2019

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (RESEARCH AND DEVELOPMENT TAX INCENTIVE) BILL 2019

EXPLANATORY MEMORANDUM

(Circulated by authority of the Treasurer, the Hon. Josh Frydenberg MP)
# Table of contents

Glossary .......................................................................................................................... 1

General outline and financial impact ............................................................................. 3

Chapter 1 Better targeting the Research and Development Tax Incentive ..................... 5

Chapter 2 Enhancing the integrity of the Research and Development Tax Incentive .......... 19

Chapter 3 Improving the administration of the Research and Development Tax Incentive .......... 41

Chapter 4 Regulation impact statement ........................................................................ 51

Chapter 5 Statement of Compatibility with Human Rights ......................................... 73
The following abbreviations and acronyms are used throughout this Explanatory Memorandum.

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bill</td>
<td>Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019</td>
</tr>
<tr>
<td>Commissioner</td>
<td>Commissioner of Taxation</td>
</tr>
<tr>
<td>Decision-making Principles</td>
<td>Industry Research and Development Decision-making Principles 2011</td>
</tr>
<tr>
<td>Incentive</td>
<td>the Research and Development Tax Incentive</td>
</tr>
<tr>
<td>IR&amp;D Act</td>
<td>Industry Research and Development Act 1986</td>
</tr>
<tr>
<td>ISA</td>
<td>Innovation and Science Australia</td>
</tr>
<tr>
<td>ITAA 1936</td>
<td>Income Tax Assessment Act 1936</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and development</td>
</tr>
<tr>
<td>Review</td>
<td>Review of the R&amp;D Tax Incentive</td>
</tr>
<tr>
<td>SES</td>
<td>Senior Executive Service</td>
</tr>
<tr>
<td>TAA 1953</td>
<td>Taxation Administration Act 1953</td>
</tr>
</tbody>
</table>
General outline and financial impact

Better targeting the Research and Development Tax Incentive

Schedule 1 to the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 (the Bill) reforms the Research and Development (R&D) Tax Incentive (the Incentive) to better target the program and improve its effectiveness and integrity.

Schedule 2 to the Bill enhances the integrity of the Incentive by ensuring that R&D entities cannot obtain inappropriate tax benefits and by clawing back the benefit of the Incentive to the extent an entity has received another benefit in connection with an R&D activity.

Schedule 3 to the Bill improves the administrative framework supporting the Incentive by making information about R&D expenditure claims transparent, enhancing the guidance framework to provide certainty to applicants and streamlining administrative processes.

Date of effect: All of the amendments made by the Bill commence on the first 1 January, 1 April, 1 July or 1 October to occur after the day the Act receives the Royal Assent. The amendments in the Bill generally apply to income years commencing on or after 1 July 2019. Some administrative amendments in Schedule 3 apply from commencement.

Proposal announced: The Bill implements the legislative measure Better targeting the research and development tax incentive from the 2018-19 Budget with changes including a later application date and refinements to the intensity-based R&D tax offset for large R&D entities.

Financial impact: These amendments are estimated to have a gain to the budget of $1.8 billion over the current forward estimates period in fiscal balance terms:

<table>
<thead>
<tr>
<th></th>
<th>2019-20</th>
<th>2020-21</th>
<th>2021-22</th>
<th>2022-23</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$175.0m</td>
<td>$435.0m</td>
<td>$585.0m</td>
<td>$570.0m</td>
</tr>
</tbody>
</table>

The financial impact has been revised since the 2018-19 Budget to account for the impact of policy and parameter variations, it does not include the impact of the departmental funding and compliance measures also announced in the 2018-19 Budget.


Compliance cost impact: The reforms are estimated to result in a total average annual regulatory cost for businesses of $26.3 million.
Summary of regulation impact statement

Regulation impact on business

*Impact:* The reforms are estimated to result in a total average annual regulatory cost for businesses of $26.3 million.

*Main points:*

- The Government is implementing reforms to the Research and Development Tax Incentive. The reforms will refocus support towards supporting additional high intensity R&D expenditure, while also ensuring the program’s effectiveness and integrity.

- The 2016 Review of the R&D Tax Incentive found that the program falls short of meeting its stated objectives of supporting additionality and spillovers. The Review made several recommendations to address this.

- The reforms are expected to result in an overall compliance cost, arising from minor changes to the registration and claims processes, as well as the initial adjustment to the new program.
Chapter 1
Better targeting the Research and Development Tax Incentive

Outline of chapter

1.1 Schedule 1 to the Bill reforms the Research and Development (R&D) Tax Incentive (the Incentive) to better target the program, and improve its effectiveness and integrity.

Context of amendments

The R&D Tax Incentive

1.2 The Incentive was introduced in 2011. The Incentive is intended 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 and spillover benefits to the broader economy.

1.3 Division 355 of the ITAA 1997 provides R&D tax offsets to R&D entities for a range of expenses and depreciation costs incurred on R&D activities. There are currently two R&D tax offsets available:

- a 43.5 per cent refundable tax offset available to most small R&D entities – those with an aggregated turnover of less than $20 million. The refundable offset can be refunded as a cash payment to an R&D entity if the offset exceeds the entity’s income tax liability; and

- a 38.5 per cent non-refundable tax offset available to larger R&D entities and R&D entities controlled by one or more exempt entities. A non-refundable tax offset may be used to reduce an R&D entity’s income tax liability for an income year but any remaining excess must be carried forward to be applied in future income years.
1.4 The basis for calculating R&D tax offsets is the concept of a notional deduction. A notional deduction is generally recognised for expenditure (Subdivision 355-D) on R&D activities and depreciation on assets held for R&D purposes (Subdivision 355-E) subject to conditions. These deductions are referred to as notional because they are only used to calculate an R&D entity’s entitlement to the R&D tax offset and for some other discrete purposes (section 355-105). That is, the entitlement to the Incentive for a notional deduction replaces any entitlement to an underlying tax deduction.

1.5 The value of the Incentive (the ‘incentive component’) is generally the difference between the R&D entity’s corporate tax rate and the R&D tax offset rate (plus the benefit of refundability where it applies). For example, the incentive component of a large R&D entity receiving the 38.5 per cent non-refundable offset and paying the 30 per cent corporate tax rate is generally 8.5 per cent.

1.6 Under the Government’s reforms to corporate tax rates, the tax rate for companies with an aggregated turnover of less than $50 million has been reduced to 27.5 per cent and will be further reduced in future income years. As the corporate tax rate has been lowered from 30 per cent for some taxpayers, the value of the incentive component of the R&D tax offsets has increased for these entities.

The $100 million expenditure threshold

1.7 The Incentive is subject to a $100 million expenditure threshold, sometimes referred to as an expenditure cap. Expenditure on R&D activities (notional deductions) in excess of $100 million is not eligible for the full rate of the relevant R&D tax offset. Rather, these notional deductions give rise to an offset at the R&D entity’s corporate tax rate. That is, excess notional deductions give rise to the same benefit as if the expenditure had instead been claimed as an ordinary tax deduction, without any incentive component.

1.8 The $100 million expenditure threshold and some associated provisions are legislated to sunset on 1 July 2024 under Part 2 of Schedule 1 to the Treasury Laws Amendment (Research and Development) Act 2015.

Review of the R&D Tax Incentive

1.9 The Government’s reforms are made in response to the recommendations of the 2016 Review of the R&D Tax Incentive (the Review).
The Review was commissioned as part of the Government’s National Innovation and Science Agenda. The Review Panel was chaired by the then Chair of Innovation and Science Australia (ISA), Mr Bill Ferris AC, Australia’s Chief Scientist, Dr Alan Finkel AO, and the then Secretary to the Treasury, Mr John Fraser. The Review Panel was asked to identify opportunities to improve the effectiveness and integrity of the program, including how its focus could be sharpened to encourage additional R&D activities in Australia.

The Review found that the Incentive was failing to fully achieve its objectives of generating additional R&D activities and was not well targeted, providing benefits for R&D activities that would have been undertaken without the Incentive.

The Review also found that the cost of the Incentive had exceeded initial estimates. The cost of the Incentive was expected to be $1.8 billion per annum when it was introduced in 2011-12. In 2016-17, it cost around $3 billion.

The Review made numerous recommendations to improve the integrity and effectiveness of the program and to promote its objectives. The Review also made recommendations to improve the administration of the Incentive. The ISA 2030 Strategic Plan, published in January 2018, made alternative recommendations informed by feedback provided on the Review report. A number of the Review’s recommendations were adopted by Government in the 2018-19 Budget.

**Summary of new law**

Schedule 1 to the Bill improves the targeting of the Incentive through the following changes:

- increasing the R&D expenditure threshold from $100 million to $150 million and making the threshold a permanent feature of the law;
- linking the R&D tax offset for refundable R&D tax offset claimants to claimants’ corporate tax rates plus a 13.5 percentage point premium;
- capping the refundability of the R&D tax offset at $4 million per annum (however, offset amounts that relate to expenditure on clinical trials do not count towards the cap); and
- increasing the targeting of the Incentive to larger R&D entities with high levels of R&D intensity, reducing the benefits provided to certain entities undertaking R&D activities and increasing the benefit to others.
1.15 In particular, large R&D entities with aggregated turnover of $20 million or more for an income year are entitled to an R&D tax offset equal to their corporate tax rate plus one or more marginal intensity premiums.

1.16 The intensity premiums apply to notional deductions within a range of R&D intensity where the R&D entity’s R&D expenditure (notional deductions) are expressed as a proportion of the entity’s total expenses.

1.17 In addition, Schedule 2 to the Bill makes a number of amendments to improve the integrity of the Incentive and Schedule 3 to the Bill makes a number of amendments to improve the administration and transparency of the Incentive. See Chapters 2 and 3 of this Explanatory Memorandum for more information.
Comparison of key features of new law and current law

<table>
<thead>
<tr>
<th>New law</th>
<th>Current law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The expenditure threshold</strong></td>
<td></td>
</tr>
<tr>
<td>The R&amp;D expenditure threshold is increased to $150 million.</td>
<td>The R&amp;D expenditure threshold applies to eliminate the incentive component of the R&amp;D tax offset in relation to notional deductions in excess of $100 million.</td>
</tr>
<tr>
<td>The R&amp;D expenditure threshold is a permanent feature of the law.</td>
<td>The R&amp;D expenditure threshold is legislated to cease on 1 July 2024.</td>
</tr>
<tr>
<td><strong>The R&amp;D Tax Offset for small R&amp;D entities</strong></td>
<td></td>
</tr>
<tr>
<td>R&amp;D entities with aggregated turnover of less than $20 million are generally entitled to an R&amp;D tax offset rate equal to their corporate tax rate plus a 13.5 per cent premium.</td>
<td>R&amp;D entities with aggregated turnover of less than $20 million are generally entitled to an R&amp;D tax offset rate of 43.5 per cent.</td>
</tr>
<tr>
<td>The amount of a refund that an R&amp;D entity can receive is capped at $4 million per annum. Offset amounts that relate to expenditure on clinical trials do not count towards the cap and remain refundable.</td>
<td>R&amp;D entities with aggregated turnover of less than $20 million are entitled to a tax refund for any R&amp;D tax offset they receive in excess of their income tax liabilities.</td>
</tr>
<tr>
<td><strong>The R&amp;D Tax Offset for large R&amp;D entities</strong></td>
<td></td>
</tr>
<tr>
<td>R&amp;D entities with aggregated turnover of $20 million or more are entitled to an R&amp;D tax offset equal to their corporate tax rate plus a premium based on the level of their incremental R&amp;D intensity for their R&amp;D expenditure.</td>
<td>R&amp;D entities with aggregated turnover of $20 million or more are entitled to a non-refundable R&amp;D tax offset at a rate of 38.5 per cent.</td>
</tr>
</tbody>
</table>

Detailed explanation of new law

**Increasing the expenditure threshold**

1.18 The $100 million expenditure threshold is increased to $150 million per annum. [Schedule 1, item 11, subsection 355-100(3) of the ITAA 1997]
1.19 The increase allows R&D entities to claim additional amounts of concessional R&D tax offset on R&D activities. The purpose of this amendment is to increase the incentive for large R&D entities to continue to engage in R&D activities when their R&D expenditure exceeds $100 million.

1.20 The current law provides that the expenditure threshold will cease on 1 July 2024 and requires the Government to conduct a review of the threshold after 5 March 2020. In light of the 2016 Review and the changes to the threshold adopted by the Government, the requirement for the review is repealed and the increased threshold is made a permanent feature of the law. [Schedule 1, items 13, 15 and 16, section 355-750 of the ITAA 1997, table item 3 in subsection 2(1) of the Tax Laws Amendment (Research and Development) Act 2015 and Part 2 of Schedule 1 to that Act]

The refundable R&D tax offset for small R&D entities

1.21 An R&D entity with aggregated turnover of less than $20 million for an income year is generally entitled to a refundable R&D tax offset equal to their corporate tax rate plus 13.5 percentage points. [Schedule 1, item 6, table item 1 in subsection 355-100(1) of the ITAA 1997]

1.22 This refundable offset does not apply to an R&D entity controlled by one or more exempt entities. These R&D entities are instead entitled to the non-refundable R&D tax offset available to R&D entities with aggregated turnover of $20 million or more. [Schedule 1, item 7, table item 2 in subsection 355-100(1) of the ITAA 1997]

The cap on refundable R&D tax offsets for small R&D entities

1.23 Only the first $4 million of any R&D tax offset is a refundable tax offset. Any excess amount of R&D tax offset must be carried forward as a non-refundable tax offset. [Schedule 1, item 4, subsection 67-30(1A) of the ITAA 1997]

1.24 However, amounts of the R&D tax offset arising from R&D activities that form part of a clinical trial do not count towards the $4 million cap and may be included in a refundable tax offset. The objective of this exemption is to incentivise clinical trials that have the potential to demonstrate a net improvement in health outcomes. [Schedule 1, item 4, subsections 67-30(1A) and (1B) of the ITAA 1997]

1.25 Non-refundable R&D tax offsets are applied in priority to refundable R&D tax offsets (table items 35 and 40 in subsection 63-10(1) of the ITAA 1997). This ensures that an R&D entity’s refund cap is not affected by amounts of taxable income the entity would have but for the application of the R&D tax offsets.
Better targeting the Research and Development Tax Incentive

Example 1.1 The refund cap and expenditure on clinical trials

In the 2019-20 income year, Aperture Research has aggregated turnover of $15 million. Without taking into account its R&D activities, Aperture Research has an income tax liability of $500,000.

Aperture Research has incurred $20 million on R&D activities. Of this expenditure, $5 million is incurred conducting a clinical trial of a new medical device.

Aperture Research is entitled to a combined R&D tax offset of $8.2 million, which is $20 million multiplied by the entity’s R&D tax offset rate of 41 per cent (where the offset rate is comprised of the entity’s corporate tax rate of 27.5 per cent plus a 13.5 percentage point premium).

$2.05 million of the tax offset (41 per cent of $5 million) is attributable to the clinical trial.

$6.15 million of the tax offset (41 per cent of $15 million) is attributable to other R&D activities.

Aperture Research is entitled to a refundable tax offset of $6.05 million. Because the value of the offset not attributable to a clinical trial exceeds the $4 million cap, Aperture Research’s refundable tax offset is $4 million plus the offset attributable to its R&D activities forming part of the clinical trial ($2.05 million).

The remaining $2.15 million (from the excess above the $4 million cap) is a non-refundable tax offset.

The $2.15 million non-refundable tax offset is applied in priority to the refundable tax offset.

$500,000 of the non-refundable tax offset can be applied to reduce Aperture Research’s income tax liability for the 2019-20 income year to nil. The value of the remaining $1.65 million non-refundable tax offset is not lost, as it can be carried forward and is available to be applied against a tax liability in future income years.

After applying the non-refundable tax offset against its income tax liability for the 2019-20 income year, Aperture Research is able to apply the refundable tax offset to obtain a cash refund of $6.05 million.

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

- the discovery, or verification, of clinical, pharmacological or pharmacodynamic effects;
- the identification of adverse reactions or adverse effects;
- the study of absorption, distribution, metabolism or excretion.
1.27 An intervention in humans in this context includes any technique, treatment or diagnostic procedure for improving human health, and includes any good that is a therapeutic good for the purposes of the Therapeutic Goods Act 1989. For example, the definition includes:

- medicines (including vaccines);
- medical devices (including in-vitro diagnostics and software);
- cells, tissues and other biological products;
- surgical procedures; and
- radiological procedures.

1.28 The discovery or verification of clinical effects is a broad concept and includes, for example, the immunogenicity of vaccines i.e. the ability of the vaccine to provoke an immune response in a human. It also includes the performance of medical devices.

1.29 This definition only applies for the purposes of the Incentive and does not affect the meaning of the term ‘clinical trial’ as used in other legislation. [Schedule 1, items 4 and 14, subsections 67-30(1C) and 995-1(1) (definition of ‘clinical trial’) of the ITAA 1997]

1.30 The clinical trial exemption only applies for the purposes of the R&D tax offset if an R&D entity has registered an activity as both an R&D activity and an activity that forms part of a clinical trial. Similarly, the exemption only applies to expenditure on clinical trials if the expenditure is on R&D activities registered with the Board of ISA.

1.31 Amendments are made to the IR&D Act to provide the Board of ISA with the power to register R&D activities forming part of a clinical trial. The Board of ISA may also make findings binding on the Commissioner of Taxation (the Commissioner) about whether an R&D entity’s activities satisfy the definition of clinical trials. The Board of ISA may make these findings as part of the registration process for the R&D entity’s R&D activities more generally or as an advance finding on application by the entity. [Schedule 3, items 4 and 6 to 15, subsection 4(1) (definition of ‘clinical trial’), subsection 27A(1), paragraphs 27B(1)(e) and (f), 27J(1)(e) and (f), and 28A(1)(ca) and (cb), section 28, Note 2 to subsection 27B(1), Note 3 to subsection 27E(2), Note 3 to subsection 277H(2), and Note 2 to subsection 27J(1) of the IR&D Act]

1.32 The Board of ISA may also make public determinations that are not specific to a particular R&D entity but that provide general guidance, including in relation to the activities it will consider form part of a clinical trial (see paragraphs 3.24 to 3.38).
Better targeting the Research and Development Tax Incentive

**Intensity-based R&D tax offset for large R&D entities**

1.33 R&D entities with aggregated turnover of $20 million or more for an income year are entitled to an R&D tax offset equal to their corporate tax rate plus marginal intensity premiums determined with reference to the R&D intensity of their R&D expenditure on an incremental basis. [Schedule 1, items 7 and 9, table item 3 in subsection 355-100(1) and subsection 355-100(1A) of the ITAA 1997]

1.34 The intensity premiums in the table below apply to notional deductions within a range of R&D intensity for R&D expenditure where notional deductions are expressed as a proportion of the R&D entity’s total expenses:

**Table 1.1 R&D tax offset intensity premiums**

<table>
<thead>
<tr>
<th>Tier</th>
<th>R&amp;D intensity range</th>
<th>Intensity premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Notional deductions representing up to and including 4 per cent of total expenses</td>
<td>4.5 percentage points</td>
</tr>
<tr>
<td>2</td>
<td>Notional deductions representing greater than 4 per cent and up to and including 9 per cent of total expenses</td>
<td>8.5 percentage points</td>
</tr>
<tr>
<td>3</td>
<td>Notional deductions representing greater than 9 per cent of total expenses</td>
<td>12.5 percentage points</td>
</tr>
</tbody>
</table>

**Example 1.2 The R&D tax offset for large R&D entities**

Contrast Industries has notional deductions of $160 million in the 2019-20 income year, exceeding the $150 million expenditure threshold. In the same income year, Contrast Industries had expenditure of $1 billion. Its aggregated turnover exceeds $50 million, meaning it is subject to the 30 per cent corporate tax rate.

Contrast Industries has an R&D intensity of 15 per cent ($150 million divided by $1 billion). The portion of the R&D tax offset calculated in relation the excess $10 million is calculated separately (see paragraph 1.37).
Contrast Industries’ R&D tax offset for the income year is calculated as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Intensity range</th>
<th>R&amp;D premium</th>
<th>Notional deductions applied</th>
<th>Offset amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>0-4%</td>
<td>4.5%</td>
<td>$40m</td>
<td>$13.8m</td>
</tr>
<tr>
<td>Tier 2</td>
<td>4-9%</td>
<td>8.5%</td>
<td>$50m</td>
<td>$19.25m</td>
</tr>
<tr>
<td>Tier 3</td>
<td>&gt;9%</td>
<td>12.5%</td>
<td>$60m</td>
<td>$25.5m</td>
</tr>
<tr>
<td>Excess</td>
<td>NA</td>
<td>Nil</td>
<td>$10m</td>
<td>$3m</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$160m</td>
<td>$61.55m</td>
</tr>
</tbody>
</table>

**R&D intensity**

1.35 To calculate the R&D tax offset, a large R&D entity must determine its R&D intensity. The R&D intensity is the proportion of the R&D entity’s total expenses spent on R&D expenditure for the income year:

\[
R&D \text{ intensity} = \frac{\text{Notional deductions}}{\text{Total expenses}}
\]

1.36 This is intended to provide a higher rate of support for incremental R&D expenditure to R&D entities that devote a significant portion of their overall operations to R&D eligible for support under the Incentive.

**Notional deductions**

1.37 Notional deductions in excess of the $150 million expenditure threshold do not attract an intensity premium and are not counted for the purposes of calculating an R&D entity’s R&D intensity (see Example 1.2). [Schedule 1, item 11, paragraph 355-100(3)(a) of the ITAA 1997]

1.38 If an R&D entity’s notional deductions for an income year are less than $20,000, the entity’s notional deductions for the purposes of calculating the entity’s R&D tax offset only includes the notional deductions that satisfy the criteria in subsection 355-100(2): that the expenditure was incurred to a research service provider registered under Division 4 of Part III of the IR&D Act or was incurred under the Cooperative Research Centre Program. [Schedule 1, item 10, subsection 355-100(2) of the ITAA 1997]

**Total expenses**

1.39 An R&D entity’s total expenses are reported in their company tax return. The expenses reported at item six of a company income tax return are the expense amounts taken from the company’s financial statements. [Schedule 1, item 12, section 355-115 of the ITAA 1997]
1.40 The Australian Accounting Standards Board’s *Framework for the Preparation and Presentation of Financial Statements* defines ‘expenses’ (at paragraph 70(b)) as:

- decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

1.41 For companies that prepare a financial report for the income year in accordance with the accounting standards and other pronouncements issued by the Australian Accounting Standards Board, those standards and pronouncements apply. For other entities, total expenses are worked out in accordance with other commercially accepted principles relating to accounting. *[Schedule 1, item 12, paragraph 355-115(2)(a) of the ITAA 1997]*

1.42 An R&D entity’s notional deductions are always included in its total expenses. If an amount of notional deductions is not otherwise included in an entity’s total expenses, an adjustment is made to nevertheless include it. *[Schedule 1, item 12, paragraph 355-115(2)(b) of the ITAA 1997]*

1.43 Rules apply to prevent any double counting of amounts recognised at different times as notional deductions and total expenses. *[Schedule 1, item 12, subsection 355-115(3) of the ITAA 1997]*

**Example 1.3 Total expenses**

On 1 July 2019, Ace Designs acquires an asset for $20,000 that it uses exclusively in its R&D activities. The R&D entity claims an up-front notional deduction of $20,000 in the 2019-20 income year (section 355-205).

For its financial accounts, Ace Designs uses the straight line method to work out the asset’s depreciation records. The asset has a useful life of four years. Ace Designs records an expense of $5,000 in each of the 2019-20 to 2022-23 income years for the asset (for simplicity, the effect of a leap year is ignored in this example).

An adjustment is required when the entity’s total expenses are calculated for R&D purposes in the 2019-20 income year. $5,000 is included as an accounting expense under paragraph 355-115(2)(a). However, an adjustment is made to add a further $15,000 to the total expenses, under paragraph 355-115(2)(b). This reflects the additional amount of notional deductions that are claimed in the 2019-20 income year.
No amount is included in Ace Designs’ total expenses for R&D purposes in the later income years in relation to the asset. In each of these years, the $5,000 accounting expenses would initially satisfy paragraph 355-115(2)(a). However, the amounts are disregarded because a corresponding amount was included under paragraph (2)(b) in the 2019-20 income year (applying paragraph (3)(a)).

Consequential amendments

1.44 A cross-reference to the expenditure threshold is amended to reflect the increase of the threshold from $100 million to $150 million. [Schedule 1, item 5, the heading to subsection 355-100(1) of the ITAA 1997]

1.45 A number of amendments are made to section 355-100 of the ITAA 1997 to accommodate and explain the introduction of R&D intensity premiums to the calculation of the non-refundable R&D tax offset. [Schedule 1, items 8 and 10, Note 2 to subsection 355-100(1) and subsection 355-100(2) of the ITAA 1997]

1.46 Similarly, subsection 355-100(3) is amended to reflect both the increased expenditure threshold and the changes to subsection 355-100(1). In turn, a consequential amendment is made to subsection 67-30(1). [Schedule 1, items 2 and 3, subsection 67-30(1) of the ITAA 1997]

1.47 Consequential amendments are made to explain that the amount of an R&D tax offset in excess of the $4 million refund cap is a non-refundable tax offset. [Schedule 1, items 1 and 8, table item 35 in subsection 63-10(1) and Note 1 to subsection 355-100(1) of the ITAA 1997]

Application provisions

1.48 The amendments commence on the first day of the quarter following Royal Assent. [Section 2 of the Bill]

1.49 The amendments in Schedule 1 apply to income years starting on or after 1 July 2019. [Schedule 1, item 17]

1.50 The amendments have a retrospective application for income years starting on or after 1 July 2019 to ensure that they apply as soon as possible to better target the Incentive to improve its effectiveness and integrity and enhance its administrative framework.

1.51 Reforms to the R&D Tax Incentive were announced on 8 May 2018 to apply from 1 July 2018 as part of the 2018-19 Budget. An Exposure Draft of the legislation implementing the 2018-19 Budget reforms was released for public consultation in June 2018. Legislation to give effect to the changes was introduced to Parliament in Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share Of Tax In Australia And Other Measures) Bill 2018. However, this Bill lapsed with
the proroguing of Parliament in April 2019. Affected taxpayers were aware of the Government’s intention to reform the Incentive and the potential impact the Budget reforms would have on the scope of the program from the date of the Budget announcement. The Government has decided that the measures in this Bill generally apply from 1 July 2019 and to implement a simplified three tiered system for the intensity-based R&D tax offset for large R&D entities.
Chapter 2
Enhancing the integrity of the Research and Development Tax Incentive

Outline of chapter

2.1 Schedule 2 to the Bill enhances the integrity of the R&D Tax Incentive by ensuring that R&D entities cannot obtain inappropriate tax benefits and by clawing back the benefit of the Incentive to the extent an entity has received another benefit in connection with an R&D activity.

Context of amendments

Recoupments

2.2 Where an R&D entity benefits from a government recoupment (such as a grant or reimbursement) in relation to expenditure that is also eligible for the R&D tax offset, a clawback applies to reverse the double benefit that arises (Subdivision 355-G). In this context, only the ‘incentive component’ of an R&D tax offset is intended to be clawed back.

2.3 The clawback takes the form of an additional tax on the recoupment (and any other expenditure required as a condition of the recoupment) at a rate of 10 per cent (sections 12B and 31 of the Income Tax Rates Act 1986). The 10 per cent rate was initially selected as a simplicity measure by making the assumption that the R&D entity obtained the initial lower offset rate of 40 per cent (now 38.5 per cent) rather than the higher rate of 45 per cent (now 43.5 per cent). The 10 per cent tax rate also assumes a fixed 30 per cent corporate tax rate for all R&D entities.

Example 2.1 Recoupments

Cross Innovations receives a $1 million grant to undertake R&D activities. In addition to the grant, Cross Innovations must spend an additional $1 million of its own money as a condition of the grant. Cross Innovations receives an offset of $870,000 (applying the 43.5 per cent offset rate to the $2 million expenditure). Cross Innovations would have otherwise been entitled to a deduction worth $550,000 at the 27.5 per cent corporate tax rate. Therefore, the incentive component of the offset is the difference of $320,000.
In the same income year, the recoupment rules clawback only 10 per cent of the total $2 million spent under the terms of the grant, which is $200,000. Cross Innovations keeps the remaining $120,000 of the offset incentive. However, the grant alone is intended to constitute sufficient incentive without the additional $120,000 from the R&D tax incentive.

2.4 The recoupment rules also apply where an R&D entity receives a recoupment for expenditure incurred by another entity to which it is connected or affiliated (subsection 355-450(4)). In these situations, the R&D entity receiving the recoupment is subject to the clawback tax even though the other entity obtained the financial benefit of the R&D tax offset.

Feedstock adjustments

2.5 Feedstock adjustments apply to recoup the benefit of the Incentive to the extent it relates to goods, material or energy used to produce marketable products sold or applied to the R&D entity’s own use (Subdivision 355-H).

2.6 The intended net outcome is that the Incentive is effectively enjoyed on feedstock expenditure to the extent that it is not offset by feedstock revenue. This is achieved by basing the adjustment on the lesser of feedstock expenditure and feedstock revenue.

2.7 Where feedstock revenue exceeds the feedstock output’s related feedstock expenditure, the feedstock adjustment will be based on the feedstock expenditure — because the effective net cost of the feedstock inputs and energy was nil.

2.8 Where feedstock revenue is less than the feedstock output’s related feedstock expenditure, the feedstock adjustment will be based on the feedstock revenue — because the effective net cost of the feedstock inputs and energy was reduced by that amount.

2.9 The adjustment is implemented by including one third of the lesser of feedstock expenditure or feedstock revenue in the R&D entity’s assessable income (subsection 355-465(2)). As with the recoupments in Subdivision 355-G, the one third formula is intended to recoup 10 percentage points of the Incentive (based on a standard 30 per cent corporate tax rate).

2.10 In contrast to the recoupment provisions, feedstock adjustments are incorporated into the income tax equation in section 4-10 and do not create a new tax.
Enhancing the integrity of the Research and Development Tax Incentive

Example 2.2 Feedstock adjustments

Wayland Enterprises, a large R&D entity, spends $100,000 on the development of a new product, producing one tangible product, which it then sells for $110,000. Wayland Enterprises is entitled to a $38,500 offset (with an in incentive component of $8,500).

$33,333 is included in Wayland Enterprises’ assessable income (one third of the feedstock expenditure). After applying the corporate tax rate to the amount included in assessable income, the feedstock adjustment would claw back 10 per cent: $10,000, which is more than the incentive component.

However, if Wayland Enterprises was a small R&D entity in the same position, it would claim an offset of $43,500 (with an incentive component of $16,000).

The $33,333 would be included in assessable income and taxed at the 27.5 per cent corporate tax rate. The feedstock adjustment would claw back just $9,166.57.

2.11 The feedstock rules also apply where an R&D entity receives feedstock revenue in relation to an R&D tax offset obtained by another entity to which it is connected or affiliated (section 355-75). However, in these situations, the R&D entity originally entitled to the R&D tax offset is subject to the feedstock adjustment rather than the entity receiving the feedstock revenue. This represents a further inconsistency between the tax treatment of feedstock revenue and recoupments.

Balancing adjustments

2.12 Balancing adjustment events occur when an entity stops holding a depreciating asset, for example when the entity sells the asset (section 40-295). Balancing adjustment events require an entity to compare the economic value of the asset (its termination value (section 40-300)) with its written-down tax value (its adjusted value (section 40-85)).

2.13 If an asset’s termination value exceeds its adjusted value, the difference (the balancing adjustment amount) is included in the entity’s assessable income in the income year in which the balancing adjustment event occurs. If an asset’s adjusted value exceeds its termination value, the entity is allowed a deduction for the difference. As such, the balancing adjustment ensures an entity’s overall tax position reflects the true decline in value of the asset (section 40-285).
2.14 R&D entities can obtain an R&D tax offset for the decline in value of depreciating assets held for R&D purposes (an R&D asset) (section 355-305). This necessitates additional consequences arising from a balancing adjustment for the R&D asset:

- for an R&D asset held only for R&D purposes where the balancing adjustment amount is included in the R&D entity’s assessable income – the amount is generally increased by one third (subsection 355-315(3));
- for an R&D asset held only for R&D purposes where the balancing adjustment amount is allowed as a deduction – the deduction is included in the R&D entity’s R&D tax offset calculation (subsection 355-315(2));
- for an R&D asset held partially for R&D purposes where the balancing adjustment amount is included in the R&D entity’s assessable income – the part of the amount attributable to the asset’s R&D use (the R&D component) is generally increased by one third (subsection 40-292(4)); and
- for an R&D asset held partially for R&D purposes where the balancing adjustment amount is allowed as a deduction – the R&D component of the amount is generally increased by one third or (for small R&D entities) or one half (subsection 40-292(3)).

2.15 Similar rules apply to R&D assets held by R&D partnerships (sections 40-293 and 355-525).

2.16 Transitional rules apply in a similar way to R&D assets acquired prior to the introduction of the Incentive in 2011. These transitional rules further increase certain balancing adjustment amounts to reflect old 1.25 rate deductions available for R&D assets under the pre-2011 law (subsections 40-292(3), 40-293(3), 355-20(4) and 255-25(4) of the Income Tax (Transitional Provisions) Act 1997 (the Transitional Provisions Act)). These transitional rules do not apply to deductible balancing adjustment amounts in respect of R&D assets used only for R&D purposes.

2.17 As with the feedstock and recoupment adjustment rules, these R&D balancing adjustment rules rely on rough approximations of the incentive component of an R&D entity’s R&D tax offsets.

**Summary of new law**

2.18 Schedule 2 to the Bill improves the integrity of the Incentive by:

- extending the general anti-avoidance rules in the tax law to R&D tax offsets directly;
Enhancing the integrity of the Research and Development Tax Incentive

- making the rate at which the offset is recouped more accurate in situations where the offset would otherwise result in an additional or double benefit; and
- making that rate at which deductible balancing adjustment amounts incorporate the Incentive more accurate.

Comparison of key features of new law and current law

<table>
<thead>
<tr>
<th>New law</th>
<th>Current law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Schemes to obtain an R&amp;D tax benefit</strong></td>
<td>The Commissioner may deny a tax benefit in the form of a refundable or non-refundable R&amp;D tax offset that an R&amp;D entity seeks to obtain from a tax avoidance scheme.</td>
</tr>
<tr>
<td>The Commissioner may also deny a tax benefit in the form of an amount of a refundable or non-refundable R&amp;D tax offset that an R&amp;D entity seeks to obtain from a tax avoidance scheme.</td>
<td></td>
</tr>
<tr>
<td><strong>The uniform clawback rule</strong></td>
<td>Recoupment amounts are subject to a standalone tax of 10 per cent.</td>
</tr>
<tr>
<td>Recoupment amounts and feedstock adjustments give rise to an amount of assessable income equal to the grossed-up value of the incentive component of associated amounts of R&amp;D tax offset.</td>
<td>One third of feedstock adjustments are included in an R&amp;D entity’s assessable income.</td>
</tr>
<tr>
<td>An amount is included in the assessable income of the R&amp;D entity that received or is entitled to the R&amp;D tax offset in relation to a recoupment amount or feedstock revenue received by a related entity.</td>
<td>In cases involving related entities, the entity receiving a recoupment is subject to recoupment tax.</td>
</tr>
<tr>
<td>In cases involving related entities, the R&amp;D entity entitled to the R&amp;D tax offset is subject to a feedstock adjustment if the related entity receives feedstock revenue.</td>
<td></td>
</tr>
<tr>
<td><strong>Balancing adjustments for R&amp;D assets</strong></td>
<td>The R&amp;D entity’s assessable income is increased by an amount equal to the grossed-up value of the incentive component of the associated amounts of R&amp;D tax offset.</td>
</tr>
<tr>
<td>The R&amp;D entity’s assessable income is increased by an amount equal to the grossed-up value of the incentive component of the associated amounts of R&amp;D tax offset.</td>
<td>For an R&amp;D asset held only for R&amp;D purposes where the balancing adjustment amount is included in the R&amp;D entity’s assessable income – the amount is generally increased by one third.</td>
</tr>
<tr>
<td>For an R&amp;D asset held partially for R&amp;D purposes where the balancing adjustment amount is included in the R&amp;D entity’s assessable income – the R&amp;D component of the amount is generally increased by one third.</td>
<td></td>
</tr>
<tr>
<td>New law</td>
<td>Current law</td>
</tr>
<tr>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>The R&amp;D entity is entitled to a deduction equal to the grossed-up value of the incentive component of the associated amounts of R&amp;D tax offset that would have been obtained if the R&amp;D component of the balancing adjustment amount was included in the calculation of the offset.</td>
<td>For an R&amp;D asset held only for R&amp;D purposes where the balancing adjustment amount is allowed as a deduction – the deduction is included in the R&amp;D entity’s R&amp;D tax offset calculation.</td>
</tr>
<tr>
<td>For an R&amp;D asset held partially for R&amp;D purposes where the balancing adjustment amount is allowed as a deduction – the R&amp;D component of the amount is increased by one third or (for small R&amp;D entities) one half</td>
<td></td>
</tr>
<tr>
<td>Similar amended rules apply to balancing adjustments for R&amp;D assets held by R&amp;D partnerships.</td>
<td>Similar rules apply to balancing adjustments for R&amp;D assets held by R&amp;D partnerships.</td>
</tr>
<tr>
<td>The transitional rules are amended in line with the primary amendments but continue to apply to R&amp;D assets acquired before the introduction of the Incentive in 2011.</td>
<td>Transitional rules apply to R&amp;D assets acquired before the introduction of the Incentive in 2011.</td>
</tr>
</tbody>
</table>

### Detailed explanation of new law

#### Schemes to obtain an R&D tax benefit

2.19 Part 1 of Schedule 2 to the Bill explicitly extends the concept of tax benefits in the general anti-avoidance rule in Part IVA of the ITAA 1936 to include the R&D tax offset. These amendments ensure that the Commissioner can apply Part IVA to prevent R&D entities from being able to obtain tax benefits by entering into artificial or contrived arrangements to access a non-refundable or a refundable R&D tax offset. [Schedule 2, items 2 to 10, paragraphs 177C(1)(bd) and (h), 177C(2)(f), 177C(3)(cc) and (i), 177CB(1)(f), 177F(1)(f), 177F(3)(g) and subsection 177C(3) of the ITAA 1936]
2.20 Part IVA of the ITAA 1936 applies in situations where a scheme or arrangement is entered into in order to obtain a tax benefit. These rules allow the Commissioner to cancel the relevant tax benefit where the conditions under Part IVA are satisfied. For example, this can include situations where an R&D entity enters into an arrangement with a dominant purpose of securing a tax benefit that is an R&D tax offset. It can also include situations where an entity enters into an arrangement with a dominant purpose to enable it to obtain a refundable R&D tax offset, where it would have, or might reasonably be expected to have, obtained a non-refundable R&D tax offset if the scheme had not been entered into or carried out.

The uniform clawback rule

2.21 Part 2 of Schedule 2 to the Bill remakes and consolidates Subdivisions 355-G and 355-H of the ITAA 1997 (about the clawback of R&D recoupments and feedstock adjustments respectively) into a new Subdivision 355-G. This Subdivision also introduces a new uniform clawback rule that applies for recoupments, feedstock adjustments and balancing adjustment amounts that are included in an R&D entity’s assessable income. The amendments ensure that an R&D entity must disgorge the entire benefit of an R&D tax offset to the extent it (or a connected entity or an affiliate entity where appropriate) receives a recoupment amount, feedstock adjustment or assessable balancing adjustment because of the offset. [Schedule 2, item 29, section 355-430 of the ITAA 1997]

2.22 Current Subdivisions 355-G and 355-H, and the various balancing adjustment rules, only partially reverse the benefit of an R&D tax offset in some circumstances. In light of the amendments discussed in Chapter 1, the current clawback rules would produce more anomalous outcomes if they are not amended. The amendments ensure the full benefit of the R&D tax offset is reversed, to remove the unintended benefits that arise in such situations.

Clawback amounts

Recoupment amounts and feedstock adjustment clawback amounts

2.23 Current Subdivision 355-G is remade into a single section and reference to the payment of extra income tax (a recoupment tax) is removed. Instead, the remade provision identifies an amount (a clawback amount) that represents the amount of notional deductions an R&D entity received or is entitled to receive in relation to a recoupment. [Schedule 2, item 29, section 355-440 of the ITAA 1997]
2.24 Current Subdivision 355-H is remade into a single section and the reference to the inclusion of an amount in assessable income is removed. Instead, the remade provision identifies an amount (a clawback amount) that represents the amount of notional deductions an R&D entity received or is entitled to receive in relation to a feedstock adjustment. The clawback amount is the lesser of the feedstock revenue received or the notional deductions attributable to the feedstock output. [Schedule 2, item 29, section 355-445 of the ITAA 1997]

**Example 2.3 Clawback amounts**

In Example 1.2, Contrast Industries had the following amounts in the 2019-20 income year (the offset year):

- aggregated turnover in excess of $50 million;
- expenditure of $1 billion;
- notional deductions of $160 million; and
- a non-refundable R&D tax offset of $61.55 million.

Further to this example, in the 2021-22 income year, Contrast Industries sells a tangible product developed during its 2019-20 income year R&D activities. The tangible product is sold for $20 million but cost $25 million to develop. All of the costs were included in Contrast Industries’ notional deductions for the 2019-20 income year.

The clawback amount is the lesser of the market value of the tangible product on sale (feedstock revenue) and the tangible product’s cost. Here, Contrast Industries has a clawback amount of $20 million.

**Balancing adjustment clawback amounts**

2.25 There are four clawback amounts that relate to assessable balancing adjustments. The primary clawback amount applies for R&D assets held only for R&D purposes. The clawback amount is the balancing adjustment amount capped at the level of the asset’s total decline in value (its tax cost less its adjusted value). The cap ensures the clawback does not apply to the extent an R&D asset’s has appreciated in value while held. [Schedule 2, item 29, section 355-446 of the ITAA 1997]

2.26 If the R&D asset was only held partially for R&D purposes, a different clawback amount applies. This clawback amount is calculated in a similar way to the primary clawback amount but it is reduced in proportion to its non-R&D use. [Schedule 2, item 29, section 355-447 of the ITAA 1997]
2.27 Different clawback amounts arise if the R&D asset is held by an R&D partnership. These two clawback amounts reflect the first two balancing adjustment clawback amounts: one for R&D assets used only for R&D purposes and one for assets held only partially for R&D purposes. These rules are necessary to ensure the clawback amount arises for the individual R&D entities that are partners in the R&D partnership. [Schedule 2, item 29, sections 355-448 and 355-449 of the ITAA 1997]

2.28 The four clawback rules outlined above apply in a modified way where the R&D asset was acquired before the introduction of the Incentive in 2011. [Schedule 2, items 41 to 45, 48 to 50, 53 and 54, subsections 40-292(3) and (3A), 40-293(3) and (3A), 355-320(4) and (4A), and 355-325(4) to (4D), and Note 1 to subsections 355-320(1) and 355-325(1) of the Transitional Provisions Act]

2.29 The clawback amount rules replace existing rules that estimated the incentive component of the R&D tax offset that need to be clawed back. [Schedule 2, items 17, 20, 28 and 32, subsections 40-292 (3) to (5), 40-293(3), 355-315(3), and 355-525(3) to (7) of the ITAA 1997]

Changes from the current law

2.30 The clawback amount is relevant for working out the amount that must be included in an R&D entity’s assessable income to disgorge the benefit of an R&D tax offset. The clawback amount reflects the amount of R&D expenditure (notional deductions) tainted by the operation of the recoupment, feedstock or R&D balancing adjustment rules. The amendments calculate the amount of R&D tax offset tainted by the tainted expenditure. The incentive component of the tainted R&D tax offset, in turn, is the benefit to be clawed back.

2.31 The clawback amount picks up the amount worked out under each of Subdivisions 355-G and 355-H, and the balancing adjustment rules, in the current law immediately before adjustments are made to bring it to account: applying tax to it in the case of recoupments and including a third of the amount in assessable income in the case of feedstock and balancing adjustments. It is primarily these adjustments in the current law that are producing inappropriate outcomes and are subject to the amendments.

2.32 Except as outlined in this Chapter, the remaking of Subdivisions 355-G and 355-H, and the R&D balancing adjustment rules, is not intended to alter the way recoupment amounts, feedstock adjustments or assessable balancing adjustments (a clawback amount in these amendments) are calculated. For further information on the operation of these provisions, refer to the Explanatory Memorandum to the Tax Laws Amendment (Research and Development) Bill 2011, and existing guidance materials and rulings issued by the Commissioner.

2.33 Table 2.1 outlines the provisions of the new law as amended that correspond with provisions of the current law.
Table 2.1 Remaking the clawback rules

<table>
<thead>
<tr>
<th>Clawback amount</th>
<th>Current provisions</th>
<th>New provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recoupment amount</td>
<td>Subdivision 355-G</td>
<td>Section 355-440</td>
</tr>
<tr>
<td>Feedstock adjustments</td>
<td>Subdivision 355-H</td>
<td>Section 355-445</td>
</tr>
<tr>
<td>Balancing adjustment – asset used only for R&amp;D</td>
<td>Subsection 355-315(3)</td>
<td>Section 355-446</td>
</tr>
<tr>
<td>Balancing adjustment – asset used partially for R&amp;D</td>
<td>Subsection 40-292(4)</td>
<td>Section 355-447</td>
</tr>
<tr>
<td>Balancing adjustment – partnership asset used only for R&amp;D</td>
<td>Subsection 355-525(3)</td>
<td>Section 355-448</td>
</tr>
<tr>
<td>Balancing adjustment – partnership asset used partially for R&amp;D</td>
<td>Paragraph 40-293(3)(b)</td>
<td>Section 355-449</td>
</tr>
</tbody>
</table>

2.34 For balancing adjustments, sections 40-292, 40-293, 355-315 and 355-525 (and section 40-285) continue to operate where appropriate to clawback the deduction component of the R&D tax offset (i.e. the amount of the offset that reflects the R&D entity’s corporate tax rate). Similarly, feedstock revenue and government grants are generally assessable as ordinary income (section 6-5). The new provisions clawback the incentive component of the R&D tax offset.

The taxing point

2.35 Consistent with the existing law, the uniform clawback rule will include an amount in assessable income in the year the clawback amount arises (the present year). The underlying offset entitlement, whether in the same year, one or more earlier years or one or more later years (each an offset year) is unchanged. [Schedule 2, item 29, section 355-435 of the ITAA 1997]

2.36 The entity receiving a recoupment or feedstock revenue could be the R&D entity entitled to the R&D tax offset or an entity affiliated with or connected to the R&D entity. [Schedule 2, item 29, subsections 355-440(5) and 355-445(5) of the ITAA 1997]

2.37 The amendments unify the taxing point in cases involving related entities: where one entity has the R&D tax offset entitlement and the other entity receives the recoupment or feedstock revenue. The R&D entity that has received or is entitled to receive the R&D tax offset is the entity with the clawback amount and must include an amount in its assessable income. [Schedule 2, item 29, section 355-435 and subsections 355-440(1), (2) and (5), and 355-445(5) of the ITAA 1997]

Example 2.4 Related entities and clawbacks

It would not change the outcome in Example 2.3 if, instead of Contrast Industries selling the tangible product itself, the tangible product was sold by a related entity. Contrast Industries would be subject to the clawback amount.
2.38 For R&D assets of an R&D partnership that are partially used for R&D purposes, the clawback rule now includes an amount in the partner’s assessable income rather than the partnership’s assessable income. This aligns the taxing point with the taxing point for R&D assets held by an R&D partnership that are used wholly for R&D purposes.

[Schedule 2, item 29, section 355-449 of the ITAA 1997]

*The amount included in assessable income*

2.39 When the clawback applies, the R&D entity entitled to the R&D tax offset includes an amount in assessable income in relation to each offset year in which it claimed an offset related to the clawback amount.

[Schedule 2, item 29, section 355-450 of the ITAA 1997]

2.40 The amount included in assessable income is worked out as follows:

\[
\text{Starting offset} - \text{Adjusted offset} - \text{Deduction amount}
\]

\[
\text{R&D entity's corporate tax rate for the present year}
\]

2.41 Each of the components of this formula is explained below.

*Calculating the offset portion subject to the clawback*

2.42 The first step in applying the formula is to calculate the portion of the R&D tax offset the R&D entity received that relates to the clawback amount. If the R&D entity received the R&D tax offset in multiple offset years in relation to the clawback amount that arises in the present year, the formula must be applied in relation to each offset year.

2.43 The primary way of working out the portion of the offset to be clawed back in an offset year is to compare the actual amount of the R&D tax offset in that year (the starting offset) with the amount of the offset (the adjusted offset) the R&D entity would have received if its notional deductions were reduced by the portion of the clawback amount that relates to the offset year. [Schedule 2, item 29, subsection 355-450(1) (definitions of ‘adjusted offset’ and ‘starting offset’) of the ITAA 1997]

2.44 This targets the clawback to the highest tiers of the R&D entity’s offset entitlement (i.e. those received for the highest intensity expenditure, the last dollars the entity spent) for an offset year. If an R&D entity had notional deductions in excess of the $150 million expenditure threshold, the excess deductions would be reduced first, limiting the difference between the starting and adjusted offset. This, when combined with the operation of the deduction amount, is equivalent to the outcome achieved under table items 2 and 3 in subsection 355-720(2) in the current law.

*Example 2.5 The starting offset and the adjusted offset*

Further to Example 2.3, the portion of Contrast Industries’ 2019-20 R&D tax offset that is subject to the clawback is worked out by subtracting the entity’s adjusted offset from its starting offset.
Contrast Industries has a starting offset of $61.55 million, the amount of the offset it received in the 2019-20 income year.

Contrast Industries has an adjusted offset calculated as if its notional deductions for the 2019-20 income year were reduced from $160 million to $140 million by the value of the clawback amount. The entire clawback amount is included in the reduction because the entire amount relates to the 2019-20 income year.

The adjusted offset is calculated as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Intensity range</th>
<th>R&amp;D premium</th>
<th>Notional deductions applied</th>
<th>Offset amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>0-4%</td>
<td>4.5%</td>
<td>$40m</td>
<td>$13.8m</td>
</tr>
<tr>
<td>Tier 2</td>
<td>4-9%</td>
<td>8.5%</td>
<td>$50m</td>
<td>$19.25</td>
</tr>
<tr>
<td>Tier 3</td>
<td>&gt;9%</td>
<td>12.5%</td>
<td>$50m</td>
<td>$21.25</td>
</tr>
<tr>
<td>Excess</td>
<td>NA</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td><strong>Totals:</strong></td>
<td></td>
<td></td>
<td><strong>$140m</strong></td>
<td><strong>$54.3m</strong></td>
</tr>
</tbody>
</table>

The adjusted offset amount reflects that $10 million has been removed from the excess tier and $10 million has been removed from tier 3, the highest tier Contrast Industries reached on its level of R&D intensity.

The difference between the two offset amounts is $7.25 million.

Recursive calculations for multiple clawback amounts

2.45 The situation is more complex where an R&D entity’s offsets in a particular offset year are clawed back multiple times because the entity receives multiple clawback amounts in relation to it or also receives a catch-up amount (see paragraph 2.59). In these circumstances, the clawback rule works in a recursive manner.

2.46 In recursive applications of the rule, the R&D entity must compare the offset amount that could have been claimed under the last counterfactual calculated and the amount that could have been claimed under a new counterfactual. In calculating the new counterfactual, the R&D entity must incorporate all previous adjustments to the notional deduction amount and make a further reduction for the new clawback amount. [Schedule 2, item 29, subsection 355-450(2) of the ITAA 1997]

Example 2.6 Recursive clawback

Flying Fox Innovations has an R&D tax offset entitlement based on $100 million of notional deductions. The entity receives two recoupment amounts: one of $10 million and one of $20 million.
Enhancing the integrity of the Research and Development Tax Incentive

For the first recoupment, the clawback is calculated by reference to the difference between the starting offset calculated on $100 million of notional deductions and the adjusted offset calculated on $90 million. For the second recoupment, the clawback is calculated by reference to the difference between the starting offset calculated on $90 million and the adjusted offset calculated on $70 million.

Allowing the benefit of the deduction

2.47 Regardless of whether the primary or recursive rule is applied in calculating the difference, once the difference is identified, it is not appropriate to bring the entire difference to account as tax. Only the incentive component (or premium) is brought to account. Therefore, the second step of the above formula requires that the difference between the starting offset and the adjusted offset be reduced by the product of the portion of the clawback amount that relates to the offset year and the R&D entity’s corporate tax rate in the offset year. This allows the R&D entity to retain the benefit of the R&D tax offset for the clawback amount to the extent it replaced the benefit of a deduction for the same expenditure. [Schedule 2, item 29, subsection 355-450(1) (definition of ‘deduction amount’) of the ITAA 1997]

Example 2.7 The deduction amount

Further to Example 2.5, Contrast Industries has a deduction amount equal to its clawback amount ($20 million) multiplied by its corporate tax rate in the offset year (30 per cent): $6 million. This is because while the expenditure is no longer eligible for the R&DTI as a notional deduction, the expenditure would have been an eligible deduction.

The $7.25 million figure reached in Example 2.5 is reduced by the $6 million deduction amount to complete the numerator of the formula at paragraph 2.40. The resulting $1.25 million represents the additional amount of tax Contrast Industries must pay to reverse the incentive component of the R&D tax offset associated with the development of the tangible product.

Bringing the amount to account

2.48 The R&D entity must bring the amount to account as assessable income in the year in which the entity received the clawback amount. The amount calculated up to this point represents the full dollar-value of the incentive component of the R&D tax offset the R&D entity obtained in connection with the clawback amount. The amount of tax the R&D entity is required to pay equals this amount. As such, this amount is grossed-up by dividing it by the R&D entity’s corporate tax rate for the present year to ensure its value is maintained when taxed.

Example 2.8 The denominator

Further to Example 2.7, Contrast Industries must divide the $1.25 million by its current corporate tax rate (30 per cent).
The resulting $4.167 million is included in the assessable income of Contrast Industries in the 2021-22 income year. Disregarding other assessable income and deductions, this will increase the income tax liability of Contrast Industries by the appropriate $1.25 million once the corporate tax rate applies to the entity’s taxable income.

2.49 Bringing the amount to account as assessable income (rather than through a standalone tax) allows R&D entities to apply deductions from the current year and carried-forward losses against the clawback. Loss-making R&D entities that only obtained a non-refundable R&D tax offset in the offset year can apply the carried-forward offset against the amount included in assessable income. This ensures the clawback rule recovers the correct amount but does not have an unintended negative cash flow impact on R&D entities.

**Catch-up rule for R&D balancing adjustments**

2.50 The amendments introduce a new catch-up rule for R&D assets. This rule provides an additional deduction to R&D entities when a deductible balancing adjustment amount arises for an R&D asset. [Schedule 2, item 29, sections 355-455 and 355-460 of the ITAA 1997]

2.51 The catch-up rule mirrors the uniform clawback rule but operates in reverse, providing a deduction in lieu of an amount of R&D tax offset forgone rather than including an amount in assessable income. [Schedule 2, item 29, section 355-475 of the ITAA 1997]

2.52 As with the clawback amounts for balancing adjustments (see paragraphs 2.25 to 2.28), there are four different catch-up amounts to cover R&D assets either wholly or partially used for R&D, assets held by R&D entities and those held by R&D partnerships. The catch-up amounts reflect the amount an R&D entity can ordinarily deduct for the balancing adjustment event. [Schedule 2, item 29, sections 355-465, 355-466, 355-467 and 355-468 of the ITAA 1997]

2.53 These catch-up amounts are calculated in a modified way where the R&D asset was acquired before the introduction of the Incentive in 2011. [Schedule 2, items 41 to 44, 46, 47, 49, 51, 52 and 54, subsections 40-292(3) and (3A), 40-293(3) and (3A), 355-320(3) and (4A), and 355-325(3) and (4A) of the Transitional Provisions Act]
The catch-up amount rules replace provisions of the current law that either sought to estimate the value of the R&D tax offset forgone or replace it with a new R&D tax offset entitlement, neither option giving rise to an accurate catch-up. [Schedule 2, items 18, 20 to 26, 30 and 31, sections 355-105 and 355-300, subsections 40-292(3) and (5), and 40-293(3), paragraphs 355-100(1)(c) and (f), the heading to Subdivision 355-E, the headings to subsections 355-315(2) and 355-525(2), the notes to subsections 355-315(2) and 355-525(2) of the ITAA 1997]

It remains a condition for accessing the incentive component of the balancing adjustment (now the deduction for a catch-up amount) that the R&D entity be registered for R&D activities in the income year in which the balancing adjustment event occurs. However, for simplicity it is no longer a requirement that the R&D entity have $20,000 of notional deductions in that income year.

For R&D assets of an R&D partnership that are partially used for R&D purposes, the catch-up rule now makes each partner entitled to a deduction rather than the partnership. This mirrors the amendment outlined in paragraph 2.38. [Schedule 2, item 29, section 355-468 of the ITAA 1997]

Table 2.2 outlines the provisions of the new law as amended that correspond with provisions of the current law.

### Table 2.2 Remaking of catch-up amount rules

<table>
<thead>
<tr>
<th>Catch-up amount</th>
<th>Current provisions</th>
<th>New provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balancing adjustment – asset used only for R&amp;D</td>
<td>Subsection 355-315(2)</td>
<td>Section 355-465</td>
</tr>
<tr>
<td>Balancing adjustment – asset used partially for R&amp;D</td>
<td>Subsection 40-292(3)</td>
<td>Section 355-466</td>
</tr>
<tr>
<td>Balancing adjustment – partnership asset used only for R&amp;D</td>
<td>Subsection 355-525(2)</td>
<td>Section 355-467</td>
</tr>
<tr>
<td>Balancing adjustment – partnership asset used partially for R&amp;D</td>
<td>Paragraph 40-293(3)(a)</td>
<td>Section 355-468</td>
</tr>
</tbody>
</table>

Sections 40-292, 40-293, 355-315 and 355-525 (and section 40-285) continue to operate where appropriate to provide a catch-up for the deduction component of the R&D tax offset (i.e. the amount of the offset that reflects the R&D entity’s corporate tax rate). The new provisions provide an additional catch-up for the incentive component of the R&D tax offset.

The amount allowed as a deduction for a catch-up amount for an offset year is worked out as follows:

\[
\text{Adjusted offset} = \text{Starting offset} - \text{Denuction amount} \\
\text{R&D entity's corporate tax rate for the present year}
\]
2.60 This formula mirrors the formula discussed in paragraphs 2.40 to 2.48 with two important distinctions. Firstly, the initial operation requires the starting offset to be subtracted from the adjusted offset (rather than the reverse). Secondly, the adjusted offset is defined as the R&D tax offset the R&D entity would have received if its notional deductions for the offset year included the portion of the catch-up amount that is attributable to the offset year. [Schedule 2, item 29, section 355-475 of the ITAA 1997]

Example 2.9 Deductible balancing adjustment amounts

Spark Transformations is an R&D entity with an annual turnover of between $20 million and $25 million in the 2018-19 to 2020-21 income years. Spark Transformations is subject to the corporate tax rate for a base rate entity.

On 18 April 2019, Spark Transformations acquires a depreciating asset for $80,000. It has an effective life of five years. Spark Transformations used the asset entirely for R&D purposes.

Spark Transformations sells the asset on 1 July 2021 for $34,800.

Decline in value notional deductions

Spark Transformations uses the prime cost (straight line) method in section 40-75 to work out the asset’s decline in value as follows:

<table>
<thead>
<tr>
<th>Income Year</th>
<th>Days asset used</th>
<th>Decline in Value</th>
<th>Adjusted Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-19</td>
<td>73</td>
<td>$3,200</td>
<td>$76,800</td>
</tr>
<tr>
<td>2019-20</td>
<td>*365</td>
<td>$16,000</td>
<td>$60,800</td>
</tr>
<tr>
<td>2020-21</td>
<td>365</td>
<td>$16,000</td>
<td>$44,800</td>
</tr>
</tbody>
</table>

* For simplicity the calculations in this example ignore that 2020 is a leap year

Spark Transformation is entitled to notional deductions for the asset’s decline in value in each income year.

The R&D tax offset

For the 2018-19 income year, Spark Transformations is entitled to an R&D tax offset at the current 38.5 per cent rate. In relation to the depreciating asset, Spark Transformations is entitled to an R&D tax offset of $1,232. Spark Transformations has total notional deductions in excess of $20,000 (so subsection 355-100(2) does not apply) but it is not necessary to quantify them.

For the 2019-20 and 2020-21 income years, it is necessary to consider the total R&D tax offset entitlement of Spark Transformations.
In the 2019-20 income year, Spark Transformations has notional deductions of $300,000 (inclusive of the decline in value notional deductions) and total expenses of $7.8 million. Therefore, Spark Transformations has an R&D intensity of 3.85 per cent. As it is subject to the corporate tax rate of 27.5 per cent in this income year, its R&D tax offset entitlement is worked out as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Intensity range</th>
<th>R&amp;D premium</th>
<th>Notional deductions applied</th>
<th>Offset amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>0-4%</td>
<td>4.5%</td>
<td>$300,000</td>
<td>$96,000</td>
</tr>
<tr>
<td>Tier 2</td>
<td>4-9%</td>
<td>8.5%</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Tier 3</td>
<td>&gt;9%</td>
<td>12.5%</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Excess</td>
<td>NA</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td>$300,000</td>
<td>$96,000</td>
</tr>
</tbody>
</table>

In the 2020-21 income year, Spark Transformations has notional deductions of $350,000 (inclusive of the decline in value notional deductions) and total expenses of $7.35 million. Therefore, Spark Transformations has an R&D intensity of 4.76 per cent. As it is subject to the corporate tax rate of 26 per cent in this income year, its R&D tax offset entitlement is worked out as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Intensity range</th>
<th>R&amp;D premium</th>
<th>Notional deductions applied</th>
<th>Offset amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>0-4%</td>
<td>4.5%</td>
<td>$294,000</td>
<td>$89,670</td>
</tr>
<tr>
<td>Tier 2</td>
<td>4-9%</td>
<td>8.5%</td>
<td>$56,000</td>
<td>$19,320</td>
</tr>
<tr>
<td>Tier 3</td>
<td>&gt;9%</td>
<td>12.5%</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Excess</td>
<td>NA</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td>$350,000</td>
<td>$108,990</td>
</tr>
</tbody>
</table>

**The catch-up amount portions**

When the asset is sold, there is a balancing adjustment event. Because the asset’s adjusted value ($44,800) exceeds its termination value ($34,800), Spark Transformations is entitled to a deductible balancing adjustment amount of $10,000. This amount is allowed as a deduction but is not a notional deduction and does not contribute towards the entity’s R&D tax offset entitlement.
This gives rise to a catch-up amount of $10,000 that relates to the three income years (each an offset year) in which Spark Transformations claimed the R&D tax offset in relation to the asset’s decline in value. It is necessary to work out the portion of the $10,000 catch-up amount that relates to each offset year. To do this, it is necessary to work out the decline in value recorded in each offset year as a proportion of the total decline in value of the asset ($35,200):

\[
\text{Catchup portion} = \frac{\text{Catchup amount} \times \text{Decline in value}}{\text{Total decline in value}}
\]

Spark Transformations has the following catch-up portions in the 2021-22 income year:
- $909.09 for the 2018-19 income year; and
- $4,545.45 for each of the 2019-20 and 2020-21 income years.

**The adjusted offsets**

The adjusted offset for each offset year is calculated by adding the catch-up portion to the R&D entity’s notional deductions. This also impacts the calculations for total expenditure and R&D intensity.

It is not strictly necessary to calculate the adjusted offset for the 2018-19 income year because the flat 38.5 per cent R&D tax offset rate applies.

The adjusted offset for the 2019-20 income year is calculated as follows:

<table>
<thead>
<tr>
<th>2019-20 adjusted offset</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tier</strong></td>
</tr>
<tr>
<td>Tier 1</td>
</tr>
<tr>
<td>Tier 2</td>
</tr>
<tr>
<td>Tier 3</td>
</tr>
<tr>
<td>Excess</td>
</tr>
<tr>
<td>Totals:</td>
</tr>
</tbody>
</table>

The adjusted offset for the 2020-21 income year is calculated as follows:
Enhancing the integrity of the Research and Development Tax Incentive

<table>
<thead>
<tr>
<th>Tier</th>
<th>Intensity range</th>
<th>R&amp;D premium</th>
<th>Notional deductions applied</th>
<th>Offset amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>0-4%</td>
<td>4.5%</td>
<td>$294,181.82</td>
<td>$89,725.45</td>
</tr>
<tr>
<td>Tier 2</td>
<td>4-9%</td>
<td>8.5%</td>
<td>$60,363.64</td>
<td>$20,825.45</td>
</tr>
<tr>
<td>Tier 3</td>
<td>&gt;9%</td>
<td>12.5%</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Excess</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Totals:</td>
<td></td>
<td></td>
<td>$354,545.45</td>
<td>$110,550.91</td>
</tr>
</tbody>
</table>

Note that the R&D intensity for the adjusted offset calculation is 3.9 per cent in the 2019-20 income year and 4.82 per cent in the 2020-21 income year. This incorporates the increase in notional deductions being included in total expenses.

The offset differential

The difference between the starting offset and the adjusted offset for the 2018-19 income year can be simply calculated as the catch-up portion multiplied by the flat R&D tax offset rate of 38.5 per cent.

For the 2019-20 and 2020-21 income years, the difference is derived by comparing the outcomes of the tables above.

Spark Transformations has the following offset differentials:

- $350 ($909.09 multiplied by 38.5 per cent) in the 2018-19 income year;
- $1,454.55 ($97,454.55 less $96,000) in the 2019-20 income year; and
- $1,560.91 ($110,550.91 less $108,990) in the 2020-21 income year.

The deduction amount

The deduction amount is the catch-up portion for an offset year multiplied by the corporate tax rate that applied in that year (27.5 per cent for the 2019-20 income year and 26 per cent for the 2020-21 income year). Spark Transformations has the following deduction amounts totalling $2,681.82:

- $250 for the 2018-19 income year;
- $1,250 for the 2019-20 income year; and
- $1,181.82 for the 2020-21 income year.

These amounts are not available as deductions but are included in the ‘deduction amount’ in the catch-up rule formula (see paragraph 2.59).
Gross-up

The total of the differences between the adjusted offsets and the corresponding starting offsets is reduced by the deduction amounts and then grossed-up by the entity’s current corporate tax rate (which in the 2021-22 income year, it is 25 per cent). Spark Transformations is entitled to a deduction for the result of the following equation:

\[
\frac{\left(350 + 1,454.55 + 1,560.91\right) - \left(250 + 1,250 + 1,181.82\right)}{25\%}
\]

\[= 2,734.56\]

The deduction will reduce the income tax liability of Spark Transformations by $683.64 once the current corporate tax rate is applied. This puts the entity in the position it would be in had the decline in value of the asset for tax purposes kept pace with the actual decline in value of the asset.

This reduction of the tax liability reflects that Spark Transformations is separately entitled to a $10,000 deduction for the balancing adjustment event under subsection 355-315(2). This balancing adjustment amount will result in Spark Transformations reducing its income tax liability by $2,500 in the 2021-22 income year.

Consequential amendments

2.61 Definitions of ‘non-refundable R&D tax offset’ and ‘refundable R&D tax offset’ linked to Division 355 of the ITAA 1997 are inserted into the dictionary in Part IVA of the ITAA 1936. [Schedule 2, item 1, subsection 177A(1) (definition of ‘non-refundable R&D tax offset’ and ‘refundable R&D tax offset’) of the ITAA 1936]

2.62 Consequential amendments are made to the remaking of the recoupment, feedstock and balancing adjustment provisions, and the introduction of the uniform clawback rule. These includes removing redundant provisions associated with the recoupment tax and repealing section 355-720, which dealt with the interaction between the expenditure threshold and the old recoupment, feedstock and R&D balancing adjustment rules. These functions are now consolidated in the new clawback rule. [Schedule 2, items 11 to 14, 33 to 36, 38 to 40, and 55, sections 4-25, 10-5, 355-530 and 355-720, table item 4A in subsection 9-5(1), table item 10 in section 20-5, subsections 355-715(2) and 995-1(1) (definition of ‘feedstock revenue’), and Note 2 to subsection 355-715(2) of the ITAA 19997, and subsection 12(7), and sections 12B and 31 of the Income Tax Rates Act 1986, and section 355-720 of the Transitional Provisions Act]

2.63 Notes are added to explain the interaction between the R&D balancing adjustment provisions and the clawback and catch-up rules. [Schedule 2, items 15, 16, 18, 19, 27, 28, 31 and 32, notes to subsections 40-292(1), 40-293(1), 355-315(2), 355-315(3), 355-525(2) and 355-525(3) of the ITAA 1997]
2.64 As part of the remaking of Subdivision 355-G, the cap on recoupment amounts is amended to clarify the meaning of the numerator in the formula. [Schedule 2, item 29, subsection 355-440(4) (definition of ‘R&D expenditure’) of the ITAA 1997]

2.65 An amendment is made to the tax incentive for early stage investors to prevent the inclusion of clawback amounts in an R&D entity’s assessable income denying the status of an early stage innovation company. [Schedule 2, item 37, subsection 360-40(2) of the ITAA 1997]

Application and transitional provisions

2.66 The amendments commence on the first day of the first quarter following Royal Assent. [Section 2 of the Bill]

2.67 The amendments to Part IVA of the ITAA 1936 apply in relation to R&D tax benefits obtained on or after 1 July 2019, regardless of when the relevant scheme was entered into or carried out. [Schedule 2, subitems 56(1) and (2)]

2.68 The amendments to the recoupment, feedstock and R&D balancing adjustment rules, and the new clawback and catch-up rules, apply in relation to income years starting on or after 1 July 2019. The new clawback and catch-up rules may apply in an income year starting on or after 1 July 2019 in relation to an R&D tax offset received in an income year starting before that date (see Example 2.9 as it applies in relation to the 2018-19 income year). [Schedule 2, subitem 56(3)]

2.69 Reforms to the R&D Tax Incentive were announced on 8 May 2018 to apply from 1 July 2018 as part of the 2018-19 Budget. An Exposure Draft of the legislation implementing the 2018-19 Budget reforms was released for public consultation in June 2018. Legislation to give effect to the changes was introduced to Parliament in Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share Of Tax In Australia And Other Measures) Bill 2018. However, this Bill lapsed with the proroguing of Parliament in April 2019. Affected taxpayers were aware of the Government’s intention to reform the Incentive and the potential impact the Budget reforms would have on the scope of the program from the date of the Budget announcement.
2.70 The amendments to the General Anti-Avoidance Rule contained in Part IVA of the ITAA 1936 ensure that the Commissioner can deny inappropriate tax benefits by entering into artificial or contrived arrangements. This is appropriate because tax avoidance schemes operate contrary to the intention of the law. Affected taxpayers were aware of the 2018-19 Budget reforms and the potential impact they would have on the scope of the program from the date of the Budget announcement. This Bill also contains minor drafting changes to remove ambiguity in respect of the operation of the general anti avoidance rule.
Chapter 3
Improving the administration of the Research and Development Tax Incentive

Outline of chapter

3.1 Schedule 3 to the Bill improves the administrative framework supporting the Incentive by making information about R&D expenditure claims transparent, enhancing the guidance framework to provide certainty to applicants and streamlining administrative processes.

Context of amendments

3.2 The Incentive is jointly administered by the Australian Taxation Office (under the authority of the Commissioner) and the Board of ISA.

3.3 One of the conditions of an expense giving rise to a notional deduction is that the R&D entity has registered an R&D activity under section 27A of the IR&D Act (for example, subparagraph 355-205(1)(a)(i) of the ITAA 1997).

3.4 Under Part III of the IR&D Act, the Board of ISA may make findings about whether an R&D entity’s activities are R&D activities. A finding binds the Commissioner for the purpose of working out an R&D entity’s R&D tax offsets (section 355-705 of the ITAA 1997).

3.5 The Department of Industry, Innovation and Science and its staff assist the Board of ISA to perform its functions. The Board and its committees may delegate their functions to a Senior Executive Service (SES) employee (subsections 21(1) and 22A(1) of the IR&D Act). The Government has identified that this limit on the delegation power has proved to be impractical and a significant barrier to the Board of ISA carrying out its functions.

Extensions of time

3.6 Part 3 of the Industry Research and Development Decision-making Principles 2011 (the Decision-making Principles) – made under section 32A of the IR&D Act – regulates the ability of the Board of ISA to grant extensions of time under the IR&D Act. This includes extensions of time for registration applications, providing requested information and applications for reviews (see subsection 3.1(1) of the Decision-making Principles).
3.7 The Board of ISA must grant extensions of up to 14 days if it is necessary and may grant a longer period if the applicant’s ability to meet the deadline is impaired by events outside the applicant’s control (section 3.2 of the Decision-making Principles). These extensions apply on top of the time limits in the IR&D Act (for example, registration applications under section 27D must be made within 10 months of the end of the income year unless extended).

3.8 The Government has observed that very long extensions for registration applications are granted, with applications often made and accepted a number of years after the relevant R&D activities were undertaken. This practice is inconsistent with the nature of the Incentive as expenditure that occurs without a business being aware of the Incentive would have occurred in the absence of the Incentive being available.

Summary of new law

3.9 Schedule 3 to the Bill makes a number of amendments to improve the administration and transparency of the Incentive. These include:

- publishing information about Incentive claimants and their R&D expenditure;
- allowing the Board of ISA to make binding determinations;
- broadening the scope of the Board of ISA’s delegation powers; and
- imposing a three-month limit on extensions of time.

3.10 These legislative changes complement other aspects of the Government’s reforms to the administration of the Incentive, including additional resourcing for additional compliance and legal activity, and the creation of improved guidance products for claimants.
## Comparison of key features of new law and current law

<table>
<thead>
<tr>
<th>New law</th>
<th>Current law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transparency of R&amp;D claimants and activities</strong></td>
<td></td>
</tr>
<tr>
<td>As soon as practicable after the period of two years following the end of the financial year, the Commissioner must publish information about the R&amp;D entities that have claimed notional deductions for R&amp;D activities, including the amount claimed.</td>
<td>No equivalent</td>
</tr>
<tr>
<td><strong>ISA determinations</strong></td>
<td></td>
</tr>
<tr>
<td>The Board of ISA may also make determinations about the circumstances and ways in which it will exercise its powers, or perform its functions or duties in relation to the Incentive. These determinations are binding on the Board of ISA.</td>
<td>The Board of ISA may make findings specific to an R&amp;D entity’s circumstances, including whether certain activities of the entity are R&amp;D activities. Findings are binding on the Commissioner.</td>
</tr>
<tr>
<td><strong>ISA delegations</strong></td>
<td></td>
</tr>
<tr>
<td>The Board of ISA and its committees may delegate their powers to any member of Australian Public Service staff assisting them.</td>
<td>The Board of ISA and its committees may delegate their powers to SES employees assisting them.</td>
</tr>
<tr>
<td><strong>Extensions of time</strong></td>
<td></td>
</tr>
<tr>
<td>The Board’s ability to grant an extension of time is subject to a cap of three months on the total extension available, unless the extension is granted to allow an applicant to wait for the outcome of a separate pending decision.</td>
<td>The Board of ISA must grant extensions of time for registrations and the provision of information of up to 14 days if it is necessary and may grant a longer period if an applicant’s ability to meet the deadline is impaired by events outside the applicant’s control.</td>
</tr>
</tbody>
</table>
Detailed explanation of new law

Transparency of R&D claimants and expenditure

3.11 Two years after the relevant income year, the Commissioner is required to publish information about the R&D activities of R&D entities claiming the R&D tax offset. This will improve public accountability for R&D claimants and encourage voluntary compliance with the program while balancing these objectives against the potentially commercially sensitive nature of the information being published. [Schedule 3, item 1, subsections 3H(1) and (2) of the Taxation Administration Act 1953 (TAA 1953)]

3.12 The Commissioner must publish the following information:

- the R&D entity’s name;
- the R&D entity’s Australian Business Number, or Australian Company Number if that is the only number available; and
- an amount representing the R&D entity’s notional deductions claimed taking into account any feedstock adjustments for the year.

3.13 As noted in paragraph 2.24, an R&D entity’s feedstock adjustment (if it has one) is the lesser of the entity’s feedstock revenue or associated feedstock expenditure and is deducted from the entity’s notional deductions. If the R&D entity’s feedstock adjustment exceeds its notional deductions for the income year, the Commissioner must not publish a dollar figure for the entity but must still publish the entity’s name and ABN or ACN. [Schedule 3, item 1, subsections 3H(3) and (4) of the TAA 1953]

3.14 The criteria for the publication and the information published are based on concepts defined in the ITAA 1997. [Schedule 3, item 1, subsection 3H(8) of the TAA 1953]

3.15 The Commissioner must publish the information as soon as practicable after the end of the period of two years starting at the end of the financial year that corresponds to the R&D entity’s income year. It is envisaged that the Commissioner would publish the information of all R&D entities at one time. [Schedule 3, item 1, subsection 3H(2) of the TAA 1953]

Source of information

3.16 The publication requirement will not apply in relation to R&D entities that do not lodge income tax returns or otherwise claim an R&D tax offset. In the case of consolidated groups and multiple entry consolidated groups, the information published will be that reported by the head company.
3.17 In determining whether the Commissioner is required to publish information about a specific R&D entity, the Commissioner can only have regard to the information that the entity has reported to the Commissioner.

3.18 Similarly, the Commissioner may only publish amounts that the R&D entity reports, subject only to simple calculations. The Commissioner is not permitted to substitute his or her own assessment of an R&D entity’s information for the purposes of determining the figures to be published. However, the Commissioner may verify an R&D entity’s identity before publication to ensure that the correct entity is identified.

**Correction of errors**

3.19 Provision for the correction of errors is an important safeguard.

3.20 The Commissioner may correct errors that are made in a publication in two circumstances: where the Commissioner has made an error and on the initiative of the relevant R&D entity.

3.21 Where the Commissioner has made an error, he or she has power to publish a correction. The correction must be made from the information the R&D entity has reported. [*Schedule 3, item 1, subsection 3H(7) of the TAA 1953*]

3.22 The Commissioner may also make information publicly available that corrects an error that the R&D entity has brought to the Commissioner’s attention. [*Schedule 3, item 1, subsections 3H(5) and (6) of the TAA 1953*]

3.23 The Commissioner has discretion in deciding whether to publish a correction, including discretion as to the time and form of the publication.

**ISA determinations**

3.24 The Board of ISA may, by notifiable instrument, make a determination about how it will exercise its powers, and perform its functions and duties. However, a determination cannot relate to the exercise of powers, or the performance of functions or duties, in a particular case or in relation to a particular R&D entity. [*Schedule 3, item 16, section 31C and subsections 31D(1) and (2) of the IR&D Act*]

3.25 Determinations seek to augment the existing program guidance by allowing the Board of ISA to publicly state its position on the application of its functions and its interpretation of the legislation, including the definition of R&D activities, the definition of clinical trials or any other administrative matters where specific guidance would reduce the compliance burden for R&D entities.
3.26 This is intended to make compliance easier for R&D entities, as they will be able to better understand what is required to demonstrate eligibility for the R&D Tax Incentive. For example, the Board of ISA may make a determination about the validity of particular forms of evidence for R&D activities, thereby providing registrants with increased clarity on how to best evidence their R&D activities in their registration applications. This would improve compliance and reduce administrative workloads.

3.27 Determinations are generally binding on the Board of ISA. The ability to make determinations binding on itself allows the Board of ISA to provide certainty to R&D claimants and helps ensure R&D entities do not unintentionally misinterpret the meaning of the law. [Schedule 3, item 16, section 31D(3) and (4) of the IR&D Act]

3.28 However, determinations are not binding when an R&D entity seeks a review of a decision. Determinations are intended to operate in a similar manner to a taxation ruling issued by the Commissioner. Determinations are not binding on R&D entities. R&D entities may continue to self-assess their eligibility for the R&D Tax Incentive in a manner that is inconsistent with a determination but risk the Board of ISA contesting their position. If R&D entities believe a determination is incorrect, they may challenge it by seeking a review of a decision made consistently with the determination.

3.29 Determinations are notifiable instruments rather than legislative instruments (see sections 8 and 11 of the Legislation Act 2003). This reflects the fact they are not binding on R&D entities and the long-standing recognition that taxation rulings are not legislative instruments (section 7 of the Legislation (Exemptions and Other Matters) Regulation 2015). [Schedule 3, item 16, subsection 31D(1) of the IR&D Act]

3.30 Making determinations notifiable instruments increases the certainty they provide to registrants. The disallowable nature of legislative instruments would undermine the Board’s ability to produce determinations that can be relied on by R&D entities. A disallowance period would create uncertainty about the validity of a determination until that period had ended.

3.31 Determinations are to be co-designed and developed in consultation with relevant stakeholders, including administrators, subject matter experts, tax advisers and peak bodies representing R&D entities by size and sector. Merits review (under Division 5 of the IR&D Act) and judicial review is available for R&D entities in the event of a dispute over a determination. The development process is intended to ensure that determinations are stable and reliable forms of guidance that can be relied upon by R&D entities over long periods of time.
Amending or revoking a determination

3.32 Subsection 33(3) of the Acts Interpretation Act 1901 provides that a power to make an instrument includes the power to revoke or vary the instrument.

3.33 These amendments provide specific circumstances when the Board of ISA must amend or revoke a determination by notifiable instrument. The amendments clarify that this does not limit the application of subsection 33(3) of the Acts Interpretation Act 1901 in relation to the power to make a determination. That is, the Board of ISA may amend or revoke a determination in a broader range of circumstances than those specified in the legislation. [Schedule 3, item 16, subsection 31E(3) of the IR&D Act]

3.34 A determination has no effect to the extent of any inconsistency with the IR&D Act, the Industry Research and Development Regulations 2011 or the Decision-making Principles. If such inconsistency exists, the Board of ISA must revoke or amend the determination to remove any inconsistency. [Schedule 3, item 16, subparagraph 31E(1)(b)(iii) and subsections 31D(4) and 31E(2) of the IR&D Act]

3.35 If the Board of ISA makes a finding specific to an R&D entity, it must be consistent with any relevant determinations. An R&D entity may still challenge a specific finding under Division 5 of the IR&D Act on the basis that the finding is incorrect and the underlying determination is similarly incorrect. An R&D entity may also challenge a finding on the basis that it is inconsistent with a determination.

3.36 In the event that a determination is found to be incorrect in a review decision or must be regarded as incorrect following a review decision, the Board of ISA must revoke or amend the determination so it is no longer incorrect. [Schedule 3, item 16, paragraph 31E(1)(a) and subsection 31E(2) of the IR&D Act]

3.37 The Administrative Appeals Tribunal may review an internal review decision of the Board of ISA. If a determination is inconsistent with a decision of the Administrative Appeals Tribunal, the Board of ISA must revoke or amend the determination so it is no longer inconsistent. [Schedule 3, item 16, subparagraph 31E(1)(b)(ii) and subsection 31E(2) of the IR&D Act]

3.38 The Board of ISA must also revoke or amend a determination that is inconsistent with a decision of a court. [Schedule 3, item 16, subparagraph 31E(1)(b)(i) and subsection 31E(2) of the IR&D Act]
ISA delegations

3.39 The Board of ISA and its committees may delegate some or all of their functions to members of the Australian Public Service staff assisting the Board. This expands the existing delegation power that authorised the Board to delegate to SES employees. [Schedule 3, items 18 and 19, subsection 22A(1) and paragraph 21(1)(e) of the IR&D Act]

3.40 The current limit on the delegation power has proved to be impractical and a significant barrier to the Board of ISA carrying out its functions necessary to the operation of the R&D Tax Incentive. These functions include the annual processing of around 14,000 registration applications as well as hundreds of compliance activities. It is unsustainable and impractical for a small number of SES delegates to be responsible for this volume of decision making.

3.41 The expansion of the delegations powers allows additional staff to be delegated responsibility for a number of administrative program tasks. This includes, but is not limited to, high-volume, low-risk functions such as the approval to grant an extension of time to submit applications, or the ability to request information on an application. Prior to the introduction of the current SES limit, a broader delegation power was used effectively and efficiently on a long-standing basis.

3.42 The expansion of the delegations powers also acknowledges the continual growth in the size of the R&D Tax Incentive and the consequent growth in resourcing needed to carry out the functions necessary for the Incentive’s effective administration.

Extensions of time

3.43 Extensions of time granted under the IR&D Act may relate to an application to register R&D activities, provide further information requested by the Board of ISA, a form to continue registration as a research service provider or an application for review of a reviewable decision. An extension will apply on top of the time limits in the IR&D Act.

3.44 The Board of ISA must not grant extensions of time under the IR&D Act in excess of three months. [Schedule 3, item 20, subsection 3.2(3) of the Decision-making Principles]

3.45 Restricting extensions to three months mitigates the risk that long extensions granted by the Board of ISA result in applications being accepted a number of years after the relevant R&D activities are undertaken. Such timeframes are inconsistent with the objectives of the Incentive as expenditure that occurs without a business being aware of the Incentive would have occurred in the absence of the Incentive being available.
Further extensions for pending decisions

3.46 This restriction does not apply if the subject matter of the extension relates to a pending decision on another matter. That is, the restriction does not apply if the extension relates to a matter corresponding with the subject of a decision relating to the R&D entity where that decision has not been finalised. [*Schedule 3, item 20, subsection 3.2(4) of the Decision-making Principles*]

3.47 This allows the Board of ISA to grant an extension in excess of three months where this is necessary to provide a deadline due after the pending decision is made in relation to decisions of the Board of ISA under Division 2, 3 or 5 of Part III of the IR&D Act. This facilitates more administratively efficient outcomes.

Example 3.1 Granting extension pending ISA decision

Doppler Dynamics seeks a review of an unfavourable registration decision in relation to the 2019-20 income year. The review (including appeals) is finalised in May 2022.

During the course of the review, Doppler Dynamics needs to consider applying for registration in subsequent years for the same ongoing activities subject to the review. It would not be efficient for it to lodge applications that may need to be varied or that may lead to decisions that need to be set aside following the outcome of the review.

In these circumstances, it is reasonable for the Board of ISA to exercise its discretion to grant an extension of time until after the pending decision is made.

Amendments to the Decision-making Principles

3.48 The amendments made by the Bill to the Decision-making Principles do not prevent the Decision-making Principles from being amended or repealed by an instrument made under section 32A of the IR&D Act (see subsection 13(5) of the Legislation Act 2003). [*Note to Section 3 of the Bill*]

Consequential amendments

3.49 A note is amended to explain that the publication of R&D entities’ R&D tax offset claims is not affected by the taxpayer secrecy provisions. [*Schedule 3, item 2, note to section 355-50 in Schedule 1 to the TAA 1953*]

3.50 The simplified outline of Part III to the IR&D Act is amended to reflect the Board of ISA’s new power to make determination about how it will exercise its powers, and perform its functions and duties. [*Schedule 3, items 5, section 26A of the IR&D Act*]
3.51 Other amendments are made to the IR&D Act to reflect the introduction of findings about clinical trials (see paragraph 1.31).

Application provisions

3.52 The amendments commence on the first day of the quarter following Royal Assent. [Section 2 of the Bill]

3.53 The transparency amendments apply to income years starting on or after 1 July 2019. [Schedule 3, item 3]

3.54 The transparency amendments apply retrospectively and were announced by the Government in the 2018–19 Budget, making taxpayers aware of the changes from the time of the announcement. The amendments improve the administrative framework supporting the Incentive by making information about R&D expenditure claims transparent.

3.55 Affected taxpayers were aware of the reforms and the potential impact they would have on the scope of the program from the date of the Budget announcement. An Exposure Draft of the legislation implementing the amendments was also released for public consultation in June 2018, prior to the 1 July 2019 application date.

3.56 The Board of ISA’s power to make determinations applies in relation to the exercise of powers, and the performance of functions and duties, by the Board of ISA on or after commencement. [Schedule 3, item 17]

3.57 The amendments to the Board of ISA’s delegation and extension of time powers apply to delegations and extension of time decisions made on or after commencement. [Section 2 of the Bill]
Chapter 4
Regulation impact statement

Background

4.1 Innovation is an important driver of productivity and economic growth, and Research and Development (R&D) is an important input to innovation. The economic impact of business investment in R&D, however, goes beyond the benefits accruing to the firm undertaking the R&D and spills over to other firms and the economy as a whole. Businesses may also have difficulty obtaining finance due to the uncertain returns from R&D activities. As a result, international research (including by the OECD) has found that firms typically underinvest in R&D relative to what is socially optimal.

4.2 The underinvestment by business in R&D represents a market failure and has been recognised internationally as justification for government intervention. In Australia, the Government primarily supports business R&D through the R&D Tax Incentive (R&DTI). While a socially optimal investment level is a theoretical construct and therefore unable to be quantified, providing support for business R&D is likely to represent a positive movement towards optimal investment.

4.3 The R&DTI program is the largest component of Australian Government support for business R&D. In the 2016-17 income year, over 12,000 R&D-performing companies claimed the R&DTI. According to the 2018-19 Science, Research and Innovation Budget tables, the estimated cost of the R&DTI program is around $2.0 billion in 2019-20.

4.4 In the 2018-19 Budget, the Government announced reforms to the R&DTI. The reforms sought to address the findings of the successive reviews of the R&DTI, while also taking into account the considerable stakeholder feedback received over a two year period between the release of the Review report in 2016 and the 2018-19 Budget.

4.5 The reforms were to commence on 1 July 2018 and contained a number of measures to better target the R&DTI towards additional R&D activities, and improve the fiscal sustainability, integrity and administration of the program. This included:

- the introduction of a $4 million cap on cash refunds for the refundable component of the R&DTI with an exemption for clinical trials;
- introducing a non-refundable R&D premium calculated with reference to the claimant’s company tax rate and R&D
intensity (R&D expenditure as a proportion of total business expenses). The premium increases with R&D intensity, rewarding companies for conducting a high intensity of R&D;

• an increase in the R&D expenditure threshold from $100 million to $150 million;
• linking the R&D tax offset rate to the prevailing company tax rate; and
• changes to improve the integrity of the program.

4.6 A Bill to implement these reforms was introduced to the Parliament on 20 September 2018. The Bill was subsequently referred to the Senate Economics Legislation Committee, which released its report on 11 February 2019. In the report, the Committee acknowledged the need for reform of the R&DTI, but recommended that consideration of the Bill be deferred until further analysis of the impacts of the Bill could be undertaken.

4.7 The Bill lapsed when Parliament was prorogued on 11 April 2019. However, the Government considers that the case for reform remains, and is now reintroducing a Bill to implement the reforms with several amendments formulated following feedback from stakeholders and the findings of the Senate Inquiry.

The problem

Current government support for R&D does not fully meet its objectives

4.8 The National Innovation and Science Agenda (NISA) was launched on 7 December 2015. When launching the NISA, the Government committed to undertaking a review of the R&DTI (the Review).

4.9 The Review was conducted by a review panel comprising Mr Bill Ferris AC (then Chair of Innovation Australia), Dr Alan Finkel AO (Chief Scientist) and Mr John Fraser (then Secretary of the Department of the Treasury). The review panel was supported by an interdepartmental taskforce comprising officers from the Department of Industry, Innovation and Science (DIIS), the Treasury and the Australian Taxation Office (ATO).

4.10 The review panel, drawing on work conducted by the Centre for International Economics (CIE), found that the R&DTI falls short of meeting its stated objectives of additionality – encouraging R&D investment that would not occur in the absence of the program – and spillovers. The panel identified a number of areas where improvements
could be made in order to improve the effectiveness and integrity of the program, primarily achieving a stronger focus on additionality.

4.11 On 30 January 2018, Innovation and Science Australia (ISA) released its report to the Government, Australia 2030: Prosperity through Innovation (the ISA 2030 Plan). The ISA 2030 Plan also found that reforms to the R&DTI were required to improve the program’s effectiveness and integrity, and included alternative recommendations to reform the R&DTI.

Inherent difficulties in measuring program effectiveness

4.12 The intended outcomes of the R&DTI – additionality and spillovers – are very difficult to quantify and necessitate analysis that relies heavily on anecdotal and qualitative evidence.

4.13 In its program evaluation, the CIE stated that:

*The two most crucial elements of the R&DTI (additionality and spillovers) turn out to be extremely difficult to empirically measure and evaluate.*

*Additionality cannot be directly measured and must be inferred through interviews, surveys, statistical analysis and modelling. Therefore, estimates of additionality will always be imprecise and subject to uncertainty.*

*Spillovers, while in principle evident from the techniques of growth accounting, have also proved to be extremely difficult to measure empirically.*

4.14 Despite the difficulties noted above, the CIE attempted to measure additionality levels in Australia using a mix of survey data and statistical analysis. DIIS also commissioned the Centre for Transformative Innovation at Swinburne University to undertake an econometric analysis evaluating the level of program additionality.

4.15 The analyses found results broadly consistent with studies from other countries (0.3 to 1.5 additional dollars of R&D per dollar of tax forgone for CIE, and 0.8 to 1.9 for Swinburne). There is also common agreement that additionality is greater for small companies than large companies.

4.16 A key finding of the Review and the CIE is that, at a conceptual level, the program’s volume based design (i.e. all R&D attracts the same benefit) is poorly targeted towards incentivising additional R&D.

4.17 The most recent estimate of spillovers in an Australian context was presented by the Productivity Commission (the PC) in 2007. The PC estimated that a 1 per cent increase in market R&D led to approximately 0.02 per cent increase in productivity or 65 cents of average spillover
benefit from each dollar of R&D conducted. It should be noted that this estimate relates to market-induced business R&D (that is, R&D that would have occurred in the absence of government support).

4.18 There is limited data in relation to spillover benefits and it is not expected that the reformed program will assist in overcoming these measurement issues.

Case for government action/objective of reform

4.19 Businesses generally invest less in R&D than is socially optimal due to their inability to fully appropriate the returns; the inherently risky nature of R&D activities; and the related uncertainty around their outcomes. There is a widely agreed role for government intervention to address this market failure and encourage additional R&D.

4.20 The Review found that the current R&DTI falls short of meeting its objectives of encouraging additionality and spillovers. Reform of the R&DTI is required to ensure the efficacy and cost effectiveness of the program. The OECD has found that ‘basic research’ (i.e. experimental or theoretical work undertaken primarily to acquire new knowledge, without any particular application or use in view) results in larger spillovers than applied research (i.e. experimental or theoretical work directed primarily towards a specific practical aim or objective).

4.21 There is, however, no evidence that specific industries or types of R&D produce additionality and spillovers in greater amounts than other industries or types of R&D. Therefore it is important that the R&DTI is industry-neutral, aiming to incentivise novel R&D in all sectors of the economy. This is catered for under the R&DTI through the broad definition of what constitutes eligible R&D.

4.22 The Review found a relatively low level of additionality under the current R&DTI, stating that “volume-based tax instruments such as the Incentive not only subsidise this additional R&D but also support the activities a company would have done anyway.” That is, the program provides the same level of support for all eligible R&D activities undertaken by a claimant, with no requirement to demonstrate that it is additional to ‘business-as-usual’ R&D that would have been progressed in the absence of government support. However, it should be noted that volume-based tax instruments tend to impose a lower regulatory burden on claimants, as eligibility is largely self-assessed.

4.23 The Review found that the program design could be improved by reducing support for business as usual activities and refocusing support towards additional R&D, particularly in the non refundable portion of the program (available to larger businesses with $20 million or more turnover per annum).
4.24 The Review recommended improving the R&DTI’s additionality for larger businesses by redirecting government support to R&D intensive companies – R&D intensity was defined as R&D expenditure as a proportion of total business expenditure. Compared to companies with lower R&D intensity, these claimants make more efficient use of scarce R&D resources such as skilled labour and specific capital equipment and are more likely to be induced to increase their investment in R&D (i.e. generate increased additionality and thus produce greater spillover benefits). It is also acknowledged that most companies will undertake some R&D to keep up with competitive pressures and additional R&D will necessarily fall into higher intensity bands.

4.25 The Review found that although the R&DTI provides effective support for small and medium sized enterprises (SMEs) via its refundable component (available to companies with annual turnover below $20 million), the significant growth in the number of SMEs participating in the program since its introduction was placing upward pressure on program costs. To address this, the Review recommended keeping the rate of benefit unchanged, but capping cash refunds for refundable R&D tax offset claimants as a way of placing some restraint on the maximum level of payment that can be made (SMEs can currently ‘cash out’ their entire R&D tax offset if they are in a tax loss position).

4.26 New taxation data indicates that growth in the refundable component of the R&DTI has moderated since the release of the Review in April 2016. The main reasons for lower growth in refundable R&DTI claims include the post-mining-boom business investment environment and increased ATO and AusIndustry compliance activity. However, factors such as the current business investment environment may not persist over the longer-term and do not necessarily preclude the re-emergence of fiscal pressures in the future.

4.27 Further, companies would need to be spending very large amounts on R&D to exceed the cap on cash refunds for refundable R&D tax offset claimants. These companies that would be impacted by a cap are likely to have access to other sources of finance, in addition to the R&DTI, to support their R&D activities. As the Review put it, “Refundability is likely to provide fewer tangible benefits for SMEs with larger R&D expenditures, who will be able to find alternative sources of finance at relatively lower costs in comparison with firms with lower R&D expenditure.”

4.28 The Review also noted that “…as the tax offsets under the program are at a fixed level, they are relatively more valuable when the company tax rate is lowered (in comparison to the deduction received for normally deductible expenses). Hence, the fixed level of the tax offset should always be calibrated to the level of the company tax.”
4.29 The CIE’s and other studies have shown that the companies most responsive to financial incentives are often cash constrained R&D start-ups, SMEs, and R&D-intensive companies (those companies whose core business is R&D-centric). These companies generally devote a greater proportion of their activities to R&D.

Policy options

4.30 This regulation impact statement compares the Government’s proposed reforms to the R&DTI to two other potential policy responses: 1) no policy change; and 2) adopting the Review recommendations.

Option 1: No policy change

4.31 If the Government took no action the R&DTI would continue in its current form. The program currently has two core components:

- a 43.5 per cent refundable tax offset for eligible entities with a turnover of less than $20 million per annum; and
- a 38.5 per cent non-refundable tax offset for all other eligible entities. Unused non-refundable offset amounts may be able to be carried forward to future income years.

4.32 The $100 million expenditure threshold would be maintained until the legislated sunset date of 1 July 2024.

4.33 In the absence of the R&DTI, companies would deduct their expenses at the relevant standard company tax rate (currently 27.5 per cent for businesses with annual turnover less than $50 million and 30 per cent for all other businesses). If a company was in tax loss, however, they would not receive any immediate benefit.

4.34 The net benefit provided by the R&DTI is the difference between the R&D offset rate and what the company would otherwise receive in the absence of the program (i.e. the value of the standard tax deduction). These rates can be seen in Table 4.1 below. As the corporate tax rate for companies with a turnover of less than $50 million continues to decrease over the coming years, the net benefit for these companies will increase serendipitously if no change is made to the R&DTI.
Table 4.1: R&DTI Net Benefit Rates, 2019-20

<table>
<thead>
<tr>
<th>Annual Turnover</th>
<th>Company Tax Rate (%)</th>
<th>R&amp;DTI Offset Rate (%)</th>
<th>Net Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - $20m (Unprofitable)</td>
<td>0</td>
<td>43.5</td>
<td>43.5 cents</td>
</tr>
<tr>
<td>0 - $20m (Profitable)</td>
<td>27.5</td>
<td>43.5</td>
<td>16 cents</td>
</tr>
<tr>
<td>$20m - $50m</td>
<td>27.5</td>
<td>38.5</td>
<td>11 cents</td>
</tr>
<tr>
<td>$50m and above</td>
<td>30</td>
<td>38.5</td>
<td>8.5 cents</td>
</tr>
</tbody>
</table>

4.35 Under the refundable tax offset, if a claimant’s offset exceeds their tax liability then the claimant receives the excess as a cash refund, rather than carrying forward an amount to offset tax liabilities incurred in future income years.

Option 2: The Review’s Recommendations

4.36 The Review found that the program does not fully meet its stated policy objectives and proposed a range of recommendations to improve its effectiveness and integrity. The recommendations included initiatives to encourage additional R&D. The Review’s recommendations are summarised in Table 4.2 below.

Table 4.2: Review’s recommendations

<table>
<thead>
<tr>
<th>Rec</th>
<th>Detail</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Retain the current scope of eligible activities and improve guidance to registrants.</td>
</tr>
</tbody>
</table>
| 2.  | Introduce a collaborative premium of up to 20 per cent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations.  
  - The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment.  
  - Companies falling below the intensity threshold should still be able to access both elements of the collaboration premium. |
<p>| 3.  | Introduce a cap on the annual cash refund (in the order of $2m) with remaining offsets treated as non-refundable offset and carried forward. |</p>
<table>
<thead>
<tr>
<th>Rec</th>
<th>Detail</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.</td>
<td>Introduce a 1-2 per cent R&amp;D intensity threshold for the non-refundable element, such that only R&amp;D expenditure over the threshold attracts a benefit. Intensity is defined as the proportion of R&amp;D expenditure over total expenditure.</td>
</tr>
<tr>
<td>5.</td>
<td>If an R&amp;D intensity threshold is introduced, increase the R&amp;D expenditure threshold from $100m p.a. to $200m p.a.</td>
</tr>
<tr>
<td>6.</td>
<td>Investigate options for improving the administration of the R&amp;DTI (e.g. adopting a single application process; developing a single program database; reviewing the two-agency delivery model; and streamlining compliance review and findings processes, publishing annually the names of companies claiming the R&amp;DTI and the amounts of R&amp;D expenditure claimed) and additional resourcing that may be required to implement such enhancements. To improve transparency, the Government should also publish the names of companies claiming the R&amp;DTI and the amounts of R&amp;D expenditure claimed.</td>
</tr>
</tbody>
</table>

**Option 3: Targeted reforms to the R&DTI (preferred option)**

4.37 The Government’s option is to proceed with targeted reforms to the R&DTI. These reforms comprise a number of targeted changes to the R&DTI including:

- a $4 million cap on cash refunds with an exemption for clinical trials;
- an R&D premium that rewards companies that commit a greater proportion of expenses to R&D;
- an increase in the R&D expenditure threshold from $100 million to $150 million;
- linking the R&D tax offset rate to the prevailing company tax rate;
- introducing a new power for ISA to make ‘general determinations’; and
- changes to improve the integrity of the program.

4.38 The changes would apply to income years starting on or after 1 July 2019.

4.39 The reforms include a $4 million annual cap on cash refunds for R&D claimants with aggregated annual turnover less than $20 million. Amounts in excess of the cap would become a non-refundable tax offset to be carried forward into future income years. Expenditure on clinical trials would be excluded from the $4 million cap on cash refunds,
recognising the critical role of clinical trials in developing life changing drugs and devices.

4.40 To help ensure support provided under the program is well targeted, the new R&D premium refocusses support for larger companies (with annual turnover of $20 million or more) towards those companies which devote a greater proportion of their expenses to R&D (i.e. with higher R&D intensity), while continuing to provide a baseline level of support for companies with lower R&D intensity. The R&D premium provides multiple rates of non-refundable R&D tax offsets, increasing with the intensity of companies’ R&D expenditure. The increasing rate of support provides companies with a greater incentive to undertake additional R&D activities.

4.41 The current $100 million expenditure threshold would be increased to $150 million and made a permanent feature of the law. The higher expenditure threshold encourages large companies to spend more on R&D, as a greater proportion of their R&D expenditure will be eligible for the R&DTI.

4.42 See Table 4.3 for the rates of benefit provided by the R&D Premium. Box 1 provides an example of how the R&D Premium would operate in conjunction with the increased expenditure threshold.

4.43 The rates of the R&D tax offsets would be linked to each claimant’s company tax rate, removing the need for ongoing legislative amendments to the R&DTI tax offset rates as company tax rates change (see Table 4.3). This ensures that companies receive a fixed premium (above the value of a standard tax deduction) for R&D expenditure as the Government’s corporate tax cuts take effect. This also removes differences in support due to the disparity between the turnover thresholds that determine a company’s corporate tax rate and its level of support under the R&DTI.

Table 4.3: The new R&DTI tax offsets

<table>
<thead>
<tr>
<th>R&amp;DTI tax offset</th>
<th>Rate of offset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refundable R&amp;D tax offset (companies with turnover less than $20 million)</td>
<td>The claimant’s tax rate for the year plus 13.5 percentage points.</td>
</tr>
</tbody>
</table>
Box 1 - How does the expenditure threshold work?

For a given income period, if Company A has total business expenses of $800 million and eligible R&D expenditure of $125 million, the company has a 15.6 per cent R&D intensity ($125 million / $800 million). Under existing policy settings, the company would receive the 38.5 per cent non-refundable R&D tax offset on the first $100 million of R&D expenditure. The excess amount above the threshold, $25 million, would receive an offset at the company’s company tax rate (a 30 per cent offset assuming the company’s turnover is above $50 million). This would result in a total non-refundable tax offset of $46 million.

Under the R&D Premium with an associated increase of the expenditure threshold to $150 million, the first $32 million (4% of $800 million) would attract an offset of $11 million (34.5 per cent x $32 million). The next $40 million would receive an offset of $15.4 million (38.5 per cent x $40 million). The remaining $53 million would receive an offset of $22.5 million (42.5 per cent x $53 million), resulting in a total non-refundable tax offset of around $49 million. As before, any R&D expenditure above the expenditure threshold (now $150 million), would receive an offset calculated at the company’s tax rate (without any premium).

4.44 The ISA Board would have the power to publish ‘general determinations’, which would be binding on the ISA Board. The general determinations would provide guidance on the circumstances in which the Board can exercise its powers or perform its functions or duties in relation to the R&DTI.

4.45 Lastly, the targeted reforms would improve the integrity of the R&DTI by strengthening anti avoidance rules, publishing claimant details and amounts of R&D expenditure claimed and improving guidance to help ensure that taxpayers do not make incorrect claims. The reforms would also make the rate at which the offset is recouped (i.e. feedstock and clawback rules) more accurate in situations where receiving the R&D tax offset would result in a company accruing an additional benefit.
Impact analysis of each option

4.46 To receive a benefit under the R&DTI, companies must go through a two stage process: registering R&D activities with the DIIS; and then claiming the incentive for the related expenditure in their annual tax return (including an R&D Tax Schedule) with the ATO. The activities associated with the registration and claiming processes comprise the R&DTI’s regulatory costs. As with the rest of the taxation system, over 80 per cent of companies that register for the R&DTI use consultants to assist with their applications. The fees paid to these consultants impose a regulatory burden on registrants, and are therefore considered when determining the regulatory costs of the different options.

Option 1: No policy change

4.47 Under this option, no action would be taken by the Government and the current R&DTI continues unchanged. There is therefore no change to the regulatory cost of the program.

Benefits

4.48 The benefit of this option would be that there is no increase in regulatory burden for claimants.

Costs

4.49 The cost of this option would be that the Government continues to provide support to ‘business as usual’ R&D which would likely have been conducted anyway (i.e. in absence of the program). The R&DTI would continue to fail to fully meet the program’s objective of encouraging greater additionality in R&D activities.

4.50 There would also be a risk that future growth in the number of companies in the program or claim amounts could place upward pressure on program costs, without an attendant increase in additionality.

4.51 Program costs will also continue to rise as the Government’s company tax cuts come into effect. Without changes to offset rates, the lower company tax rates increase the effective benefit of the R&DTI and the resulting cost to government.

Option 1 - Net outcome

4.52 While there would be no change to the regulatory burden on business, the identified deficiencies in the efficacy of the program would continue, limiting the economic benefits and cost effectiveness of the R&DTI.
Option 2: R&DTI Review Recommendations

4.53 This option would implement the recommendations of the Review without any alterations.

Benefits

4.54 Introducing a minimum R&D intensity requirement would target support towards companies that are the most significant participants in Australia’s R&D landscape. As the benefit would not be provided for R&D expenditure under the threshold (the Review found that at least such a level of expenditure would be expected as business as usual in a truly innovative company), the intensity threshold is more likely to direct support to companies investing in additional R&D.

4.55 Companies below the threshold would no longer be eligible to receive a benefit under the program, which, in some cases, may reduce the overall administrative burden. This would be due to fewer companies needing to complete the registration process and separately account for related expenses, therefore removing the need for associated record keeping and compliance-ready measures.

4.56 The Review also recommended that the $100 million expenditure threshold should be increased to $200 million so that large R&D intensive companies retain an incentive to increase R&D in Australia. The higher expenditure threshold, when combined with the intensity threshold, would likely sharpen the additionality of larger companies. This is because the companies in a position to benefit from the higher expenditure threshold would be able to register more R&D activities in order to receive the greater benefit.

4.57 A $2 million cap on cash refunds would constrain the costs of the refundable R&D offsets under the program. At the time of the Review, the refundable R&D offset was the most costly element of the program and was growing at unsustainable rates. However, it should also be noted that these companies were found by the Review to be the most responsive to support being provided and the most likely to reinvest the support provided into additional R&D.

Costs

4.58 The introduction of an intensity threshold in isolation is estimated to deny an R&DTI benefit to those claimants with intensities less than 1 or 2 per cent. Conceptually, the companies falling below the threshold are more likely to be undertaking ‘business as usual’ R&D than ‘additional’ R&D. While business as usual R&D is expected to continue without Government support, there may be an overall decline in R&D that would have been conducted in Australia. For example, this measure would impact some businesses for which R&D is complementary rather than
central to their core activity – such as manufacturing. In these businesses, while R&D intensity might not be high due to the relatively high level of expenditure on other costs, the introduction of the threshold could reduce their incentive to conduct additional R&D.

4.59 A $2 million refund cap may deter some start-ups from investing in additional R&D and could significantly impact the development of new innovative start-up companies in Australia. The biotech and medical industries would be particularly affected. These industries are generally very R&D intensive, with long term R&D projects that require large amounts of persistent capital and financing. The industry frequently incurs large expenses before any returns on investment are made. There is often a long time between the initial R&D and commercialisation due to the rigorous safety and efficacy testing requirements required for new medications and medical devices. Without a specific exemption, the $2 million cap could force clinical trial activities offshore as the cash refund cap would limit cash flow.

4.60 The collaboration premium may be limited in its ability to effectively increase the level of collaboration. While the collaboration premium would reward companies for collaborating with publicly funded research organisations, factors such as the differing objectives of industry and universities in conducting research and poor mobility between academia and businesses would remain significant inhibitors of collaboration. Further, as with the R&DTI generally, additional support would be offered for collaborative R&D activity already underway at no additional benefit to the taxpayer. A collaboration premium also creates the potential for distortionary impacts and rorting. For example, a company with the internal capability to undertake R&D may choose to outsource the activity simply to receive a higher benefit rate. This would not be an efficient allocation of resources.

**Option 2 - Net benefit**

4.61 The net result would be lower regulatory costs for the R&DTI, largely driven by changes that effectively exclude companies from accessing the program.

4.62 The intensity threshold precludes a significant number of non-refundable claimants from accessing the R&DTI. As these companies would no longer be required to register their R&D activities or complete the R&D schedule to their tax return, their regulatory burden is reduced.

4.63 The $2 million refund cap proposed by the Review is significantly more restrictive than the $4 million refund cap included in the targeted reforms to the R&DTI (Option 3) and has no exemptions. It would be expected to adversely impact smaller companies with significant, longer term investments in R&D (including biotech, medtech and life science companies). These companies might have to go to
significant effort and incur higher costs to secure alternative sources of financial support should they choose to continue their R&D activities in Australia.

4.64 The design elements of the collaboration premium – such as the specific definition of ‘collaboration’, the eligibility criteria and the claiming process – were not elaborated upon by the Review. While the Review proposes a premium rate for collaborative R&D, those activities are already eligible under the current program arrangements. The regulatory impact would require separating out the related expenses. This is likely to occur already through contract agreements, given intellectual property is being created. As a result, the regulatory impact from the measure is believed to be negligible.

4.65 Regulatory costings for the Review recommendations are lower than the Option 3 reforms as a result of companies being excluded from the program, which reduces registration, record keeping and audit costs for these companies.

4.66 Overall, this option would result in an estimated total average annual regulatory saving for businesses of $12.3 million.

**Table 4.4: Regulatory burden estimate (RBE) table (Option 2)**

<table>
<thead>
<tr>
<th>Change in costs ($ million)</th>
<th>Business</th>
<th>Community organisations</th>
<th>Individuals</th>
<th>Total change in cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total, by sector</td>
<td>$12.3 save</td>
<td>Nil</td>
<td>Nil</td>
<td>$12.3 save</td>
</tr>
</tbody>
</table>

*Average annual impact (calculated over 10 years).

**Option 3: Targeted reforms to the R&DTI (preferred option)**

4.67 Under this option, the Government’s targeted reforms to the R&DTI would be implemented.

**Benefits**

4.68 Introducing an R&D Premium for larger claimants would target support towards R&D intensive companies that are the most significant participants in Australia’s R&D landscape. R&D intensive companies are considered to be more responsive to fiscal incentives intended to support R&D. Focussing on targeting these companies would therefore better target the program’s focus on additionality and spillovers.

4.69 Under the R&D Premium, large companies with lower R&D intensities will have their R&D claims reduced, resulting from the reduction in the level of support for R&D expenditure that is more likely to be business as usual. The level of support will be increased for R&D that is more likely to be additional. The reduced support for business as
usual R&D and increased support for additional R&D expenditure is expected to improve the additionality of the program.

4.70 Although companies with low R&D intensities are expected to have some behavioural response to the reduction in their overall support, their response may be quite small. This is because the reduction in support is for R&D expenditure that is more likely to be business as usual – that is, likely to be conducted even in the absence of the program.

4.71 There are a number of distinct benefits of targeting support for larger companies under the program towards those that are more R&D intensive. The Review found that large R&D intensive companies are more likely to:

- use R&D inputs such as skilled labour and specialised equipment efficiently;
- partner with other bodies, increasing prospects for spillover benefits; and
- be undertaking basic research and novel R&D (found to generate greater spillovers).

4.72 The current $100 million expenditure threshold would be increased to $150 million and made a permanent feature of the law. The higher expenditure threshold would encourage large companies to spend more on their R&D in Australia.

4.73 The package of changes to the non-refundable R&DTI is estimated to provide a higher average level of support to approximately 25 companies compared to the existing program. This modelling is based on tax administration data reported for the 2016-17 income year.

4.74 A $4 million cap on cash refunds would sharpen the R&DTI’s focus on additional R&D activity by ensuring that government resources are provided to those most in need. The $4 million cap would place a reasonable constraint on the amount of refund provided to a company in a given year. Companies would retain access to the full amount of their R&D offset but, refundable amounts exceeding $4 million would be carried forward as a non refundable tax offset for use in future years.

4.75 To be impacted by the cash refund cap of $4 million, a company needs to spend around $10 million on eligible R&D expenditure in an income year. R&D spending of this size cannot be sustained by tax refunds alone, resulting in the conclusion that these companies have access to alternative sources of finance. As one of the key rationales of the refundable component of the program is to support small, cash constrained SMEs, there is little policy rationale in providing unlimited Government funding to companies capable of obtaining finance through private means. As is the case with most other international jurisdictions offering cash refund for R&D activities (e.g. Denmark, Ireland and
Spain), it is reasonable for an upper limit to be placed on the amount of cash benefit a company can receive in an income year.

4.76 The reforms to the refundable tax offset would also include a carve out for clinical trials. This carve out would mean that eligible expenditure incurred on clinical trials would be exempt from the $4 million cap. The carve-out would ensure that support is maintained for critical drug and medical device development.

4.77 Linking R&D offset rates to the company tax rate would address the expected program cost increases resulting from the proposed company tax rate reductions in a manner which avoids the need to amend the tax law in the future. In the absence of linking to company tax rates, the program would need to be amended every time the company tax rate was changed in order to maintain the level of benefit available under the R&DTI. The linking also removes the different levels of support that is caused by the disparity between the turnover thresholds that determine a company’s corporate tax rate and its level of support under the R&DTI.

4.78 The ISA Board would have the ability to publish ‘general determinations’, which would be binding on the ISA Board and pertain to the circumstances in which the Board can exercise its powers or perform its functions or duties in relation to the R&DTI. The broad scope of general determinations would assist in improving the clarity of advice provided to industry claimants, and would provide program participants with clearer guidance about eligibility and other requirements. Practically, this is expected to result in reduced time and money devoted to program registration and dealing with compliance activities. Clearer guidance and eligibility will also result in a reduced need for companies to engage consultants and expert advice when engaging with the program.

4.79 Amending Part IVA of the Income Tax Assessment Act 1936, to include both the refundable and non-refundable R&D tax offsets in the definition of a ‘tax benefit’ would provide the ATO with the ability to challenge contrived tax arrangements that seek to utilise R&D tax offsets.

**Costs**

4.80 Around 1,030 (65 per cent) of companies claiming the non-refundable R&D tax offset currently have intensities of 4 per cent or lower, giving these firms access to the lowest R&D Premium. The remaining non-refundable offset recipients (approximately 550) have intensities greater than 4 per cent.

4.81 Some companies receiving the refundable R&D offset would see a reduction in their overall benefit amount as a result of linking to the company’s tax rate.

4.82 It is estimated that a $4 million cap would impact the cash refund values of around 20 claimants receiving the refundable offset,
taking into account other elements of the package. These registrants would no longer receive a cash refund for amounts in excess of the $4 million cap, however they would be able to carry forward the excess amounts to future financial years as a non-refundable tax offset.

4.83 For companies that are impacted by the cap on cash refunds, those conducting clinical trials would still be able to receive a cash refund above $4 million.

4.84 The linking measure will reduce the level of benefit available to profitable SMEs from 16 per cent to 13.5 per cent. However, this measure is required to reset the level of benefit to that which was available prior to the company tax cuts. Profitable SMEs have in the meantime been the beneficiaries of an unintended windfall arising from this anomaly.

4.85 Unprofitable SMEs will see a reduction in their refundable benefit of 2.5 per cent. This is an acknowledged policy consequence of the linking measure, and provides a consistent level of benefit for both profitable and unprofitable SMEs.

4.86 There are difficulties measuring the responsiveness of R&D expenditure incurred by smaller claimants that would allow an assessment of the likely impact of the measure on the aggregate level of R&D. While the level of benefit is being slightly reduced, the equivalent reduction in company tax rates will have more widespread positive cash flow consequences. Given the two policies will be implemented over a similar period, future analysis is also unlikely to be able to clearly disaggregate the effects of these two policies.

4.87 Given the changes being made to the program, the feedstock, clawback and balancing adjustment rules would need to be amended to ensure they correctly reverse the tax benefit of claiming R&D in situations such as where the R&D activities are funded by other forms of government support or the results of R&D activities are sold. This may result in some transitional costs for taxpayers already claiming under the program.

4.88 It is expected that the regulatory impact of the changes would be moderate. The intensity calculation for companies receiving the non-refundable offset would use information from existing tax return labels. As companies already collect the required information, making an additional calculation would impose limited additional costs. The introduction of the cap on cash refunds is not expected to change the way that companies would register or claim their R&D expenditure, except for those claiming a clinical trials exemption.

4.89 Increased regulatory burdens would largely lie with companies who would benefit under changes in the program. For example, the companies in a position to benefit from the higher expenditure threshold
may choose to register additional R&D activities in order to maximise their benefits under the program.

**Option 3 - Net benefit**

4.90 The net result is that the R&DTI would be more focused towards supporting additional high intensity R&D expenditure, reducing support for activities likely to be business-as-usual and improving the returns to the economy and to taxpayers. The changes help reduce the cost of the program, delivering an estimated gain to the budget of $1.8 billion over the current forward estimates period in fiscal balance terms.

4.91 Under Option 3, the regulatory burden is higher than for Option 2, however this is due to retained access for all non-refundable claimants. These companies would still be able to access a baseline level of support even if their R&D intensity is less than one or two per cent. These lower intensity companies are excluded under Option 2, and so reduce the associated regulatory costs under that option.

4.92 The targeted reforms to the R&DTI would have minimal regulatory impact on program participants and the reforms do not exclude any companies from claiming under the R&DTI. Minor changes would be required to the registration and claims processes as a result of the changes. Record keeping requirements would remain largely unchanged, and information required to calculate a company’s intensity (e.g. total expenses) is already available as part of the company tax return process. Accordingly, only a minor increase in compliance costs is expected.

4.93 The potential for companies to establish specific R&D entities for the purpose of accessing the higher R&D intensity benefits was considered during the legislation consultation process. Following stakeholder feedback, it was considered that the risk of this occurring is manageable and the ATO has advised that the anti-avoidance provisions in the tax law, which are being strengthened as part of this legislative package, may apply to such schemes.

4.94 This option would result in an estimated total average annual regulatory cost for businesses of $26.3 million:

**Table 4.5: Regulatory burden estimate (RBE) table (Option 3)**

<table>
<thead>
<tr>
<th>Change in costs ($ million)</th>
<th>Business</th>
<th>Community organisations</th>
<th>Individuals</th>
<th>Total change in cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total, by sector</td>
<td>$26.3</td>
<td>Nil</td>
<td>Nil</td>
<td>$26.3</td>
</tr>
</tbody>
</table>

*Average annual impact (calculated over 10 years).*
Consultation plan

4.95 There has been significant consultation on the reforms to the R&DTI.

4.96 The first round of public consultation occurred during the Review of the R&DTI in early 2016. To inform their deliberations, the Review Panel conducted a program of targeted consultations with a variety of stakeholders including those from industry, the research sector, and government and tax agents. The Review consultation period began on 13 January 2016 and ended on 18 March 2016.

4.97 The Review was released publicly on 28 September 2016. To inform its response to the Review’s recommendations, the Government announced a four week public consultation period, which was undertaken following the public release of the Review report. In addition to written submissions, the then Minister for Industry, Innovation and Science convened a number of roundtables with peak industry bodies, and one-on-one meetings with targeted stakeholders and DIIS conducted multiple stakeholder forums in all states and territories to receive feedback. The written submissions are publicly available on the DIIS website at industry.gov.au.

4.98 Following the Government’s announcement of reforms in the context of the 2018-19 Budget, draft legislation was released for public consultation from 29 June to 26 July 2018. In addition to written submissions, consultations included a series of face-to-face meetings with key stakeholders conducted by DIIS in consultation with the Treasury and the ATO. Consistent with the prior consultation processes, some stakeholders objected to the potential reduction of benefits under the proposed changes. However in general, feedback from this process helped refine the legislation with the following stakeholder suggestions being adopted:

- amending the ‘R&D premium’ so that it is calculated as a portion of ‘total expenses’ and not ‘total expenditure’. Stakeholders argued this would be easier to comply with as the information is more readily available in their accounting systems;
- clarified the scope of the clinical trial exemption to remove ambiguity;
- expanded the new mechanism for working out clawback and feedstock adjustments to include balancing adjustments for R&D assets, meaning a single mechanism is used for adjustments to the amounts of benefit received under the Incentive;
• excluded clawback amounts from the income tests that apply to early stage investment companies (ESICs), to ensure the Incentive does not inadvertently impact eligibility for other Government programs; and

• explicitly legislated a minimum 2 year delay for the ATO publishing R&DTI claimant details to help alleviate stakeholder concerns that data published soon after year end could be commercially sensitive in nature.

4.99 Following its introduction to Parliament, the legislation was referred to the Senate Economics Legislation Committee for review. The Committee received 75 written submissions and held three public hearings between 16 November 2018 and 31 January 2019. The Committee released its report on 11 February 2019. Further refinements to the legislation have been made with the recommendations of the report in mind, including a delay to the start date of the legislation to 1 July 2019 and the increased rate and changes to the calculation of the R&D Premium.

4.100 In addition to the above formal consultations, the Minister for Industry, Science and Technology and DIIS and the ATO have continued to engage with stakeholders (for example, through face to face meetings, roundtables and teleconferences), and will continue to do so throughout implementation of the reforms.

Option selection/conclusion

4.101 The preferred policy option is to implement the targeted reforms to the R&DTI (Option 3). Option 3 would better target the R&DTI by inducing greater additionality and spillovers, while improving the integrity of the program. Option 3 addresses the issues raised in the Review and provides a greater incentive to high R&D intensity companies than that recommended by the Review (Option 2). Option 3 implements a larger annual cap on cash refunds and provides a minimum base rate of support for claimants with low R&D intensity.

4.102 Although Option 3 is expected to result in higher regulatory costs, it continues to provide support to companies that would be completely excluded from the program under Option 2. It also addresses the policy concerns with the current program, which would have persisted under Option 1. It is therefore the preferred approach to reform the R&DTI.
Implementation and evaluation/review

4.103 Legislation is required to implement this proposal. The reforms to the R&DTI will apply for income years commencing on or after 1 July 2019. As such, legislation will need to be passed by 30 June 2020 as the measures apply to the 2019-20 year.

4.104 To support R&DTI claimants in understanding their obligations under the reformed program, the ATO and AusIndustry will issue improved guidance products for claimants. This will be augmented by the proposed changes that permit ISA to issue binding public guidance, increasing certainty for claimant’s as to what is and is not eligible R&D activity under the R&DTI. Additional resourcing for the regulators is also being used to undertake greater enforcement activity, further improving the integrity of the R&DTI.

4.105 Following the passage of the legislation, the ATO and ISA will continue to undertake their client feedback processes, which assist in identifying opportunities to improve the administration of the R&DTI. Treasury and DIIS will also consider feedback from regulators and stakeholders as to how the reformed R&DTI is operating in practice.

4.106 Following the end of a financial year, there is a 16 month delay before complete registration and taxation data for that years’ R&DTI registrants becomes available. This time lag means that analysing companies’ behavioural responses to the proposed measures would not be possible for some time (late 2021 at the earliest). This is because a number of years of data from the reformed program would be necessary to perform a useful evaluation of the effects of any changes. Accordingly, any review performed before 2023/24 would be of limited value as the dataset would not cover a sufficient period.

4.107 Evaluations for the R&DTI are performed in consultation with DIIS’s internal evaluation unit, and the results are made public at Ministerial discretion.

4.108 As discussed earlier in this document, there are longstanding challenges in evaluating program effectiveness against its objectives of additionality and spillovers. To again quote the CIE:

...there are significant difficulties in measuring additionality and spillovers arising from the R&D TI. This means that a sound quantitative estimate of the overall benefits of the scheme to the economy (or an estimate of the value that the taxpayer receives for their expenditure) will always be subject to considerable uncertainty.

4.109 It is not expected that the reformed program will assist in overcoming these data issues.
4.110 General summaries of Government support provided for business R&D will continue to be published publicly in the annual Science, Research and Innovation Budget Tables. In addition, the reforms to the R&DTI will ensure transparency of the program by publishing the names of companies, and their claim amounts, following a two year delay.
Chapter 5  
Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Better targeting the Research and Development Tax Incentive

5.1 The Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the Human Rights (Parliamentary Scrutiny) Act 2011.

Overview

5.2 Schedule 1 to the Bill reforms the R&D Tax Incentive to better target the program, and improve its effectiveness and integrity.

5.3 Schedule 2 to the Bill enhances the integrity of the Incentive by ensuring R&D entities cannot obtain inappropriate tax benefits and by clawing back the benefit of the Incentive to the extent an entity has received another benefit in connection with an R&D activity.

5.4 Schedule 3 to the Bill improves the administrative framework supporting the Incentive by making information about R&D expenditure claims transparent, enhancing the guidance framework to provide certainty to applicants and streamlining administrative processes.

Human rights implications

5.5 The Bill does not engage any of the applicable rights or freedoms. The amendments in the Bill only applies to bodies corporate.

Conclusion

5.6 The Bill is compatible with human rights as it does not raise any human rights issues.