amounts you are claiming for your R&D activities are eligible. You should seek help or advice from the agency that administers the aspect of the program that relates to your query.

Advice and decisions from AusIndustry and Innovation Australia

AusIndustry offers general guidance about the program so that R&D entities are better informed about their entitlements and obligations in relation to registration and the eligibility of R&D activities.

Contact details for AusIndustry can be founding the section called Contact Us.

Innovation Australia can make decisions called 'findings'. A finding is a decision by Innovation Australia about a company's eligibility in specific circumstances. Findings are made on a range of matters including:

- the eligibility of activities;
- activities performed overseas; and
- particular technology acquired for the purpose of R&D activities.

More information on findings is available in the Guide to Findings which can be downloaded from the AusIndustry website www.ausindustry.gov.au.

Advice and decisions from the ATO

The ATO's rulings and determinations offer general guidance but you can receive specific advice through private rulings, which set out the ATO's opinions about how tax laws apply to you particularly. The ATO website also provides information to help taxpayers understand and meet their obligations and be aware of their rights and entitlements in relation to their notional R&D deductions or R&D tax offsets.

Contact details for the ATO can be founding the section called Contact Us.

Correcting Mistakes and Disputing Decisions

Once you have lodged your registration or your claim for the *R&D Tax Incentive*, you may find that you need to vary your registration details, amend or vary your claim, or that you want to dispute the decisions either Innovation Australia or the Australian Taxation Office (ATO) have made.

AusIndustry (on behalf of Innovation Australia) manages the process for:

- correcting a mistake in your registration; and
- disputing a decision by Innovation Australia.

The ATO manages (and provides information about) the process for correcting mistakes in your claim for the R&D Tax Incentive, and disputing decisions or actions by the ATO.

Correcting Mistakes in your Registration

Introduction

To correct a mistake in your company's registration you must request a 'variation'. A variation of registration could include removing particular activities, reclassifying activities as core or supporting activities, or amending the times during which activities were conducted.

AusIndustry (on behalf of Innovation Australia) varies registrations either at the request of the registered company, or as a result of a decision by Innovation Australia to vary the registration.

Variation requested by the R&D entity

1. Prior to the deadline for registration applications

You may change your company's registration within ten months of the end of its income year (i.e. prior to the final deadline for registration applications) by resubmitting the registration application form. AusIndustry will accept and process the request upon receipt.

2. After the deadline for registration applications

Note that activities can only be added to a registration through an application for registration. If you want to add activities to your registration after the deadline for applications, this is considered a late application rather than a variation. More information about late applications can be found in the section on Registering.

To request a variation to your company's registration (more than ten months after the end of your company's income year), you must complete and submit the approved form. As registrations for the *R&D Tax Incentive* cannot be made until 1 July 2012, forms to vary a registration will not be available initially.

AusIndustry will only accept a request for a variation submitted after the deadline for applications (i.e. more than ten months after the end of your company's income year) in certain situations.

The *Industry Research and Development Decision Making Principles 2011* are currently in preparation. These Decision Making Principles may describe

the circumstances in which AusIndustry (on behalf on Innovation Australia) can accept a variation after the deadline for registration applications.

When considering a request for a variation to a registration, AusIndustry needs to be satisfied that the variation is consistent with any relevant prior findings that Innovation Australia has made. AusIndustry may request additional information to assist themselves (or Innovation Australia) to decide whether to accept the variation request.

AusIndustry cannot vary registrations which are being reviewed internally, or by an external agency such as the Administrative Appeals Tribunal.

Variation made by Innovation Australia

There are three circumstances in which AusIndustry (on behalf of Innovation Australia) would examine a registration:

1. **At AusIndustry's own discretion, at any time:** AusIndustry systematically reviews registrations in order to assess whether the registered activities are eligible. If AusIndustry is not satisfied with the outcome of this process they may refer the matter to Innovation Australia (or its delegate) to make a finding which may vary the company's registration.

2. **If requested by the ATO:** In these circumstances, AusIndustry will investigate the activities that are the subject of the request. This investigation will lead to a finding by Innovation Australia about whether the activities are eligible core research and development (R&D) activities or supporting R&D activities. This examination can take place at any time.

3. **If an R&D entity applies for a finding in relation to its registered activities:** AusIndustry will investigate the activities and Innovation Australia will either make a finding about the activity, or refuse to make a finding.

A registration that has been varied is deemed to have always existed as varied. A R&D entity cannot claim expenditure in relation to R&D activities that have been found by Innovation Australia to have been registered incorrectly.

Revoking a registration

AusIndustry will revoke a registration where Innovation Australia is satisfied that the registered company was not a R&D entity at any time during which registered activities were conducted during the income year. You may also request for your company's registration to be revoked.

When AusIndustry revokes a registration for an income year, the activities that are the subject of the registration are taken to have never been registered.

Disputing a Decision

Internal Review

You can dispute some types of decisions that Innovation Australia has made by applying for an internal review of the decision.

You can only apply for an internal review of a decision if your interests (or the interests of a company you represent) were affected by the decision. Your application must be made within 28 days of notification of the decision (unless an extension is allowed by Innovation Australia).

The ATO can also apply for internal review of any reviewable decision relating to any research and development (R&D) entity. The ATO can apply for an internal review at any time.

When applying for an internal review, you should specify the reasons why the review is sought. Typical grounds for requesting internal review include:

- you believe that Innovation Australia's interpretation of the provided information is incorrect;
- you disagree with Innovation Australia's interpretation of the legislation; or
- you are able to provide relevant new information.

When AusIndustry receives an application for review, they will investigate the original decision and Innovation Australia will make a decision to either:

- confirm the original decision;
- vary the original decision; or
- set aside the original decision and make a new one.

The internal review involves a fresh assessment of all the information provided during the original assessment and also provides an opportunity for companies to provide further information. New information should be provided as part of the application for internal review.

Innovation Australia must review the decision within 90 days of the request for an internal review. If it does not confirm, vary or set aside the decision within 90 days, it is 'deemed' to have confirmed the decision. However, the 'deemed decision' may be superseded if Innovation Australia subsequently makes a decision on the matter (unless an application has already been made to the Administrative Appeals Tribunal for a review of the deemed decision).

When an internal review decision is made, AusIndustry writes to the relevant company and the ATO to advise them of the decision and the reasons for that decision.

Decisions that may be reviewed internally

You can apply for an internal review of any of the following decisions by Innovation Australia:

Decisions that relate to registration of activities:

- registering or refusing to register activities;
- refusing to vary a registration on application;
- revoking a registration;
- refusing an extension of time for:
    - making an application to register activities;
    - giving information about an application for registration of activities (when requested); or
    - giving information about a request to vary a registration of activities (when requested).

Decisions about findings:

- findings or refusing to make a finding; and
- refusing an extension of time for providing information to Innovation Australia when requested as part of an investigation for the purpose of making a finding.

Decisions about Research Service Providers:

- registering or refusing to register a Research Service Provider;
- refusing to vary a Research Service Provider's registration;
- refusing an extension of time for providing information (when requested) about an application to register a Research Service Provider;
- refusing an extension of time for providing information (when requested) about an application to vary a Research Service Provider's registration of activities;
- varying a registration (other than at the Research Service Provider's request); and
- revoking a Research Service Provider's registration.

Decisions about internal reviews:

- Refusing an extension of time for making an application for review of a decision.

Review by the Administrative Appeals Tribunal (AAT)

You can apply to the Administrative Appeals Tribunal (the AAT) for a review of Innovation Australia's internal review decisions (including deemed decisions). The AAT will undertake a fresh examination of the R&D entity's activities and determine whether they are R&D activities.

Forms and advice about applying for an AAT review are available at www.aat.gov.au.

An application for review by the AAT must be made by the R&D entity within 28 days of receiving notification of the internal review decision or, in the case of a deemed decision, within 28 days from the time the internal review decision was deemed to have been made.

Due to the commercially sensitive nature of many R&D activities, AAT hearings about Innovation Australia's decisions are held in private.

Decisions made by the AAT take effect from the day on which the AAT made the decision and written notice will be provided to the ATO.

Contact Us

AusIndustry

To contact AusIndustry about matters relating to registering for the *R&D Tax Incentive* and the eligibility of activities:

- phone the AusIndustry Hotline on **13 28 46**
- email hotline@ausindustry.gov.au
- visit AusIndustry's contact us page www.ausindustry.gov.au/contactus for additional contact details.

The Australian Taxation Office (ATO)

If you are a business and you would like more information about how to claim an R&D tax offset or whether the expenditure you are claiming for your R&D activities is eligible for a notional deduction, contact the ATO on **13 28 66 between 8.00am and 6.00pm Monday to Friday.**

If you are a tax agent, call **13 72 86** and select the relevant fast key code.

If you do not speak English well and want to talk to an ATO tax officer, phone the Translating and Interpreting Service on **13 14 50** for help with your call.

If you have a hearing or speech impediment and have access to appropriate TTY or modem equipment, phone **13 36 77**.

If you do not have access to TTY or modem equipment, phone the Speech to Speech Relay Service on **1300 555 727**.

Appendix 1: The Process for Identification of Core R&D Activities

This decision tree describes the process for identifying core research and development (R&D) activities (see below for a text version of the decision tree).

See the section on Eligible Activities for further information about each of the questions in the decision tree.

Text version

This decision tree describes the process for identifying core research and development (R&D) activities:

1. Was an experiment (or set of related experiments) carried out?
    - If YES, go to 2
    - If NO, go to 9

2. Could the outcome of the experiment have been known or determined in advance?
    - If YES, go to 9
    - If NO, go to 3

3. Did the experimental activities employ the scientific method?
    - If YES, go to 4
    - If NO, go to 9

4. Was the purpose of the experiment to generate new knowledge?
    - If YES, go to 5
    - If NO, go to 9

5. Is the activity on the core R&D activity exclusions list?
    - If YES, go to 9
    - If NO, go to 6

6. Was the activity conducted in Australia or an external territory?
    - If YES, go to 8
    - If NO, go to 7

7. Has a finding been made that says this activity meets the conditions in section 28D of the *Industry Research and Development Act 1986*?
    - If YES, go to 8
    - If NO, go to 9

8. The activity is a core R&D activity. You must retain records which demonstrate that your activities are eligible.

9. The activity is not a core R&D activity.

Appendix 2: The Process for Identification of Supporting R&D Activities

This decision tree describes the process for identifying supporting research and development (R&D) activities (see below for a text version of the decision tree).

See the section on Eligible Activities for further information about each of the questions in the decision tree.

Text version

1. Have the project's core R&D activities already been identified?
    - If YES, go to 2
    - If NO, identify the project's core R&D activities before supporting R&D activities.

2. Is the activity:
    - excluded from being a core R&D activity; or
    - one that produces, or is directly related to producing, goods or services?
    - If YES, go to 3
    - If NO, go to 4

3. Is the activity undertaken for the dominant purpose of supporting core R&D activities?
    - If YES, go to 5
    - If NO, go to 8

4. Is the activity directly related to core R&D activities?
    - If YES, go to 5
    - If NO, go to 8

5. Was the activity conducted in Australia or an external territory?
    - If YES, go to 7
    - If NO, go to 6

6. Has a finding been made that says this activity meets the conditions in section 28D of the *Industry Research and Development Act 1986?*
    - If YES, go to 7
    - If NO, go to 8

7. The activity a supporting R&D activity. You must retain records which demonstrate that your registered activities are eligible.

8. The activity is not a supporting R&D activity.

Appendix 3: Case studies illustrating the identification of R&D activities

Use the following table to choose a case study that illustrates the process of identifying core research and development (R&D) activities and supporting R&D activities in a particular sector or in relation to a particular aspect of the R&D activity definition.

Case Study name	Industry sector	R&D activity scenarios			
		Core R&D activities	R&D in production environment	Directly related supporting R&D	Dominant purpose supporting R&D
EcoStartup	Manufacturing	**Yes**	**Yes**	**Yes**	**Yes**
Smartread	Manufacturing	**Yes**	**Yes**	**No**	**Yes**
Boulevard & Mimic	Mining	**Yes**	**Yes**	**No**	**Yes**
Grandheap Mining	Mining	**Yes**	**Yes**	**No**	**Yes**
Matryosh-koala	Manufacturing	**Yes**	**Yes**	**No**	**Yes**
Hayk Hockey Stix	Manufacturing	**Yes**	**Yes**	**No**	**Yes**
Tabby Marine	Manufacturing (SME)	**Yes**	**Yes**	**No**	**Yes**
Whist Constructions	Construction	**Yes**	**Yes**	**No**	**Yes**
Two Wheels	Information Technology, Manufacturing	**Yes**	**No**	**Yes**	**No**
E C Plus	Information Technology	**Yes**	**No**	**No**	**No**
Sanctuary	Information Technology, Financial	**Yes**	**Yes**	**No**	**Yes**

EcoStartup Case Studies

These two case studies illustrate the distinction between conducting research and development (R&D) in a production and a non-production environment.

EcoStartup I

This case study illustrates the identification of R&D activities that precede commercial production and have no by-products. Key observations drawn from this case study are as follows:

1. Investigations into new uses for existing technology can be core R&D activities if their effectiveness in the new circumstances could not have been determined in advance.
2. The dominant purpose test does not apply to supporting R&D activities since no production activities are taking place.

EcoStartup was formed to investigate the potential for a chemical known as C23 to be added to petrol to reduce greenhouse gas emissions.

C23 has analogous properties to K32, which is known to reduce greenhouse gas emissions in cars. C23 is normally used as a paint additive but a thorough search uncovers no record of previous use as fuel additive. The related chemistry is complex and underdeveloped, such that whether C23 can be used in this way cannot be determined in advance from current knowledge.

The company devises a R&D plan and systematically conducts documented experiments to investigate this idea, by measuring exhaust emissions produced from a range of engines by different amounts of C23 for fuels across a range of octane values. The test batches are consumed in these experiments. EcoStartup's project proves successful and the company then decides to manufacture and sell the fuel additive.

Core R&D activities

Experimentation is evident in the form of a hypothesis ("Could C23 will reduce greenhouse gas emissions in cars?") and a series of tests of that question.

C23 is widely available but normally used as a paint additive; that it can serve as a fuel additive to target greenhouse gas emissions would be new knowledge. The related chemistry is complex and underdeveloped, such that whether C23 can be used in this way cannot be determined in advance from current knowledge.

EcoStartup is addressing a knowledge gap that can only be resolved by applying the scientific method. The activities are experimental and are conducted for the purposes of acquiring new knowledge. The activities do not fall within the scope of any items on the core R&D activities exclusions list. EcoStartup's experimental activities are core R&D activities.

Supporting R&D activities

EcoStartup can also claim supporting R&D activities that are directly related to core R&D activities.

EcoStartup's directly related activities include researching the properties and applications of C23 and K32; mixing and measuring the ingredients for the test batches; constructing apparatus to capture and record exhaust emissions; and developing a computer model to assist in interpreting the results. These activities have a direct, close and relatively immediate relationship with the experimental activities that constitute the core R&D activities.

EcoStartup does not need to subject its supporting R&D activities to the dominant purpose test, as the supporting R&D activities are not activities on the core R&D activities exclusions list, do not produce goods or services, nor do they contribute to activities that produce goods or services. It is not relevant that the activities contribute to experiments that, by their success, could lead to subsequent production.

EcoStartup II

This case study illustrates the identification of supporting R&D activities where they produce incidental by-products that are sold. Key observations drawn from this case study are as follows:

1. The dominant purpose test requires consideration of the overall circumstances of the activities.
2. Records that a company might use to support a decision about the dominant purpose of an activity could include documents that describe the company's business plan or R&D planning documentation (such as test plans).

As a variation on EcoStartup I, assume that the number of tests needed for each particular fuel batch is uncertain prior to the experiments. Accordingly, each batch is made sufficient to accommodate the maximum number of tests that might be required. EcoStartup sells the leftovers to a nearby oil refinery to blend away in its general production.

Supporting R&D activities

EcoStartup's supporting R&D activity of blending the test batches would be a production activity. Accordingly, that activity will only qualify as a supporting R&D activity if conducted for the dominant purpose of supporting the experiments.

EcoStartup is not in the business of producing or selling fuel. The quantities of fuel blended for the test batches were justified by the analysis in the experimental plan and the actual amounts that would be left over were uncertain and incidental. Accordingly, the activity of preparing the test batches is a supporting R&D activity since it was conducted for the dominant purpose of supporting core R&D activities.

Smartread Case Study

This case study illustrates the identification of research and development (R&D) activities where the experimental activities use production equipment and have an overarching commercial purpose. Key observations drawn from this case study are as follows:

1. Core R&D activities and supporting R&D activities can exist where a company uses its normal production facilities for an experiment.
2. Where R&D activities make use of production facilities, the R&D entity needs to put in place a method for identifying the R&D activities (and their associated expenditure) separately from the normal production activities.
3. Retained records assist companies to justify the scope of their R&D activities.

Smartread manufactures tyres. It also conducts an ongoing research program testing new compounds with a view to developing improved products that it can exploit commercially.

The test tyres are produced using Smartread's normal production facilities (which only allow one compound to be used in a given production run). The production aspects of the compounds (such as how they function during the moulding process) were not at issue for Smartread's tests. Smartread's research program does not produce any marketable outputs.

Core R&D activities

Although the research has an overriding commercial objective, the relevant purpose of Smartread's experimental activities is to create knowledge in the form of product improvements. Accordingly, Smartread's experimental activities can satisfy the tests for core R&D if they are part of a valid application of the scientific method to address a knowledge gap.

Supporting R&D activities

The cost of the activities involved in manufacturing the actual test tyres (such as running the production line) will be determined in the same way as for a normal production run, using normal accounting principles. That is, plant costs, floor space rent, labour and corporate overheads will be attributed to the cost of the activity of manufacturing the test tyres.

This activity of manufacturing the test tyres is directly related to the experiments but is a production activity, so the dominant purpose test applies. In the context of Smartread's experimental plan, the manufacture of the test tyres does not have the prospect of producing commercial outputs. The dominant purpose test is satisfied so the activity is a supporting R&D activity and Smartread is eligible for a tax offset on the costs attributable to the activity.

Boulevard Mining Case Studies

http://syntergy.ausindustry.gov.au/InnovationandRandD/RandDTaxIncentive/Pages/RandDTaxIncentive-CustomerInformationGuide.aspxThis series of Boulevard Mining case studies illustrates the distinction between conducting and applying research and development (R&D) in a production environment.

Boulevard Mining I

This case study illustrates the identification of R&D activities where existing technologies are modified for use in a novel application, adjacent to normal production, with the experimental activities supported by otherwise normal production activities. Key observations drawn from this case study are as follows:

1. Modifications of existing technologies can be eligible where their effect cannot be determined in advance based on current knowledge, information or experience.
2. Normal production activities can be supporting R&D activities if they are undertaken for the dominant purpose of supporting core R&D activities.
3. An activity is unlikely to meet the dominant purpose test if it would have been undertaken even in the absence of the core R&D activity.

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

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

Boulevard's mine plan indicates that the seam will be mined regardless of the outcome of the experiments. The coal extracted in the activity of creating the tunnel used for the experiments is mixed and sold with the other output of the mine.

Core R&D activities

The experimental activities address uncertainty over how the truss will function as a tunnel support, rather than a cantilever roof support, to allow significantly wider tunnels. The experiments are conducted for the purpose of acquiring new knowledge.

The truss will be subject to forces of a significantly different nature to those in its previous applications. Further, how the truss design interacts with tunnel widths and shapes cannot readily be determined using existing knowledge of the properties of trusses and tunnels. Rather, application of the scientific method is required in this instance to address the gap in knowledge.

The experimental activities are core R&D activities.

Supporting R&D activities

In order for the experiments with the truss to take place, tunnelling of various widths and shapes needs to be undertaken into the coal seam. This tunnelling has a direct, close and relatively immediate relationship with the actual experimental activities. Accordingly, it is a directly related activity.

However, in addition to creating a tunnel, the tunnelling also produces coal, so the dominant purpose test applies. In this instance, it is clear from the mine plan that the dominant purpose of undertaking the tunnelling activities is to allow the seam to be mined, rather than to support experimental activities. Accordingly, the tunnelling activity does not qualify as a supporting R&D activity. This outcome would apply were Boulevard to sell the coal or use the coal itself (for example, as fuel or as an input to a coking oven) or stockpile it for later use.

Boulevard Mining II

This case study illustrates the identification of R&D activities where the knowledge gained from experiments is used in subsequent applications that are systematically conducted and monitored. Key observations drawn from this case study are as follows:

1. It is critical to clearly identify the scope of core R&D activities. Core R&D activities end once the new knowledge has been generated. Activities that continue after new knowledge ceases to be generated are applying existing knowledge rather than generating new knowledge.
2. In order for an activity to be a core R&D activity, a knowledge gap must exist and the scientific method must be required to address this gap. A calculation based on a known relationship and/or 'fine tuning' does not involve the application of the scientific method and is not sufficient to establish a core R&D activity.

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

The scope of core R&D activities at Evans Range only extends to the amount of experimentation necessary to acquire the new knowledge to create the improved process — not to the determination of all of the various combinations of truss scale and tunnel width used in the mine.

In this instance, it was found that the Boulevard Mining I experiments with 10 combinations proved sufficient to ascertain the relationship between the two factors and prove the hypothesis that the truss can function as a tunnel support to allow significantly wider tunnels. When using the technique in other tunnel widths at the Evans Range mine, the experimental results can be interpolated and, by monitoring forces as the work is in progress, the structure 'fine tuned' by adding reinforcing segments or adjustments to the tunnel shape.

Although these implementation activities entail a degree of trial and error in applying the knowledge gained from the Boulevard Mining I activities, they do not demand the application of the scientific method. Also, these subsequent activities are conducted for the purpose of applying knowledge, rather than acquiring knowledge.

Consequently, the implementation of the technique developed in Boulevard Mining I does not constitute R&D activities.

Boulevard Mining III

This case study illustrates that determining whether and/or how knowledge can be applied in new circumstances can potentially be a core R&D activity. Key observations drawn from this case study are as follows:

1. Experiments to further develop or modify known technology so it can be applied in a fundamentally different location may be core R&D activities in some circumstances.
2. Resolving how known technology may be applied in a new location by using routine problem solving steps or techniques is unlikely to be a core R&D activity.

Boulevard Mining also has a mine in the Bowers Valley, where, based on current knowledge, the coal is considered too crumbly for the approach developed at the Evans Range mine to be usefully applied. However, Boulevard Mining conducts further experiments that discover the truss can, with modification, still permit significant increases in tunnel widths for crumbly coal seams.

This outcome could not be determined from the Evans Range experiments and its feasibility could only be ascertained by application of the scientific method. Although applying existing knowledge from earlier R&D, the Bowers Valley activities were conducted for the purpose of producing knowledge, rather than merely resolving routine problems in applying knowledge.

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

Boulevard Mining IV

This case study illustrates the application of the dominant purpose test where production activities are contingent upon the outcome of the experimental activities and there is no alternative plan. Key observations drawn from this case study are as follows:

1. Activities which are directly related to the experimental activity, but which are undertaken for the dominant purpose of future production activities are not supporting R&D activities.
2. the scope of supporting R&D activities should be restricted so that only the actions that relate to core R&D activities are included. In this case study, 'road maintenance during the experiment' was eligible as a supporting R&D activity whereas 'road maintenance outside of the time of the experiment' was not.

3. Where the scope of an activity is restricted in this way, the company should establish a method for distinguishing between the activities and expenditure that are 'in scope' and those that are not.

As a variation on Boulevard Mining I, Boulevard Mining decides instead to conduct the tunnel support experiments (which are core R&D activities) at Marginal Prospect, a new mine it is about to commence, rather than at Evans Range. If the experiments fail, the Marginal Prospect Mine will not proceed at currently foreseeable coal prices.

In order for the experiments to occur, roads and access tunnels need to be built, which will be used for ongoing mining operations should the mine proceed. The company banks on the experiments being successful, and builds the roads to the standard necessary to service the mine over its expected 10-year production life, and with numerous passing bays to accommodate movement of significant output when the mine is in full production. The company also commences constructing a lengthy railway spur line to the mine and coal train loading facilities.

Supporting R&D activities

The road and access tunnel construction activities are directly related to the experimental activities. However, the dominant purpose test applies because these activities are directly related to producing coal.
In discerning the dominant purpose for these supporting activities, regard would be had to their place in the company's overall activities and plans in relation to the Marginal Prospect site.

In this instance, it is evident that, although the road and access tunnel will initially be used for the experiment, the company mainly envisaged them as infrastructure for future mining operations. Accordingly, the construction activities were not for the dominant purpose of supporting the core R&D activities and so do not constitute supporting R&D activity. Activities that maintain the road and supply light and ventilation to the tunnels would qualify during the experimental period.

Mimic Mining

This case study illustrates the identification of R&D activities where the experimental activities seek to replicate knowledge that already exists and is commercially available. Key observations drawn from this case study are as follows:

1. Replicating an existing technique based on readily accessible information is not eligible experimentation.
2. In order for an activity to be a core R&D activity, a knowledge gap must exist and the scientific method must be required to address this gap. A knowledge gap that can be addressed by a calculation based on a knowledge that is readily accessible is not sufficient to establish a core R&D activity.

Mimic Mining learns of the technique developed at the Evans Range mine and wishes to apply it to a mine it owns in the Oates Range that is of similar geological structure. Boulevard Mining offers to sell its data and designs for a commercially reasonable sum. Mimic Mining declines the offer and instead replicates the experiments that had been undertaken by Boulevard Mining.

Mimic Mining's experimental activities are not undertaken for the purpose of generating new knowledge. The experiments at Evans Range by Boulevard Mining have proven the hypothesis that it is feasible to use the new truss design to significantly widen tunnel sizes and have established the relationship between truss and tunnel. This information is available to Mimic Mining on a reasonably accessible basis.

Consequently, Mimic Mining is not undertaking eligible R&D activities. Rather, the adoption by Mimic Mining of the Evans Range technique at Oates Range — along with similar adoption by other mining companies — exemplifies the shared benefits that the *R&D Tax Incentive* seeks to foster.

Grandheap Mining Case Study

This case study illustrates the identification of research and development (R&D) activities where the experimental activities are linked to production activities. Key observations drawn from this case study are as follows:

1. Core R&D activities end when the new knowledge is generated the knowledge gap is resolved. The application of the new knowledge to resolve routine questions is not a core R&D activity.
2. here experimental activities are conducted in a production environment, it is important for the company to make a reasonable and justifiable decision about the scope of its core R&D activities.
3. A company should keep records to demonstrate how much experimentation was required in order to resolve the knowledge gap. These might include:

- the company's plan for the activities
- the results obtained from the activities
- analysis and calculations by the company or consultants.

Grandheap Mining learns of new ground vibration sensors developed for vulcanology. Grandheap undertakes reasonable inquiries, but is unable to resolve whether and how it might be practical to apply the technology to assist in optimising slope angles for overburden heaps. Grandheap decides to conduct experiments on the ability of this technology to reliably identify incipient heap instability prior to a collapse occurring.

Grandheap Mining conducts the experiments in the course of its disposal of overburden at a working mine site, Compact Gorge. Grandheap will apply the findings to minimise the land area lost to overburden heaps at a range of open cut mines it operates, by allowing slope angles to safely approach more closely the actual angle at which the heap would fail. Due to the restrictive geography of the Compact Gorge site, minimising the number of overburden heaps will be a key factor in maximising access to the minerals there.

Core R&D activities

At the initial stages it would be fairly straightforward to demonstrate that the activities are being undertaken to test the hypothesis that the new sensor technology can reliably identify incipient heap instability.

As the number of experiments progresses, closer scrutiny would be expected as to whether further heaps were still part of the R&D activities related to resolving technological uncertainty, or were more appropriately considered to be the application of that technology to resolve routine uncertainty about the optimal slope angle for a particular heap. That is, whether the state of knowledge had reached the point where, using the innovative sensor technology, a competent professional in the field could determine when the appropriate slope angle had been reached.

Regard would be given to factors such as Grandheap's original plan for the R&D activities, the results obtained and the evidentiary basis for the number of trials considered necessary. Although Grandheap conducted all of the 'tests' at Compact Gorge in a similar manner, it was found that the state of knowledge had reached the point that the hypothesis had been established. Accordingly, those latter activities, despite their form and appearance, were not undertaken to generate new knowledge and therefore were not core R&D activities.

The core R&D activities would include 'incremental' building of overburden heaps beyond the known safe slope angle, along with clearing of overburden from collapsed heaps.

Supporting R&D activities

Testing the vibration sensors at Compact Gorge requires a supply of overburden. The activity of extracting overburden and delivering it to the site of the experiments has a sufficiently direct, close and relatively immediate relationship with the experimental activities to be considered 'directly related'.

However, removing the overburden and carting it away from the open cut contributes to mining activities, which are production activities. Accordingly, the dominant purpose test applies to the activities of removing and carting overburden.

It is clear from Grandheap's mining plan that the overburden would be removed regardless of the experiments with the sensors, in order to access mineral deposits. Further, there is no apparent difference between the activity of removing overburden used in the experiments and removing overburden subsequent to the experiments. In the context of Grandheap's activities at Compact Gorge, the dominant purpose of removing and carting the overburden is to access mineral deposits rather than supporting the core R&D activities. Accordingly, removing and carting the overburden do not qualify as supporting R&D activities.

Similarly, basic heap building, which is not part of the experimental activities, would fail the dominant purpose test for supporting activities.

Matryosh-koala Case Studies

This series of Matryosh-koala case studies illustrates the identification of research and development (R&D) activities where experimental activities occur within a normal production run. The extent of the experiment relative to the normal production activities can be a guide to the purpose of activities.

Matryosh-koala I

This case study illustrates the identification of R&D activities for a small scale experiment conducted in conjunction with a factory production run. Key observations drawn from this case study are:

1. Companies can conduct R&D activities in a factory production run. In this case study the hypothesis could only be tested by conducting the experiment on the production line.
2. The production of materials actually used in a core R&D activity is eligible as a supporting R&D activity.
3. Normal cost attribution rules may be used to determine the cost of producing materials actually used in the experiment.

Matryosh-koala operates a factory manufacturing koala-shaped Russian dolls from wood. The production line produces the seven sizes of doll halves in sets of bare forms, which it then paints, glazes, assembles in the nested form and packages. The speed of the production line is constrained by the need to allow the paint on the dolls to dry before the set of dolls can be coated in glaze, dried and nested inside each other, prior to moving to the packaging stage of the production line.

Matryosh-koala has learned of a new fast drying permeable polymer glaze that is used to protect leather from scratching while still allowing it to breathe. Matryosh-koala conducts experiments on whether, in a production line context, using this glaze might allow the dolls to be glazed and nested before the paint has fully dried, such that the paint does not smudge and does finish drying in storage. Because the glaze serves to protect the design painted on the dolls, the experiments will also investigate the maximum thickness of glaze that will be permeable enough to allow the paint beneath to dry.

A production line diversion is fitted with a spare glazing unit and glaze tank, to allow several sets of test doll to be coated with the permeable glaze in various formulations and thicknesses in conjunction with a normal production run. The diversion also contains a spare nesting machine to allow the test doll halves to be nested at an earlier than usual stage of the production line and set aside for examination.

The test dolls will not be sold with the firm's normal output, as they will be inconsistent due to the range of glaze formulations and thicknesses being tested. Also, they will be subject to considerable handling during the inspections. Those not retained for future reference are to be donated to a local preschool or destroyed.

These experiments had been preceded by removing several dolls from a normal production run as they approach the glazing machine, and spray coating them by hand with the polymer glaze. The results were ambiguous, but suggested the glaze might work as intended.

Core R&D activities

The experimental activities are for the purpose of acquiring new knowledge about the drying and permeability properties of the glaze — specifically the effect of nesting the doll halves before the glaze has dried — for varying formulations and thicknesses of glaze. The outcome of the experiment cannot be determined from existing knowledge about the glaze, and the application of the scientific method is required to address the knowledge gap. Further, the hypothesis can only be tested by replicating how the materials would be handled in a production line context.

The experimental activities qualify as core R&D activities.

Operating the diversionary stage of the production line where the test dolls are coated with the glaze and assembled would form part of the experiment.

The less formal manual trial prior to the experiments proper would also form part of the core R&D activities.

Supporting R&D activities

Matryosh-koala's experiment on an alternative glaze can only be done on a production line, so activities involved in the production run that have a direct, close and relatively immediate relationship with the actual experimental activities are activities directly related to the core R&D activities. However, being production activities, the dominant purpose test applies.

The main production line is operated for the dominant purpose of conducting the normal production run rather than supporting the experiment. Consequently, its operation per se will not fall within the scope of eligible supporting R&D activities.

However, producing the painted doll halves actually used in the glazing experiment would be eligible as a supporting R&D activity (as would acquiring the painted doll halves if they were sourced externally). Normal cost attribution rules would be used to determine the cost of producing the test dolls.

Matryosh-koala II

This case study illustrates the identification of R&D activities for an experiment conducted in the midst of a full scale production run. Key observations drawn from this case study are as follows:

1. Companies can conduct core R&D activities in a production run even where the products derived from experimental activities are able to be sold. The dominant purpose test would apply to proposed supporting R&D activities.
2. The dominant purpose test requires consideration of the overall circumstances of the activities. In this case study, the reason that the experiment needed to be done as part of the normal production run, and the related consequences, are particularly important.

Due to concerns over the viscosity and curing properties of the test glaze, the experiment is next run at full scale, to also test whether the glaze will clog the lengthy ducts leading to the glaze applicator over the duration of a typical production run. A range of formulations that proved acceptable for the dolls in the first experiment will be tested, for their feasibility with respect to the ducts.

The dolls produced in the experiment will again not be a consistent product that can be sold through normal distribution channels. However, Matryosh-koala agrees a 'job lot' price with an exporter that will ensure a satisfactory margin over the cost of materials and running the full production line.

Core R&D activities

The hypothesis being tested is that the various formulations of glaze will remain sufficiently fluid over the duration of a normal production run. The core R&D activities will therefore include the processes from the glaze storage tanks through to the nozzles on the glazing unit — these are the activities whose outcome cannot be determined in advance.

Supporting R&D activities

The production line supplies and removes the dolls that the test nozzles apply the glaze to, which has a direct, close and relatively immediate relationship with the experimental activities, and so running the production line during the experiment is a directly related activity. Because it is also a production activity, the dominant purpose test applies.

In determining the dominant purpose for the production run, several considerations are relevant:

- Running the production line to some extent is necessary to supply dolls and move them away from the glazing unit to a place where they can be inspected, so there is a purpose of supporting the experiment.
- However, that production run goes beyond the needs of the experiment by also nesting the dolls and packaging them — but the design of the production line makes it impractical to avoid performing those integrated activities.
- Conducting the production run along with the experiment is profitable in its own right — such that it would be done regardless of whether necessary for the experiment — so there is a commercial purpose.

In this instance, the determinative factor lies in the reason why the production line needs to be run and the related consequences. The requirements of the experiment could not be met simply by running the nozzles into a bucket for the duration of a normal production run. Glazing the dolls is a part of the experiment itself, to test whether the glaze has retained the necessary fluidity when exiting the nozzles to apply evenly without flecking. The production run differs significantly from a normal commercial run due to the inconsistent glazing outturns that the experiment anticipates, together with the risk of flecking.

Together, these factors indicate that the dominant purpose for running the production line during the experiment is to support the experiment, rather than to make commercial use of the available glaze. Profitably disposing of the resulting dolls is incidental to this dominant purpose.

Accordingly, the activities involved in relation to running the production line during the experiment are for the dominant purpose of supporting the experiment, so they qualify as supporting R&D activities.

Matryosh-koala III

This case study illustrates identification of R&D activities for an experiment conducted on a portion of a production line that is run at full scale. Key observations drawn from this case study are:

1. In this case study the dominant purpose test is met where a core R&D activity is conducted on a portion of a production line that is run at full scale.
2. It is critical to determine the extent of activities that form part of the R&D activities and those which fall outside of the R&D activities.
3. The scope of core R&D activities must be restricted so that only the actions and expenditure that relate to the core R&D activities are included. In this case study the scope of the core R&D activity is restricted to the section of the production line that specifically related to the experiment.

Matryosh-koala adopts the experimental glaze, allowing it to considerably shorten the paint and glaze drying sections of its production line to free up floor space for other activities. A resulting tight turn causes recurring problems for the chain that drives the conveyor belt through this 10 metre section of the production line.

Matryosh-koala hypothesises that the optical recognition device it uses in the quality control section of the line can be modified to reliably detect chain movement anomalies and trigger a mechanical jolt to set the chain back on its cogs.

Modifications are devised and made to the optical recognition device and related software and the mechanical 'kicker' designed and fabricated.

The system is brought up to satisfactory performance in offline tests, but a lengthy test in the actual production line is required to prove the hypothesis. Conducting the test while undertaking a full production run ensures that the test section of the production line is subject to realistic loads.

Core R&D activities

The lengthy test with the production line running is a part of the experiment, as its outcome cannot be determined in advance. However, although running the production line as a whole might be necessary for the experiment, only running the 10 metre section encompassing the tight turn would form part of the experiment.

The cost of the experiment would include a reasonable apportionment of the cost of running the production line. Matryosh-koala apportions on a 'length in metres' basis, plus a loading for the extra power costs and maintenance this section gives rise to because of the extra drag caused by the tight turn.

Supporting R&D activities

Although running the full production line is, to some extent, necessary for the experiment, it also serves the commercial purpose of producing standard dolls. In determining the dominant purpose for the production run, regard would be given to:

- the perceived likelihood that the run would be normal from a production standpoint
- the implications for production costs were the line to be subject to interruptions
- whether actual doll production was necessary in order to provide a realistic test load.

It was found that interruptions from the test equipment not working as intended would be comparable with those that had been experienced from the chain jumping off in the period prior to the experiment. It was not credible that Matryosh-koala would attempt a full production run if serious delays were likely, due to the cost of the glaze that would need to be pumped to waste out of the lengthy ducts. A realistic test load could have been achieved without the risk of painting and glazing doll halves, by using available halves that had the correct weight but had been rejected at quality control due to paint imperfections.

Accordingly, in the circumstances, it was found that the dominant purpose of conducting a full production run was commercial, rather than to support the experiment. That is, Matryosh-koala, quite sensibly, took the economic opportunity to piggyback the experiment onto a production run.

Hayk Hockey Stix Case Study

This case study illustrates the identification of research and development (R&D) activities where the experimental activities are a subset of a long production run. Key observations drawn from this case study are:

1. Companies can conduct core R&D activities as a subset of a long production run. However, the scope of the R&D activities is restricted to the minimum production required to test the experiment's hypothesis.
2. Where an R&D activity is a portion of a production run, the R&D entity needs to put in place a method for separately identifying the R&D activity and its associated expenditure.

Hayk Hockey Stix produces field hockey sticks in large numbers for supply to a world market. Hayk experiments with integrating a multi axial scanner with an existing numerically controlled laser guided cutting and rasping machine. If successful, this will allow real time detection of output that is outside of tolerances, allowing faulty adult sticks to be recut — if necessary to a junior specification — prior to leaving the machine.

Statistical analysis determines that in a production run of 1,000 sticks the cutting and rasping machine would generate sufficient out of tolerance sticks to test, to the 95 per cent confidence level, whether the scanner can accurately identify them.

Hayk has a large order, so it integrates the experiment into a production run of 5,000 sticks. The production stage itself consists of little more than the machine in question, which accepts pre-cut lengths of timber and produces the cut forms, which are rested for curing prior to further processing.

Core R&D activities

Cutting and rasping the first 1,000 sticks of the 5,000 stick production run would be part of the experiment. The cost of the experiment would include a reasonable apportionment of the cost of running that production stage over the 5,000 stick production run. Hayk apportions on a 'per stick' basis, plus a loading for stopping the line to check for false positives.

Supporting R&D activities

The remainder of the 5,000 stick production run is undertaken for the dominant purpose of commercial production. It is not a supporting R&D activity.

Tabby Marine Case Studies

These linked case studies for Tabby Marine illustrate the identification of research and development (R&D) activities conducted during the production of a marketable product. In all three stages, the experimental activities are conducted on prototypes that are intended for sale.

Tabby Marine I

This case study illustrates the identification of R&D activities where normal production components are unsuccessfully matched with experimental ones, increasing the overall cost of what ultimately turns out to be a normal production unit. Key observations drawn from this case study are:

1. The fact that an activity is necessary in order for a core R&D activity to occur does not mean that it will qualify as either a core or supporting R&D activity.
2. The dominant purpose test requires consideration of the overall circumstances of the activities.

Tabby Marine manufactures catamarans. Generally four boats are under construction at any one time. Tabby experiments with a novel combination of steering rudder and propeller screw, in the hope of achieving increased speed without sacrificing steering control. Trials with scale models were considered, but found not to be an economical or reliable option. Tabby constructs a prototype catamaran using its usual design, but with the test rudder-screw assembly fitted. The boat is otherwise fully fitted out as usual for eventual sale. Trials are then conducted on open water**.**

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

Core R&D activities

The experimental activities principally entail developing and testing the rudder-screw design using a computer model and, separately, testing the fabricated assembly in sea trials. These are activities:

- whose outcome cannot be determined in advance;
- that require the application of the scientific method to test a hypothesis about the test rudder-screw assembly; and
- that are conducted for the purpose of generating knowledge about the creation of new/improved products.

Therefore these activities are core R&D activities.

Fabricating the rudder-screw assembly from the computer-tested design was, in this instance, a routine step. Consequently, it is not a core R&D activity, but may qualify as a supporting R&D activity.

Supporting R&D activities

As the experiments pertain to testing how the rudder-screw assembly operates with Tabby's standard hull design, constructing the hull (and other boat elements that are necessary for the experiments) would be directly related activities and so potentially would be eligible as supporting activities. However, because they are production activities, the dominant purpose test would also apply.

Although earmarked for the experiment, the conventional hull was predominantly constructed with a view to the commercial sale of a finished boat. The experiments would only affect whether that boat would be sold with the experimental rudder-screw assembly or a regular rudder and screw. Had the R&D not been undertaken, the hull would have been constructed as part of Tabby's normal business activities. The dominant purpose of its construction was commercial and so constructing the hull is not a supporting R&D activity.

Fitting out the catamaran has direct, close and relatively immediate relationship with the experimental activities, by aiding crew comfort. However, in the context of Tabby's activities, the dominant purpose of the chosen fit out is to assist completing the boat for eventual sale and so it does not qualify as a supporting R&D activity.

Fabricating the rudder-screw assembly was a directly related production activity that was only undertaken to support the experiments on the design. As there would be no obvious alternative use for the assembly (should it fail to perform as hoped) the dominant purpose for constructing it was clearly to support the experiments. Accordingly, along with installing and removing the test rudder-screw assembly (to allow a conventional rudder and screw to be fitted for the ultimate sale), fabricating the test assembly would qualify as a supporting R&D activity. This would still be a qualifying supporting R&D activity had the experiment been successful and the boat sold with the test assembly.

Tabby Marine II

This case study illustrates the identification of R&D activities where modified production components are matched with experimental ones in a follow-up experiment that produces immediate commercial rewards. Key observations drawn from this case study are:

1. An activity is not a core R&D activity if the knowledge of whether it is scientifically or technologically possible, or how to achieve it in practice, is deducible by a competent professional in the field on the basis of current knowledge, information or experience.
2. A relevant factor in determining whether the dominant purpose requirement is met in this case study is the commercial risk to the company in conducting the claimed supporting R&D activity.

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

Had the modified hull segments been unsuccessful, it would have been impractical to replace them with conventional segments.

Core R&D activities

These experiments test a different hypothesis about the test rudder-screw assembly and are still for the purpose of generating new knowledge about the rudder-screw assembly design.

The experimental activities principally entail developing and testing the design for the modified hull segments using a computer model and testing, in sea trials, the performance of the resulting catamaran hull in combination with the rudder-screw assembly.

Fabricating the modified hull segments from the design proved problematic due to tight curves in the design and the need for joints accommodating segments entering at varying angles. Tabby's boat builders tried several approaches, consulted colleagues and researched boatbuilding articles to overcome the challenges. These were not experimental activities because the uncertainty was of a kind that could be resolved by a competent professional in the field on the basis of current knowledge, information or experience.

Supporting R&D activities

Although the modified catamaran incorporated mainly conventional catamaran hull segments, it would not have been a practical option to rebuild the boat with purely conventional segments — all of the hull construction was committed to the experimental design. Further, there was significant uncertainty as to how marketable the finished boat would be. Accordingly, constructing the entire hull (not just the experimental segments) was for the dominant purpose of supporting the experiment and so would qualify as a supporting R&D activity (inclusive of the failed attempts to fabricate the modified segments).

Tabby Marine III

This case study illustrates the identification of R&D activities where a prototype fails and is made from over-specified materials. Key observations drawn from this case study are:

1. Experiments to adapt known technology to a new set of circumstances may include eligible core R&D activities if the outcome could not be determined by a competent professional in the field on the basis of current knowledge, information or experience.
2. The dominant purpose test requires consideration of the overall circumstances of the activities. In this case study, the high quality of the fittings indicated that the fit out was conducted for the dominant purpose of the commercial sale of the boat rather than to support core R&D activities.

Tabby then experiments with applying the novel rudder-screw assembly design to a similarly modified monohull boat. With an eye to the luxury market, Tabby uses expensive timbers when building this boat. Being optimistic, Tabby also completes the fit out to a high standard, gold plating numerous interior surfaces, prior to commencing sea trials.
The results for the monohull boat are disappointing and the experiment is discontinued. The unsuccessful monohull prototype is sold at a loss as being usable but with performance limitations.

Core R&D activities

Again, these experiments test a different hypothesis about the test rudder-screw assembly and, although applying results from previous R&D, are still for the purpose of generating new knowledge about the rudder-screw assembly and modified hull segments. In this instance, application of what is still only proven as catamaran hull technology to a monohull is a significant step that requires scientific experimentation to assess its feasibility.

Translating the catamaran hull modifications to the existing monohull design, along with related computer testing, would be core R&D activities for which the outcome could not be determined in advance.

Supporting R&D activities

Constructing the modified monohull is a supporting R&D activity as it was undertaken for the dominant purpose of supporting the experiment. It is not relevant that the materials used in the experimental activities (such as the planking for the hull) were of a higher standard than necessary to conduct the experiment.

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

Whist Constructions Case Study

This case study illustrates the identification of research and development (R&D) activities where experimental activities are an integral part of an inherently one-off production task under a fixed price contract. Key observations drawn from this case study are:

1. It is critical to clearly identify the scope of core R&D activities. Core R&D activities end once the new knowledge has been generated.
2. Supporting R&D activities may take place after the core R&D activities have ended.
3. 'One-off' production activities need to meet the dominant purpose requirement in order to be supporting R&D activities (as with any other production activity).

Whist Constructions enters into a fixed price contract to construct a bridge across River Gorge. Whist tendered on the basis of using a suspension bridge.

The type of rock to which the suspension cables must be anchored has known weaknesses. Whist hopes to address this weakness by an innovative approach to anchoring that would only need holes drilled to a narrow diameter and would spread the forces along the depth of the drill hole.

The anchor design is tested in situ at the point in the construction schedule that anchors would normally be inserted. As it was not economical to halt construction and wait for load test results, the identical non-test anchors were also fabricated in advance and installed as soon the installation and activation procedure had been verified. As usual, the anchors are closely monitored as the load increases throughout construction of the remainder of the bridge.

Core R&D activities

The hypothesis being tested is that the modified anchor design — in conjunction with its installation and activation method — will hold in this rock type when subjected to the design forces of the bridge. In this instance, the scientific approach is needed to determine whether this is so. Further, significant uncertainty remained after computer simulations.

Whist's core R&D activities include developing and finalising its original conception for the design using a computer model, and installing the necessary number of test anchors into the drill holes while closely monitoring their activation. The experimental activities would also include monitoring the test anchors as they were subjected to load.

However, the core R&D activities only extend to the installation and testing of sufficient anchors to acquire the new knowledge about the improved product and related process (the new anchor design and its installation). Beyond this, installing and routinely testing anchors is part of the non-experimental activities involved in building the bridge using the knowledge gained from the experiment.

Supporting R&D activities

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

Fabricating (or sourcing) the anchors would be directly related to the experiment, as all of the anchors will either be used in the experiment or contribute to the bridge's completion, which allows the test anchors to be tested to the full load. Fabricating sufficient test anchors to conduct the experiment would be for the dominant purpose of allowing the experiment to take place, and so would qualify as a supporting R&D activity.

Anchors beyond those used in the actual experiment contribute to finalising the bridge, and so facilitate the full load test on the test anchors. They also, through routine monitoring, provide a supplementary source of data. However, as with the rest of the bridge (which also serves to assist the full load test) the dominant purpose for fabricating and installing the non-test anchors is the commercial purpose of completing the bridge. The fabrication and installation of the non-test anchors are not supporting R&D activities.

Two Wheels, E C Plus, and Sanctuary Case Studies

These case studies illustrate the application of the identification of research and development (R&D) activities in relation to software development projects, including the application of the software core R&D exclusion.

Two Wheels

Key observations drawn from this case study are:

1. In order to qualify as R&D activities, software development activities must meet the same requirements as other forms of proposed R&D activities.
2. The development of software for use in a core R&D activity (such as the development of a new gearbox) may qualify as a supporting R&D activity.

Two Wheels Ltd undertakes a project to develop a new gearbox for motorcycles. The project involves investigating the potential for using multiple lay shafts within a gear box in order to reduce its overall size without compromising effectiveness. Such an approach has not been attempted before and it is not known whether it will succeed.

Computer-aided engineering and simulation software is used to explore how such a gearbox might be designed and developed. While the software needs to be adapted for the project in question, this is achieved using existing application program languages, and is within the design capabilities of the software used.

Core R&D activities

The outcomes of the software activities are not uncertain and are not intended to achieve new knowledge in relation to computer science as the adaptation is based on existing knowledge. The software activities, by themselves, would not constitute core R&D activities. However, assuming that the larger gearbox project itself constitutes an eligible R&D project, the software activities may constitute eligible supporting activities.

Supporting R&D activities

While developed for in-house use, the software is applied in nature rather than related to the administration of the business, and consequently would not have fallen within the software exclusion if it were a core R&D activity. As such, under the supporting R&D activity rules, Two Wheels only need demonstrate that the software activity was directly related to the core R&D project. The software activities are eligible supporting R&D activities.

E C Plus

Key observations drawn from this case study are:

1. Software development activities are not core R&D activities if a competent professional in the field is able to deduce in advance whether the outcome is scientifically or technologically possible, or how to achieve it in practice, on the basis of current knowledge, information or experience.
2. Whether the software being developed, modified, or customised will be used 'in-house' or more broadly is relevant in determining whether the core R&D activities exclusions list applies.

A software company, E C Plus Ltd, wants to develop a new computer language that will simplify and streamline the coding of on-line software applications without impacting on functionality. E C Plus intends to release the language as open-source in order to promote its uptake and thereby support E C Plus's longer term business strategy. As the proposed language differs significantly from those currently used, a series of development, evaluation and testing activities needs to be systematically undertaken to ascertain whether its idea is workable, and if so, how it performs relative to existing software applications.

Core R&D activities

Considerable uncertainty exists regarding the project, which needs to be addressed through a structured series of activities. These activities are conducted for the purpose of generating new knowledge in relation to computer science and information technology. The activities are core R&D activities.

Core R&D software exclusion

The software is not being developed for use by E C Plus or a related or connected entity for internal business administration purposes. The exclusion does not apply to the project activities.

Sanctuary

Key observations drawn from this case study are:

1. A software project may comprise multiple activities each of which may (or may not) be eligible as either a core or supporting R&D activity.
2. Developing, modifying or customising computer software for the dominant purpose of use by the developer (or certain related entities) for its 'internal administration' is excluded from being a core R&D activity.
3. Software developed for the company's customers (rather than for the company's internal administration) is not subject to the core R&D activities software exclusion.

Sanctuary Ltd, a financial institution, intends to re-engineer its disparate systems for managing customer accounts into one customer focused system.

As part of the project, Sanctuary also intends to build a secure payment system that operates by providing customers with a single-use encryption 'key' via a mobile device, allowing them to access their accounts in a secure manner over the Internet. Developing such a system will require an experimental process to develop and effectively utilise the advanced cryptographic algorithms and protocols that such a system will require.

During testing of the payment system, Sanctuary discovers that a modification will need to be made to the new customer accounts system for the payments system to operate in a secure manner.

Core R&D activities

The outcome regarding the proposed new secure payment system cannot be determined in advance, as it is dependent on the successful development and operation of the envisaged new secure algorithms and protocols. To address this uncertainty, a systematic process involving design, evaluation and testing is undertaken. The software is being developed to provide a new service for customers, and not for Sanctuary's internal administration, and so the core R&D exclusion does not apply. The activities related to the development of the secure payment system are core R&D activities.

The activities related to the re-engineering of customer account software involve developing and/or modifying software for the dominant purpose of use by Sanctuary for its internal administration, and so are excluded from being core R&D activities.

Supporting R&D activities

The activities related to customer accounts are software activities for Sanctuary's internal administration and so are subject to the dominant purpose test. That is, they may be eligible as supporting R&D activity if the dominant purpose for undertaking them was to support the core R&D activities. In this case, the dominant purpose for the integration of the disparate systems was to streamline Sanctuary's customer accounts system. These activities are not supporting R&D activities.

However, the additional modification made to the customer accounts system following the testing of the payments system was undertaken for the dominant purpose of supporting the core R&D activities. The modification activities qualify as eligible supporting R&D activities.

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