IT 2552 - Income tax : research and development (R & D) - costing of expenditure

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TAXATION RULING NO. IT 2552

INCOME TAX : RESEARCH AND DEVELOPMENT (R&D) - COSTING OF EXPENDITURE

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OTHER RULINGS ON TOPIC: IT 2442, 2451

PREAMBLE IT 2442 and IT 2451 laid down general guidelines on various interpretational aspects of section 73B of the Income Tax Assessment Act which provides a special concession for Australian companies in respect of expenditure incurred on eligible R&D activities.

2. This Ruling deals with some of the practical problems encountered by companies. These relate mainly to the identification and calculation of "salary" and "other" expenditure incurred directly in respect of R&D activities. These and other matters are discussed under the following headings:

	Paragraphs
Salary expenditure	4 - 12
Other expenditure	13 - 21
Cost of prototype	22 - 29
Miscellaneous	30
Examples of calculations	Appendices A - D
Common questions and answers	Appendix E

3. The methods set out in this Ruling for calculating "salary" and "other" expenditure incurred directly in respect of R&D activities are not intended to be definitive. However, where a method other than one in this Ruling is adopted by the taxpayer, the method should be consistent with the principles contained in the law and this and related Taxation Rulings. Where an alternative method is adopted, the taxpayer would need to demonstrate the appropriateness of the method used.

RULING Salary expenditure

4. "Salary expenditure" for the purposes of the R&D concession includes only the salaries of those employees who are actually engaged in carrying out an eligible R&D activity, i.e. the salary of:

- researchers engaged in the conception and/or creation of new knowledge and products,
- persons performing technical tasks in support of R&D activities usually under the direction of a researcher, such as, assistants and persons keeping records, preparing charts and graphs, operating equipment and writing computer programs, and
- supervisors of researchers and technical staff.

5. Salaries of "support staff", for instance, general supervisors or administrative staff, who are not directly connected with the research activity should not be included as salary expenditure. This expenditure should be taken into account as "other expenditure".

6. Where an employee performs other activities in addition to work on eligible R&D projects, it will be necessary to apportion that employee's salary between R&D and non-R&D activities (see IT 2442). It is expected that the company will be able to demonstrate, by reference to appropriate records such as timesheets, jobcards or diaries, the amount of time spent on R&D activities. Where a company is unable to determine exactly what each employee has been paid for each hour worked on R&D (refer IT 2442), it would be acceptable to use an annualized hourly rate calculated on the following basis:

amount of salary* / total number of hours worked (working days x hours per day)

* including holiday pay, long service leave, sick pay, allowances, bonuses, overtime payments, and penalty rate payments. Amounts set aside as provisions for these expenditures should not be included in the calculations.

7. For example, in a case where salary and other payments totalled $30,000 and the employee worked 8 hours per day and 226 days in the year, the employee's hourly rate would be:

$30,000 / 226 days x 8 hours per day

= $16.59 per hour.

If the employee spent 120 hours on eligible R&D activities, the R&D salary expenditure of that employee would be:

120 hours x $16.59/hour

= $1990.80.

8. These calculations must be made for each relevant employee to

arrive at the company's "R&D salary expenditure". The average hours per day actually worked would need to be used to avoid inflating the amount of salary allocated to R&D.

9. "On-costs" would also qualify for the concession. These comprise eligible employer contributions to a superannuation fund, premiums for workers' compensation insurance and pay-roll tax. Section 73B provides that, in respect of workers' compensation and pay-roll tax, the Commissioner is to take into account R&D salary expenditure, total company expenditure on salaries and other matters that may be "relevant".

10. Where pay-roll tax and workers compensation premiums paid for R&D staff are known, the amounts should be added to the amount of R&D salary expenditure. However, if the amounts cannot be separately identified, pay-roll tax and workers compensation premiums may be allocated to R&D as follows:

pay-roll tax	+	workers compensation premiums	x	eligible R&D salaries and wages total company salaries and wages

11. Adjustments would need to be made to respective amounts in the formula in the following circumstances:

- The amount incurred for salaries and wages would need to be reduced by the amount of salary and wages exempt from pay-roll tax. An appropriate adjustment would also need to be made where salaries of certain employees receive concessional treatment under the pay-roll tax law.

- Different employees may attract different workers' compensation premiums: factory employees may attract a higher premium than that payable in respect of R&D staff. In these cases, the company should ensure that the amount allocated to R&D salary expenditure is representative of the expenditure that would have been incurred for R&D staff.

- Any rebate of workers' compensation premiums received or to be received will have to be deducted from total premiums paid.

12. Deductible contributions to a superannuation fund ought to be clearly identifiable from staff records and the relevant amounts added to the amount of R&D salary expenditure. Where this is not practicable, eligible contributions to a superannuation fund would need to be allocated to R&D in accordance with paragraph (b) of the definition of "salary expenditure" in sub-section 73B as follows:

eligible contributions to superannuation fund in respect of the class of employees to which R&D staff belong	x	eligible R&D salaries and wages (per par.7 above) total company salaries and wages of that class

Other Expenditure

13. A company will incur a number of administrative costs and overheads as a result of conducting its R&D activities and as a result of employing R&D staff. For instance, these costs may include the salaries of a supervisor, typist, pay-roll and recruitment staff and their on-costs. It may also include overheads, such as rent, light and power, property rates and taxes, cleaning and certain types of insurance.

14. The expenses which can be claimed as "other expenditure" are prescribed by sub-section 73B(1) which restricts such expenditure to that "incurred ... directly in respect of R&D activities". The type of expenditure that qualifies for deduction under sub-section 73B (1) must turn on the facts of each particular case. However, it is considered that expenditure is "directly in respect of R&D activities"

- where the carrying on of eligible R&D activities contributed to the incurring of all or an identifiable part of the expenditure

OR

- where the conduct of eligible R&D activities by the company would be materially impaired if the expenditure were not incurred.

In general, this expenditure falls into two classes.

15. The first class encompasses expenditure which could reasonably be expected to be identified as directly relating to an eligible research project. This may include:

- Overseas and domestic travel by research and technical officers working on an approved project.
- Motor vehicle expenses which could be apportioned to R&D projects on a basis similar to that required under the substantiation provisions (section 82KTF).
- Parts and materials used in the course of a project and which can be clearly identified from invoices and other source documents.
- Other expenses which are attributable solely to an approved project, e.g.
    - leasing charges for a computer used solely in connection with an approved project,
    - legal fees incurred in taking out a patent during an eligible R&D project.

16. The second class encompasses expenditure which may not be clearly identifiable as R&D expenditure because it relates to a number of business operations but some of that expenditure may

nonetheless include a component which is applicable to an eligible R&D project. The onus is on a company to show the nexus, in accordance with the principles explained in paragraph 14 above, between the incurrence of the expenditure and the relevant R&D project. A company would also be expected to demonstrate the accuracy of the amount of expenditure allocated to a particular R&D project. As a general rule, the following expenses (referred to later as "eligible apportionable expenses") would be accepted as being connected to eligible R&D projects:

- Cleaning.
- Consumables; for instance, expenses such as oils, grease and cloths used generally, including R&D activities.
- Electricity, gas and water.
- Insurance premiums to the extent that they are relevant to R&D activities. (Insurance for loss of profits, product liability or finished products would not be eligible).
- Interest paid to arms' length sources on funds used solely as working capital (interest payments must be segregated to exclude interest paid, for instance, on funds used to finance takeovers or to service loans from associates).
- Leasing charges on office equipment.
- Pay-roll costs.
- Postage.
- Printing and stationery.
- Rates and land taxes.
- Recruitment.
- Rent of a building used partly for R&D purposes.
- Repairs and maintenance of a building used partly for R&D purposes.
- Salaries of support staff who perform some duties connected with eligible R&D activities (for instance, cleaners, typists, supervisors) plus associated costs and on-costs.
- Security.
- Stationery.
- Subscriptions to industry associations and for technical journals.
- Telephone and telex.
- Training.

17. Ineligible expenses would include:

- Advertising (for instance, of a company's product).
- Audit fees.
- Bad debts.
- Company establishment and other fees incurred under the companies code in relation to the administration of the company.
- Costs incurred in preparing taxation returns.
- Depreciation which is not deductible under section 73B for qualifying plant.
- Directors' fees.
- Distribution and selling expenses.

- Donations.
- Employee benefits such as canteen and recreational facilities.
- Entertainment expenses.
- Factory overheads.
- Fringe benefits and Fringe Benefits Tax.
- Grounds and gardens - maintenance costs.
- Insurance premiums on matters unrelated to R&D such as loss of profits and product liability.
- Legal expenses not associated with any approved research project, e.g., legal expenses incurred in carrying out a patent search prior to undertaking a research project or in taking out a patent after a successful project.
- Patents and trademarks in marketing a new product or technology, or as a result of R&D activity.
- Rent paid for premises which are not to any extent used in R&D activities.
- Salaries, associated costs and on-costs of support staff not linked with R&D activities and of staff employed in areas such as distribution, sales, marketing and debt collection.
- Tender costs.

18. In respect of other eligible expenses, it is accepted that it may be impracticable for many companies to examine each expense, decide if there is an R&D component and to then calculate the portion applicable to the R&D component. In these cases it would be open to the company to apportion the expenses on some basis which the company can show allocates expenses to R&D activities with a reasonable degree of accuracy. The method of allocation, though, may depend on the internal accounting procedure adopted by a company. Internal accounting procedures generally come within one of the following:

- R&D is absorbed within the company's administration cost centre. Separate records are prepared for this cost centre in addition to records for other cost centres such as selling and distribution or manufacturing.

- R&D is undertaken by a separate section which is a cost centre in its own right. In such a case, records are prepared for this centre. Separate records are kept for the administration centre and other cost centres.

- Only one set of accounts is prepared.

19. In the first and third cases, the administration cost component of eligible R&D expenditure could be determined as follows:

$$\text{eligible apportionable expenses} \times \frac{\text{eligible R\&D salaries and wages}}{\text{total company salaries and wages}}$$

Examples of calculations using the above formula are provided at Appendices A and B respectively.

20. In the second case, where R&D is undertaken by a separate

section but administrative services are still provided by an administrative division, it is necessary to calculate the eligible expenses in the administration section as well as the eligible expenses of the R&D section.

The eligible expenses in the R&D section could be determined as follows:

eligible apportionable expenses of R&D section	x	eligible R&D salaries and wages total R&D salaries and wages

The eligible expenses of the administration section can be determined as follows:

eligible apportionable expenses of administration section	x	(eligible R&D salaries and wages + eligible indirect R&D salaries and wages) total company salaries and wages

The above two formulas reduce to:

$$[(a) + (b)\ [(c) + (d)]] / (c) \times (e)$$

where (a) = eligible apportionable expenses of R&D section
(b) = eligible apportionable expenses of administration section divided by total company salaries and wages
(c) = total salaries and wages of R&D staff
(d) = total indirect salaries and wages of R&D section
(e) = eligible R&D salaries and wages

N.B. (c) + (d) = total labour of R&D section. This combined formula eliminates the need to calculate eligible indirect R&D salaries and wages separately.

An example of the calculation using the two formulas and the combined formula is provided at Appendix C of this ruling.

21. If the R&D centre is self-contained in terms of administration, then the administration cost of R&D is simply:

eligible apportionable expenses in the R&D section	x	eligible R&D salaries and wages total R&D section salaries and wages

Cost of a Prototype and similar works.

22. As part of an R&D project, it may be necessary to construct a prototype. This should be distinguished from the construction of pilot plant which will provide a company with lasting benefits from the production of trading stock. All expenditure associated with the construction of a pilot plant (costs of labour, materials and a portion of overheads) would need to be isolated and capitalised as part of the cost of the pilot plant which is subject to deduction at special rates of depreciation.

23. Where the prototype is constructed within the R&D section, the

costs associated with the construction of the prototype would be included in the costs of the R&D centre and subject to the concessional rate of deduction (sub-section 73B(15)).

24. However, where a prototype is constructed in a company's manufacturing/engineering division, it will be necessary to identify the costs directly associated with the construction of the prototype. This would also be so where other work is done in the manufacturing/engineering division in connection with other approved R&D projects. Eligible expenditure would include the following costs:

Labour: the labour costs of staff engaged directly in the construction of the prototype. All other labour costs (indirect labour of the foremen, factory managers, storemen, supervisors and cleaners) are to be included in the calculation of overheads.

Materials: the costs of which could be substantiated from invoices and other source documents as having being applied to a particular prototype.

Overheads: calculated on a reasonable apportionment of expenditure having regard to items of eligible and ineligible factory expenses.

25. Eligible factory expenses for the purpose of calculating an appropriate portion of overheads may include:

. Cleaning.
. Consumable items such as oil, grease and cloths which are used generally including the construction of the prototype.
. Costs of transporting a prototype to another location for testing.
. Electricity, gas and water.
. Freight in.
. Indirect materials and supplies.
. Leasing charges.
. Rent.
. Repairs and maintenance of plant, machinery and the building.
. Safety (for instance, protective clothing or fire protection).
. Salaries and wages of eligible indirect staff (for instance, foremen, supervisors, cleaners) plus associated costs and on-costs.
. Security.
. Stationery.
. Telephone and telex.
. Tools and equipment.
. Waste removal.

26. Ineligible expenses would include:

. Depreciation.
. Employee benefits such as canteen facilities.
. Factory amenities.

. Freight out.
. Fringe benefits.
. Gardening.
. Motor vehicle expenses.
. Royalties not associated with R&D activities.

27. The above lists of eligible and ineligible expenditure are not exhaustive. The classification of other expenditure should be made with reference to the criteria mentioned in paragraph 14 and the lists contained in paragraphs 15-17 above.

28. Other eligible expenses within the factory can be aggregated and the amount allocated to R&D could be determined as follows:

$$\text{eligible apportionable expenses of factory} \times \frac{\text{eligible direct labour costs of prototype}}{\text{total direct labour of factory}}$$

The administration cost component of eligible R&D expenditure could be determined as follows:

$$\text{eligible apportionable expenses of administration section} \times \frac{\text{(eligible R\&D direct labour + eligible R\&D indirect labour)}}{\text{total company salaries and wages}}$$

The two formulas above reduce to one formula as per paragraph 19. An example is provided at Appendix D of this ruling.

29. If the factory is self-contained in terms of administration, then the factory overhead allocated to R&D is simply:

$$\text{eligible apportionable expenses of factory} \times \frac{\text{total eligible labour costs of prototype}}{\text{total factory salaries and wages}}$$

Miscellaneous.

30. Companies making claims for R&D are expected to comply with the guidelines on substantiation contained in paragraphs 48-50 inclusive of IT 2442. Where a company cannot comply with these guidelines, it is open to it to demonstrate to the Commissioner that an alternative accounting and reporting system or basis for calculating an R&D deduction produces, as far as practicable, accurate claims consistent with the law and its interpretation. A claim for R&D expenditure which cannot be substantiated by reference to reliable source documents cannot be allowed.

COMMISSIONER OF TAXATION
17 August 1989

APPENDIX

APPENDIX A - R&D CONDUCTED WITHIN THE ADMINISTRATION DIVISION

Apportionable Administrative Expenses	Ineligible	Eligible-Charged Separately	Eligible-Expenses

	$	$	$
advertising	13200		
audit fees	42100		
bad debts	10600		
banking charges	7400		
cleaning fee			32600
depreciation	11800		
directors' fees	40600		
electricity, gas and water			23200
entertainment	9000		
insurance - fire and general			21000
leasing - general			62000
patents and trademarks	900		
postage			7700
printing and stationery			16200
provision for doubtful debts	11500		
rent			32300
salaries-R&D staff		82600	
-indirect (administrative)			108200
-R&D management			42700
-other (eg legal)	72000		
subscriptions			16200
superannuation-R&D staff		4215	
-indirect			5521
-R&D management			2179
-other	3674		
telephone and telex			19600
travel (domestic)	41600		
	264374	86815	389400

Total Company Salaries and Wages

factory - direct	$731600
- indirect	271000
administration (including R&D)	305500
selling and distribution	63800
	$1371900

R&D staff prove that 50% of their time is spent on eligible R&D activities. Eligible R&D salaries are $41300 (50% of $82600 salary).
Administration cost of R&D

eligible apportionable expenses x eligible R&D salaries and wages / total company salaries and wages

= 389400 x 41300/1371900

= $11723

Allocation of superannuation

Assume that the employer contributions to the superannuation fund total $70000. The scheme is identical for each employee. Superannuation contributions allocated to each section would be as follows:

Factory		
Direct	70000 x (731600/1371900)	= 37329
Indirect	70000 x (271000/1371900)	= 13828
Administration		
R&D staff	70000 x (82600/1371900)	= 4214
Indirect	70000 x (108200/1371900)	= 5521
R&D management	70000 x (42700/1371900)	= 2179
Other	70000 x (72000/1371900)	= 3674
Selling and distribution	70000 x (63800/1371900)	= 3255
Total		$70000

The "on-cost" of superannuation allocated to R&D is:

superannuation contributions x eligible R&D salaries and wages / total company salaries and wages

= 70000 x 41300/1371900

= $2107

Total R&D claim

R&D salaries	$41300
R&D salary on-costs	2107
Administration costs	11723
Total	$55130

APPENDIX B - GENERAL ACCOUNTS

Apportionable Expenses	Ineligible	Eligible-Charged Separately	Eligible-Expenses
	$	$	$
accounting and audit fees	19100		
advertising	22600		
bank charges	2000		
bad debts	13200		
cleaning			8900
consumable stores			2300
depreciation	14600		
electricity, gas and water			17800
employee benefits	3700		
insurance-fire and general			4500
interest			6400
lease payments (office machines)			26100
marketing expenses	15900		
postage			2800
pay-roll tax - R&D staff		800	
- eligible admin			600
- other	300		

rent			29200
repairs and maintenance			21600
royalties	2100		
salaries - R&D staff		140000	
- eligible admin			100000
- other	391800		
staff recruitment			28200
stationery and office supplies			4700
subscriptions			5900
travel and accommodation		19300	
vehicle expenses		12700	
workers' compensation premiums			
- R&D staff		500	
- eligible admin			2000
- other	6300		
	491600	173300	261000

Administration cost of R&D

Assuming that R&D staff spend 20% of their time on eligible R&D activities, eligible R&D salaries would be $28000 (i.e., 20% of $140000).

eligible apportionable expenses x eligible R&D salaries and wages / total company salaries and wages

= 261000 x 28000/631800

= $11567

Allocation of on-costs

Pay-roll tax and workers' compensation premiums have been separately identified and R&D staff spent 20% of their time on eligible R&D activities as above. The portion applicable to R&D salary expenditure would be:

20% x (800 + 500)

= $260

Total R&D claim

R&D salaries	$28000
R&D salary on-costs	260
R&D travel and accommodation (assume 50%)	9650
R&D vehicle expenses (assume 30%)	3810
R&D administration costs	11567
Total	$53287

APPENDIX C - R&D CONDUCTED BY A SEPARATE COST CENTRE

R&D Section Expenses	Ineligible	Eligible-Charged Separately	Eligible-Apportionable Expenses

	$	$	$
consumables			5100
depreciation	16200		
field expenses		2600	
lease charges - general			10200
motor vehicle expenses		7300	
parts and materials		13100	
printing and stationery			1900
repairs and maintenance		2700	
salaries-R&D staff		80000	
-indirect			24900
superannuation			
-R&D staff		9782	
-indirect			5490
telephone and telex			2600
travel (domestic)	8000		
	24200	115482	50190

Assume that: 1) eligible apportionable administration section expenses = $104880

2) total company salaries and wages including R&D salaries and wages = $400000

R&D staff prove that 50% of their time is spent on eligible R&D activities. Eligible R&D salaries are $40000 (i.e., 50% of $80000).

R&D section expense component equals:

eligible apportionable expenses of R&D section x eligible R&D salaries and wages / total R&D salaries and wages

= 50190 x 40000/80000

= $25095

Administration expense component equals:

eligible apportionable expenses of administration section x (eligible R&D salaries & wages + eligible R&D indirect salaries & wages) / total company salaries & wages

= 104880 x (40000 + 12450*)/400000

= $13752

* [R&D indirect salaries and wages (as per R&D section expense formula above)

= 24900 x 40000/80000

= $12450

Alternatively using the combined formula (as per paragraph 20):

[(a) + (b) [(c) + (d)]] / (c) x (e)

where (a) = eligible apportionable expenses of R&D section

(b) = eligible apportionable expenses of administration section divided by total company salaries and wages
(c) = total salaries and wages of R&D staff
(d) = total indirect salaries and wages of R&D section
(e) = eligible R&D salaries and wages

$$= \frac{50190 + \frac{104880}{400000}}{80000} \times \frac{80000 + \frac{24900}{}}{} \times 40000$$

= $38847

On-cost of superannuation

= R&D staff superannuation x eligible R&D salaries and wages / total R&D salaries and wages

= 9782 x 40000/80000

= $4891

Total R&D claim

Field expenses (assume 100%)	$2600
Motor vehicle expenses (assume 40%)	2920
Parts and materials (assume 80%)	10480
Repairs and maintenance (assume 70%)	1890
Salaries	40000
Superannuation	4891
Administration expenses	13752
R&D section expenses	25095
Total	$101628

APPENDIX D - FACTORY RATE (in conjunction with Appendix A)

Factory Expenses	Ineligible	Eligible-Charged Separately	Eligible-Apportionable Expenses
	$	$	$
canteen facility	6200		
cleaning fee			82000
depreciation	32600		
electricity			107100
equipment hire			6300
freight in			3900
lease charges - general			110500
motor vehicle expenses	9800		
parts and materials		93100	
printing and stationery			2300
rent			83700
repairs and maintenance			72400
safety			36200

security			36900
stationery			2000
subscriptions			1800
superannuation - direct		37329	
- indirect			13828
tools and equipment			14300
telephone and telex			3200
training			21600
travel (overseas)		22900	
wages - direct labour		731600	
- indirect labour			271000
waste removal			18300
	48600	884929	887328

The direct labour cost of constructing the prototype is $7316.

Factory expense component equals:

eligible apportionable expenses of factory x eligible R&D direct labour / total direct labour of factory

= 887328 x 7316/731600

= $8873

Administration expense component equals (using expense details from Appendix A):

eligible apportionable expenses of administration section x (eligible R&D direct labour + eligible R&D indirect labour) / total company salaries and wages

= 389400 x (7316 + 2710)/1371900<
= $2846

[R&D indirect labour (as per factory expense formula above)

= 271000 x 7316/731600
= $2710

Alternatively using the combined formula (as per paragraph 20):

$$[(a) + (b)\ [(c) + (d)]] / (c) \times (e)$$

where (a) = eligible apportionable expenses of factory
(b) = eligible apportionable expenses of administration section/ total company salaries and wages
(c) = total direct labour of factory
(d) = total indirect labour of factory
(e) = eligible R&D direct labour

$$= \frac{887328 + \frac{389400}{1371900}\ (731600 + 271000)}{731600} \times 7316$$

= $11719

Cost of prototype:

Direct labour (as per costed timesheets)	$7316
Direct parts and materials (as per cost cards)	12000
Administrative expenses	2846
Factory expenses	8873
Overseas travel (assume 40%)	9160
Total	$40195

APPENDIX E - COMMON QUESTIONS AND ANSWERS

(The comments in this Appendix are for general guidance and should be read in conjunction with the text of this Ruling and Taxation Rulings IT 2442 and IT 2451.)

Question 1

A company is undertaking greenfields exploration. Section 73B of Income Tax Assessment Act (ITAA) excludes exploration for the purpose of determining the size or quality of an ore body. If the company wishes to claim the tax incentive for the greenfields exploration, and as exploration in these circumstances may or may not be an excluded activity, who decides its eligibility: the Australian Taxation Office (ATO) or the Industry Research and Development Board (IRD Board)?

Comment

While the ATO administers section 73B, the IRD Board has sole responsibility for determining whether an activity is eligible R&D in terms of the legislation. The IRD Board is able to assist a company determine whether an activity is eligible R&D.

If the ATO undertakes an audit of a company and doubts the eligibility of an activity, the ATO must refer the question of eligibility to the IRD Board and the ATO is then bound to accept the determination made by the IRD Board. The ATO cannot make a decision regarding eligibility.

Question 2

Section 73B claims invariably involve taxpayers making apportionments and estimates. What level of disclosure in relation to such activities will protect against penalties?

Comment

It should not be necessary for a company to attach any additional documents to the return other than those requested in the return form and the accompanying instructions. The company will be expected to retain working papers for 7 years (section 262A of ITAA) showing how the amounts claimed have been calculated. In the event that the working papers upon which a company's claim is based are found to be false or misleading in a material particular and that statement is reflected in claims made by the company in the

company's taxation return, statutory additional tax will be attracted.

Question 3

A company puts forward what it considers to be a genuine R&D claim. The claim is later rejected because the activities are not considered by the IRD Board or ATO to be eligible R&D activities. Will additional tax (penalty) be charged?

Comment

A preliminary point to note is that the ATO would not, of its own accord, disallow a claim on the basis that it is not an eligible R&D activity: the ATO relies on determinations made by the IRD Board.

If an activity is deemed to be ineligible by the IRD Board, so that no claim should have been made for expenditure incurred in respect of that project, additional tax will only be attracted under section 223 if a false or misleading statement or omission of a material particular has been made. It follows that the application of section 223, and the remission of any section 223 additional tax under section 227, can only be determined in the light of the facts of each particular case. It is not possible to state categorically whether a penalty by way of additional tax will be attracted. Nor is it possible to state the extent to which the statutory additional tax will be remitted in a particular case. Guidelines on the remission of additional tax imposed pursuant to section 223 are set out in IT 2517. However, where a genuine claim has been made and no false or misleading statement or omission of a material particular has occurred, additional tax (penalty) under section 223 will not be attracted.

Question 4

In a situation where part of the R&D is undertaken by an outside contractor, what invoicing details are required to include the contract in the claim?

Comment

When including in a claim a fee paid to an arm's length contractor, the following details should be available for substantiation purposes:

- Relevant dates.
- The invoice should contain sufficient detail to ascertain the amount of eligible R&D expenditure.
- A description of the activities performed by the contractor in order to link the fee with a particular R&D project. This information may be provided in the contract of performance or in the research report prepared by the contractor.

It should be noted that if the contract is with an associate, the fee must be charged on an arm's length basis.

Question 5

What degree of substantiation does the ATO require in the calculation of personnel hours dedicated to R&D? To what degree can they be summarized e.g., computer print out detailing person involved, job number and hours?

Comment

Substantiation of time spent on eligible R&D projects is of course required in respect of those R&D staff who actually carry out the R&D project (that is, the researchers and technicians). The form that substantiation takes depends partly on the circumstances. Where possible, timesheets should be retained. These are regarded as the most accurate and persuasive evidence of hours worked. However, it is acknowledged that it may not always be practicable, for whatever reason, to retain timesheets. For instance, the number of employees may make it impractical or onerous for the company to retain individual timesheets. In such a case, a summary sheet or computer printout would be acceptable so long as the ATO could be satisfied that the information is accurate and is safeguarded against manipulation; that is, it is as reliable as a timesheet.

It should be noted that in some cases employees may also have to demonstrate the time spent on non-R&D activities if it becomes apparent that they do not work a standard number of hours each day. This of course would be necessary to calculate an employee's hourly rate of pay and thus the cost of employing that person on R&D activities.

No timesheets need to be retained for R&D substantiation purposes in respect of staff not directly related to R&D, even where a portion of their salaries may be allocated to R&D as a component of "other" expenditure.

Question 6

What does the ATO wish to see included in the return from the viewpoint of substantiation? For example, how does one disclose the basis of the calculations supporting a claim for overheads?

Comment

As a result of self-assessment, the ATO no longer requires detailed documentation to be attached in support of a claim. Since a company's return will not, before an assessment is made, be subject to technical scrutiny, the company is only required to provide the information requested in the return form and in the associated instructions.
There is no need to show details such as the basis of calculating overheads in the return. For substantiation purposes, as is the case with any item of expenditure, companies will have to retain working papers for 7 years (section 262A ITAA) showing how the R&D components were calculated.

Question 7

How would ATO regard a company that, despite its best efforts, is having difficulties in maintaining the discipline of timesheets?

Comment

If a company expects to make a claim for R&D salary expenditure, it must maintain adequate records to support that claim. It is the company's responsibility to satisfy the ATO of the accuracy of how time is allocated between R&D and non-R&D activities. The most accurate and the most persuasive method of allocating time clearly is to maintain timesheets or jobcards. The more a company strays from this, the greater is the onus on the company to show that the allocation of time is accurate. The company must be able to satisfy an auditor of the accuracy of the system, whether it be timesheets or another method.

An example of where detailed timesheets need not be kept would be where an employee works exclusively on eligible R&D activities. Similarly, timesheets need not be kept where an employee works on long term projects of which most are eligible R&D activities and some are ineligible, and the ratio of time devoted to the 2 types of activities is fairly constant. In such a case, it would be acceptable if the employee simply maintained a diary of activities rather than a detailed timesheet.

Question 8

Is it true to say that all R&D expenditure ineligible for the concession has to be capitalized?

Comment

As a general rule, R&D expenditure which is ineligible for the section 73B concession would only need to be capitalized when it is also not deductible under other provisions of the income tax law. For example, R&D expenditure need not be capitalized in the following circumstances:

- The expenditure is deductible under section 51(1). This would include, for instance, certain recurrent expenses such as quality control of items in production.
- The expenditure is deductible under one of the categories provided for in section 73A; viz., payments to an approved research institute for scientific research related to the taxpayer's business or class of business; expenditure of a capital nature on scientific research related to the taxpayer's business (other than expenditure on plant, machinery, land or buildings or alterations, additions or extensions to buildings, or the acquisition of rights in or arising out of scientific research); or capital expenditure on plant used solely for scientific research. It should be noted that the definition of "scientific research" is quite different from that given to "R&D activities" in section 73B.

- The expenditure comes within Division 10B which, broadly, allows for the amortization of expenditure of a capital nature incurred in the development or purchase of a patent,

registered design or copyright, or the purchase of a licence to use a patent, registered design or copyright over the effective life of the industrial property.

Question 9

Would the ATO regard the project descriptions contained in the IRD Board registration document as amounting to full and true disclosure of the nature of the project, i.e., a full description of the project as required by the Form C instructions?

Comment

An opening point to note is that a description of the activity no longer needs to be included in the income tax return.

Nevertheless, the description in the IRD Board registration application form will still be relevant since information provided to a third party (the IRD Board) is taken into account in deciding if a false or misleading statement has been made for taxation purposes.

In this regard, whether the description of the project in the application form amounts to a full and true disclosure of the nature of the project is a question of fact to be determined in the circumstances of each case. For instance, a vague or general description would not be regarded as a full and true disclosure.

Question 10

What policy will ATO adopt on R&D audits? What is the basis of the audit initiation procedure?

Answer

Companies with R&D claims may become the subject of an audit under different programs. For example, a company may be selected for audit under the "top 100 companies" program or under any other selection system used by the ATO from time to time. An R&D claim may be examined as part of such an audit.

R&D claims of some companies are also likely to be the subject of a special audit selection program. The audits would be intended to identify and remove difficulties companies may be having in making claims for R&D. The results of the audits would also govern the extent to which further audits of R&D claims would need to be undertaken in order to achieve an acceptable level of compliance with the law.

The IRD Board can also initiate assessments of the eligibility of R&D projects claimed by companies.

Question 11

Do costs of tax agents and consultants incurred in the preparation of taxation claims qualify for the R&D concession?

Comment

Costs incurred in the preparation of taxation claims do not qualify for the 150% deduction under section 73B of the ITAA because the expenditure is not incurred directly in respect of eligible R&D activities.

Question 12

What action should a taxpayer take if it is in doubt about the success of a claim for R&D expenditure or the method for calculating the claim?

Comment

A taxpayer in these circumstances should request a specific ruling on the matter from the Commissioner prior to the lodgment of the relevant income tax return or seek a request for the Commissioner's interpretation of the law.

Question 13

What is the set-up of the IRD Board in respect of the concession, especially in terms of its technical audit facilities?

Comment

Background on the IRD Board and its role, including that in relation to technical assessments of whether activities constitute R&D, is contained in the IRD Board's published guidelines. In particular, please see R&D Tax Concession Guidelines Nos. 1, 10 and 14. Further specific information on any aspect could be sought direct from the IRD Board.