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Delivered via email to: RnDamendments@treasury.gov.au

To Whom It May Concern

**Re: Feedback and Comments on the Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials.**

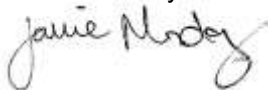
Ernst & Young (EY) is pleased to make this submission in response to the implementation of the Government's 2018-19 Budget measure – *'Better targeting the research and development tax incentive'*.

As requested, please find attached our feedback and comments on the *Treasury Laws Amendment (Research and Development Incentive) Bill 2018* and Explanatory Materials for your consideration.

We would welcome the opportunity to meet with Treasury and discuss the below in further detail and to assist to rectify some of the unintended consequences and complexity we have highlighted.

Thank you again for the opportunity to provide our comments. If you have any queries in relation to our submission, please contact me on (02) 9276 9087, Mark Chan on (03) 9655 2523 or Ezra Hefter on (08) 9429 2293.

Yours sincerely



Jamie Munday

Partner

*Enc.*

# EY Submission

## Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials

July 2018

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# 1. Executive Summary

Further to the Consultation paper released on the draft *Treasury Laws Amendment (Research and Development Incentive) Bill 2018* ('Exposure Draft') and the Explanatory Memorandum ('EM'), we recognise and support the need to improve the integrity, additionality and fiscal sustainability of the Research and Development ('R&D') Tax Incentive Programme.

The R&D Tax Incentive Programme continues to be a highly valued incentive to support continued innovation by Australian businesses. It provides support to companies to invest in Australian R&D – employing scientists and technical staff, supporting investment and encouraging companies to pursue new ideas and initiatives.

Having reviewed the Exposure Draft, we provide below our overall consideration of the proposed changes to the R&D Tax Incentive. In the context of integrity, additionality and fiscal sustainability:

- We recognise the need to implement a cap on the refundable tax offsets available on the basis that this enables the fiscal affordability of the programme.
- Whilst we support the exclusion from this cap for Clinical Trials, it is our view that this exclusion should be expanded to provide an industry-agnostic exclusion for any activity which is considered 'high value' R&D activity.
- We do not support the proposed implementation of a benefit which is tied to R&D intensity (and ultimately, company expenditure). We have further concerns over the proposed methodology for this intensity calculation.
- In our view, the proposed legislation will significantly increase the level of complexity and compliance burden on R&D Tax claimants. It is complex, and requires a more thorough analysis.
- We are unclear on how the key elements of the proposed changes assist the R&D Tax Incentive to achieve its stated goals to '*support additionality in R&D activities and spillover benefits to the broader economy*'<sup>1</sup>

In our analysis of the Exposure Draft, we have also identified a number of particular issues and unintended consequences with the legislation in its proposed format and would welcome the opportunity to further discuss these. These include:

- The significant differences between Tax and accounting treatment of expenditure and the various fact patterns which can create unexpected outcomes for R&D Tax claimants.

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<sup>1</sup> Explanatory materials, *Exposure Draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018*, Page 3, Paragraph 1.2.

- Due to the complexity of the R&D Intensity test, claimants are unable to determine their R&D benefit prior to committing to their R&D activity – reducing the incentivising effect of the R&D Tax Incentive.
- A substantial impact on R&D Intensity can occur as a result of a specific claimants circumstances, and not as a result of the intensity of their R&D activity, for example:
  - Whether the claimant has elected to be Tax Consolidated
  - Whether the claimant's R&D expenditure is capitalised for accounting
  - Whether the claimant is headquartered in Australia (and hence has additional expenditure in Australia) or is a Foreign inbound corporation

Whilst each of these facts significantly impacts an R&D Entity's benefit available through the R&D Intensity test, they will have no impact on the additionality of spillover benefit created by the entity's R&D activity, nor will it encourage the R&D entity to undertake additional R&D activity in future years.

- A fundamental conflict exists between the intentions of the R&D Tax Incentive – to change behaviours and encourage additional R&D Activity by providing a tax benefit – and the proposed Part IVA changes which attempt to discourage taxpayers from entering into arrangements to obtain a tax benefit.
- A definition for clinical trials which may inadvertently exclude the study of the efficacy of 'medical devices'
- Limit the ability of to request advanced findings for Overseas R&D activities which are clinical trial activities.
- Potentially exclude supporting R&D activities which are directly related to Clinical Trials.
- Amended feedstock and grant clawback provisions which significantly increase complexity and compliance burden for claimants, particularly where existing guidance enabling claimants to avoid these calculations can no longer be relied upon.
- Extension of time provisions which result in unintended consequences where a claimant would have no recourse in the event of an error by the Board of Innovation and Science Australia ('ISA')
- Amendments to the Tax Transparency system which could impact industries where strategic and sensitive R&D information is made public.
- Additional Board delegation powers which create concerns in relation to the consistency and robustness of decision making processes when these responsibilities are expanded.

We welcome the opportunity to provide our comments in relation to the Exposure Draft and its impacts on the broader innovation ecosystem in Australia. Where possible, we have not just

provided our analysis but we have also highlighted any potential recommendations for the program for consideration.

## 2. Overall Consideration of Proposed R&D Tax Changes

Prior to providing feedback to the 6 specific questions outlined in the Consultation Paper, we provide below our commentary in relation to the overall nature of the policy changes and their impact on Innovation in Australia.

### 2.1 R&D expenditure caps provide stability and fiscal sustainability to the programme

In the past six years, the R&D Tax legislation has been changed multiple times, including a change in the eligible R&D activity definition, changes to the R&D benefit rate, the introduction of a cap on total R&D claims, and uncapping of the refundable R&D expenditure amount. These regular changes to the legislation have created substantial uncertainty within claimants where they are considering long term R&D investments in Australia. Some of the changes, including the removal of caps on the refundable R&D Tax expenditure amounts have resulted in cost increases to the programme and in some significant benefits accruing to individual taxpayers.

We are not in favour of arbitrary caps on R&D expenditure, and believe that any arbitrary cap should be subject to regular review to ensure it is still relevant for incentivising and supporting R&D activity. An arbitrary cap does not support the principles of additionality or spill overs.

However, given the focus around fiscal sustainability, we acknowledge the Government's desire for the \$4million cap on refundable R&D Tax offsets on the basis that this will provide fiscal certainty and long term sustainability to the programme. Similarly, we recognise the need to implement the proposed \$150mil cap on non-refundable tax offsets on the basis that this will provide certainty and longevity to the programme.

As outlined in part 3.2 below, we also support the provision of specific exclusions (including *clinical trials*) from this cap but believe this should be expanded to any activity which is considered worthy of this support. If the goal of this legislative change is to support key R&D activities which are considered to provide larger spill over benefits to the broader economy, these exclusions should also be available for any other company (no matter what industry they are in) who meets the same key requirements as the clinical trials.

**Recommendation: The proposed cap amounts should be regularly reviewed by parliament to ensure it remains an incentivising amount for claimants.**

**Recommendation: Exclusions to the refundable cap should be extended to be made available for any (industry agnostic) activities where they provide significant benefit and spillovers to**

**the Australian economy. This could include a pre-approval process and guidelines for any activities which are not clinical trials.**

## **2.2 Intensity calculation reduces certainty and does not incentivise additional activity**

The EM to the proposed legislation identifies that the objective of the Incentive is to encourage R&D activities that might not otherwise be conducted in cases where the new knowledge gained is likely to have a wider Australian economic benefit. That is, the Incentive is intended to support additionality in R&D activities across a range of industries, and maximise the spill-over benefits to the broader economy. Whilst this is the stated intention it is not clear to us that the proposed intensity model will actually have the desired effect to incentivise firms to change their R&D investment behaviour and consequentially increase their level of R&D activity (the additionality), and nor is it apparent how it assists in the capturing of spill over benefits.

The reason is a simple one: the determination of which tier of R&D Intensity a company might fall into cannot be determined at any point in time during a company's income year. Therefore, the notion that the Intensity model might incentivise claimants to "do more R&D" during the year is a false one. At best, the determination of Intensity Tier can only be accurately calculated at year end, when both R&D and total expenditure figures have been finalised. As opposed to providing an incentive to "do more R&D" during the year, the R&D credit might be better described as a "rebate" on past year R&D intensity instead of its stated intention of supporting additionality.

Expanding further, there are several reasons why in many cases, this form of R&D Intensity based incentive runs counter to the stated objectives of the R&D legislation, including:

1. **Decreased certainty** – Claimants cannot predict with accuracy the potential R&D incentive rate their planned expenditure will receive in advance. This makes it harder to accurately factor the R&D Tax Incentive into company decision making and reduces the effectiveness of the stated intentions of encouraging additionality.
2. **Internationally uncompetitive** - The tiered design of the intensity calculation means that the maximum benefit available to claimants is less than the 12.5% benefit rate listed in the Exposure Draft (closer to 12% at 100% intensity) – this puts Australia's R&D benefit below many similar jurisdictions in our region, including New Zealand<sup>2</sup> and Singapore<sup>3</sup>. In addition,

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<sup>2</sup> NZ Tax Incentive rate 12.5% - New Zealand Government, "R&D Tax Incentive Fuelling Innovation to Transform Our Economy" (April 2018) Page 14 (Accessible at: <http://www.mbie.govt.nz/info-services/science-innovation/funding-info-opportunities/rd-tax-incentive/research-and-development-tax-incentive/rd-incentive-discussion-document.pdf>)

<sup>3</sup> Singapore allows a deduction of between 150%-250% of eligible R&D Expenditure - Ministry of Finance Singapore, "Research and Development and Intellectual Property" (Accessible at <https://www.mof.gov.sg/Policies/Tax-Policies/Corporate-Income-Tax/Research-and-Development-and-Intellectual-Property>)



there are very few regimes internationally which utilise a tiered system, with the vast majority choosing a more certain and less complex flat benefit.

3. **The Intensity Test discriminates against certain industries** - Industries, such as manufacturing, minerals processing, and industrials, with large cost of goods sold (COGS) naturally have large accounting expenditure amounts and thus receive lower R&D Incentive rates. Conversely, industries with limited COGS, or with high capitalised amounts, such as software development companies, will receive higher incentive amounts. The intensity test will also discriminate against Australian companies who have made large historical capital investment to set up long term operations in Australia, by continually capturing the long term investment (via depreciation expenditure) within the intensity test calculation. In this manner companies who decide to make long and ongoing commitments to the Australian economy will be adversely impacted as the annual depreciation associated with their capital investment will be included in the cost base calculation to determine their R&D rate for many years following their investment.
4. **The Intensity Test discriminates against consolidated entities** – a consolidated group with an R&D ‘arm’ receives a lower R&D incentive than if that R&D ‘arm’ was a standalone R&D entity. Such differences have no impact on the additionality of the R&D expenditure, but will greatly impact any benefit that a company’s receives for making its R&D investments.
5. **The Intensity Test reduces the benefit as companies grow** – an R&D entity can spend the same amount on R&D activity for a number of years, but receive an ever decreasing incentive amount as the company grows as outlined in part 2.2.2
6. **Definitional Complexity** - The Intensity calculation creates significant additional complexity to the R&D Incentive legislation – the substantial variation between rules around ‘Accounting Expenditure’ and the tax rules will result in significant uncertainty and complexity, and various potential unexpected outcomes as outlined in part 3. It is relevant to recall that complexity was one key reason for changing from the R&D Tax Concession to the ‘less complex and more predictable tax credits’ under the R&D Tax Incentive<sup>4</sup>
7. **Punishes existing Australian companies (especially Australian Headquartered companies)** – It is only appropriate and natural that Australian Headquartered corporates will incur significant overhead costs for maintaining and running its Head Office functions (corporate, general and administrative activities) in Australia. Conversely multinational groups which maintain regional or global head offices in jurisdictions outside Australia do not incur these costs in Australia, or at a minimum, incur such costs on a significantly smaller scale. Therefore the additional ‘cost base’ of maintaining Australian corporate head office here means that Australian head offices organisation will receive an unintended bias against them.
8. **Many “Losers”, especially in companies that manufacture in Australia** – Based on our modelling, a substantial proportion of claimants of the non-refundable R&D Tax Offset will be

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<sup>4</sup> The Treasury, “Consultation Paper - The New Research and Development Tax Incentive” (18 September 2009)

worse off under this Exposure Draft and a disproportionate share of ‘losers’ are in industries where discretionary R&D expenditure is highly valuable and margins are low – manufacturing, industrials etc. This will significantly impact these company’s investment on innovation going forward.

Overall, we are deeply concerned with the intent of the proposed Intensity calculation as a fundamental concept for supporting innovation additionality and supporting spillover benefits – the overall objectives of the R&D Tax legislation. In our opinion, this policy is flawed in its design and will not achieve its stated intentions for the reasons outlined above.

We are also deeply concerned with its proposed implementation. The substantial additional complexity from using ‘accounting expenditure’ in this calculation will create further uncertainty and complexity in the R&D Tax legislation (refer to our response in Section 3).

**Overall Recommendation: The R&D Intensity calculation should be replaced by an alternative methodology which achieves the stated savings objectives of the amendments, but also provides certainty to claimants and incentivises additionality. For example, the introduction of a collaboration premium, as discussed in section 1.4 below, while not delivering any cost savings, is likely to encourage additionality in R&D Expenditure, by encouraging collaboration projects outside of the claimants business R&D programme.**

### 2.2.1 No proven link between R&D Intensity and additionality

There is limited evidence regarding any link between a tiered R&D Intensity system and either additionality or spillover benefits. We are unable to identify significant existing modelling or research literature which supports the link between a tiered R&D benefit rate and additionality in R&D expenditure.

Global analysis of different data<sup>5</sup> indicates that the level of R&D intensity is in fact much more likely linked to the industry that you are in, rather than the level of additionality or spill overs provided. Thus for example some industries (e.g. software and biotechnology) are inherently more R&D intensive, while others, especially with large cost bases and smaller margins are less R&D intensive (eg. agriculture and resources). R&D Intensity should not be confused for additionality- just because an industry or sector is more R&D intensive does not mean that it will be more sensitive to doing additional R&D based on a tax incentive.

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<sup>5</sup> For example see: <https://www.forbes.com/sites/tendayiviki/2016/08/21/why-rd-spending-is-not-a-measure-of-innovation/#772fc9cc77dd>, which is based on data from Strategy and their global 1000 innovation index of innovation companies: <https://www.strategyand.pwc.com/innovation1000/past-year-studies>

In fact, in the nearest analogue, the Centre for International Economics considers incentives for incremental R&D and 'Brackets and Ceilings' on R&D expenditure and outlines these to be 'not recommended' based on its study of 83 Incentive programmes worldwide<sup>6</sup>. On this basis, the question that is raised is – will the R&D Intensity test result in any additional R&D activity or expenditure, and the associated spillover benefits, occurring in Australia over a non-intensity based system?

## 2.2.2 Limited Incentive to increase expenditure to reach a higher bracket

Under the proposed R&D Intensity calculation, the overall benefit of increasing R&D activity expenditure for the majority of claimants is minimal. Should a company marginally reach a higher benefit bracket, the additional benefit received is only applied to this marginal amount and therefore the net increase in benefit is immaterial compared to the increase in R&D Expenditure required to achieve this. In our view, the tiered R&D Intensity system does not sufficiently incentivise an increase in R&D expenditure by claimants of the non-refundable tax offset.

Further, the proposed method of calculation using the R&D intensity formula in effect creates a cap on the numerator in the calculation of \$150 million<sup>7</sup>. As a result of this, any company with an accounting expenditure of over \$7.5 Billion is effectively capped at a maximum benefit rate of 4% (or a maximum incentive amount of \$6 million) because its R&D Intensity is unable to exceed 2% of total expenditure.

This 'Expenditure cap' has a negative impact on innovation in Australia as it effectively punishes an R&D claimant for growing. For example, if we consider a company that spends almost all of its accounting expenditure on R&D activities each year (i.e. ~100% Intensity), supporting universities whilst creating many spill-over benefits to the Australian economy, and progressively grows over a number of years to a large and successful innovative company - their R&D benefit will slowly reduce from approximately 12% to 4% as they grow. This therefore fails to encourage any additional R&D expenditure and actively punishes the growth of the entity.

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<sup>6</sup> The CIE – R&D Tax Incentive Programme Review – 29 March 2016, Tables 3.3, 3.4 and 3.5

<sup>7</sup> *Exposure Draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018*, Schedule 1, paragraph 355-100(3)

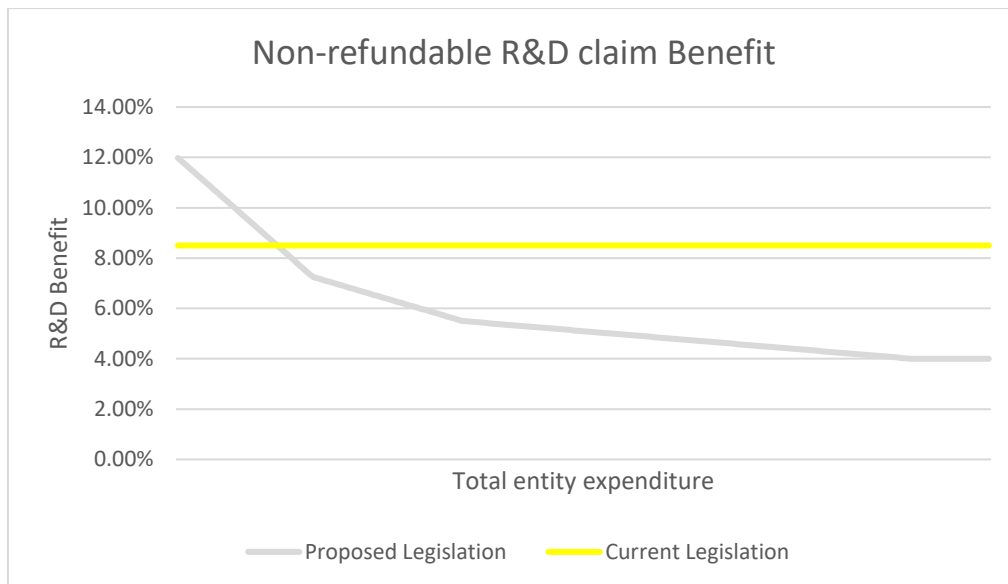


Figure 1 – comparison between old R&D legislation and Exposure Draft and their effective benefits for claimants

**Recommendation:** The Intensity Calculation should not cap the numerator in the calculation as this creates an artificial cap at 4% for some larger claimants - even if their R&D intensity is higher – and it reduces the benefit as companies grow and spend more.

## 2.3 Conflicting Objectives – Encouraging R&D & Anti-Avoidance

As stated in the EM, the objective of the R&D Tax Incentive is to encourage activities that might not otherwise have occurred. The fundamental objective of the incentive is to encourage companies to change behaviours to undertake R&D activities, and to take actions to obtain this tax benefit (in this case conduct R&D activities). This objective appears to directly conflict with the proposed changes to Part IVA of the *Income Tax Assessment act 1936* – which are focussed on anti-avoidance rules (and claimants being motivated to take actions to obtain a tax benefit).

Whilst we support the principles espoused in Part IVA and the additional compliance focus outlined in the budget announcement, we have concerns around the balancing of the R&D Tax and Part IVA intentions for the R&D Tax programme. This is particularly concerning where there exists limited guidance for claimants in this area, so accidental non-compliance with the requirements can occur (though we appreciate that ISA's planned 'Determinations' may rectify this shortfall as outlined in part 4.4).

There exists a fundamental conflict in objectives with the proposals in the exposure draft – the system encourages claimants to perform activities and structure their affairs to obtain the R&D tax benefit, and regulatory bodies are pushing companies to plan and document R&D activities in advance – to encourage spill over benefits and additional activity – and ensure their R&D agreements are structured

in a way to make them the rightful claimant. On the other hand, the anti-avoidance provisions attempt to discourage taxpayers from entering into arrangements for the purposes of obtaining a tax benefit and potentially punishing these behaviours. It can be foreseen that much compliance effort may be expended in the future on discerning the fine line between commercial R&D structuring and ‘contrived arrangements’ to maximise the tax benefits available under the R&D tax incentive regime.

As an example of this, a small entity undertaking R&D activities which was originally created under a trust structure would not be able to access the R&D Tax Incentive. In this case, it is not unusual for this entity to adjust its structure (to a company) to access the R&D Tax Incentive and utilise this benefit to increase its R&D expenditure (providing spillover benefits and additionality). Company restructuring activity such as this, whilst supported under the objectives of the R&D Tax Incentive, could also raise concerns from the changes outlined in the Exposure Draft.

As a result, we suggest that a mechanism to resolve this inherent conflict is created. We would suggest that where R&D claimants are trying to do the right thing and acting in “good faith” with a reasonable expectation of making an R&D claim, that they be excluded from Part IVA provisions, in respect of R&D tax claims only. This would still allow Part IVA to apply to the worst transgressions (with no reasonable expectation of an R&D Tax claim) but not harm those who have taken reasonable action to access the R&D Tax Incentive.

**Recommendation: While we support all efforts in improving the integrity of the R&D Tax system, we note the competing objectives of the tax system to simultaneously encourage changing behaviours (under the R&D Tax system) and mitigate any malicious behaviours through Part IVA Tax anti-avoidance. As such, we would suggest a “good faith” exclusion where parties can reasonably demonstrate that the activities they undertook were for the purposes of obtaining an R&D Tax benefit, and they had reasonable basis to make an R&D Tax claim.**

## 2.4 Collaboration Premium

Recommendation 2 of the 3F Review<sup>8</sup> of the R&D Tax Incentive programme recommended the implementation of a collaboration premium for work with publicly funded research organisations. It also specifically states that this premium should be excluded from any R&D Intensity amounts.

There is substantial value in collaborations between research organisations and industry, both in terms of spill over benefits and the support of broader innovation ecosystems, and these collaborations

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<sup>8</sup> Ferris, B, Finkel, A & Fraser, J, Review of the R&D Tax Incentive, Australian Government Department of Industry, Innovation and Science, Canberra, (4 April 2016) <<https://industry.gov.au/innovation/InnovationPolicy/Research-and-development-tax-incentive/Pages/R-and-DTax-Incentive-Review-report-and-submissions.aspx>>.

should be actively supported. We support this proposed recommendation of the 3F report and are disappointed that the Exposure Draft does not incorporate this.

One suggestion for enabling this collaboration Premium would be to create an additional benefit tier (20% as recommended by the 3F review) to the intensity cap for any expenditure amounts with registered Research Service Providers ('RSP'). RSP amounts are already identified by R&D claimants in their expenditure calculations, so identifying these amounts for this premium would not result in any additional compliance burden to R&D Entities.

This would allow all claimants (regardless of their R&D Intensity) to access a premium benefit and encourage further collaboration between research organisations and industry. The benefits of such an initiative include:

- It is a flat benefit – applying regardless of a claimant's R&D Intensity
- It provides certainty to claimants and can be planned / budgeted in advance
- It is simple and industry agnostic, without favouring local / overseas companies
- It is a premium amount (that is globally competitive)
- It encourages additionality in R&D collaboration with universities and research organisations, supporting Australian science and innovation and the activities likely provide the largest spillover benefits.

**Recommendation: That a collaboration premium for expenditure with Research Service Providers (including universities and the CSIRO) be included in the Exposure Draft to encourage collaboration between Industry and research organisations, that would apply regardless of their R&D Intensity tier.**

### **3. Response to Specific Questions**

Further to the request for feedback and comments, we provide the following responses to the specific questions outlined in the consultation document.

#### **3.1 Calculation of R&D Intensity – total expenditure**

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

###### **3.1.1.1 Increased complexity and compliance burden**

We believe the proposed changes will create significant additional complexity in the R&D tax system, increasing the compliance burden on claimants.

The complexity associated with predicting a company's total accounting expenditure, as well as R&D expenditure for an income year means that most companies would be unable to pre-determine what proportion of their expenditure may be eligible for incentivised treatment, and at what rate, prior to the end of the financial year. Uncertainty in predicting an R&D entity's total accounting expenditure can arise from a variety of factors, including the inherently volatile nature of markets and foreign exchange rates, variations to input cost of goods sold or bad debts. The presence of so many moving variables makes predicting intensity unfeasible prior to the end of the claimant's financial year.

The presence of this uncertainty reduces the incentivising effect of the program, as companies on the threshold will be unsure if they are able to claim R&D expenditure at the time when they are making R&D investment decisions. Alternatively, it will provide a windfall gain with limited incentivising effect for companies on the borderline of a higher tier which end up exceeding the tier threshold in a given income year.

Implementing this change will also impose an additional compliance burden on companies (increasing program cost and reducing the incentive to participate in the program). In addition, imposing this requirement may increase business planning complexity – companies will have to make a technical determination in advance on what might or might not qualify (a technical function), as well as make an assessment of likely expenditure over an entire organisation (a finance function). This is an undesirable distortion as it increases the administrative tasks companies have to undertake, taking away resources available to core business functions (including R&D activities).

###### **3.1.1.2 Compliance challenges**

The proposed legislation places a substantial importance on accounting expenditure. Given this, and the material impact that this figure will have on a claimant's incentive rate, it is expected that the ATO

would take a significant interest in the makeup of these amounts. Therefore there exists a concern that the ATO may be required to investigate these amounts through its compliance activity, effectively reviewing a company's (usually externally audited) accounting policies. The overlap between tax and accounting considerations may create some compliance challenges.

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

#### **3.1.2.1 Mismatch between Accounting and Tax Rules**

In relation to what is the total expenditure, the Consultation Paper states "The total expenditure will be based on that of the claimant, which would be retrieved from the claimant's own tax return." The definition in the legislation however states that an R&D entity's expenditure is worked out by reference to accounting standards and other pronouncements issued by the Australian Accounting Standards Board.

In Australia, there is no systematic connection between the income tax law and accounting concepts or standards, and there may be risks of using such a hybrid of specific tax and accounting rules. At the outset, the use of accounting standards for these purposes within the confines of the R&D tax law is unsatisfactory, since accounting concepts can be different to taxation laws, and accounting standards do not require transactions to be measured on an arm's length basis.

One particular risk in using the accounting standards for example is the tax terminology of 'incurred' together with accounting standards, which themselves distinguish between expenses and expenditures, and rely on the concept of matching rather than incurred. Accounting standards are not always precise, and calculating 'Total Expenditure' based on accounting concepts may lead to an inflated representation of expenditure and confusion when trying to tally up the concepts to tax rules.

As an example, if we consider an example of an R&D entity that is required to make Transfer Pricing adjustments pursuant to an ATO review or audit activity for historical years. These adjustments in the accounting standards only require such adjustments to be disclosed in the current year accounts, whilst the tax adjustments must be reflected in each of the years in question. The company therefore must reflect an increased amount in the current year accounting expenditure, amend its historical tax returns to increase its Interest expenditure, and also recalculate its R&D Intensity in each of these years. In this example, the company has been forced to increase its accounting expenditure in the current year and reduce its R&D Intensity, but also increase its expenditure in prior years and reduce its R&D Intensity. It has effectively double counted the same adjustment.

Extending this example further, this concept could apply to all related expenditure adjustments and that flows on to tax amendments where expenditure may be denied as a deduction, re-classified or re-characterised; these changes (whilst prima facie has no relevance to R&D activities) could have



unintended consequences where changes to the company's "total expenditure" would result an adjustment to the level of "R&D intensity", and therefore result in a reduction (or increase) in the R&D tax offset.

### **3.1.2.2 R&D Grouping and Intensity**

The proposed legislation doesn't address whether accounting expenditure would include expenditure of entities that are 'connected' or 'affiliated' pursuant to Section 328 of the ITAA97 when determining aggregated turnover. As this intensity is determine on an R&D Entity basis, there may be an incentive in not consolidating the R&D Entity to the broader tax group (making this R&D Entity a standalone entity), as not consolidating would theoretically reduce compliance burden as well as potentially increase the R&D intensity. This goes against the principles of tax efficiency and reduced administrative burden of consolidation.

Similarly, the proposed R&D legislation appears to inadvertently punish R&D Entities who are consolidated or MEC groups. Take, for example, a consolidated R&D Entity with a 'technology' subsidiary which has a very high R&D Intensity, but the overall group R&D Intensity is very low as the MEC group has many other non-R&D entities. If the MEC group was not consolidated, this "technology" subsidiary would achieve a higher R&D benefit as its R&D Intensity is higher. This increased R&D Intensity and benefit is not a reward for the company for increased R&D expenditure, spillover benefits or any of the other intentions of the R&D Tax Incentive legislation, it is merely a result of the company's structure.

While this appears to be an unintended consequence of the Draft R&D Legislation, it is important that Treasury understands that adjusting this definition to include 'connected' and 'affiliated' entities would result in a substantial increase in the compliance burden for claimants as discussed in part 3.1.3 below.

### **3.1.2.3 Unintended Consequence - Capitalised R&D expenditure in the R&D Intensity calculation**

The proposed method for calculating an R&D entity's expenditure includes expenditure incurred for the income year as per accounting principles, plus any amount included in the R&D entity's R&D expenditure calculations not included in these accounting principles<sup>9</sup>.

This proposed methodology effectively incentivises the capitalisation of expenditure for accounting purposes. Should an R&D entity have capitalised substantial amounts of its expenditure during the year, its R&D Intensity will be artificially higher than an R&D entity that did not - as the denominator of the R&D Intensity calculation will be lower. Whilst we support the concept of excluding capitalised

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<sup>9</sup> *Exposure Draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018*, Proposed s355-115.

amounts in general – companies with substantial capital projects should not be provided with a lower intensity rate – it does create some unintended consequences in its current format.

Industries which would often have substantial capital expenditures that also includes R&D expenditure<sup>10</sup> (e.g. software development costs are often capitalised) will have higher R&D Intensities than those with higher accounting expense amounts (e.g. manufacturing with a high Cost of Goods Sold) even though the total R&D expenditure amounts and effective intensities are the same.

Similarly, there could be similar scenarios where an R&D entity which is required to capitalise a large proportion of its expenditure under the accounting rules, but claims a small percentage of these amounts under the R&D Tax incentive, would have a very high R&D Intensity. Again, this has no bearing on how 'intensive' the company's R&D focus is, it is merely a result of the accounting treatments of different expenditure amounts.

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

This approach, while appearing to be simple, requires careful consideration as to whether it would give rise to integrity concerns or additional complexity. Aggregating of accounting expenditure across diverse and largely unrelated parties, who may be somehow connected in an undefined 'economic group', would be a substantial administrative task for R&D claimants. For example, if multiple R&D entities with different financial year ends are considered part of the same 'economic group' for this calculation – would each claimant be required to prepare accounts for an alternative period to calculate its total accounting expenditure?

Further, such a requirement would exacerbate the unpredictability of the R&D benefit and would further limit the 'incentivising' nature of the R&D Tax programme. Any potential R&D Entity would need to consider the planned expenditure of all entities in its 'economic group' before determining the likely incentive available in Australia – an administratively complex and uncertain task to undertaken prior to commencing any R&D activity. It is also unclear if the economic group would be limited to Australia or apply globally – this could add further complexity.

In addition to this, depending upon how the aggregation of this expenditure occurs, there is also a risk of double counting of expenditure amounts in a broader economic group. For example, where a head entity pays a non-consolidated subsidiary to bear the employment costs of its operations. In this example, the head entity accounts for a cost for its payments to the subsidiary, and the subsidiary accounts for expenditure in the form of salaries. If these amounts were aggregated, there would be double counting of these amounts and the entity's R&D Intensity will be erroneously reduced as a

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<sup>10</sup> Any R&D claim would only include intangible amounts due to the exclusion under s355-225

result of this. Any 'economic group' definition will need to cater for these scenarios and ensure intra-group amounts are ignored or removed from the Intensity calculation - however this would further complicate the design of the Intensity calculation and further reduce certainty for claimants.

It is also relevant to recall the earlier precedence of the 175% Incremental R&D benefit calculation under the previous R&D Tax Concession, where the grouping of R&D expenditure was required to determine increases in average expenditure - and was particularly complex and required the removal of these inter-company amounts. It was generally accepted at the time that this benefit provided limited spillover benefits and limited certainty for companies in their R&D Tax planning. To revert to a similarly complex calculation for grouping expenditure in the R&D Intensity Test appears to add significant complexity to the R&D Tax Incentive for limited economic benefit to Australia.

Another comparable area of the R&D legislation is the \$20million turnover test for 'connected' entities and 'affiliates' of the R&D entity. The difference with this test is that administratively, it is merely a question of whether the R&D entity is above or below this amount. Should a similar definition be included in the R&D Intensity calculation, companies would be required to know their exact expenditure for all entities in its 'group' to accurately determine its intensity. This is a substantially higher burden for claimants. Furthermore, these rules were based on the Simplified Tax System provisions that are developed for small businesses, and would not envisage the potentially larger and more complex groupings that exist amongst medium and large businesses.

**Recommendation: For administrative simplicity, claimants should be able to elect to receive the lowest R&D benefit rate without having to determine its exact R&D Intensity – in a similar manner to the \$20million turnover test for refundable R&D Tax offsets.**

**Alternative Recommendation: That total expenditure not be aggregated across a broader economic group, due to the complexity of such an aggregation.**

## 3.2 Clinical Trials exemption under the \$4 million refund cap

### 3.2.1 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?

While the proposed definition of a clinical trial for the purpose of the R&D Tax Incentive appears to be sufficiently broad to cover a number of medical trials that could be undertaken by R&D entities, there is a concern that the wording is such that medical devices could be unintentionally excluded from the exemption. As medical devices under development, like medicines and diagnostic procedures, must be subjected to an extensive program of clinical trial prior to regulatory approval and commercial release, it may be prudent to extend the clinical trial definition to include reference to these items.

**Recommendation: Broaden the definition of clinical trials to specifically include medical devices – for example:**

*A clinical trial is a planned study of the safety or efficacy in humans of an intervention (including a medicine, treatment, device, or diagnostic procedure) with the aim of achieving at least one of the following:*

- a) The discovery, or verification, of clinical, pharmacological or other pharmacodynamic effects;*
- b) The identification of adverse reactions or adverse effects;*
- c) The study of absorption, distribution, metabolism or excretion.*

Further, the R&D activities that would be deemed to form part of a clinical trial have not been well defined in the draft legislation nor explanatory memorandum. When an R&D entity seeks to undertake a clinical trial much time and expense is spent on ancillary activities such as clinical trial design, seeking ethics approval, and clinical trial material manufacture, to name a few, that are intrinsic to the execution of the clinical trial. While we note that the Board of ISA will have the power to make findings about whether an R&D entity's activities satisfy the definition of a clinical trial, guidance documentation needs to be released prior to implementation as to whether supporting activities with a direct, supportable, nexus to the core clinical trial activities would be deemed to form part of the clinical trial and thus be covered by the clinical trial exemption.

**Recommendation: Release further guidance material as to what R&D activities would be taken to form part of a clinical trial and thus likely be eligible for the clinical trial exemption**

Additionally, there is a concern that by imbedding the R&D Tax Incentive clinical trial definition in legislation, the definition would lack sufficient agility to enable it to be modified as industry disruptors emerge and redefine what clinical trials are and how they are undertaken. Trends such as digitisation and participatory health in particular, have the potential to have a significant impact. As such, it is uncertain as to whether the proposed clinical trial definition would appropriately cover activities undertaken in the future.

**Recommendation: The clinical trial definition should be subject to regular review to ensure it is fit for purpose.**

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

We note that the exposure draft has been structured such that the Board of ISA may make a finding as to whether an R&D entity's activities satisfy the definition of a clinical trial at the time of registration through either '27B Findings about application for registration', '27J Findings about a registration', or as an advance finding through '28A Advance findings about the nature of activities'. It is unclear as to whether these findings will be issued on a self-assessment basis (similar to existing R&D Registration processes) or if this will require detailed review by ISA.

The review process associated with all of these findings can be extremely time intensive and impose significant administrative burden on both the R&D entity and the Board of ISA representatives.

In order to mitigate this burden, guidance documentation should be released ahead of the proposed measures outlining the activities that would be covered under the clinical trial exemption, and the supporting documentation required to enable the Board of ISA to make a finding. A streamlined and timely review process will be integral to the application of this exemption.

**Recommendation: Clear guidance outlining the documentation required to support a finding in favour of a clinical trial exemption should be released ahead of implementation to help streamline the review and approval process**

### **3.2.3 Other Comments on Clinical Trials Definition**

#### **3.2.3.1 Overseas Findings for Clinical Trials**

Currently companies who undertake activities overseas can apply for an Advance Overseas Finding pursuant to section 28C of the *IR&D Act*. The Exposure Draft has failed to include a capacity for ISA to make Findings about clinical trials under s28C of the *IR&D Act*.

In certain situations companies have no choice but to undertake a portion of the clinical trials overseas - for example in situations where there are not enough candidates to undertake the clinical trial wholly in Australia. In these cases, the clinical trial (or aspects of it) must be undertaken overseas. In our view these activities, where they meet all the other stringent requirements of s28C regarding eligible

overseas R&D activities (that more than 50% of expenditure is in Australia, a significant scientific link to Australian R&D activities etc.), should be supported.

**Recommendation: The Exposure Draft should be updated to enable ISA to make Findings under s28C of the *IR&D Act* in relation to clinical trials undertaken overseas.**

### 3.2.3.2 Supporting Activities for Clinical Trials

We note that the Exposure Draft has effectively created a third type of R&D Activity – activities are now either Core R&D Activities, Supporting R&D Activities or Clinical Trials<sup>11</sup>. This then creates a question regarding supporting activities for these new Clinical Trials.

s355-30 of the ITAA97 currently defines supporting activities as '*directly related to \*Core R&D Activities\**'. It would appear that without amendment to this section, companies undertaking clinical trials would not be able to capture supporting R&D Activities for these clinical trials. We presume this is an unintended outcome of the draft legislation.

**Recommendation: Update s355-30(1) of the ITAA97 to '*Supporting R&D activities are activities directly related to \*core R&D activities or \*Clinical Trials\**'.**

### 3.2.3.3 Extension of this specific exclusion to support all 'high value' R&D activities

As outlined at 1.1 above, we are not in favour of the precedent created by specifically supporting one industry's R&D activity to the exclusion of all others. We therefore recommend the broadening of any exclusion to be non-industry specific. This can only be achieved by determining what qualities exist in clinical trials that warrant such support from taxpayers and applying similar conditions in an industry-agnostic manner.

In our view, support is warranted for clinical trial activities due to the broader benefits created in the economy by such activities – employment to scientists, technical staff and broader spillover benefits to Universities and other research organisations. It is therefore reasonable to assume that any other R&D activities which result in these significant spillover benefits to the Australian economy should also be considered for exclusion from the \$4million cap.

**Recommendation: We recommend that the definition excluding clinical trials from the \$4million refundable R&D Tax Offset cap be expanded to enable any activities which meet the same criteria (in terms of spillovers, innovation and broader economic good) to be supported. Guidelines or an Advanced Finding process could be created to provide certainty to other industries.**

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<sup>11</sup> *Exposure Draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018*, Proposed s27B(1)(e) & s27B(1)(f), s27J(1)(e) & s27J(1)(f) etc.

### 3.3 Feedstock and Clawback

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

We welcome the move away from the clawback tax to an assessable amount for companies in losses, as instead of paying the clawback tax, the companies can now utilise existing tax losses.

Unfortunately, however, this appears to have come at the cost of simplicity and a greater compliance burden.

Claimants are now required to determine its 'Adjusted Offset amount' for each year of claim, and reflect these adjustments (in the form of taxable income) in the year in which the Feedstock adjustments are triggered. Further, for each year the claimants are required to calculate at which rate the adjustment should apply due to the various tiers of the proposed R&D Intensity Test and the R&D offset rate – which will vary depending on the company's Income Tax rate.

Whilst the methodology appears to provide the intended outcome (i.e. the R&D benefit obtained is correctly offset by additional assessable income), the complexity associated with these calculations will result in a substantial compliance burden for claimants.

We note that joint Specific Issue Guidance released by the ATO and AusIndustry in relation to Feedstock provided claimants with significant certainty in relation to Feedstock adjustments. This guidance material effectively enabled claimants to not register relevant activities which would trigger the feedstock adjustments, allowing them to avoid having to perform the complex calculations required for no net benefit. This Specific Issue Guidance substantially removed the compliance complexity for many claimants where there is no net gain, and its administrative principles should continue to be supported.

**Recommendation: We recommend that the Specific Issue Guidance in relation to Feedstock be re-released as a Determination as soon as possible to provide claimants with further certainty on this new legislation.**

## 4. Recommendations on Other Matters in Exposure Draft

### 4.1 Extension of Time

We note that part 4 of Schedule 3 of the Exposure Draft legislation seeks to limit the further periods allowed for providing information to 3 months in the Industry Research and Development decision-making Principles 2011 (The Decision Making Principles). Whilst we agree in principle to this amendment, we disagree with the way this change has been implemented.

Specifically, the proposed addition at section 3.2 (3) has 'effect despite section 3.4'. Section 3.4 of the Decision Making Principles considers when the Board allows further periods where there has been 'an act or omission of the Board' – in other words, the Board has inadvertently made an error. In these cases, it is incumbent on the Board to provide the R&D entity with any additional time required to rectify these errors. The examples of these omissions provided in the Decision Making Principles include:

- Provision of incorrect information that is detrimental to the interests of the interested person
- Failure to correctly address correspondence to the interested person.

Should the proposed exposure draft be implemented in its current state, these accidental omissions or errors by the Board would still have a limited timeframe of 3 months for the R&D entity to rectify. This could create potential circumstances where the Board has erred, and the R&D entity, the Board or any relevant interested person has no legal capacity to rectify the error after 3 months. This appears to be an unintended consequence of the proposed legislation.

**Recommendation: We support efforts to reduce the retrospectivity in the R&D Tax Process, but suggest that the Exposure Draft legislation omit the words 'This subsection has effect despite section 3.4' from line 8 of Part 4 of Schedule 3 of the Exposure Draft legislation.**

### 4.2 Public Reporting – Opt Out System

As soon as practicable after the end of the income year, the proposed legislation requires the Commissioner to publish information about the R&D entities that have claimed notional deductions for R&D activities, including the amount claimed and feedstock amounts.

While EY strongly supports the efforts around tax transparency, the detail and commercially sensitive nature of this information on R&D expenditure must be carefully considered. The benefits of having this information in the public domain must be carefully balanced against the costs, commercial impacts and security concerns which may apply.



Amounts that companies have spent on R&D activities in a given year is highly commercially sensitive. In the event that an entity has a significant increase or decrease in its R&D expenditure in any given year, and its competitors were able to learn of this information through this public reporting, there are potentially significant commercial ramifications for the entity. Furthermore, this may act as a signal to competitors (including in Australia and Overseas) regarding business plans and strategies.

Concern around publication of this information is especially high for many sensitive industries that would be concerned about disclosure of this information in real time or near real time. Australia would be unique globally in requiring disclosure of this type of information with no potential to opt out of the system. On the other hand, with the passage of time, the disclosure of this information may become less commercially sensitive.

Further, public reporting of R&D expenditure could create circumstances where 2 unrelated parties who collaboratively undertake R&D activities, both claiming their relevant share of eligible R&D expenditure, could identify commercially sensitive information about the other party. An example of this would be 2 companies who have the same R&D expenditure with the same Feedstock adjustments, but different R&D Intensities because one party has achieved cost savings elsewhere in its operations. In this case, both parties would have different Feedstock amounts reflected in their publicly reported data (due to differing R&D intensities and therefore benefit rates) and the publication of this discrepancy could result in commercial implications on their future R&D collaborations.

This concept of publishing the notional R&D expenditure does not provide the true tax benefit, and can be misuse by media agencies to report on R&D expenditure when the true cost is the net tax benefit obtained. This net tax benefit may be much lower due to distortionary effects of feedback clawbacks and lower R&D intensity tier, and therefore what might seem to be a large reported R&D expenditure number may in yield a very low (<4%) rate of R&D benefit.

**Recommendation: While EY strongly supports the efforts around tax transparency, the detailed and commercially sensitive nature of this information on R&D expenditure may cause issues. As such, we recommend that the Exposure Draft legislation amend Part 1 of Schedule 3 to allow companies to self-select out.**

**Recommendation: We recommend that the Committee consider delaying the publication of R&D data for at least a number of years after the year end. For example, release of 2017-18 information could be released 3 years later, in 2020/21, when the information would be considered less sensitive.**

**Recommendation: We recommend that the Committee consider reporting on net tax benefit, instead of notional R&D expenditure.**

### 4.3 Board Delegation

We note that part 3 of Schedule 3 of the Exposure Draft Legislation seeks to omit the existing limitation on Board delegation to SES employees, or acting SES employees. The stated reason for this additional delegation power was to provide the Board with greater assistance in carrying out its functions. The EM states that the expansion will allow these additional staff to undertake 'high volume, low risk functions' to assist the Board, however does not formally limit these additional staff to these functions.

In our experience, the experience and industry expertise in question of ISA delegates is key to ensuring the decisions made are accurate, consistent and robust. Should this decision making power be expanded, we expect an increase in the quantum of decisions that are required to be reviewed. The significant cost involved with claimants associated with reviewing any Reviewable Decisions should be recognised, and the frequency of these reviews should be minimised.

In its current state, we would hold concerns in relation to the extent of these delegation powers beyond those of an administrative nature, for example, assisting companies with registration issues. In particular, the delegation of powers of the Board which have significant ramifications to R&D Entities – such as the making of Reviewable Decisions – should, in our view, be made by senior staff only, such as SES employees (and any of the listed persons in paragraph 21 of the Industry Research and Development Act).

**Recommendation – We would suggest a legislated limitation on this delegation power to administrative tasks, but not in matters that may compromise the quality of review activity such as Reviewable Decisions – it should be explicit on which matters will be dealt with and ensuring appropriate review. We suggest a service charter and commissioner oversight (similar to the Tax Commissioner for the ATO) would also assist with this.**

### 4.4 Determinations

We note that Part 2 of schedule 3 of the Exposure Draft allows the Boards to make Determinations about the Boards powers, functions and duties. The Board may, by notifiable instrument, make a determination about how it will exercise its powers, and perform its functions or duties and these determinations are binding on the Board. These Determinations will not be binding on R&D entities.

In general, we support the implementation of the Boards powers to make determinations, however note that this is not exactly the previously discussed public rulings database.

In particular, we support that these Determinations are to be co-designed and developed in consultations with relevant stakeholders<sup>12</sup> as we believe this process is important to ensure binding determinations do not result in unexpected outcomes – particularly where R&D entities have no ability to appeal or amend these determinations (unless through the Administrative Appeals Tribunal).

**Recommendation: That the publicly available Determinations system also enable a capacity for claimants to request Determinations (similar to the ATO Private Binding Rules database) to further provide clarity and certainty to claimants.**

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<sup>12</sup> Explanatory materials, *Exposure Draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018*, Page 30, Paragraph 3.34

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