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Dr Stuart Boag  
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Dear Dr Boag

**Submission: Consultation on proposed R&D Plan Guideline**

We refer to your request for feedback on the proposed *Guidelines for Research and Development Plans 2009* (Proposed Guidelines). Michael Johnson Associates (MJA) welcomes the opportunity to provide feedback on these Proposed Guidelines.

**Summary**

MJA has, through various submissions to the government since 1995, supported a more proactive component in the R&D Tax Concession program that links R&D activities with a company's business strategy. We support Innovation Australia's efforts to provide better guidance to companies on the intent and requirements of R&D plans. However, we do not believe that the Proposed Guidelines clarify or simplify the R&D planning requirement.

We believe key improvements in the Proposed Guidelines include the:

- amalgamation of the Part A and Part B plans. However MJA believes claimants who have already instituted a regime with Part A and Part B plans should be allowed to continue to do so;
- recognition that plans can cover multiple projects where appropriate; and
- standardisation of the planning requirements for small and large claimants so that the only distinction is the level of detail provided rather than the information expected.

The Proposed Guidelines however introduce as well as reinforce aspects of R&D planning that are commercially unviable for claimants of the R&D Tax Concession program and change the focus of plans from a planning tool to a predictive, compliance document. Specifically, we believe the Proposed Guidelines:

- require additional information that does not assist in planning for R&D and emphasises form over substance;
- introduces detail that is more onerous on prospective claimants;
- will result in higher compliance costs for smaller and larger claimants alike; and
- fails to provide companies with complete clarity on how to plan for R&D.

Detailed below is our feedback on the Proposed Guidelines and suggested improvements to ensure the guidelines better assist companies to meet the R&D planning requirement.

### Proposed Guidelines favour form over substance

The Explanatory Memorandum to the *Taxation Laws Amendment (Research and Development) Bill 2001* (the 2001 EM) and the Objects Clause of the R&D Tax Concession provisions<sup>1</sup> outline the purpose of the R&D planning requirement. The purpose is to, *inter alia*:

- reinforce the importance of planning in R&D projects; and
- to encourage companies to think strategically about the R&D conducted as a critical and ongoing part of their business.

The proposed introduction of a requirement to include legal arguments on the eligibility of each activity and the restriction on who can approve plans runs the risk of shifting the focus on R&D plans from this strategic purpose towards compliance.

### Requirement to include legal arguments on eligibility for each activity

The Proposed Guidelines will require companies to provide the following legal arguments for each R&D activity:

- Description on how the technical objective of the activity links with the company's strategic objectives.
- Identification of whether the activity will be an *SIE activity* and/or a *directly related activity*.
- Description of why the activity is either an *SIE activity* and/or a *directly related activity*.
  - For an *SIE activity* this would include a description on
    - (a) why/how each *SIE activity* is systematic;
    - (b) why/how each *SIE activity* is investigative;
    - (c) why/how each *SIE activity* is experimental;
    - (d) why/how each *SIE activity* either (i) involves innovation, (ii) involves high levels of technical risk, or (iii) both; and
    - (e) the purpose each *SIE activity* is undertaken.
  - For a *directly related activity* this would include a description on why/how the activity is undertaken for a purpose directly related to the carrying on of an *SIE activity*.

MJA does not believe information on eligibility will in any way assist claimants to plan their R&D, nor does it encourage claimants to think strategically about R&D. Specifically, MJA believes the requirement to draft legal arguments for each activity will provide *no* substantive assistance to claimants in undertaking their R&D activities.

This information will only ever explain why activities meet the legislative definition of R&D for the purpose of calculating a claimant's R&D tax deduction. Whilst these reasonably arguable positions are relevant to the tax and legal functions within a company, we argue this information has no relevance to the technical division(s) undertaking the R&D activities.

We believe an R&D plan should be a dynamic document that details *how* a company proposes to undertake its research rather than a compliance document that predicts *why* that research may meet the eligibility requirements of the R&D Tax Concession program.

In the past, legal arguments were required in the Application for Registration of R&D Activities Form (Registration Form) which was used by companies and Innovation Australia as a central compliance document. Changes were made to reduce the level of detail

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<sup>1</sup> s73B(1AAA) of the *Income Tax Assessment Act 1936* (ITAA 36)

required in the Registration Forms and there is now no key compliance document that companies must maintain to claim an R&D tax deduction.

In the absence of any central compliance document, MJA is concerned these proposed changes will move the focus of an R&D plan from planning to becoming the primary document used by Innovation Australia to monitor compliance<sup>2</sup>.

MJA submits the Registration Form is the appropriate document for any legal arguments on eligibility. Registration Forms are prepared after an activity is undertaken and at a time after the company has assessed whether the activity met the eligibility requirements. Conversely, an R&D plan is prepared in advance of work commencing and as such it is entirely unsuitable as a company's central compliance document.

### **Changes to authorisation procedures**

MJA also believes the exclusion in the Proposed Guidelines of an *authorised officer* of board of directors or an officer of a company to approve the R&D plans does little to enhance the strategic relevance of R&D plans.

Under the existing guidelines<sup>3</sup> released in 2001 (2001 Guidelines), an *authorised officer* (i.e. a person within a company who has the authority of the board of directors to commit resources and funding to the proposed R&D activities) can approve R&D Plans. The Proposed Guidelines have removed the concept of an *authorised officer* thus restricting approval to a very limited group within a company.

In some companies (predominately very small, single entity companies) approval from the board of directors or officers of the company would provide the relevant authority, however in most SMEs and larger company groups, key technical personnel would be the relevant authority. These key technical personnel are the people better equipped to understand the R&D being conducted and understand how the R&D advances the strategic objectives of the company. These key technical personnel are unlikely to be officers of the company or sit on the board.

Additionally, there are a number of circumstances where it would be inappropriate or impossible for a board of directors or an officer of a company to authorise R&D plans. This would occur when R&D is undertaken by companies in a consolidated tax group or by companies in a joint venture arrangement.

In a consolidated tax group, the board of directors or officers of the ultimate head entity (i.e. the taxpayer) will almost always be too removed from the individual activities undertaken by each subsidiary entity. As such they would not be in a position to provide approval in any meaningful way. In the case of a joint venture, there will not be a board of directors or company officer. In this example the appropriate authority to approve the conduct of activities can only be the key technical or commercial personnel working in the joint venture.

As such, MJA submits that restricting the people that can approve R&D plans emphasises form rather than substance, and detracts from the relevance of the plans.

### **Proposed Guidelines are more onerous**

MJA rejects the argument that the Proposed Guidelines provide a streamlined approach compared to the existing planning guidelines. The Proposed Guidelines impose undue

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<sup>2</sup> The current R&D planning Single Issue Reviews appear to support this concern.

<sup>3</sup> formulated by Innovation Australia pursuant to s39KA(1A) of the *Industry Research and Development Act 1996 (IR&D Act 96)*

burdens on both small and larger claimants alike because of the greater detail that is required for each R&D activity.

The need to draft legal arguments on eligibility for every activity (as outlined above) is an onerous compliance burden that exceeds the level of detail required to register R&D activities. In our experience, this level of detail is only ever required when the claimant's activities are being formally assessed by Innovation Australia under ss39L, 39LAAA, 39LAAB, 39EC, 39HH of the *IR&D Act* 96 and for other formal assessments of a claimant's R&D activities. While this level of detail is relevant in assisting the completion of formal assessments of claims, it is not relevant in helping companies think strategically about R&D. Furthermore, the legal arguments on eligibility for each proposed R&D activity in the R&D plan will not be used by Innovation Australia in any review of R&D. At a planning stage of a project, companies will struggle to define detailed information on the activities to be undertaken let alone develop legal arguments on eligibility of proposed R&D activities. As such, we believe the requirement for legal justification on eligibility of activities that have not yet taken place is too onerous.

In addition, we believe that the requirement in the Proposed Guidelines to provide estimated expenditure for each activity is too onerous. Standard business planning practices involve budgeting at a project rather than activity level. Our experience shows companies are not able to accurately predict budgets at an R&D project level and therefore are unlikely to provide any meaningful budget information at an activity level. We do not believe providing estimates at an activity level will operate as a true tool to enhance planning.

MJA submits that as R&D activities are registered and formally assessed on a project basis, estimates of expenditure for R&D planning purposes should similarly be provided on a project basis<sup>4</sup> (and as currently required under the 2001 Guidelines).

#### **Proposed Guidelines will result in increased compliance costs**

The 2001 EM at page 46 estimated that R&D planning might result in higher compliance costs, but went on to say that "these costs would be balanced by the cost savings expected when many companies begin to use a planning process for their R&D activities." As outlined above, MJA does not believe that legal arguments on eligibility for each activity or estimating expenditure for each activity will assist companies in conducting their R&D and therefore we believe claimants will see no cost saving from including this additional detail.

At the time of the legislative changes in 2001, Innovation Australia amended the Registration Documents so that companies were only required to provide limited information in respect of the activities the company intended to claim. This amendment was a response to feedback on the high compliance costs associated with the R&D tax deduction. We believe that the requirement in the Proposed Guidelines to provide legal arguments on eligibility and estimated expenditure for each activity in the R&D plans will see compliance costs return to even higher levels than pre-2001.

The introduction of these features to the Proposed Guideline erodes the value of the concession for claimants and will ultimately result in greater fees for R&D advisers without any positive impact on strategic R&D planning. We suggest that those hardest hit by the increased compliance costs will be the small to medium enterprises (SMEs) who can least afford to absorb the additional costs.

#### **Proposed Guidelines fail to provide clarity on how to plan for R&D**

A shortcoming of the 2001 Guidelines has been the limited guidance on the minimum expectations Innovation Australia has in respect of R&D planning mechanisms.

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<sup>4</sup> In Part B of the Guide to the R&D Tax Concession June 2008 at page 14, the notion of a project is accepted by Innovation Australia as the "basis upon which R&D activities are undertaken".

While guidance has been provided on the minimum level of *content* expected in each plan, the Proposed Guidelines remain silent on *how* companies should plan for their R&D. Specifically, there is no guidance on:

### *The regularity of planning updates*

If a company is to comply with the 2001 Guidelines, the company must first identify work that is likely to meet the definition of R&D. Following this, a detailed<sup>5</sup> R&D plan must be drafted or amended where relevant. These plans must then be approved by the board of directors or an *authorised officer* of the company.

There is no clarity in either the 2001 Guidelines or the Proposed Guidelines on how often R&D plans should be drafted, updated and approved. Although the Proposed Guidelines recommend such reviews be undertaken "as frequently as appropriate, and at least on annual basis", it is entirely unclear what is considered *appropriate*.

In looking to find a commercially workable R&D planning review solution, it is instructive to consider how companies undertake planning exercises outside of the R&D compliance framework. Such exercises would satisfy the objective of the EM 2001 and the Objects Clause in that they assist companies in thinking strategically about projects to be undertaken and are true tools to enhance planning.

These planning exercises include strategic business planning, company budgets and capital project planning and provide good examples of planning regimes that ensure work undertaken aligns with a company's strategic objective(s) and ensures work is undertaken in a planned way.

The regularity of these planning exercises varies but range from reviews on a quarterly basis for capital project planning to five year strategic business plans.

It would be commercially unworkable if an R&D planning review was required on a weekly or even monthly basis. Most claimants of the R&D Tax Concession do not have the capacity<sup>6</sup> to undertake R&D planning reviews on weekly or monthly basis. Similarly, if R&D planning reviews were required every time a project commenced or when the direction of a project changed, very few companies would be able to manage such a compliance burden in a commercially feasible way.

Weekly or monthly reviews may be possible in a very small number of companies; however the complexity in organising such planning reviews increases exponentially as the size of the company increases. Even SMEs would find weekly/monthly/as-needs-basis R&D planning reviews commercially unviable.

As such, MJA submits that Innovation Australia adopt minimum expectations of the regularity of reviews in line with standard business practices.

Additionally, MJA submits there should be guidance on how to accommodate projects that commence outside of a company's official R&D planning regime. It is submitted that in addition to adopting a minimum expectation of regularity of reviews, guidance be provided for instances where projects commence in between regular planning reviews. That is, there should be recognition that if a project commenced or changed direction in between planning reviews, a company can still meet the R&D planning requirement if those activities are drafted and approved in an R&D plan at the next scheduled R&D review.

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<sup>5</sup> The level of detail required will increase substantially under the Proposed Guidelines.

<sup>6</sup> i.e. the availability of the required technical staff and the availability of the board of directors or officers of a company

### *Planning for potential projects*

The 2001 Guidelines and the Proposed Guidelines remain silent on how companies should treat *potential* projects in their R&D planning reviews.

It is our experience that many companies prepare R&D plans that meet the 2001 Guidelines for projects that, after a detailed assessment at the end of an income year, do not meet the eligibility requirements for R&D and are therefore not deductible. Similarly, potential projects that are identified often do not commence<sup>7</sup>. In these instances, a company receives no benefit if detailed R&D plans are drafted and approved.

MJA submits Innovation Australia should provide instructions on the minimum expectations for companies that identify *potential* projects in their R&D planning reviews.

Ordinarily companies will acknowledge the conduct of *potential* projects through the generation of contemporaneous, internal documentation. However, this documentation is unlikely to meet the minimum content requirements either under the 2001 Guidelines or the Proposed Guidelines. This will be the case because companies will not know all the activities required to resolve the technical risks for a *potential* project or know what innovative solution is required. Companies may identify work that has the potential for high levels of technical risk and/or require innovative solutions but the degree to how much risk, where that risk will manifest itself or what innovative solutions are required will not be known until a project starts. This is the nature of R&D.

To ensure the R&D planning reviews remain commercially relevant, guidance should be provided on how such *potential* projects can meet the R&D planning requirements.

A suggested process to cater for these *potential* projects is to require approval of the project as a *potential* R&D project and require companies to maintain some contemporaneous records; though these records would not need to strictly meet the R&D planning content requirements. Once the project commences and/or has been assessed for eligibility by the company, the company should then be required to draft and approve a detailed R&D plan that meets the planning content requirements.

### *Approval of updates*

The Proposed Guidelines are also silent on the practicalities of what constitutes "approval" and how approval for projects can be given.

There is no guidance on whether acknowledgement of a project constitutes approval. Such acknowledgement may take the form of an email or a meeting minute.

For logistical reasons, there can often be a time delay between the drafting of R&D plans and the official approval of that plan. It would seem contrary to the intent of the R&D planning requirement if the date of approval could not be that of the date the R&D plans were drafted. As such, we suggest that Innovation Australia provide guidance on whether an effective date of approval can be given to plans.

### **Recommendations**

MJA believe R&D plans should be aligned to good business practices and include only the data that is useful for companies in a planning sense. We believe R&D plans should not include items that serve no purpose unrelated to strategic planning.

MJA submits that the following changes be made to the Proposed Guidelines to ensure that better guidance is provided to all claimants of the R&D Tax Concession for R&D planning

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<sup>7</sup> This can be for a variety of reasons including lack of available resources/funding or changes in market demands.

purposes so that a commercially sensible R&D planning regime can be adopted by companies:

1. Explicitly allow companies to continue preparing Part A and Part B plans if those two documents meet the minimum content requirement set out in the planning guidelines.
2. Remove the need to provide legal arguments on eligibility for each activity.
3. Reinstate the notion used in the 2001 Guidelines of *authorised officers* as one of the relevant groups able to authorise R&D plans.
4. Remove the need to provide estimates of expenditure on an activity basis and reinstate the requirement under the 2001 Guidelines of estimated expenditure on a project basis.
5. Provide detailed guidance on how to plan for R&D including
  - the regularity of R&D planning reviews;
  - how to accommodate projects that commence or change direction outside of the official R&D planning reviews;
  - how to plan for *potential* projects;
  - whether written acknowledgement (emails, meeting minutes etc.) of a project constitutes approval; and
  - whether effective dates of approval can be given to plans that are drafted before written approval is possible.

If Innovation Australia is to adopt any changes to the R&D planning guidelines, MJA suggests that these changes be introduced in a well communicated timeframe to ensure companies can adjust their current R&D planning processes and templates.

MJA looks forward to providing further assistance if required in relation to the Proposed Guidelines and thank Innovation Australia and AusIndustry for the opportunity to assist in improving the operation of the R&D Tax Concession program.

Yours sincerely  
Kris Gale

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**Michael Johnson Associates**