I
finite creativity. It is the characteristic of human beings that sets us apart from all other forms of life. And as scientists we have the privilege of being at the forefront of the human creative impulse. We investigate. We discover. We progress.

Now it might seem a shuddering clash of gears to shift from the inspiring work of scientists to tax matters, but here in Australia the two have a strong link. The federal government’s R&D Tax Incentive program is specifically designed to encourage and support Australian R&D activity. And my role, assisting companies in accessing their entitlements under the program, affords me the wonderful opportunity to learn about the widest variety of Australia’s ideas and talent.

The new R&D Tax Incentive has just finished its first full year of implementation (the 2011–12 tax year), replacing the former R&D Tax Concession, and so this is a good opportunity to take stock of how it is working.

The new system offers a better fit to the natural practices of companies doing R&D as an ongoing enhancement to their products and services, maintaining their competitive edge in a fast-paced environment.

Already, we are seeing companies coming forward who had previously rejected applying for entitlements under the former concession, but now recognise that the new system is more financially attractive and is definitely worth a fresh look. Much of this change of heart is due to the fact that, where the old system required companies to pre-plan and document their full R&D program in advance, the new system recognises that most R&D is actually a lot more dynamic and agile than that.
The R&D Tax Incentive’s planning and record-keeping requirements are simply better suited to standard laboratory practice. Critically, the R&D Tax Incentive is also more generous than previous programs. Companies with turnover of less than $20 million may be entitled to a 45% cash rebate on eligible R&D expenditure, dropping to 40% non-cash rebate for companies with larger turnover – up to a $20 billion cut-off. For profitable companies, this can appreciably reduce a tax liability. For loss-making companies, the benefit of an immediate cash rebate is often more attractive than the future benefit foregone of accumulating tax losses.

Indeed, for some small companies, this can mean the difference between having to raise capital, or not.

**Eligible R&D requires ‘core activity’**

Under AusIndustry’s definition, R&D must include at least one ‘core activity’, which is an experimental activity where the outcome cannot be known in advance, following the scientific method, for the purpose of generating ‘new knowledge’.

In short, much of the experimental design and testing conducted by scientific companies will quite naturally fall into AusIndustry’s definition. And the conventional practices of planning and documenting the work would typically be done anyway. So, taking the experimentation and the scientific method as given for a typical scientific company, the key to defining core R&D activity then falls to the other two components.

**Where is the risk?**

Put simply, there has to be an element of risk in the R&D for it to qualify as core activity. Can the outcome be predicted in advance by a competent professional? Most likely, you are either testing whether an idea can be done at all or, if this is known, experimenting to determine how the idea can be achieved.

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A clear imperative in describing your R&D to AusIndustry is to also note the setbacks, dead ends and hurdles in your work. By demonstrating the systematic progression of your R&D through the scientific method, you demonstrate that your work adheres to three of the four criteria for core activity.

Another good question on risk is ‘who owns the resulting intellectual property?’ It can be important to have clear documentation to show who is taking the technical risk, and who the reward. If you are using a contractor for your R&D, then the contract should specify that you own the resulting IP.

**Where is the knowledge gap?**

A key task for all applicants is in clearly defining where their R&D testwork is developing ‘new knowledge’ – for new or improved materials, products, devices, processes or services. Importantly, this means new on a worldwide basis, not just in Australia.

The R&D needs to be more than ‘a simple progression from what is already known’ or ‘applying existing knowledge in a different context or location’.

Under the new system, possibly the single most important step is complying with AusIndustry’s requirements for identifying and documenting the knowledge gap. While this would be done as part of good R&D practice, for many it might not be done as thoroughly as AusIndustry would prefer. Although this may have been performed and/or documented somewhat informally, the onus is on the company to be able to supply evidence in relation to the R&D’s new knowledge.

Clearly, the issue of new knowledge is also intrinsically linked to the concept that the outcome cannot be predicted in advance by a competent professional in the field. Together, these are linked to both technical and commercial risk.

**Supporting R&D activities**

Supporting activities can also be claimed as R&D if they were directly related to or for the dominant purpose of the core R&D. There are no fixed definitions, but as a guide an activity might be a supporting activity if it is in addition to routine activities; it would not have occurred in the absence of the core activity; normal production practices are extenuatively disrupted; and/or there is a risk that production outcomes will be compromised.

The table on page 22 contains typical activities in an experimental R&D program.

**Record keeping and evidence**

The R&D Tax Incentive program, like company tax in general, is a self-assessment system. As with any government program, and particularly any program linked to taxation, the onus is on the entity to maintain appropriate records as evidence in the event of a future audit. And there are no ‘hard and fast’ rules on precisely what constitutes evidence.

Fortunately, good business practice is once again on your side.
### Typical activities in an experimental R&D program

<table>
<thead>
<tr>
<th>Activity</th>
<th>Allocation</th>
<th>Example records/evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identify an industry need, research client(s) to determine requirements</td>
<td>Supporting</td>
<td>Emails, client specs, meeting notes</td>
</tr>
<tr>
<td>Research existing solutions, and document existing state of knowledge</td>
<td>Supporting</td>
<td>Literature reviews, patent searches, technology reviews, trade journals</td>
</tr>
<tr>
<td>Develop a hypothesis and experimental design, procedures and/or test methods</td>
<td>Supporting</td>
<td>Experimental procedures, project planning documents</td>
</tr>
<tr>
<td>Prepare, purchase and set-up equipment and materials for the experiment, Plant changeover (production environments)</td>
<td>Supporting</td>
<td>Invoices, timesheets, Work orders, safety evaluations</td>
</tr>
<tr>
<td>Test the hypothesis via an experimental procedure</td>
<td>Core</td>
<td>Timesheets (useful, not absolute)</td>
</tr>
<tr>
<td>Collect data and evaluate results</td>
<td>Core</td>
<td>Invoices, emails, lab notes, photos and videos, samples and prototypes</td>
</tr>
<tr>
<td>Refine or reject hypothesis, and continue iterative experimentation</td>
<td>Core</td>
<td>Collated data (e.g. spreadsheets), Lab reports, meeting notes, internal reports</td>
</tr>
<tr>
<td>Prepare internal and/or external reports</td>
<td>Supporting</td>
<td>Published papers, client reports, patent applications</td>
</tr>
<tr>
<td>Management, oversight and administration</td>
<td>Supporting</td>
<td>Emails, meeting notes, timesheets, asset usage logs, management accounts</td>
</tr>
</tbody>
</table>

Clearly your company is almost certain to keep detailed financial records of its expenses, invoices, payroll and transactions. The main addition required is that some form of time recording/accounting (such as timesheets), while not universal, will be particularly helpful for identifying and proving costs associated with the R&D activities.

Any single project might have multiple core and supporting activities. However, it is not necessary to separate all of the R&D costs down to the level of each activity. The best way to determine R&D costs is to start with the company’s payroll, timesheets, profit and loss statement and general ledger. Labour is the most common component of any R&D activity and therefore the best starting point for determining R&D expense.

More widely, the types of documents that you would prepare and retain as part of good experimental process also serve as evidence of your R&D ‘core’ and ‘supporting’ activities. The table includes some forms of evidence that could be useful.

Overall, we recommend collating examples of this evidence in an audit file associated with your R&D claim for each year.

### Adjusting to implementation

The R&D Tax Incentive program has been established by AusIndustry and the ATO with the aim of helping more businesses do R&D and innovate. It is open to firms of all sizes in all sectors who are conducting eligible R&D.

Most importantly, the new R&D Tax Incentive represents a clear improvement over the former R&D Tax Concession. Now that it has had a full year for both industry and the regulators to develop some experience, the particular complexities of implementation are much better understood by all of the participants.

Overall, the R&D Tax Incentive is much better suited to the ‘natural’ business practices of scientific companies performing experimentally based R&D. Much of the required reporting, documentation and evidentiary processes should follow along the same lines that most companies would have already adopted. One of the few major differences to common practices is a greater emphasis on the identification and documentation of the ‘new knowledge’ component of a company’s R&D project.

However, as with any government funding program, there is always a certain degree of complexity in the detail of implementation. A registered tax agent specialising in the R&D Tax Incentive can help ensure that your SmartForm complies with AusIndustry’s best practice, and can help identify your full suite of R&D expenses for your claim.

You can learn more from AusIndustry’s website (www.ausindustry.gov.au) or contact us at Access RnD Tax Solutions for a free copy of our paper from a recent RACI seminar, ‘Optimising Value from Your R&D Investment’.

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