



Tax Insights

R&D Tax Incentive Bill introduced into Parliament

Snapshot

On Thursday 20 September 2018, the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* was introduced into Parliament, which surprisingly included the measures to enact the proposed changes to the Research & Development (R&D) Tax Incentive program originally announced in the May Federal Budget.

There is a disappointing lack of any substantial changes resulting from the consultation process that was undertaken on the exposure draft (ED) legislation introduced in late June. It is difficult to understand why the Government would undertake such an extensive consultation process in respect of a policy that is fundamentally critical to innovation in Australia, and then disregard the views and concerns of the key affected stakeholders.

There is a lack of any substantial changes resulting from the consultation process

What next?

We understand that the Opposition may request a detailed review of the Bill by a Parliamentary committee, and that further contributions to the proposed legislation may be invited. It is to be hoped that this substantial change in innovation support may yet get the scrutiny it deserves.

If not, the R&D amendments, once enacted, will generally apply to income years commencing on or after 1 July 2018, with some administrative amendments applying from the day after Royal Assent, providing businesses conducting R&D activities in Australia with one of the poorest innovation tax policies seen globally.

With remarkably little change between the broad Budget announcements and the final design of the proposed amendments,, Australia's attraction as a location to conduct R&D has undoubtedly already been diminished. The net tax benefit available for non-refundable offset claims are now amongst the lowest on a comparison of international R&D tax regimes.

From ED to Bill

The key changes that can be observed in a comparison of the Bill and the ED legislation largely centre on a number of amendments made to the calculations necessary in the event of a balancing adjustment event involving an R&D asset, being:

- The measures seek to rewrite the assessable balancing adjustment event provisions that are currently contained within sections 40-292 and 355-315 where a decline in value of an asset has been included in R&D expenditure over its effective life. This rewrite includes such assessable balancing adjustment amounts in the amalgamated uniform clawback measures in new subdivision 355-G (discussed below). The new clawback provisions for recoupments, feedstock and balancing adjustments will ensure that the full benefits of the R&D tax offsets claimed are reversed to remove the unintended benefits that arise in such situations.
- The amendments also introduce a new catch-up rule in new subdivision 355-H for R&D assets when a deductible balancing adjustment amount arises for an R&D asset. The catch-up rule mirrors the operation of the new uniform clawback rule but operates in reverse, providing a deduction in lieu of an amount of R&D tax offset forgone. Such deductions will be now real deductions rather than notional R&D deductions, which means that going forward, these can only create tax losses rather than refundable tax offsets.
- There are also minor changes in proposed subsection 355-115(3) to prevent the double counting of amounts when calculating the incremental intensity of R&D expenditure of an entity. Incremental intensity will be calculated under the Bill as eligible R&D expenditure as a percentage of "total expenses" (which was denominated as expenditure under the ED legislation). This concept disappointingly remains firmly tied to the concept of accounting principles and is intended to include all amounts reported in item 6 of a company income tax return, but will now exclude capital expenditures.

The Bill will still also require the annual publication of R&D information. However, the measures in the Bill will delay the publication for two years in the interests of protecting commercially sensitive information. Disappointingly, it is the notional deduction amounts that will be reported rather than the net tax benefit of the claim, which could lead to misunderstandings.

There are also some minor changes to the proposed definition of clinical trials in proposed subsection 67-30(3) for the purposes of the refundable tax offset exemption, discussed below.

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 in the Bill to section 355-100, the rate of the refundable tax offset, available to companies with an aggregated 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, until the corporate tax rate falls further, the rate of the refundable tax offset would be 41 per cent for income years commencing on or after 1 July 2018. 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 Bill would also 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 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 in the Bill 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 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 current legislative practice with there being no other legislated tax offsets that fundamentally change in value or character on being carried forward.

If enacted, 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 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, vaccine, treatment, diagnostic procedure or medical device) with the aim of achieving at least one of the following:

(a) the discovery, or verification, of clinical, pharmacological or 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 the Bill specifically included medical devices within the scope of the definition. However, the nuances of

this definition will still need to be worked through further to understand the potential scope of “clinical trials”.

The Bill also includes 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 could be considered clinical trials are also anticipated.

Proposed changes to non-refundable R&D tax offset

The most controversial announcement in the Budget was 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 measures included in the Bill continue to 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 expenses, such that:

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

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 for the income year. 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.

Overall R&D intensity rate *	R&D tax offset premium amount
Less than 2%	4% for R&D expenditure between 0%-2% R&D intensity
Between 2% and 5%	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
Between 5% and 10%	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

Overall R&D intensity rate *	R&D tax offset premium amount
	9% for R&D expenditure above 5% to 10% R&D intensity
Over 10%	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 / Total expenses*

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 tax offset premium will be Nil, attracting only a tax offset at the prevailing corporate tax rate.

These 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.

However, it is clear that the net tax benefit available under the new regime will be critically dependent on the calculation of the 'total expenses' denominator, a concept that the measures in the Bill have sought to define in a new section 355-115, as follows:

s355 115 Working out an R&D entity's total expenses

- (1) *For the purposes of subsection 355 100(1A), an *R&D entity's total expenses 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 *R&D entity's total expenses for the income year worked out in accordance with:*
 - (i) *the *accounting principles; or*
 - (ii) *if accounting principles do not apply in relation to the R&D entity—commercially accepted principles relating to accounting;*

(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) for the income year.

Amounts counted once only

(3) For the purposes of subsection (2):

(a) disregard an amount to which paragraph (2)(a) otherwise applies if paragraph (2)(b) has previously applied in relation to the amount; and

(b) disregard an amount to which paragraph (2)(b) otherwise applies if paragraph (2)(a) has previously applied in relation to the amount.

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 still believe that there are many potential hazards of using such a hybrid of specific tax and accounting rules.

The explanatory memorandum to the Bill states that this definition will include expenses reported in item 6 of the company income tax return. Once enacted, this will discriminate against industries which have high value production inputs and those who have not offshored non-R&D activities. A net approach to cost of goods sold would be less discriminatory.

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

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.

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 expenses", 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 rewrite and amendments

As in the ED legislation, the Bill will amend the feedstock and grant clawback provisions that currently claw back a flat rate net tax benefit of

10%, which is unsustainable in light of the substantially reduced benefits that will now be available. The Bill also recognises the need to include assessable balancing adjustment amounts in the uniform

The Bill 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, as well as where an assessable balancing adjustment amount arises. These provisions 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 that 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 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 tax losses.

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

Catch up deductions

The Bill also introduces a new subdivision 355-H to replace the current provisions that deal with when a deductible balancing adjustment amount arises for an R&D asset. The catch-up rule will mirror the operation of the new uniform clawback rule but will operate in reverse, providing a deduction in lieu of an amount of R&D tax offset forgone.

Notably, amendments made will also mean that such balancing adjustment deductions will be now real deductions rather than notional R&D deductions. This means that, going forward, these can only create tax losses rather than refundable tax offsets. For example, if R&D pilot plant is scrapped with a high adjustable value, the resulting deduction will be increased in line with the R&D usage, but the amount will constitute a deduction rather than a tax offset, and cannot be 'cashed out'.

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.

The measures in the Bill will 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 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

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 Bill still 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. However, the measures in the Bill will delay the publication of these details for two years in the interests of protecting commercially sensitive information.

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. Disappointingly, it is the notional deduction amounts that will still be reported, rather than the net tax benefit of the claim, which could lead to misunderstanding.

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 Bill 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.

Conclusions

It is notable that the enactment of this legislation would see the Australian tax incentive available fall from 24.5 per cent in 1986 when the R&D tax concession was first introduced, to a marginal 4 per cent for many key Australian businesses.

This fall in the net tax benefit of R&D Tax Incentive non-refundable claims is also markedly below the original level of 10 per cent that was introduced in 2011.

That said, the impact of the 'relaunched' program is less detrimental than was anticipated by some before the formal 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, unless increased support is on offer. 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 expenses, 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:

R&D expenditure (A)	\$5 million	\$5 million	\$5 million	\$5 million
Total expenses (B)	\$20 million	\$40 million	\$80 million	\$160 million
Overall R&D intensity rate (A/B)	25%	12.5%	6.25%	3.125%
2% intensity threshold (B x 2%) = C	\$400,000	\$800,000	\$1,600,000	\$3,200,000
5% intensity threshold (B x 5%) = D	\$1 million	\$2 million	\$4 million	\$8,000,000
10% intensity threshold (B x 10%) = E	\$2 million	\$4 million	\$8 million	\$16,000,000
Offset amount based on corporate tax rate of 30% = F	\$1.5 million	\$1.5 million	\$1.5 million	\$1.5 million
4% premium offset amount (C x 4%) = G	\$16,000	\$32,000	\$64,000	\$128,000
6.5% premium offset amount ((A or D – C) x 6.5%) = H	\$39,000	\$78,000	\$156,000	\$117,000 ^
9% premium offset amount ((A or E) – D) x 9%) = I	\$90,000	\$180,000	\$90,000 ^	-
12.5% premium offset amount = ((A – E) x 12.5% = J	<u>\$375,000</u>	<u>\$125,000</u>	=	=
Total R&D tax offset available (F + G + H + I + J)	<u>\$2,020,000</u>	<u>\$1,915,000</u>	<u>\$1,810,000</u>	<u>\$1,745,000</u>
Previous R&D tax offset (@38.5%)	<u>\$1,925,000</u>	<u>\$1,925,000</u>	<u>\$1,925,000</u>	<u>\$1,925,000</u>
Difference to previous tax offset available of \$1.925 million	<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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