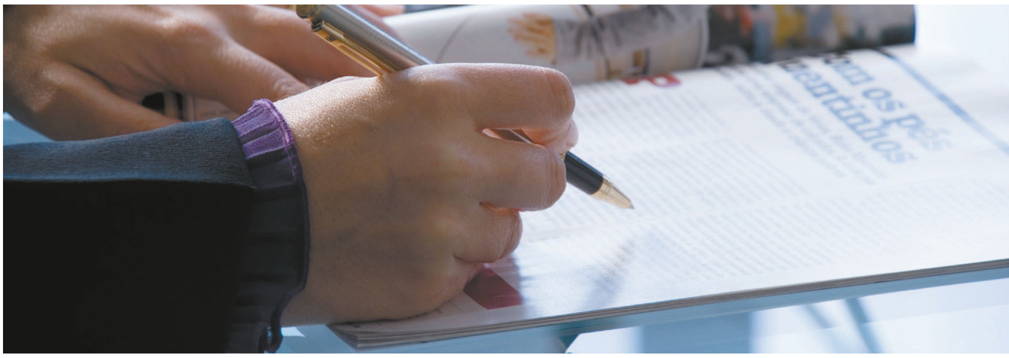

TECHNICAL UPDATE

R&D TAX INCENTIVE

The Federal Government has released the report in its Review of the R&D Tax Incentive. The Government has asked for submissions on this report by 28 October 2016. This review was the result of numerous submissions and consultations from business leaders and research. Broadly, it was found that the R&D Tax Incentive could do more to encourage additional research and research spillovers into other sectors. In particular, the review panel found that the current programme falls short of meeting its stated objectives of additionality and spillovers.

The review panel made six recommendations to improve the overall effectiveness and integrity of the programme while encouraging additional R&D.

Three of these recommendations encourage research that would otherwise not take place, known as 'additionality'. These include providing extra incentives for businesses to hire PhD graduates and to collaborate with Australia's world class research institutions.

The other three recommendations seek to strengthen the integrity and effectiveness of the programme, including through reducing compliance costs for companies.

The six main recommendations in the report are as follows:

Recommendation One: No change to the definition of R&D but more guidance

Retain the current definition of eligible activities and expenses under the law, but develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses.

The review panel considered that the main issue associated with the scope of eligible activities were the lack of clarity and consistency. This uncertainty lead to significant fees as potential recipients had to engage R&D consultant and tax agents. The panel found that compliance costs for company registrants were relatively high as a percentage of the benefit. Accordingly, the panel recommended that administrators develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses.

BDO agrees with this recommendation, as the current definitions broadly align with what both the OECD, and the various industry stakeholders consider to be eligible R&D activities. While further guidance materials would be appreciated, the administrative bodies must recognise that no two R&D projects are the same and that highly prescriptive guidance may fail to fully consider the various issues and challenges encountered by companies in different industries.

SECTOR

Tax

CONTACT

NICOLA PURSER
Partner, Brisbane
Tel: +61 7 3237 5999
nicola.purser@bdo.com.au

CHRIS VITTAS
Partner, Melbourne
Tel: +61 3 9603 1733
chris.vittas@bdo.com.au

NATALIE MILNE
Partner, Perth
Tel: +61 8 6382 4860
natalie.milne@bdo.com.au

GRAHAM WAKEMAN
Partner, Sydney
Tel: +61 2 9240 9901
graham.wakeman@bdo.com.au

Recommendation Two: 20 per cent extra non-refundable offset for collaboration with public research organisations

Introduce a collaboration premium of up to 20 per cent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations. The premium would also apply to the cost of employing new Science, Technology, Engineering and Mathematics (STEM) PhD or equivalent graduates in their first three years of employment. If an R&D intensity threshold was introduced (see Recommendation Four), companies falling below the threshold should still be able to access both elements of the collaboration premium.

The review panel noted there were merely a modest amount of collaboration with publicly-funded research organisations (PFROs) as well as the low employment level of STEM PhD graduates relative to other OECD countries. This represented a lost opportunity for greater spillovers of knowledge between larger companies, PFROs and the broader marketplace. Accordingly, the panel recommended the Government consider providing a premium rate for the component of a project's total R&D expenditure that is undertaken in collaboration between recipients of the non-refundable tax offset and PFROs. In addition, the collaboration premium would also fund the cost of employing new STEM PhD or equivalent graduates in their first three years of employment. There would need to be detailed consideration of how this could be done in a way that maintains integrity and does not distract research organisations from fulfilling their core functions.

BDO agrees with this recommendation in that it has the dual aims of promoting collaboration between various R&D participants, as well as encouraging employment of specialised maths and science graduates to prevent a potential 'brain drain' as currently the only opportunities available to many of them are overseas.

However, we believe the collaboration premium should be open to all companies, not just large businesses as suggested by the review. SME's typically do not have the resources required to manage collaborative arrangements with PFROs or the funds necessary to hire high quality STEM PhD graduates. While the Panel has mentioned that SMEs have the added cash-flow benefit due to the refundable offset, it has failed to recognise that successful SMEs receive no permanent benefit from the programme due to the way the refundable offset interacts with Australia's franking system.

Recommendation Three: $2 million cap on refundable R&D tax offsets

Introduce a cap in the order of $2 million on the annual cash refund payable under the R&D Tax Incentive, with remaining offsets to be treated as a non-refundable tax offset carried forward for use against future taxable income.

The review panel found that the programme incorporated effective additional support for SMEs and start-ups, since its refundable component was available at a premium rate to companies with turnover less than $20 million. This provided important cash-flow assistance to SMEs and increases the potential for additional investment in R&D.

However, the considerable growth in the cost of the refundable component was impacting on the programme's long-term sustainability. Refundability was likely to provide fewer tangible benefits for SMEs with larger R&D expenditures, who would be able to find alternative sources of finance at relatively lower costs in comparison with firms with lower R&D expenditure. Accordingly, the panel considered that placing a cap on the amount of cash refund, for example, at $2 million would maintain strong cash-flow support for SMEs up to that limit, while improving the sustainability of the programme. While refunds would be capped, any remaining entitlement to a tax offset through the programme would be carried forward and able to be offset against any future tax liability.

BDO agrees with this recommendation in principle as the sustainability of the programme is important. However, a $2 million annual cap may be too low for some of Australia's most innovative industries such as biotech, where the cost of clinical trial can rapidly exceed this cap.

Recommendation Four: R&D expenditure threshold of one or two percent of total expenditure for non-refundable offset

Introduce an intensity threshold in the order of one to two per cent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit.

The ability to target additional R&D in a volume-based scheme was limited. Therefore, it was considered that additionality could be improved by better targeting larger companies' access to the scheme through the introduction of an intensity requirement. With such a requirement, only companies directing a specified percentage of their total business expenses to R&D would begin to receive the non-refundable tax offset. This reflects, firstly, the fact that spillovers are more likely to flow from R&D in large companies that exhibit higher R&D intensities. Secondly, at least such a level of expenditure would be expected as a usual business feature in a truly innovative company.

BDO is cautious of this recommendation. Although we understand the intent of the mechanism is to encourage larger companies to undertake 'additional' R&D activities, in practice the threshold introduces an artificial barrier for a number of companies looking to innovate.

Among other concerns, some of the key issues BDO has identified with the mechanism include:

- It unfairly targets industries with high operational expenses including Australia's agribusinesses and manufacturers; it will substantially reduce their R&D claims, and in many cases prevent them from accessing the programme entirely
- A tiered system adds additional administrative burden to the ATO, and the design of the mechanism is open to manipulation
- Depending on when a company's year-end falls during the R&D project lifecycle, a company may only be able to claim the project in one year and not the other even though the activities in both years are part of the same project.

Recommendation Five: Increase the maximum R&D expenditure threshold to $200 million

If an R&D intensity threshold is introduced, increase the expenditure threshold to $200 million so that large R&D-intensive companies retain an incentive to increase R&D in Australia.

The review panel recommends that if an intensity threshold is introduced, the $100 million expenditure threshold be raised. The expenditure threshold has effectively locked-in a maximum annual $10 million tax benefit to around 25 large and very large companies that undertake more than $100 million in R&D, removing their incentive to undertake additional R&D in Australia. An intensity threshold would remove or substantially reduce the usual business claims of some large and very large companies, while increasing the expenditure threshold would make the full benefits of the Incentive available for additional R&D by the remaining (R&D-intensive) companies.

BDO agrees with this recommendation as it will promote additional R&D activities in Australia, which will provide greater employment opportunities as well as nurturing further innovation.

Recommendation Six: Improve the administration of the R&D Tax Incentive

That the Government investigate options for improving the administration of the R&D Tax Incentive (e.g. adopting a single application process; developing a single programme database; reviewing the two-agency delivery model; and streamlining compliance review and findings processes) and additional resourcing that may be required to implement such enhancements. To improve transparency, the Government should also publish the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed.

The review panel noted that despite the level of coordination between AusIndustry and the ATO, the significant growth in the scale of the programme was placing increasing strain on the administrative and compliance model for the programme. Therefore, options to improve administration should be considered. These could include: adopting a single application process rather than the current separation of registration and claims, introducing a single database for the entire programme, reviewing whether both AusIndustry and the ATO should continue to administer the programme jointly and closer collaboration and streamlining around review and findings. Either or both agencies may require additional resourcing to enable such improvements.

Tax secrecy provisions should be adjusted to allow the publication of the names of companies claiming the Incentive and the amounts of R&D they have claimed, in order to align the programme with modern expectations and to allow public visibility of companies receiving public support for their activities.

BDO cautiously agrees with this recommendation. More streamlined administrative measures are welcomed (as any red-tape cutting measures are), however, it may be the case that any attempts to simplify may lead to unintentional greater complications, particularly if it results in two overlapping regimes.

We would question the ability of the either the ATO to gain the knowledge to apply the definition of core and supporting R&D activities, or the ability of Innovation Australia to understand or apply the required provisions of the Tax Act and associated case law (e.g. capital vs revenue, trading stock, work in progress, tax consolidations etc.). There is an existing rationale for the separation. Ultimately, this is difficult to gauge until the final form of the purported improvements are evaluated.

In regards to the greater transparency provisions, it is noted this is consistent with the progression of other transparency measures in the taxation regime. However, we note that without context it would be difficult for the average member of the public to pass fair judgement on the company's activities and the benefit received. This measure could potentially put pressure on companies to disclose the nature of their R&D activities to justify the offset they're receiving before the R&D activities have been completed.

BDO Comment

Overall BDO welcomes a number of the proposed measures, as they attempt to improve the sustainability of the programme without introducing substantive changes. However, we recommend that the government carefully considers the full implications of the proposed refundable offset cap, intensity threshold, and transparency measures. The final form that the recommendations will provide further insight into their ultimate effectiveness, which presumably will eventuate after the consultation and submission process. To this end, BDO will be preparing a submission to the Report.

National expertise

The BDO Tax team is one of the largest and most dynamic tax practices in Australia, with 30 partners and more than 150 specialists located in each major city across the country.

MORE INFORMATION

1300 138 991

www.bdo.com.au

NEW SOUTH WALES

NORTHERN TERRITORY

QUEENSLAND

SOUTH AUSTRALIA

TASMANIA

VICTORIA

WESTERN AUSTRALIA