

AUGUST 2018

TECHNICAL UPDATE



BDO SUBMISSION LODGED ON DRAFT LEGISLATION WITH R&D TAX INCENTIVE CHANGES

BDO'S SUBMISSION IN RESPONSE TO THE GOVERNMENT'S CONSULTATION ON R&D TAX INCENTIVE AMENDMENTS HIGHLIGHTS KEY CONCERNS WITH THE PROPOSED AMENDMENTS, INCLUDING:

- THE CALCULATION OF R&D INTENSITY
- THE CLINICAL TRIALS EXEMPTION
- CHANGES TO DRAFT FEEDSTOCK AND CLAWBACK PROVISIONS; AND
- IMPROVED TRANSPARENCY AND NEW ANTI-AVOIDANCE PROVISIONS.

BACKGROUND

On Friday 29 June 2018, the [exposure draft legislation 'Research & Development Tax Incentive Amendments'](#) (draft legislation) was released for public consultation regarding the 2018/19 Federal Budget announcements on 8 May 2018 to narrow the benefits available under the current R&D tax incentive programme. The proposed amendments seek to address certain perceptions that the existing programme requires fine-tuning to achieve the intended innovation policy outcomes of "additionality" and "spillover" benefits. Following a consultation session on the proposed changes attended by BDO R&D Leader, Nicola Purser, BDO lodged a [submission](#) on 26 July 2018 highlighting our key recommendations.

REFUNDABLE R&D TAX OFFSET

Under the proposed amendments to section 355-100 ITAA 1997, 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 (which is currently 27.5 per cent for entities with that level of aggregate turnover). BDO recommends returning the incentive component for the refundable tax offset to 15 per cent as was originally introduced. BDO also encourages an increase to the turnover threshold required to access the refundable offset in line with changes to the corporate tax rate (i.e. \$50 million).

SERVICE LINE

Tax

NICOLA PURSER

Partner, Brisbane

+61 7 3237 5648

nicola.purser@bdo.com.au

GRAHAM WAKEMAN

Partner, Sydney

+61 2 9240 9901

graham.wakeman@bdo.com.au

NATALIE MILNE

Partner, Perth

+61 8 6382 4860

natalie.milne@bdo.com.au

MORE INFORMATION

1300 138 991

www.bdo.com.au

NEW SOUTH WALES •
NORTHERN TERRITORY •
QUEENSLAND • SOUTH
AUSTRALIA • TASMANIA •
VICTORIA • WESTERN AUSTRALIA

ANNUAL REFUND CAP

The draft law seeks to amend section 67-30 of the ITAA 1997 and introduce an 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. BDO recommends that if a cap is introduced that it be applied retrospectively from 1 July 2018 and that transitional rules should apply to allow companies an exemption from the cap where they can demonstrate investment in a project reliant on refunds greater than the \$4 million. BDO also believes that the refundable offset component in excess of the \$4 million cap should be refundable in subsequent years.

CLINICAL TRIALS

Further to the abovementioned amendments to section 67-30 ITAA 1997, it should be noted that the proposed refundable cap does not apply to eligible expenditure on 'clinical trial' activities. For an incentive which was designed to be industry agnostic, this exclusion specifically favours a certain industry and does not address the fact that the majority of clinical trial activities of this magnitude are conducted overseas. This highlights the strong focus the Government is placing on the advancement of the medical and pharmaceutical industry, as opposed to other sectors conducting R&D in Australia which still contribute significantly to Australia's GDP.

BDO suggests removing the cap exemption for clinical trials, as current and previous tax incentives have been industry agnostic incentive programmes. In lieu of removing the cap, the clinical trial definition should follow that as dictated by the Therapeutic Goods Administration regulatory body, and should still be required to meet the current definitions of eligible core and supporting activities in sections 355-25 and 355-30 of the ITAA 1997. If the cap exemption is to remain, further clarification of the definition is required (i.e. is it only intended to apply to trials in humans and to include medical devices?). There should also be a tightening of the definition of expenditure attributed to clinical trials that is limited to resources used directly in the clinical trials and not the currently ambiguous term 'relating to'.

NON-REFUNDABLE R&D TAX OFFSET

The draft legislation includes a range of tiered "R&D premiums" for the non-refundable component of the incentive, with a view towards encouraging incremental R&D spending. Intensity is to be determined by taking the company's R&D expenditure over total expenditure. The proposed tiered mechanism will only provide proportionally larger R&D benefits than those currently available to companies with a 'R&D intensity' greater than 13.25 per cent. Very few companies with a turnover greater than \$20 million have an intensity of this level.

BDO notes that the proposed intensity calculation utilises tax principals for the determination of the company's R&D expenditure, whilst using accounting principles for the determination of the total expenditure. The difference in expenditure treatment will add further complexity and provides an incentive for the manipulation of expenditure treatment to achieve a greater intensity. BDO recommends simplifying the intensity test or replacing it altogether with a mechanism based upon incremental R&D spending, as the proposed mechanism dis-incentivises businesses with high operational expenses, such as agribusiness, resources and manufacturing, from conducting R&D activities.

BDO further recommends that there be an 'opt out' option made available for companies subject to the intensity test, and that the base rate for the non-refundable offset be increased to at least 7 per cent. This percentage allows the programme to remain internationally competitive as well as offset the costs of compliance. It should be noted that, should the proposed measures pass at a 4 per cent incentive rate, many companies will be discouraged from claiming, or may choose to undertake R&D activities in more favourable jurisdictions.

CLAWBACK OF GRANTS & FEEDSTOCK

The feedstock and grant clawback provisions currently clawback a flat rate benefit of 10 per cent, which is unjustifiable in light of the substantially reduced benefits that will now be available. A new subdivision 355-G ITAA 1997 will introduce a uniform clawback rule that consolidates the existing two subdivisions that currently deal with the clawbacks for R&D recoupments and feedstock adjustments. The proposed changes introduce a new complicated formula which compares the offset claimed to the amount that would have been received if notional deductions were reduced by the clawback amounts calculated for the income year. The examples in the explanatory memorandum particularly with regard to feedstock are unrealistic and provide little guidance as to how the provisions would work in practice.

IMPROVED TRANSPARENCY

The draft law proposes to insert a new section 3G in Part 1A of the Taxation Administration Act 1953, as a means of increasing programme transparency, requiring the ATO to publish information about the R&D claims of R&D entities as soon as practicable after the end of the income year. BDO believes that this may result in companies losing their competitive advantage. Instead, BDO proposes that the Government should publish sanitised versions of all findings, rather than a public reporting of company claims. BDO also suggests that sector guidance materials should use case studies based on sanitised real life examples and encompass both the eligibility of activities, as well as the expenditure attributed to the activities. A conciliatory approach to resolving disparities is, in our opinion, more effective than a confrontational one.

NEW ANTI-AVOIDANCE PROVISIONS

The draft law seeks to amend section 177C of ITAA 1936 to explicitly extend the concept of tax benefits to include the R&D tax offset, preventing companies from structuring themselves in such a way that they can exploit the programme. It is unclear how this will apply in practice since R&D entities are often formed within or between large corporate groups. For example, joint ventures could be susceptible to this provision given that they are often established specifically for the purpose of undertaking R&D activities and could achieve a very high R&D intensity. Rather than an intensity test based upon business expenditure, the intensity test should reward companies that increase their investment on R&D activity, similar to the premium under the R&D Tax Concession. This would be a more industry agnostic approach to rewarding further investment in R&D activity. Alternatively, a 'patent box' type arrangement for reduced tax on expenditure attributed to new products or services that directly resulted from investment in R&D activity could be implemented. Specific guidance and examples would be required for how the anti-avoidance provisions would apply.

BDO COMMENT

The R&D Tax Incentive is due for a review following its implementation from 1 July 2011. The Government is attempting to address aggressive claimants and better target Government funding, however companies undertaking legitimate R&D should not be penalised as a result of this. In BDO's opinion, the proposed changes will be a disincentive for business R&D, create additional scrutiny, and add additional unnecessary complexity to the R&D tax incentive programme.

The proposed changes are also due to take effect retrospectively from 1 July 2018, so companies that currently claim the R&D Tax Incentive, or plan to do so, should contact BDO for assistance with:

- ▶ Undertaking reviews of R&D expenditure against broad annual business expenditure to assess the potential impact of the new R&D premium intensity thresholds
- ▶ Determining how the refund cap and the proposed clinical trials exemption from the cap could impact the availability of refunds
- ▶ Planning R&D activity and expenditure effectively in line with the proposed changes
- ▶ Performing documentation reviews to prove the nexus between expenditure and R&D activities to determine eligibility to claim the R&D Tax Incentive.

Distinctively different - it's how we see you
AUDIT • TAX • ADVISORY

MORE INFORMATION

1300 138 991

www.bdo.com.au

NEW SOUTH WALES • NORTHERN TERRITORY • QUEENSLAND • SOUTH AUSTRALIA • TASMANIA • VICTORIA • WESTERN AUSTRALIA

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact the BDO member firms in Australia to discuss these matters in the context of your particular circumstances. BDO Australia Ltd and each BDO member firm in Australia, their partners and/or directors, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

BDO refers to one or more of the independent member firms of BDO International Ltd, a UK company limited by guarantee. Each BDO member firm in Australia is a separate legal entity and has no liability for another entity's acts and omissions. Liability limited by a scheme approved under Professional Standards Legislation other than for the acts or omissions of financial services licensees.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2018 BDO Australia Ltd. All rights reserved.

BNE 0963/0718