



## Tax Insights

# Draft legislation for R&D Tax Incentive changes released

### Snapshot

On Friday 29 June 2018, Exposure Draft (ED) legislation and the associated Explanatory Materials were released for public consultation. These seek to enact the 2018-19 Federal Budget announcements made on 8 May 2018 to narrow the benefits available under the current R&D Tax Incentive program.

A formal Consultation Paper was released at the same time, with the Government seeking specific feedback and public comments on the proposed implementation of a number of key issues.

These measures represent the Government's formal response to the Review of the R&D Tax Incentive originally released in September 2016 (the 2016 Review). The proposed amendments seek to address certain perceptions that the existing program requires fine-tuning to achieve the intended innovation policy outcomes of "additionality" and "spillover" benefits.

The proposed changes seek to address certain perceptions that the existing program requires fine-tuning

## Background

The Federal Budget announcements on 8 May 2018 largely endorsed most of the recommendations that were made by the 2016 Review, with the higher cap on annual refunds that was suggested by the 2030 Innovation & Science Australia Strategic Plan (2030 Report), released in January 2018, being adopted.

Despite an evident delay between the announcements and the issue of the ED legislation, which led to some speculation of potentially revenue neutral modifications, there is remarkably little change between the broad Budget announcements and the design of the proposed amendments, if any.

One point of clarity that was not evident in the original announcements is that the proposed \$150 million annual cap will now become a permanent feature of the landscape, with the sunset period of 1 July 2014 for the original \$100 million cap being repealed.

Other expected amendments, discussed below, centre on the required amendments to the clawback provisions and the general anti-avoidance provisions.

The proposed ED measures, discussed in detail below, will, once enacted, generally take effect for income years commencing on or after 1 July 2018.

## Proposed changes to refundable R&D tax offset

### Net tax benefit recoupled to corporate tax rate

Despite the net tax benefit of the R&D Tax Incentive having been deliberately decoupled from the corporate tax rate since 2011, the current progressive reductions in corporate tax rates have resulted in the Government effectively seeking to recouple the two.

Under the proposed amendments to section 355-100, the rate of the refundable tax offset, available to companies with an aggregate turnover of less than \$20 million, will be altered from the current flat rate of 43.5 per cent to a rate of 13.5 per cent over the prevailing corporate tax rate (currently standing at 27.5 per cent for entities with that level of aggregate turnover).

Effectively therefore, until the corporate tax rate falls further, the rate of the refundable tax offset will be 41 per cent. These changes to the rate of the offset mean that eligible companies will no longer see incremental increases in the net after tax benefit arising from continuing falling corporate tax rates.

However, for entities in a tax loss position, this also means that the maximum refundable amount for entities will now be 41 per cent of eligible R&D expenditure, rather than the previous 43.5 per cent.

### Annual refund cap

The ED legislation also seeks to enact the recommended annual cap on R&D tax offset refunds of \$4 million per annum, with any remaining offset amounts being treated as non-refundable tax offsets that can be carried forward to future income years.

This is achieved in the ED legislation by proposing to substantially amend section 67-30 of the *Income Tax Assessment Act 1997* (ITAA 1997) which deals with the refundable R&D tax offset. The substantive effect of the proposed amendments is that:

- The total R&D tax offset available on eligible R&D expenditure is calculated by applying a rate of 13.5 per cent plus the prevailing corporate tax rate
- The resulting tax offset is assigned into two parts, one being that part attributable to R&D activities involving eligible clinical trials (see below), and the second part being all of the remaining available offset
- The part of the offset attributable to eligible clinical trials is treated as a refundable tax offset
- The remaining part of the offset is treated as a refundable tax offset to the extent that it does not exceed \$4 million
- Any excess of the remaining part over \$4 million is treated as a non-refundable tax offset and applied in priority to the refundable offset components
- Any excess non-refundable component can be carried forward

It is beneficial that this mechanism allows the non-refundable components to be used in priority, which will maximise the refunds available (if any) in respect of the components that are refundable.

Although the introduction of a cap on refundable amounts is credible, we believe that the amounts in excess of the \$4 million cap that are carried forward should retain their character as potential refundable tax offsets. The re-characterisation of the offsets to ones of a non-refundable nature is against the ongoing legislative practice set out in subsection 65-35(2).

This provision asserts that carried forward tax offsets are applied as if they were a tax offset for that future income year. Subsection 63-10(2) then requires tax offsets arising in more than one income year to be deducted on a 'first-in, first-out' (FIFO) basis. The interaction of both of these provisions implicitly asserts that any excess tax offsets carried forward to future income years currently retain their character.

Indeed, aside from the conversion of current year excess franking credits to tax losses that can be carried forward under subdivision 36-C of ITAA 1997 (which does not fundamentally change the value or nature of the tax attribute), there are currently no other tax offsets that fundamentally change character on being carried forward.

The ability of carried forward amounts to 'fill up' unused \$4 million caps of future income years is also not unheard of – this treatment would largely parallel the mechanism of the relatively new \$200,000 non-refundable Early Stage Innovation Companies (ESIC) annual cap.

If enacted as announced after consultation, these provisions will mean that offsets exceeding the annual cap cannot be cashed out in subsequent income years even where the annual cap for that respective year is not reached. Additional compliance planning for R&D activities may be required to maximise the refund opportunities available against these annual caps.

Overall this measure will certainly still dismay start-ups with notional cash refunds under the refundable offset provisions in excess of \$4 million per annum that face difficulties in obtaining initial funding, often for long and intensive R&D programs.

### **Clinical trials defined**

Critically, it was announced that eligible expenditure on clinical trials that are registered as R&D activities would be scoped out of the refundable cap given the acknowledged opportunities for growth in the medical technology, biotechnology and pharmaceutical sectors.

This key carve-out is legislatively achieved by the amendments made to the calculation of the refundable tax offset in section 67-30, with clinical trials defined only for these purposes in subsection 67-30(1C) as follows:

*(1C) A clinical trial is a planned study of the safety or efficacy in humans of an intervention (including a medicine, treatment or diagnostic procedure) with the aim of achieving at least one of the following:*

*(a) the discovery, or verification, of clinical, pharmacological or other pharmacodynamic effects;*

*(b) the identification of adverse reactions or adverse effects;*

*(c) the study of absorption, distribution, metabolism or excretion.*

Helpfully, this definition is relatively simple and fairly uncomplicated. However, the nuances of this definition will need to be worked through further to understand the potential scope of the definition.

The ED also proposes amendments to the *Industry Research and Development Act 1986* (the IRD Act 1986) to provide the Board of Innovation & Science Australia (ISA) with the power to make findings that are binding on the Commissioner of Taxation (the Commissioner) about whether an R&D entity's activities will satisfy the definition of clinical trials in subsection 67-30(1C).

The Board of ISA (the Board) may make these findings as either part of the registration process for the R&D entity's R&D activities more generally, or as an advance finding on application by the eligible R&D entity. The EM also notes that public determinations providing general guidance on activities that would be considered to be clinical trials are also anticipated.

As a final note on the refundable tax offset changes, the recommendation for a maximum cumulative refund cap has not been accepted, potentially due to the complicated tracing and integrity provisions that would be required.

**Proposed changes to non-refundable R&D tax offset**

Unlike the two separate recommendations previously made by the 2016 Review and the 2030 Report, the Budget announced a range of tiered “R&D premiums” for the non-refundable component of the incentive, based on intensity thresholds with a view to encouraging incremental R&D spend.

**Application of tiered R&D premiums**

The proposed measures will tie the amount of the non-refundable R&D tax offset to the incremental intensity of R&D expenditure of an entity. Incremental intensity will be calculated as eligible R&D expenditure as a percentage of total expenditure, such that:

$$\text{R\&D intensity} = \text{Notional deductions} / \text{Expenditure}$$

Legislatively, the amended table in subsection 355-100(1) will allow a ‘basic’ non-refundable tax offset amount at a rate equal to the entity’s corporate tax rate. New subsection 355-100(1A) will then create a set of tiered thresholds whereby increasing levels of R&D expenditure can potentially attract ‘premium’ R&D tax offset amounts.

Effectively, one or more marginal R&D premium offsets will be calculated in accordance with the following table. The sum of the premium rates for each tier will be added to the tax offset amount calculated at the entity’s prevailing corporate tax rate to arrive at the total R&D tax offset amount.

<b>Overall R&amp;D intensity rate *</b>	<b>R&amp;D tax offset premium amount</b>
<b>Less than 2%</b>	4% for R&D expenditure between 0%-2% R&D intensity
<b>Between 2% and 5%</b>	4% for R&D expenditure between 0%-2% R&D intensity; plus
	6.5% for R&D expenditure above 2% to 5% R&D intensity
<b>Between 5% and 10%</b>	4% for R&D expenditure between 0%-2% R&D intensity; plus
	6.5% for R&D expenditure above 2% to 5% R&D intensity; plus
	9% for R&D expenditure above 5% to 10% R&D intensity
<b>Over 10%</b>	4% for R&D expenditure between 0% - 2% R&D intensity; plus
	6.5% for R&D expenditure above 2% to 5% R&D intensity; plus
	9% for R&D expenditure above 5% to 10% R&D intensity; plus
	12.5% for R&D expenditure above 10% R&D intensity

\* Calculated under new ss.355-100(1A) as *Notional R&D deductions / Expenditure*

A detailed worked example is set out in the Appendix below.

In line with these changes, the R&D expenditure threshold in subsection 355-100(3) will be increased from \$100 million to \$150 million per annum

(and the current sunset period of 30 June 2024 will be repealed). As such, for any eligible expenditure in excess of \$150 million, the R&D offset premium will be Nil, attracting only a tax offset at the prevailing corporate tax rate.

Treasury recognises that this tiered concept was widely misunderstood at the time of the announcement with some publications believing the offset to be a flat rate scheme depending on the overall R&D intensity of a company.

Rather, the proposed tiered provisions will, once enacted, completely replace the former concept of a flat rate non-refundable R&D tax offset and commensurate after tax benefit.

### **Definitions surrounding R&D intensity**

The numerator in calculating an entity's R&D intensity rate will be equal to the notional deductions determined under section 355-100. Notably this will exclude any expenditure incurred but not paid to an associate, that will be notionally deducted in the income year it is paid.

However, it is clear that the net tax benefits available under the new regime will be critically dependent on the calculation of the 'expenditure' denominator, a concept that the new ED legislation has sought to define in new section 355-115 as follows:

#### *355-115 Working out an R&D entity's expenditure*

*(1) An \*R&D entity's expenditure for an income year is the sum of the amounts covered by subsection (2).*

*(2) The following amounts are covered by this subsection:*

*(a) the expenditure incurred by the \*R&D entity for the income year worked out in accordance with the \*accounting principles;*

*(b) any amount the R&D entity can deduct for the income year as mentioned in subsection 355-100(1), to the extent the amount is not covered by paragraph (a).*

Understandably the implementation of this issue forms a substantial part of the questions posed by the formal Consultation Paper since a number of issues arise in this legislative attempt to define such a critical term.

In Australia, there is no systematic connection between the income tax law and accounting concepts or standards, and we believe that there are many potential hazards of using such a hybrid of specific tax and accounting rules.

At the outset, the use of accounting standards for these purposes within the confines of the R&D tax law is unsatisfactory, since accounting standards are significantly less precise than the taxation laws, and accounting standards do not require transactions to be measured on an arm's length basis.

Admittedly certain specific statutory tax rules do directly refer to accounting concepts or standards such as Division 240 of the ITAA 1997 which can

provide for the apportionment according to generally accepted accounting principles, between income years of 'notional interest' payable by a hirer under a hire purchase agreement. Similarly, statutory rules relating to accounting concepts and standards are found in the tax consolidation regime's asset provisions.

However, an informed examination of the implementation of the tax consolidation regime alone demonstrates that a mix of accounting and jurisprudential approaches can lead to greater complexity than if it were designed on one basis alone. Indeed, it is unlikely that the coherence of this proposed law would in any way minimise complexity and associated compliance costs as may be intended.

Indeed, we believe that the hazards that could result are adequately demonstrated by the conflation in proposed subsection 355-115(2)(a) of the tax terminology of 'incurred' together with accounting standards, which themselves distinguish between expenses and expenditures, and rely on the concept of matching rather than incurred.

Such a definition is also likely to encompass expenditure on a gross basis which will discriminate against industries which have high value production inputs. A net approach to cost of goods sold would be less discriminatory. By way of other examples, such a definition of expenditure could lead to including all accounting capital expenditures on assets, as well as any tax decline in value that is included in R&D notional deductions. Expenditure to eliminate liabilities may also not be recognised as expenditure.

In summary, we believe that this proposed definition is at best, confusing. We believe that the introduction of a clear jurisprudential approach is preferred.

It is also unsurprising that the Consultation Paper invites comments on whether these R&D intensity calculations should be based on a claimant level or as part of a broader economic group.

Despite the strengthening of the general anti-avoidance provisions discussed below, it is to be expected that taxpayers will properly structure their affairs to maximise the availability of the R&D Tax Incentive. It can be foreseen that much effort may be expended in the future on discerning the fine line between commercial structuring and contrived arrangements to maximise the tax benefits available under the R&D Tax Incentive regime.

Under any definition that is introduced, we also believe that it would be more suitable in terms of certainty to adopt a base or prior year threshold to determine expenditure, rather than a current year definition. As drafted, companies will be consistently tracking a moving expenditure target.

Nevertheless, on the basis of any definition, the new regime will undoubtedly create uncertainty in forecasting the level of the incentive available for each income year.

Although this intensity mechanism is not as blunt as was anticipated before the announcements, as drafted it will still unduly discriminate against companies with high levels of general "total expenditure", largely in

industries such as mining, manufacturing and fast moving consumer goods (FMCG).

Overall, the changes as they are intended to apply will certainly mean that companies with a low R&D intensity as defined will receive a reduced benefit going forward, whilst other companies that have a high R&D intensity may receive an increased benefit.

### Clawback consequential amendments

The announcements confirmed that the feedstock and grant clawback provisions would also be amended, since without amendment they claw back a flat rate benefit of 10%, which is unsustainable in light of the substantially reduced benefits that will now be available.

The ED legislation seeks to remake and consolidate the existing two subdivisions that currently deal with the clawbacks for R&D recoupments and feedstock adjustments.

A new subdivision 355-G will introduce a uniform clawback rule that will apply in both scenarios, and will require R&D entities to calculate a clawback amount that will reverse the full net tax benefit that has been obtained.

This is achieved by the use of a complicated formula which compares the amount of the offset claimed with the amount that would have been received if notional deductions were reduced by the clawback amounts calculated for the income year. The amounts are removed from the highest tiers. The calculations become iterative when there is more than one clawback and will be extremely complex to apply in practice.

The amounts to be included in assessable income are tax effected to reflect only the net tax benefit and ensures that the benefit of the tax deduction that would otherwise have been claimed is not removed.

The complication of the 10% additional income tax payable when R&D recoupments are received will therefore disappear going forward. This also means that any R&D recoupment clawback can now be sheltered by carried forward losses.

Unfortunately, these changes merely serve to add further layers of significant complexity to a regime within compliance areas which, of themselves, add no tax benefit.

### Part IVA to explicitly apply to R&D tax offsets

Although R&D notional deductions have always been taken to be real deductions for the purposes of the Part IVA general anti-avoidance provisions contained in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936), the Budget announcements also alluded to amendments to the general anti-avoidance provisions.

Indeed, the ED legislation seeks to amend section 177C of ITAA 1936 to explicitly extend the concept of tax benefits to include the R&D tax offset. These will ensure that the Commissioner can apply Part IVA to prevent R&D

entities obtaining tax benefits by entering into artificial or contrived arrangements to access the R&D tax offset.

The amendments to Part IVA will apply with effect from 1 July 2018 in connection with a scheme, whether or not the scheme was entered into, or was commenced to be carried out, before that day.

It is worth noting in this context the recent Federal Court of Australia (FCA) decision handed down in *Commissioner of Taxation vs. International Indigenous Football Foundation Australia Pty Ltd* [2018] FCA 528 which demonstrates the wide application of the Promoter Penalty integrity provisions to potential R&D claims.

In this case, Logan J. ordered a civil penalty of \$4.25 million to a company for acting as a promoter of a tax exploitation scheme under the first decision involving the existing promoter penalty provisions, which involved R&D claims.

With this precedent, the courts will evidently seek to maintain the integrity of these tax incentives through the imposition of heavy civil, and potentially criminal, penalties upon entities found to engage in the promotion of R&D tax exploitation schemes.

Companies will certainly need to take care that they do not fall foul of the strengthened Part IVA integrity provisions when structuring the location and operational details of future eligible R&D activities.

### Administrative R&D announcements

On the remaining recommendations made by the 2016 Review, the Government also announced that it would:

- Retain the current definition of eligible R&D activities and expenses, but has committed to developing further guidance to provide more clarity regarding the scope of these; and
- Commit to increasing resources to improve the administration and integrity of the R&D tax incentive.

In the Budget announcements, the Government committed to improving transparency by providing the ATO with the option of publishing the names of companies claiming the R&D Tax Incentive and the quantum of R&D expenditure claimed annually.

The ED legislation now proposes to insert new section 3G in Part 1A of the *Taxation Administration Act 1953* (TAA 1953) which will require the Commissioner of Taxation to publish information about the R&D activities of R&D entities claiming the R&D tax offset as soon as practicable after the end of the income year. This is similar to the existing PRRT reporting.

The information that will be published will encompass the name and ABN of the entity that has lodged the company income tax return, and the amount representing the R&D entity's notional deductions, taking into account any feedstock adjustments.

It is envisaged that one annual report will be published similar to the existing annual income tax transparency publication. Treasury is of the view

that this level of transparency has been welcomed by the wider business community.

Amendments will also be made to the IRD Act 1986 to insert new section 31E – this will set out specific circumstances when the Board must amend or revoke a determination issued by ISA in a broader range of circumstances than those specified in the legislation.

As expected, the ED legislation also seeks to amend the *Industry Research and Development Decision-making Principles 2011* to cap the ability of the Board to grant extensions of time beyond three months, unless the extension is granted to allow an applicant to wait for the outcome of a pending decision.

### Absence of collaboration premium

Surprisingly at the time, the Federal Budget announcements did not include the introduction of a previously mooted 20 per cent collaboration premium aimed at increasing collaboration between companies and research bodies.

Subsequent to Federal Budget night, the Government has formally responded to the 2030 Report, and only 'notes' the collaboration premium recommendation, rather than accept it as a recommendation or accept it in principle.

However, we understand that the Biotech community believes that the R&D Tax Incentive is not, in any case, the appropriate mechanism to incentivise collaboration between industry and publicly funded research organisations.

### Conclusions

Deloitte will be making a submission on the proposed measures as set out in the ED legislation in line with the questions posed in the Consultation Paper, and other issues in line with the views set out above.

Overall, assuming that the changes are enacted largely as drafted, with the net tax benefit of R&D non-refundable claims now being markedly below the original level of 10 per cent, it is undoubted that the overall attraction of the non-refundable component of the R&D Tax Incentive has been substantially diminished since its introduction in 2011.

It is also evident that Australia's attraction as a location to conduct R&D has diminished, with the net tax benefit available for non-refundables now being amongst the lowest on a comparison of international R&D tax regimes.

That said, the impact of the 'relaunched' program is less detrimental than was anticipated by some before the announcements, in particular the life-sciences sector. Benefits will still be available through making robust and substantiated claims, especially for industries with higher levels of R&D intensity.

It is hoped that this round of legislative amendments will be the last for a significant period of time. It is critical that confidence in the longevity of the program is restored for those taxpayers that seek to claim the R&D Tax Incentive, and factor the program's benefits into making critical innovation investment decisions.

Going forward, companies that currently claim the R&D Tax Incentive, or plan to do so, should now be undertaking the following where relevant:

- Considering any planned R&D expenditure on a regular basis to assess potential breaches of the proposed annual refund cap;
- Considering the application of the proposed clinical trials definition;
- Considering how expenditure would be calculated based on the accounting principles and standards adopted;
- Undertaking reviews of R&D expenditure against broad annual business expenditures over the last few years to assess the potential impact of the new R&D premium intensity thresholds

## Appendix – Worked Example

By way of example, suppose a company is eligible for the non-refundable R&D tax offset and a prevailing corporate tax rate of 30 per cent, and has eligible R&D expenditure of \$5 million. Previously a flat rate of 38.5% would have been applied to eligible expenditure, arriving at an R&D tax offset of \$1.925 million and a net tax benefit of 8.5%.

Considering differing scenarios of total expenditure, being \$20 million, \$40 million, \$80 million and \$160 million, the outcomes for the new non-refundable R&D tax offset would be as follows:

<b>R&amp;D expenditure (A)</b>	<b>\$5 million</b>	<b>\$5 million</b>	<b>\$5 million</b>	<b>\$5 million</b>
<b>Total expenditure (B)</b>	\$20 million	\$40 million	\$80 million	\$160 million
<b>Overall R&amp;D intensity rate (A/B)</b>	25%	12.5%	6.25%	3.125%
<b>2% intensity threshold (B x 2%) = C</b>	\$400,000	\$800,000	\$1,600,000	\$3,200,000
<b>5% intensity threshold (B x 5%) = D</b>	\$1 million	\$2 million	\$4 million	\$8,000,000
<b>10% intensity threshold (B x 10%) = E</b>	\$2 million	\$4 million	\$8 million	\$16,000,000
<b>Offset amount based on corporate tax rate of 30% = F</b>	\$1.5 million	\$1.5 million	\$1.5 million	\$1.5 million
<b>4% premium offset amount (C x 4%) = G</b>	\$16,000	\$32,000	\$64,000	\$128,000
<b>6.5% premium offset amount ((A or D - C) x 6.5%) = H</b>	\$39,000	\$78,000	\$156,000	\$117,000 ^
<b>9% premium offset amount ((A or E) - D) x 9%) = I</b>	\$90,000	\$180,000	\$90,000 ^	-
<b>12.5% premium offset amount = ((A - E) x 12.5%) = J</b>	<u>\$375,000</u>	<u>\$125,000</u>	=	=
<b>Total R&amp;D tax offset available (F + G + H + I + J)</b>	<u>\$2,020,000</u>	<u>\$1,915,000</u>	<u>\$1,810,000</u>	<u>\$1,745,000</u>
<b>Difference to previous tax offset available of \$1.925 million</b>	<u>\$95,000</u>	<u>(\$10,000)</u>	<u>(\$115,000)</u>	<u>(\$180,000)</u>

^ Actual R&D expenditure sits between relevant intensity thresholds

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