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Research and Development Tax Incentive Amendments – Consultations

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Input to R&D Consultation Paper

Calculation of R&D Intensity- total expenditure

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

Response:

(1) The proposed calculation of R&D intensity takes into considerations the ratio of the notional R&D deductions to the total expenses incurred by a R&D entity on its Australian operations. The purpose of the R&D TI is to encourage the conduction of R&D activities in Australia through indirect funding that would otherwise not be conducted. Conduction of R&D activities is linked closely to a company's business strategy and the availability of R&D expertise, resources and infrastructure to successfully conduct experimental activities. The incentive for an R&D entity to conduct its activities in Australia is thus not just the ability to access the incentive, but also to ensure that it can successfully conduct R&D activities in Australia based on its requirements for R&D expertise, resources and infrastructure.

(2) The proposed calculation rewards R&D entities with a higher proportion of notional R&D deductions with respect to their total expenditure. Theoretically this would mean that R&D entities that have the same notional R&D deduction figure but lesser total expenditure stand to benefit more.

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However, the nature of business of a R&D entity may involve it to incur more expenditure on non-R&D activities. This would be unfair to it compared to other R&D entities with similar notional R&D expenses in this regard. A challenge is thus managing the perception of fairness on the R&D entity's part for incentivizing it to conduct its R&D activities in Australia. We think that a benchmarking factor used in the proposed calculation of R&D intensity depending on the R&D entity industry type (e.g. ANZSRC standard research classification) and the nature of the R&D activities conducted by the R&D entity could make the application of this calculation fairer to R&D entities.

(3) Multinational companies operating through a permanent establishment in Australia may only have a consolidated set of financial statements to report its accounting activities. This could pose a challenge in recognizing expenditure incurred in Australia from an accounting standpoint. Another challenge in this regard is the reporting and recognition of expenditure for overseas companies conducting joint ventures with Australian companies and the determination of the correct proportion of notional R&D deductions that may be attributed to each entity.

(4) An Australian company with overseas subsidiaries that conduct R&D activities in overseas jurisdictions for the benefit of the Australian company can access the R&D Tax Offset only if it successfully receives an Overseas Finding from ISA. This necessitates it to conduct at least one core R&D activity in Australia to which the overseas activities have a strong link, and the expenses it incurs on the overseas activities need to be less than the expenses it incurs on its Australian R&D activities. However this may not be practical from a commercial standpoint at all times. If the Australian company funds the operations of its overseas subsidiaries and maintains a set of consolidated financial statements, it would be able to show a total expenditure figure but no notional R&D deductions if it does not conduct any core R&D activity in Australia. Based on the proposed calculation, the Australian R&D entity would not be able to access the full benefits of the R&D TI scheme. We propose that accounting and tax treatment of intellectual property ownership and exploitation be studied and understood in details from the perspectives of tax consolidation.

(5) Another challenge could be posed in the identification of the ultimate beneficiary in a consolidated group. In some jurisdictions, disclosure of controlling entities can be difficult to obtain. There could be different legal structures interposed on one another which could create complications in determining the exact expenditure figures and the beneficiary of the intellectual property arising out of conducting the R&D activities. Issues can also surface in cases where R&D entities are controlled by exempt entities in overseas jurisdictions where limited disclosure details are available.

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

Response:

(1) Consider a scenario where there is an intellectual property (IP) holding company H incorporated in Australia. There are two Australian R&D entities R1 and R2 that are conducting R&D activities independently under contract with H. R&D Services Agreements are made between H and R1, and between H and R2. Suppose that in the R&D Services Agreement between H and R1, the following are cited:

- (a) Clear tangible deliverables to H by R1;
- (b) H to pay R1 for its deliverables on the basis of its technical acceptance criteria regardless of whether the deliverables are considered a technical success or failure;
- (c) H not to pay R1 if R1 fails to deliver;
- (d) H to own all the intellectual property related to the deliverables by R1 only, excluding know-how;
- (e) R1 to own know-how that it generates through conducting the R&D activities necessary to provide the deliverables to H

In this scenario, R1 bears both the financial risk (as it does not get paid if it fails to deliver (in a scenario where the experimental hypotheses fail to be tested correctly and there are no experimental outcomes)) and technical risk (as it conducts the experiments necessary to provide the deliverable). As R1 also owns the know-how generated through conducting the R&D activities, and assigns only the intellectual property associated with the deliverable, it could assess itself as a R&D entity. H, in this case, also bears the financial risk (if it accepts the deliverable made by R1 but it is not deemed a technical success based on its own experimental objectives) and technical risk (based on technical failure of the deliverable made by R1) and owns the intellectual property associated with the deliverable. H can also assess itself as a R&D entity.

There are the following issues around tax integrity in this scenario:

- (a) R&D Services Agreements may be drafted with a bias to enable multiple companies access the R&D Tax Offset
- (b) H in this case can have a very high R&D intensity ratio because its notional R&D deductions and total expenditure are the same. If the R&D Services Agreements are structured with bias, along with H, both R1 and R2 are admitted to accessing the R&D Tax Offset for a single set of experiments done overall
- (c) Consider a different entity E entering into R&D Services Agreements with R1 and R2, and H is an IP holding company different from E. E incurs all contract expenses for R&D activities conducted by R1 and R2. H incurs no expenses and has no income. H and E are not associate entities/affiliates. Under the R&D Services Agreements, H is the ultimate beneficiary of the conducted R&D activities, and R1 and R2 assign all know-how obtained to H by default. In this scenario E, R1 and R2 are not R&D entities. H is the ultimate beneficiary of the intellectual property generated by the R&D activities but does not incur any total expenditure or notional R&D deductions. In this situation, H will not be able to access the R&D Tax Offset under the proposed method of calculation. There could be further complications if any one of E, R1 and R2 or its associate entities/affiliates obtain a grant for conducting the R&D activities assigned by E in the R&D Services Agreements.

We think it would be helpful if specific guidance materials could be provided on intellectual property ownership and exploitation for the correct application of the R&D Intensity calculation method.

(2) Another issue that can arise is for approved Advance Findings from the ISA. For instance in the previous example, R1 obtains an approved Advance Finding on its conducted R&D activities (assuming it owns the know-how generated) for three successive financial years. In the first year, depending on how much its' estimated total expenditure is, it assesses the ratio applicable to it based on the proposed R&D Intensity calculation method. It also assesses the ratio applicable to it based on estimated figures for the next two financial years and determines that the ratio would be less compared to the first year in terms of R&D Intensity. Thus, it has a strong incentive to either sub-contract the R&D activities to another company in Australia after the first year or move its R&D activities overseas in a jurisdiction where it can obtain higher R&D Tax Offset equivalents (e.g. Israel). The proposed R&D Intensity calculation method is based on a fixed figure at the end of a given financial year, whereas for an Advance Finding, expenses on eligible R&D activities are estimated. We think that the proposed calculation method could integrate an element of estimated future expenses to the present value while determining the R&D Intensity factor. That would help R&D entities better plan their R&D activities and ensure that they obtain the most benefits out of the R&D TI scheme.

(3) Another issue that can arise is the assignment of approved Overseas Findings on a continuous basis to different R&D entities without the need to obtain a new Overseas Finding for the originally approved activities. This poses a challenge in monitoring experimental activities conducted overseas by different entities on behalf of an Australian R&D entity that has already secured an approved Overseas Finding. For example, B is an Australian R&D entity that has secured an approved Overseas Finding in the 2017-18 income year for that year and two successive financial years. In all the 3 years, overseas company C1 services B for the approved activities. At the end of the three years, B could still access the R&D Tax Offset by engaging another overseas company C2 for conducting the same approved activities in the Overseas Finding. This could potentially cause a problem as C2 could enter into a R&D Services agreement with another overseas company C3 for subcontracting specific tasks, and B could still access the R&D Tax Offset for the extra expenses incurred via that contract. It could be a problem to monitor the activities of the overseas companies C2 and C3 and there could be issues in obtaining information on interests in these companies for specific jurisdictions.

(4) Another issue that can arise is the element of collaborative research between entities. For instance, suppose Australian R&D entities N1 and N2 are collaborating with an overseas company N3 to conduct specific experiments. Due to the nature of the experimental activities and the design of experiments, N2 will need to obtain the finds of a specific experiment conducted by N1 and N3 to proceed. This experiment is based on core technology developed jointly by N1 and N3. In this scenario, integrity measures on acquisition of core technology may be applicable to N2, which cannot conduct its set of experiments without accessing this technology. Similarly, N3 cannot develop its core technology further without the finds from N2. The finds of N2 are given to N3 which conducts its own experiments to develop an updated form of its technology that is then made available to N1 for further experimentation. Another level of complication can be introduced by the timelines of these events. In this situation, correction factors must be introduced overall to the R&D Intensity factor to correctly and fairly apply the ratio for N1 and N2 to access the R&D Tax Offsets. We think that a correction

factor could be introduced to the R&D Intensity calculation method for collaborative R&D activities between multiple entities as well as entities working under a cross-licensing scheme of intellectual property use and co-development. Specific guidance materials on such situations may be provided for better understanding of R&D entities on tax integrity measures. Such guidance materials should cover topics on cross-licensing of intellectual property between entities and co-development of intellectual property by different entities from a fairness perspective of participating in the R&D TI scheme.

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

Response:

(1) Total expenditure could theoretically be aggregated across a broader economic group where there is a clearly identified ultimate beneficiary entity. However, this could give rise to the following issues:

(a) A economic group could have multiple entities as its members that are spread across Australia and the world. In some jurisdictions, disclosures of the interests in such member entities may not be publicly available. In such instances, it can become difficult to identify all the members of the economic group.

(b) The intent of the R&D TI scheme is to encourage the conduction of R&D activities in Australia which otherwise would not have been conducted. This implies the notion of financial incentive availability as an attraction factor to companies to conduct their R&D activities in Australia. However, the mere availability of an incentive is not the sole determining factor for conducting R&D. Based on recent reports such as The Australia 2030: Prosperity through Innovation, it has been found that Australia lacks necessary infrastructure, resources and expertise in a large number of science and engineering fields that make it less viable for large R&D entities and multinational companies to conduct their R&D activities in Australia. Also, based on the same report, OECD countries such as Sweden, Israel, UK and the USA provide better direct funding support for conducting R&D. These jurisdictions also possess highly skilled resources, expertise and infrastructure to support R&D. Hence, aggregation of an economic group for a multinational company across its operating jurisdictions to determine the R&D Tax Offset in Australia may not be an attractive proposition for such entities to conduct R&D in Australia as the R&D Intensity factor would be low.

(c) Competitive jurisdictions in R&D have clear strategic service delivery models that exhibit high levels of transparency, administrative accountability and assistance to companies in accessing government and public funds for conducting R&D. Innovation and R&D programs are administered efficiently with high degrees of reporting and disclosure of entities participating in such programs. This would help eliminate some of the problems associated with grouping of economic entities if there is sufficient incentive for them to be disclosed for the purpose of maximizing their benefits under the R&D TI scheme.

(d) In some instances, aggregated turnover of a R&D entity can exceed the threshold mark due to its associated entities and affiliates. These associated entities and affiliates may not be doing any

R&D. If aggregation of expenses of these entities is done and the R&D Intensity factor determined in its proposed form, the ratio might be quite low for the R&D entity. This would be unfair to the R&D entity that conducts its R&D activities independently. It would be akin to getting penalized for being part of a larger group that has a large and successful revenue base and non-R&D expenses. In such situations, there would be innovative schemes at avoiding the connection between associated entities and affiliates for a R&D entity through legal structuring and contracting.

(e) In some instances, there may be a variety of legal structures of members of an economic group. This would pose complications in identifying the true beneficiary of the intellectual property generated through R&D activities. Selective application would need to be made for specific activities and types of R&D entities, which could increase the reporting and record keeping burden of R&D entities. For large R&D entities, this could involve significant efforts in terms of time and costs, and may defeat the purpose of their participation in the R&D TI scheme.

(f) Another issue could be brought about by the issue of tax residency of certain entities forming part of the economic group, as well as different standard reporting periods of such entities. There are also issues that can arise by specific events in legal restructuring of entities, especially in overseas jurisdictions. For example, entities held privately may be dissolved in an overseas jurisdiction without reporting to Australian regulators. Such events would need to be reconciled and the right elements of the law applied.

(g) There should be more monitoring and compliance activities for detecting various events in an aggregated broader economic group comprising of different members. The ATO and AusIndustry should work with ASIC and other global incorporators to gather more data in this area.

Specific guidance materials to R&D entities would provide better understanding of these matters.

Clinical Trials exemption under the \$4 million refund cap

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

Response:

(1) We think that providing a channel whereby R&D entities can submit a brief description of their proposed/conducted R&D activities and the substantiation basis of notional R&D deductions to a panel jointly administered by the ISA and ATO and obtain notification about their eligibility and substantiation correctness would be of assistance to R&D entities looking to claim expenditure for clinical trials. The current Advance Finding process scopes the legally binding nature of the eligibility of R&D activities only, which could also be extended to identification of activities as eligible clinical trials. However the Advance Finding says nothing about the substantiation of notional R&D deductions, which is a crucial component for R&D entities to correctly manage from a risk management and tax integrity perspective. Obtaining a notification about substantiation correctness at the time of conducting the R&D activities would be very helpful to R&D entities doing clinical trials. This would enable the R&D entity link notional R&D deductions better with registered R&D activities and identify clinical trials expenditure of the \$4 million refund cap.