Tel: +61 7 3237 5999
Fax: +61 7 3221 9227
www.bdo.com.au

Level 10, 12 Creek St
Brisbane QLD 4000
GPO Box 457 Brisbane QLD 4001
Australia

Via email: RnDamendments@treasury.gov.au

Manager
Small Business Entities & Industry Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

26 July 2018

Dear Sir/Madam

RESEARCH & DEVELOPMENT TAX INCENTIVE AMENDMENTS

BDO welcomes the opportunity to provide feedback in response to the exposure draft legislation and consultation paper 'Research & Development Tax Incentive Amendments' released on 29 June 2018.

These materials outlined key areas where the Federal Government requests specific feedback on the implementation of reforms to the Research and Development Tax Incentive (R&DTI) to better target the program and improve its integrity and fiscal affordability in response to the recommendations of the 2016 Review of the R&D Tax Incentive.

Our submission contains both our key concerns with the proposed new measures on industry and our responses to the questions in the consultation paper, which are outlined in the Appendix of the submission.

Should you wish to discuss any of our comments, please feel free to contact me on +61 7 3237 5648 or +61 405 771 837 or Nicola.Purser@bdo.com.au

Yours sincerely

Nicola Purser
BDO National R&D Leader

Executive Summary

A request for feedback and comments from industry has been sought through a consultation paper which contains six questions associated with compliance challenges, integrity and unintended consequences with respect to the calculation of R&D intensity, the clinical trials exemption, and the draft feedstock and clawback provisions.

Whilst the matters raised in the six questions in the consultation paper are important in the context of how the proposed new legislation will operate in practice, which we respond to in the appendix, we wish to highlight some concerns with the proposed changes and provide some recommendations on how the legislation could be improved to achieve 'the targeting' aims.

- Remove the cap exemption for clinical trials. The current and previous tax incentives have been industry agnostic incentive programmes
- Any claim with notional deductions that would provide an offset in excess of the cap should require an approved finding
- Return the incentive component for the refundable tax offset to 15% as was originally introduced
- Increase the turnover threshold to access the refundable offset to align with changes in corporate tax rate
- Make the intensity test simpler and/or replace it with a simpler mechanism based upon increases in R&D spend. The current mechanism dis-incentivises businesses with high operational expenses such as agribusiness, resources and manufacturing to conduct R&D activity
- The base incentive rate for companies able to access the non-refundable offset should be increased to at least 7% to be internationally competitive and to offset the costs of compliance. At 4% many companies will "opt out" of the system and/or choose to undertake R&D offshore
- Companies should be able to 'opt out' of any intensity test and access the base incentive rate
- Companies should be able to 'opt out' of applying the clawback and feedstock provisions by excluding the relevant expenditure

Reforming the Research and Development Tax Incentive

The proposed changes to the R&DTI are based on some of the recommendations that came out of the Government's 2016 review of the R&DTI and the subsequent 'Australia 2030: Prosperity through Innovation Report' ('The Review') released in January 2018 by the Board of Innovation and Science Australia (ISA). The Review found the Incentive was failing to fully achieve its objectives of generating additional R&D activities, was not well targeted, providing benefits for R&D activities that would have been undertaken without the Incentive, and the cost was exceeding initial estimates. The proposed changes are intended to improve the targeting of the Incentive and are estimated to have a net gain to the budget of $2.4 billion in fiscal balance terms over the forward estimates period.

According to ISA, the top priority of Australia's innovation policy should be to increase business expenditure on R&D to push us to the forefront of the global innovation race. Our view is that in the current climate where both business expenditure on R&D (BERD) in Australia and the cost of the R&DTI is falling, a $2.4 billion reduction in innovation support will in our opinion, not be able to achieve the policy objectives, but most likely, achieve the opposite. The type of additionality that the Federal Government (Government) wants to see enhanced are activities that are well planned and go beyond so called 'business as usual' activities. However, in our opinion, not only is the Government's frame of reference in seeking additionality based on a static, rather than dynamic, concept of what BERD will be achieved through the proposed measures. Indeed, the proposed measures will skew assistance towards companies 'business as usual' activities rather than genuine additionality within a dynamic business investment framework.

During the 2016 Review of the R&DTI programme, BDO previously emphasised the need to ensure that the administration and compliance burden on industry is minimised, whilst also meeting the Government's Science and Innovation agenda. The increased complexities and compliance requirements associated with identifying eligible activity and expenditure under the proposed changes to the program in our opinion are unlikely to offer little to no incentive for companies to access the R&DTI program, particularly those with a group turnover over $20 million.

Furthermore, whilst the certainty that the existing program provides has led to activities that have generated new solutions and improved efficiencies for Australia, this is the second time changes have been introduced since 2011. A continually changing R&D program makes it difficult for many innovators to plan their R&D strategically particularly at a time when governments in other jurisdictions are increasing their support of innovation. Furthermore, the changes introduce a number of measures that will only allow the tax benefit to be identified retrospectively.

We highlight some of our concerns with the proposed changes below, and would urge the government to reconsider introducing these measures in their current format.

BDO's key concerns with the proposed new measures on industry

Industry Favouritism

The R&DTI program has supported Australian businesses as an industry agnostic incentive for over 30 years. The program was initially established to provide support to businesses of all sizes and across all industries, with the goal of encouraging innovation and advancement.

The draft legislation introduces for the first time a number of specific provisions that specifically favour certain industries. Firstly, the legislation proposes an exclusion from the proposed $4M annual rebate cap for the refundable R&D tax offset entitlement of companies undertaking clinical trials (i.e. for companies with a turnover of less than $20 million, there is no limit on the cash refund that can be gained from undertaking clinical trials).

This is a stark contrast to the cash refundable limit of $4 million proposed for all other R&D projects, irrespective of the fact that a lot of clinical trials activity supported by the program are actually not conducted in Australia. This highlights the heavy focus the government is placing on the advancement of the medical and pharmaceutical industry, as opposed to other sectors conducting R&D in Australia that also contribute significantly to Australia's GDP.

Secondly, in its current form, the proposed legislation applying to non-refundable offset recipients discriminates against those businesses which operate in industries characterised by high turnover and low margins (including the manufacturing, agribusiness and resources sectors) through the introduction of a new tiered non-refundable offset. This tiered mechanism will provide proportionally larger R&D benefits to those companies with a high 'R&D intensity'.

Under this tiered offset, companies with a turnover over $20 million will be required to have an R&D intensity of greater than 13.25% to receive a greater offset than the current 38.5%. This will ultimately be a significant disincentive for companies to innovate, become more efficient and achieve sustainable growth. In our experience, only a handful of companies with a turnover over $20 million could achieve an R&D intensity of greater than 13.25%.

Recommendations

- Whilst we agree with a cap on the refundable offset that can be obtained in an income year, the RTI should remain industry agnostic with no exclusion beyond any cap for any industry.
- We recommend that if a cap is introduced, transition rules apply such that companies that can demonstrate commitment/investment in a project reliant on refunds greater than the $4m cap be able to apply for exemption from the cap for the budgeted life of that project
- Allow the refundable offset component in excess of the $4 million cap to be refundable in a subsequent year
- Should the cap be applied retrospectively to 1 July 2018, allow any expenditure attributed to sufficiently documented agreements/transactions to be excluded from the cap.

Increased Level of Complexity

Despite recommendations to the contrary in The Review, the proposed legislation introduces a number of measures that, due to their complexity, will act as a disincentive for investment in R&D activity in Australia, and in their current state, could also be open to manipulation including:

- The Intensity Test
    - The R&D benefit will operate on a tiered basis, which can only be calculated on a retrospective basis at year end and therefore cannot be determined in advance of conducting R&D activity. This is particularly disadvantageous to those companies which utilise the expected R&D benefit in creating business cases for upcoming capital projects
    - As noted in our specific response to the questions in the consultation paper, the intensity calculation formula 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 therefore add further confusion, complexity and provide an incentive for manipulation of expenditure treatment to achieve a greater intensity
- Clawback of Grants & Feedstock
    - The proposed changes introduce a new complicated formula which compares 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. Similar to that of the tiered mechanism itself, companies will be required to act on a retrospective basis, limiting their ability to make decisions
    - 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. Furthermore, the example shows that there is no tax benefit (other than potentially increasing the intensity threshold) for those with a turnover over $20 million to pursue claiming feedstock which aligns with current guidance material.
- New Tax Anti-Avoidance Provisions
    - The government is seeking to introduce specific provisions within Part IVA of the Income Tax Assessment Act 1936 to prevent companies from structuring themselves in such a way that they exploit the program. 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.

Recommendations

- Claimants should be able to opt in or out of both the intensity test and the clawback of grants
- 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.

Reduced Investment in Innovation Support

- The proposed changes are being introduced as a means of preventing the cost of the R&DTI program from ballooning beyond its current $3 billion/year cost, compared to the $1 billion allocated at the release of the program in 2012. However, recent statistics indicate that the cost of the program has actually fallen in recent years (by 12% in FY15/16 according to Australian Bureau of Statistics' figures). The government is yet to substantiate the basis for the claim that the program is ballooning beyond its control. Furthermore, given the object of the program is to boost investment in R&D, it should be an expectation that the cost of the program increases over time but offset by an increase in GDP resulting from that investment.
- The proposed changes to the refundable tax offset will couple the offset rate to 13.5% above the relevant corporate tax rate. When the R&DTI was introduced for income years from 1 July 2011 the R&D tax offset of 45% was specifically decoupled from the corporate tax rate so that companies had certainty around the benefit they could receive as a result of their spend on R&D activity. Although the offset rate has reduced, companies that qualify for the 27.5% corporate tax rate have been able to enjoy a 16% net tax benefit. The proposed changes will reduce the refundable offset to 41%, a four percentage point drop in the refundable offset available in the space of 7 years. If the corporate tax rate is reduced to that outlined in the Enterprise Tax Plan, claimants will be reduced to a refundable tax offset of just 38.5%.
- It must also be noted that despite the reduction in offset rates, and the proposed increase in the expenditure threshold from $100 million to $150 million, the turnover threshold of $20 million for those companies able to access the refundable offset has not changed since the Incentive was introduced. Yet in the 2019FY the threshold for companies being able to achieve the base rate for the 27.5% corporate tax rate is $50 million.
- A base R&D tax offset of 4% for those companies with a turnover greater than $20 million under the changes would be the least attractive offering available by any R&D tax regime globally. At this level, the costs of compliance and administration for the R&DTI dissuade many companies from accessing the scheme.
- The changes will be a disincentive for 'additionality' within the Australian business ecosystem. Given that a large number of companies accessing the non-refundable offset are multinational, the government is in effect incentivising these businesses to move or undertake key innovative developmental activities outside of Australia where the benefit may be greater. We are already aware of businesses considering relocation offshore should the new measures come into effect with a base incentive rate of 4%, and of foreign businesses that have been discouraged from investing in R&D activities in Australia on the basis of the impending changes to the R&DTI regime.

- As a result of the introduced measures, the government predicts it will derive $2.4 billion in savings over the next 4 years. However, it is important to note that these savings are not being redirected into industry R&D, as was recommended in the 'The Review'.

Recommendations

- The threshold for those accessing the refundable R&D Tax Offset should be raised to $50 million
- Reinstate the 15% incentive component for the non-refundable offset rather than the intended 13.5%
- The base incentive rate for the non-refundable offset should be raised to at least 7% in order to be an incentive for 'additionality'
- Redirect the savings from the new measures towards other programmes that support and reward Australian innovation

Increased Transparency

As a means of increasing program transparency, the proposed changes will incorporate the publishing of each company's R&D tax benefit and intensity in the public domain. Although these values will not be published until 2 years after the year in which the application is lodged, it may result in companies losing their competitive advantage.

The board of ISA will also be given additional powers to make determinations about about the circumstances and ways in which it will exercise its powers, or perform its functions or duties, and may delegate their powers to any member of Australian Public Service staff assisting them. A cap of three months on the total extension available for registrations will also be introduced. Whilst these measures intend to provide greater integrity of the program, we believe that less disparity between industry and government can be achieved through providing early effective engagement training using real life examples of both activities that the program intends to incentivise, and those that it does not.

There are also a number of examples of differences in interpretation of eligibility between industry and government, including computer modelling, routine testing, product development, and overhead allocation. Whilst the government retains internal guidance on their interpretation of the application of the legislation to these issues, little guidance has been provided to industry. In order to achieve true transparency, industry should have access or provide input to any such interpretations in a timely manner.

Recommendations

- The government should publish sanitised versions of all findings, rather than a public reporting of company claims
- 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 in opinion, rather than a confrontational one.

Retrospective Start Date

If the proposed legislation is passed, a retrospective start date of 1 July 2018 will be incorporated in relation to the new benefit. This is detrimental to businesses since a majority of applicants would have planned their activities for the 2019FY under the assumption that they would receive a certain R&D Tax offset following the completion of the 2018FY claim. In a large number of cases, the amount will drop significantly, thereby putting planned work in jeopardy

Recommendation

- Any changes to the R&DTI should apply from 1 July 2019.

Appendix

Core questions

Part A - Calculation of R&D intensity

1. **Do you foresee any implementation and ongoing compliance challenges arising from the proposed calculation of R&D intensity?**

   In our view, the proposed R&D intensity measure does have the potential to cause compliance challenges on implementation. There are two elements to the R&D intensity measure that could result in either misinterpretation or miscalculation.

   For the first element, the R&D intensity calculation requires a determination of the total expenditure incurred by a company worked out in accordance with accounting principles.

   Expenditure is not a term defined in any relevant accounting standard and its only relevance to the accounting standards is in respect of a starting position when recognising assets and expenses. Further, expenditure incurred and worked out in accordance with accounting concepts deviates from income tax recognition and deductibility.

   The actual determination of expenditure according to the accounting standards will likely involve a calculation separate to the existing financial reporting and income tax processes where a taxpayer will be required to reconstruct the statement of profit or loss and the statement of financial position so as to reverse all entries that do not constitute expenditure. This will include the reversal of items such as depreciation, amortisation, impairments, realised and unrealised losses FX losses, and accruals.

   Taxpayers with complex financial arrangements could also increase the difficulty with achieving compliance. For example, with FX and hedging transactions, only the margin is generally recognised in the financial statements, whereas the concept of expenditure could result in the requirement for the underlying transactions to be recognised.

   There may also be situations where taxpayers confuse the concept of expense and expenditure. Expense, under the Australian accounting standards, generally excludes assets, whereas expenditure would include all outgoings, including on assets such as land and buildings.

   For the second element of the measure, the actual calculation of rate and amount of benefit we also consider to be very complicated. In our experience, the calculation requires the creation of a worksheet to automate the calculation. While tax agents that regularly deal with the tax incentive will have developed their own worksheets, there is the possibility that companies or agents not familiar with the required calculation will make unintentional errors because the calculation methodology may not be readily ascertainable from the wording of the proposed legislation.

2. **Does the proposed method of calculation of R&D intensity pose any integrity risks?**

   There are potential integrity risks associated with the calculation based upon the two elements as noted in our response to question one.

   Another potential risk could arise in connection with the definition of expenditure incurred by the entity since many wholly-owned groups of companies with a turnover greater than $20m have elected to consolidate for tax purposes. As such, total “expenditure” incurred by the entity will be that of the Australian located wholly-owned group. Many groups do not prepare financial statements on a tax consolidated basis.

   Where wholly-owned groups are not consolidated, then under the current definition total expenditure will be limited to that entity. For taxpayers with pre-existing technology and research projects, there is the theoretic ability to restructure the development function of the business into a separate entity to take advantage of a higher concessional deduction. However, such restructures are often complicated from a tax and legal perspective where a transfer of intellectual property is involved. Further, in order to take advantage of the R&DTI, the separate entity must be in a taxable position. Often entities that generate valuable intellectual property incur early losses as a risk for future profit.

3. **Could total expenditure be aggregated across a broader economic group? Would this create any implementation and ongoing compliance challenges?**

   Depending on the aggregation rules, BDO questions the practical feasibility of requiring taxpayers to aggregate total expenditure across economic groups as this will have several implications. Firstly, the integrity of the measure could be improved in line with the discussion above, however, expanding the calculation to economic groups could result in significant difficulties with compliance and also potentially distort the apparent policy purpose.

   For example, certain economic groups include international entities. Many Australian entities also conduct R&D overseas. The calculation of R&D intensity that includes only Australian R&D (and not ineligible foreign expenditure) in the numerator has the potential to create a significant distortion as it will unfairly impact on the benefit available.

   Secondly, the inclusion on foreign entities with potentially different reporting cycles would result in additional costs and compliance to obtain annualised expenditure reports.

Recommendations:

- The intensity test should be calculated based on tax treatment of expenditure. The denominator should be comprised of total tax deductions (label Q of item 6 in the ITR) plus any R&D expenditure not deducted elsewhere in the ITR (i.e. label Z of the R&D schedule 'Total notional R&D deductions' less Label D 'accounting expenditure subject to R&D tax incentive')
- Should the denominator require expenditure to be included based on accounting standards, a provision should be included to allow companies to 'opt out' of the intensity test and accept a 4% incentive component to avoid the likely additional time and resources required to calculate this correctly
- The intensity test should be applied on an entity basis

Clinical Trials exemption under the $4 million refund cap

4. Does the definition of clinical trials for the purpose of the R&DTI appropriately cover activities that may be conducted now and into the future?

The fact that the definition of 'clinical trial' is based on that of the Therapeutic Goods Administration (TGA) is useful in that it provides some certainty to applicants as to the type of activity that would qualify for the R&DTI and the exclusion from the proposed refund cap. It will assist companies with the planning of their clinical trial activities, which as TGA dictate, must be sufficiently planned and applications submitted well in advance of the commencement of the clinical trial activity. Therefore, at a superficial level the definition would appear to appropriately cover clinical trial activities that are undertaken now and into the future, however such an approach invokes a number of other concerns we draw attention to below.

In particular, we understand that the intention is to limit the definition of clinical trials to those conducted in humans and not extend to pre-curser research studies including trials in animals. If this is the intention, this needs to be clarified in the legislation.

Although amendments will be made to allow the Board of ISA to make findings binding on the commissioner of taxation as to whether an activity satisfies the definition of 'clinical trials', we note that under the R&DTI program not all clinical trial activities would meet the eligibility criteria for a 'core' or 'supporting' activity. For instance, a phase IV trial may not be conducted for the purpose of generating new knowledge within the intended ambit of the provisions. Furthermore, there are specific criteria required to be met under the IR&D Act 1986 for R&D activities conducted overseas that may not be met in certain clinical trials. The introduction of a Finding for clinical trials will add additional administrative burden to ISA who already will be making Findings on the eligibility of activities under the existing Findings process.

Secondly, the TGA already have extensive approval processes in place for assessing the validity of clinical trials. An obvious potential issue that could arise in such circumstances is opposing views between a governing body and the ISA. Rather than doubling up of the assessment of what constitutes a 'clinical trial', BDO suggest that ISA base their understanding of what constitutes a 'clinical trial' on those that would receive the TGA's approval, and rather focus on the eligibility of the activities in line with the current legislative definitions. This would also prevent any further changes to the ITAA 1997 should the definition of ‘clinical trials’ change to meet market needs.

5. **Does the proposed finding process represent an appropriate means of identifying clinical trials expenditure for the purposes of the $4 million refund cap?**

BDO does not believe that the finding process is an appropriate means of identifying clinical trial expenditure. The current and proposed finding process require a finding to be submitted in advance or in the year of the relevant activities being performed. Given the usual timeframes associated with conducting clinical trials these findings will mostly rely upon budgeted numbers in order to make their assessment. Due to the very nature of R&D, the expenses attributed to these activities can likely change and may not accurately reflect the expenditure that will actually be spent on the clinical trial activities.

Secondly, the draft legislation introduces a definition of expenditure attributed to clinical trials which allows a refundable offset for any expenditure that ‘relate to’ the R&D activities that form part of a clinical trial. The term ‘relate to’ is highly ambiguous and could bring in expenditure beyond the intention of the intended amendments by the very nature of having a relationship with the clinical trials. Not only does this definition of expenditure lack appropriate guidance, but it increases an entities’ risk of incorrectly claiming under self-assessment. Furthermore, without further guidelines on how such a provision would work in practice, the potential for inconsistency to occur across the industry is greatly increased.

Should the government choose to proceed with enacting provisions that provide an additional tax benefit for clinical trial activities, BDO suggests that further refinement and clarification be provided of the scope of clinical trial activity and expenditure that would qualify for the R&D Tax Incentive. Furthermore, BDO does not agree with the implementation of a finding process to provide certainty around the scope of eligible clinical trial activity and expenditure. Rather, the existing finding and registration process should be retained to provide some certainty relating to clinical trial activities.

Recommendations:

- Any R&D projects with sufficient R&D expenditure to receive greater than a $4 mil refundable offset in any one income year should be required to submit a Finding. A three month extension to submit a Finding should be provided to accommodate the few that fall into this category
- The clinical trial definition should follow that as dictated by the TGA, and will still be required to meet the current definitions of eligible core and supporting activities in 355-25 and 355-30. Further clarification is needed should it only be intended to apply to trials in humans and include medical devices
- Tightening of the definition of expenditure attributed to clinical trials. It should be limited to resources used directly in the clinical trials, not ‘relating to’

Additional questions

6. Do the draft feedstock and clawback provisions give rise to any unintended consequences that need to be addressed?

BDO understands the intention of the new feedstock and clawback provisions, however the mechanism proposed is cumbersome and unnecessarily complex. The proposed changes introduce a new complicated formula which compares 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. Similar to that of the tiered mechanism itself, companies will be required to act on a retrospective basis, limiting their ability to make decisions.

We understand that the intention is to have the same clawback mechanism for both feedstock and government recoupments, where under the current legislation, one results in additional assessable income (feedstock) and the other in additional tax payable (recoupments). As changes to assessable income can have flow on impacts to other provisions in the tax law, additional taxable income may be a better means of clawback.

Whilst the changes have eliminated the negative benefit for those accessing the non-refundable offset, for those able to access the refundable offset it 'disgorges' the benefit for items sold at a profit – not the original intention of the provision when first introduced in 2011. Whilst some benefit may be obtained if tangible products are sold at a loss, entities would have to incur increased administration costs associated with calculating a clawback amount for feedstock adjustments despite not getting much benefit. Furthermore, despite guidance published by the ATO and AusIndustry in 2015 '*Can an R&D entity choose not to claim feedstock input and avoid feedstock adjustments?*', no specific provision has been included to allow entities to 'opt-out' of applying the feedstock clawback. in order to determine whether it is worth claiming feedstock, claimants have to do what-if analysis whereby assume claiming all and compare to assume not claiming any.

We are also of the view that the current legislation generally addresses the taxing point of a clawback between related entities.

Recommendations:

- Provisions should be provided to allow entities to opt in or out of including feedstock/clawback expenditure as R&D expenditure. Ideally this expenditure could still be included in the numerator of any R&D intensity calculation
- Have the clawback mechanism as additional tax payable rather than assessable income
- Provide more realistic and accurate examples of how the changes will operate in practice.