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The R&D Tax Incentive

Compliance Readiness

THE IMPORTANCE OF RECORD KEEPING AND THE PREPARATION OF REGISTRATIONS AND APPLICATIONS

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Introduction

The R&D Tax Incentive *is a targeted, generous and easy to access entitlement program that helps businesses offset some of the costs of doing R&D. The program aims to help more businesses do R&D and innovate, and is available to firms of all sizes*[1] *in all sectors who are conducting eligible R&D.*

AusIndustry and the Australian Taxation Office (ATO) are responsible for delivering the *R&D Tax Incentive* and work closely together to help companies accessing the program.

The *R&D Tax Incentive* is a self-assessment program – companies assess for themselves the eligibility of their R&D activities and associated expenditure. AusIndustry and the ATO want to make it as easy as possible for business to understand how the program works, what is eligible and how to register and claim.

The material presented in this guide seeks to assist companies in meeting their compliance responsibilities under the *R&D Tax Incentive*. It provides guidance in relation to business R&D planning, systems and record keeping.

What is compliance readiness?

Simply put, compliance readiness is about having in place the appropriate systems and processes to effectively identify, evaluate and record eligible R&D activities and their associated expenditure.

In terms of both the eligibility of R&D activities themselves and the expenditure attributed to such activities, participants in the program need to develop an understanding of their compliance obligations.

AusIndustry's compliance assurance activities such as risk reviews are an important aspect of the overall approach to program integrity. If selected for a review, companies who are compliance-ready will be more easily able to demonstrate that they are complying with the program's requirements.

This guide provides advice around record-keeping and how to fill in the *R&D Tax Incentive* registration form. As with all guidance, it is intended to help and inform companies to self-assess the eligibility of their R&D activities. It is not a prescriptive or mandated list of program requirements.

This material builds on comprehensive guidance that AusIndustry has already released. AusIndustry will progressively release more sectoral specific guidance that includes further advice about the type of records that should be kept.

1 The Australian Government has committed to target access to the *R&D Tax Incentive* to entities with aggregated assessable income of less than $20 billion. This change requires legislation. More information is available from AusIndustry.

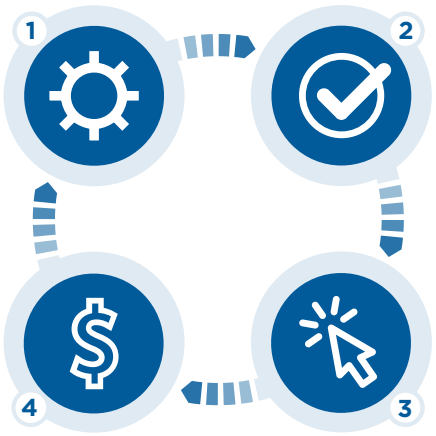
The *R&D Tax Incentive* establishes a link between the management of a company's R&D portfolio and its annual tax return process.

Good record-keeping and appropriate business systems ensure that there is a strong link between activities and claimed expenditure and that this can be evidenced as required.

The *R&D Tax Incentive* is based on self-assessment, therefore businesses and their advisors must work together in order to ensure that eligible R&D activities are registered on time and that the related costs are claimed through the tax system.

FIGURE 1: Participation in the *R&D Tax Incentive* "at a glance"

1. Conduct eligible R&D activities
- Check the business.gov.au website for more guidance
- Contact an AusIndustry office or the ATO for advice
- Use our online eligibility tool



2. Register with AusIndustry
- Keep records of your R&D activities and amounts you can claim
- Fill out the online registration form
- Register within 10 months of the end of your income year

3. Lodge your company tax return with the ATO
- Check what amounts you can claim on the ATO website
- Use the ATO's *Research and Development Tax Incentive Calculator*
- Claim in your company tax return

4. Pay less tax
- Improve your bottom line
- Grow your business
- Re-invest in R&D

Effective compliance and record keeping

Effective business systems and processes, and in particular the maintenance of good records will help companies comply and receive the maximum benefit from the R&D Tax Incentive.

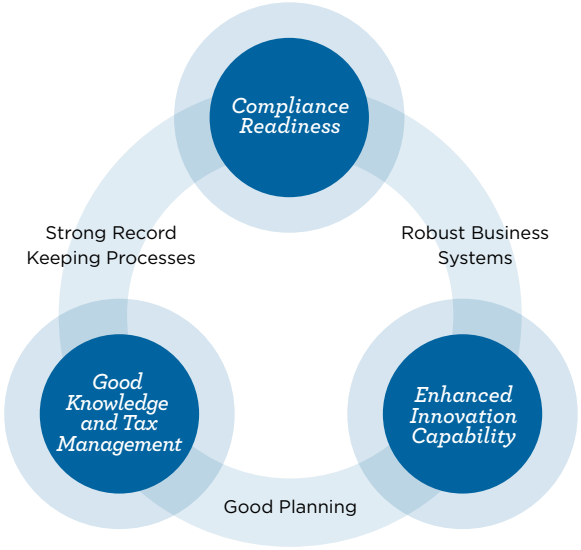
In particular, it can reduce a company's compliance costs and risks if selected by AusIndustry for a *R&D Tax Incentive* risk review or finding.

However, the benefits of effective business systems and record keeping are broader than the *R&D Tax Incentive* program – good planning combined with knowledge management and robust business systems and processes are the key ingredients to enabling a company to improve its capacity to access and capitalise on its investment in R&D.

Good R&D planning and record keeping is an important part of a company's operations because it:

- Enhances the likelihood of successful R&D outcomes through:
  - implementing appropriate systems to capture and record work undertaken across the R&D project lifecycle from idea generation to commercialisation
  - encouraging companies to think strategically about their R&D activities as a critical and ongoing part of their business; and
  - providing a focus and structure to R&D activities.
- Assists companies to manage their tax risk and establish compliance with the program's requirements; and
- Allows companies to easily and effectively prepare their application for registration and provide a basis for clear and accurate descriptions of activities and the reasons for eligibility.

Figure 2: Linkages between compliance readiness, innovation capability and knowledge management



Principles of good record keeping

The following set of record keeping principles is suggested by AusIndustry in order to assist companies in developing appropriate systems and processes to document their R&D activities and associated expenditure. It is important to note that the first step to ensuring compliance is reviewing and understanding the *R&D Tax Incentive* guidelines and requirements.

These principles have been formulated on the basis of AusIndustry's experience in conducting compliance assurance activities. They also take into account recent Administrative Appeals Tribunal[2] (AAT) decisions, where failures in relation to records management has been a key factor in a number of decisions that resulted in tax claims for R&D being overturned.

Principle 1

Ensure that internal processes and systems allow for *R&D Tax Incentive* documentation requirements to be satisfied as part of the overall project planning and management process.

Principle 2

Identify and document your R&D projects and eligible activities at the time they are conducted – this can improve the potential to capture associated costs in real time.

Principle 3

Document your methods for evaluating projects, identifying eligible R&D activities and recording expenditure associated with eligible activities – this ensures that there is a clear understanding of how information has been derived and enables the process to be repeated in future years.

Principle 4

Forge strong connections between those responsible for preparing and maintaining *R&D Tax Incentive* records and staff who understand the technical aspects of a project to enable a shared understanding of program requirements.

Principle 5

Ensure that strong links have been established between activity and expenditure records.

What sort of records should a company decide to keep?[2]

It is up to each company what documents they should keep and each company will approach the task of documenting eligible research and development activities and recording eligible expenditure differently.

Whilst the precise records kept will vary, a 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'.

Companies will have their own systems and methods for evaluating projects and activities and for preparing their applications for registration. This will depend on many factors including the size of the company, the nature of the R&D work being undertaken and the company's information requirements and systems.

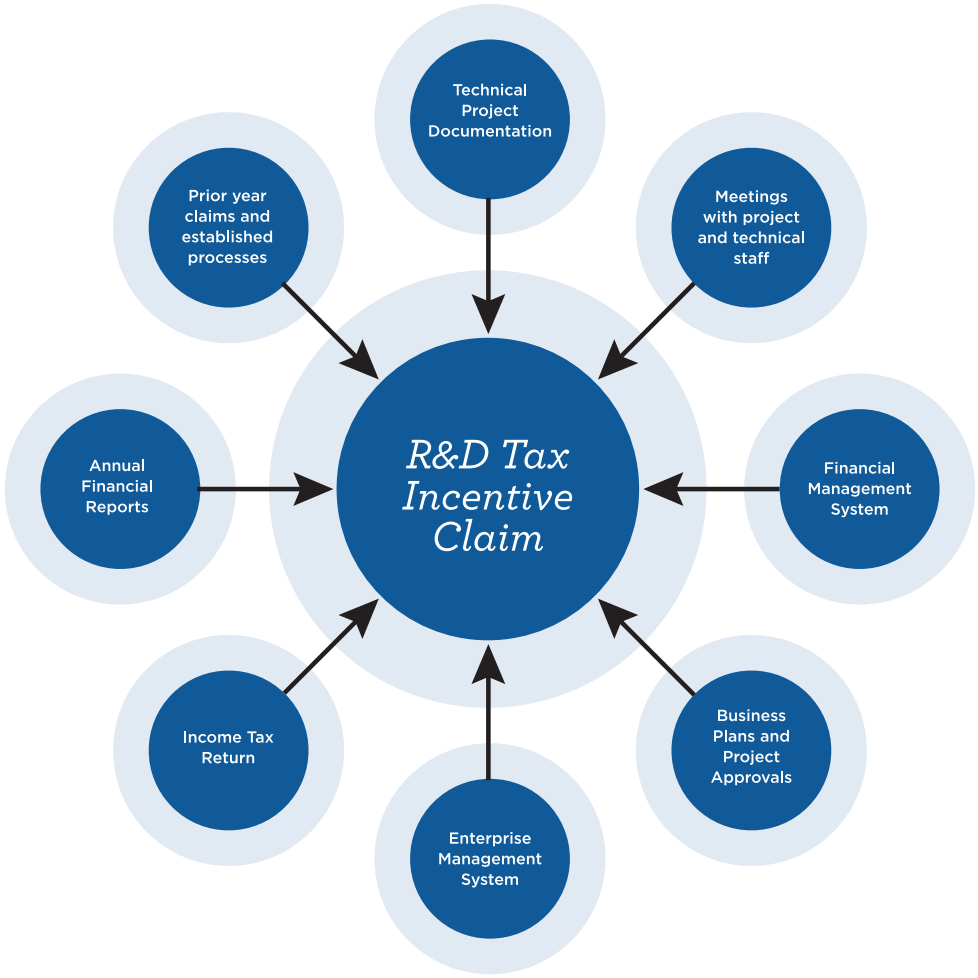
Companies will derive information for the preparation of the registration from a variety of sources and the quality of this information will underpin the integrity of their claim. Companies with a registration history may have this process already developed and documented, whereas new registrants will need to identify what information and figures they need to collate and how to obtain the data.

Some of the sorts of records that should be kept are included in the following diagram.

2 http://www.austlii.edu.au/au/cases/cth/aat/2012/386.html, http://www.austlii.edu.au/au/cases/cth/aat/2012/743.html

3 More information is available in the *Customer Information Guide* on the business.gov.au website.

FIGURE 3: Sources of information for the preparation and management of *R&D Tax Incentive* claims



Records must demonstrate eligibility of "core" and "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?

For core R&D activities records 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; and
  - trade journals.
- documents detailing the experiments undertaken, the experiments' results, the analysis of the results, and the subsequent changes implemented to the experiments

For supporting 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 activity 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.

The records that need to be kept will vary depending on the nature of the 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 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.

Is your company compliance ready – questions AusIndustry could ask

As part of its risk review processes to ensure the eligibility of a company's R&D activities, AusIndustry may ask the following questions. More information about the different types of reviews and findings AusIndustry may undertake is available in *Compliance Readiness – A Guide to Risk Reviews and Findings* which is available on the business.gov.au website.

In being compliance ready, a company should have kept and be able to produce records that support their response to these sort of questions.

- Was an experiment or set of related experiments carried out? If yes, has the company described that activity.
- What was the new knowledge that the company was seeking to generate?
- What existing technology was available and why did it not meet the company's needs?
- Could the proposed solution to the 'knowledge gap' be found using current knowledge, information and experience? If not, why not?
- Did the experimental work progress in a systematic way? If yes, how?
- If an eligible activity was identified, how long did it retain the characteristics of an eligible activity – when did it stop being an eligible activity?
- Were any of the activities specifically excluded (in the legislation) from being core R&D activities?
- Were there any non-experimental activities that were directly related and necessary to conducting the eligible experimental activities?
  - Was the activity undertaken as a normal part of business operations and what was its link to eligible R&D activities?
  - Was there a purpose to the activity other than to support the core R&D activity? If so, what was that purpose?

Compliance readiness checklist

The following checklist shows how the principles of good record keeping and management might be applied by a company as part of its approach to R&D tax compliance management. Considering, and being ready to answer, the above questions will help a company be compliance ready.

This is not intended to be a definitive or exhaustive checklist, but it may assist your company in implementing good record keeping and related business processes. This may be especially useful to companies new to the *R&D Tax Incentive*.

Identifying eligible R&D activity

- Review and understand the *R&D Tax Incentive's* basic requirements including the key legislative definitions of core and supporting activities.
- Ensure that the proposed core R&D activity involves 'an experiment or a set of related experiments'. Note that activities with similar objectives, addressing the same or similar knowledge gaps can be grouped together as a distinct core R&D activity.
- Prepare and retain a short statement that can be provided as a record of your company's self-assessment rationale (i.e. the steps that you took in order to establish the eligibility of your claim).
- It is important that the method, including any judgements and underlying assumptions for extracting expenditure from accounting systems and assigning that expenditure to eligible R&D activities is clearly documented.

Record keeping

- Prepare a template to use for evaluating projects and activities and for meeting with the project's key technical staff.
- Record externally sourced information such as literature reviews, patent searches and scientific journals.
- Capture and record specific technical project documentation, including conversations with relevant technical project staff or from external information sources.
- Keep expenditure records such as timesheets, general ledger entries and invoices to verify the amount of expenditure incurred on R&D activities. Further guidance on electronic record keeping can be found on the ATO's website at ato.gov.au.
- Prepare a spreadsheet or template that allows for eligible R&D costs to be consolidated into a format which allows for direct input into the ATO Research and Development Tax Incentive Schedule.
- Continue to make file notations and update records to track the progress of an R&D activity.

Management systems

- Aligning R&D tax requirements with existing processes, including accounting and project management systems, may assist in identifying and costing eligible R&D activities.
- Larger businesses may consider developing a more detailed 'R&D Tax Incentive Manual' which lists all of the tasks and processes associated with the preparation of applications for registration and for maintaining appropriate records. This may be considered an appropriate measure due to the variety of business systems used to collate R&D tax information, the size and complexity of projects and the diverse groups of people involved in the process.
- Staff responsible for coding expenses to eligible R&D activities and deciding on eligible R&D expenditure need to understand the program's requirements and ideally have a good understanding of the R&D project and its activities.

Preparing Effective Applications

Among the most important compliance records are your company's registration and findings applications to AusIndustry. A complete, thorough application form that is supported by appropriate records will help companies comply with the requirements of the R&D Tax Incentive.

This is illustrated through two case studies.

The case studies provide a description of the respective business R&D scenario and commentary around relevant record keeping and business management issues faced by the company.

This information is then transcribed into the relevant application forms, with simple observations on how the information provided can mitigate compliance risk under a range of AusIndustry compliance assurance processes.

Registration of R&D Activities[3]

The first case study, **DataCoAnalytics**, highlights the importance of the registration process in providing clear and accurate descriptions of projects and activities.[4]

The case study illustrates the principles of good registration of R&D activities and why it forms an important part of compliance readiness.

Companies should invest time in ensuring that they have the appropriate systems and processes to effectively identify, evaluate and record eligible R&D activities and their associated expenditure – this is the single best way to de-risk participation in the program. In completing their registration the company uses the AusIndustry Application for Registration of R&D Activities smart-form and associated Application Notes.

Advance/Overseas Finding Application

The second case study, **Biofnatics**, is an application for an Overseas Finding which illustrates the detail and type of information AusIndustry is looking for in assessing your application.

This case study outlines the company's R&D project and the rationale and records for the self-assessment. Specifically, the case study shows:

- the level of detail needed for AusIndustry to assess its application
- the self-assessment process for core and supporting R&D activities
- supporting activities for a future core R&D activity
- appropriate record keeping, and
- the importance of prior planning and documentation.

4 This case study is part of the *R&D Tax Incentive ICT Guidance* (Sept 2012) which is available from business.gov.au.

Case Study One: Registration of R&D Activities

DataCoAnalytics

This case study illustrates the principles of a good registration and why it forms an important part of compliance readiness. The case study also shows how by providing clear and accurate information in their application for registration, DataCoAnalytics:

- minimises their compliance risks including the likelihood of being selected for a *Pre-Registration Review*, *Desk Review* or a *Finding about a Registration Application*; and
- is better prepared to provide the necessary information as part of a *Registration Review* or *Post Registration*.

Business Scenario

DataCoAnalytics has received an extremely large data set courtesy of the Square Kilometre Array (SKA), and plans to use it to produce a primary school teaching package ("SkyWonder") which will use the data to create 3D visual depictions of areas of outer space.

The company conducted a range of activities in order to research, develop, test and finalise its product. After searching the market place, DataCoAnalytics could not find any existing tools or solutions it could apply to query the SKA data set in the way needed for SkyWonder. This meant that the company needed to develop and then implement a new approach to solving its problem.

DataCoAnalytics embarked on a project to create a new algorithm that could search the SKA data set to locate elements necessary to display 3D images based on parameters a user has selected. DataCoAnalytics also proceeded to develop the graphical user interface (GUI) for SkyWonder using the Java and OpenGL programming languages.

To access the *R&D Tax Incentive* DataCoAnalytics prepared the following registration and categorised the various activities as either core or supporting. In the course of identification and claiming of R&D activities the company deemed that it would register one core R&D activity and one supporting R&D activity.

What records did DataCoAnalytics keep?

As part of their experimental work, DataCoAnalytics:

- retained the results of test runs of the algorithm, including 'failed' tests that produced incorrect results, and documented the results of running these prototypes on test data from the SKA
- kept version repository logs with sufficiently detailed comments on the prototypes indicating the iterative development, testing and improvement of the algorithm including weaknesses that were identified and rectified in successive versions
- managed their R&D using a project plan, including a risk management plan, that set out the business aims and technical hypotheses, explained the design of the experiment to test the hypotheses, described the observations and analysis that resulted from each of the experimental processes they engaged in; and
- kept a register of all of the relevant technical scoping and business planning documents which could be used to substantiate their claim should they be subject to an AusIndustry compliance assurance review.

A *Sample Application Form – Registration of R&D Activities* is available on business.gov.au.

Case Study Two: Application for Advance/Overseas Finding

Biofnatics Pty Ltd

The company identified early that it needed to have an Overseas Finding in place so it could claim a tax offset for its overseas R&D activities. The case study below outlines the company's R&D project and the thinking behind its self-assessment. Specifically, the case study shows:

- the level of detail needed for AusIndustry to assess its application
- the self-assessment process for core and supporting R&D activities
- examples of supporting activities for a future core R&D activity
- likely evidence requirements for record keeping; and
- the importance of prior planning and documentation in self-assessing the eligibility of R&D activities.

Business Scenario

Biofnatics are an Australian company engaged in the development of medical devices for surgical applications. They have embarked on a development project to create an improved biodegradable coronary stent device for use in heart surgery.

As part of their initial planning of the project, Biofnatics identified that within the market for coronary stents, existing biodegradable stents had a number of functional limitations when implanted in human patients, including low material strength, high rates of inflammation and a slow rate of biodegradability.

Biofnatics believed that they could develop an improved stent that could overcome these limitations. They developed a program of research and development centred on the:

- identification of suitable candidate biodegradable polymer blends
- subsequent design and modelling of stents with the properties of the candidate polymers
- feedback from evaluations of the modelling experiments into the additional polymer blending and centrifuge moulding
- manufacture of prototype stents; and
- clinical trials of these prototype stents in humans.

As part of their project planning, Biofnatics considered how the *R&D Tax Incentive* could be of benefit to their project. On evaluation of the guidance material for the *R&D Tax Incentive* they quickly realised that as certain aspects of their project would require work to be undertaken overseas, Biofnatics would have to apply for and receive an Overseas Finding from Innovation Australia for the activities in their project.

Even though they have received an Advance/Overseas Finding for their project, Biofnatics will be required to register their activities under the *R&D Tax Incentive* program for each income year in which they conduct eligible R&D activities.

Tips for Findings Applications

- Provide enough detail to assess the eligibility of R&D activities
- Differentiate between core, supporting, excluded and ineligible R&D activities
- Focus on what is being done in the activities and not the outcomes
- Describe the hypotheses (project objectives are not hypotheses)
- Describe experiments that address the hypotheses.

• Tips specifically for Overseas Findings

- Describe which aspects of the activities are being conducted overseas and the related expenditure
- Provide evidence of why the activity cannot be conducted solely in Australia
- Explain the significant scientific link to an Australian core R&D activity.

What records will Biofnatics Keep?

Biofnatics will ensure that they maintain appropriate business documentation to verify the eligibility of their activities and substantiate their claim for the *R&D Tax Incentive*. Their effective management, good planning and robust business systems will be fundamental ingredients to successful innovation.

In relation to the individual R&D activities themselves the company will need to be careful to maintain records that demonstrated a systematic progression of work based on the principles of established science and proceeding from hypothesis, observation and evaluation and leads to logical conclusions. For example they plan to:

- Retain the results of polymer blending experiments, including 'failed' blends with material properties that did not meet the desired requirements
- Keep versions of stent designs for Finite Point Analysis with sufficiently detailed comments on the prototypes indicating the iterative development, testing and improvement of the designs including weaknesses that were identified and rectified in successive versions
- keep records of the supplier identification and procurement process for the preparation of the polymer properties report and the supply of the polymer materials, and for the manufacture of the prototype stents, along with quality control reports in both cases
- keep records of the planning for the clinical trials, including the identification of potential clinics and surgeons, and ethics clearance processes.
- plan and conduct their R&D project in a systematic way.

A *Sample Form – Application for Advance/Overseas Finding* is available on business.gov.au.

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