
Developments in R&D: the year in review

1 April 2016

In brief

To help keep you abreast of the latest research and development (R&D) news, we examine recent developments in the R&D Tax Incentive program; including updates on the progress of R&D legislation, the R&D program review status and guidance issued by AusIndustry and the Australian Taxation Office (ATO).

In detail

R&D Application – reminder of lodgment deadline 30 April 2016 (for June balancers)

The deadline of 30 April 2016 for lodging the *Application: Registration of R&D Activities* (R&D Application) with AusIndustry is fast approaching for companies with a June year end. Please reach out to your usual PwC adviser if you need assistance with your application.

R&D Tax Incentive Program Reviews

Throughout the past year, the R&D Tax Incentive Program has remained the subject of a series of reviews.

In late March 2015, the program was made a key point of focus of the Federal Government's 'Re:think' tax reform process. By August 2015, this had extended into a complementary review headed by the Centre for International Economics (CIE). Then, in December 2015, the Government announced another review of the program, this time to be led by Bill Ferris (the Chair of Innovation Australia), Dr Alan Finkel (Australia's Chief Scientist) and John Fraser (the Secretary of the Treasury).

The Government has said the Ferris-Finkel-Fraser review will build on the work already undertaken as part of the earlier CIE review and 'Re:think' tax reform process. Its main aims are to evaluate the effectiveness and integrity of the current arrangements for supporting business R&D and the level of additionality they stimulate. It is due to conclude in April 2016, and it is widely assumed that some of its recommendations will then be reflected in the Federal Budget on 3 May 2016.

In our submissions to each of these reviews, PwC has continued to emphasise the strengths of the current program and argued that, if any changes are to be made, they should generally only be minor.

Government Policy

There has been a considerable emphasis from the Federal Government on innovation policy during the past 12 months, particularly since Malcolm Turnbull became Prime Minister in September 2015. This was most directly reflected in the release in December 2015 of a detailed Innovation Statement, containing \$1.1 billion of new science, technology, engineering and mathematics (STEM) and innovation initiatives. The Statement did not signal any move toward a patent box regime, but a number of other changes have the potential to complement local R&D activity.

On the legislative front, the major development of the past year was the Senate's decision in March 2015 to pass the Tax Laws Amendment (Research and Development) Bill 2013. This Bill included a measure to make annual offsets through the R&D Tax Incentive available for only the first \$100 million of eligible R&D spending by companies. This change applies to assessments for income years starting on or after 1 July 2014 and before 1 July 2024.

By contrast, the progress of the Tax and Superannuation Laws Amendment (2015 Measures No.3) Bill 2015 has remained stalled. This legislation contains a proposed 1.5% reduction to the offset rates of the R&D Tax Incentive. Originally part of the Abbott Government's first Budget (in May 2014), these changes were rejected by non-Government Senators in March 2015 and the relevant legislation has not subsequently proceeded to another vote in the Senate.

ATO guidance

On 15 October 2015 the ATO jointly with AusIndustry released Taxpayer Alert, TA 2015/3 - Accessing the R&D Tax Incentive for ineligible broadacre farming activities.

The ATO and AusIndustry are reviewing arrangements where primary producers involved in broadacre farming are claiming the R&D Tax Incentive for the cost of fertilisers and other treatments (soil improvers) where a significant part (or all) of the expenditure that is incurred relates to 'business as usual' farming activities and not to R&D activities. The ATO and AusIndustry are monitoring registrations that are similar to that set out in the Alert and AusIndustry is developing a Specific Issue Guidance product to assist taxpayers in the farming industry.

AusIndustry updates

There have been two cases in recent times concerning the application of the R&D provisions. AusIndustry lost the JLSP case (*JLSP and Innovation Australia* [2016] AATA 23), handed down on 23 January 2016, but AusIndustry won the Docklands Science Park case (*Docklands Science Park Pty Ltd and Innovation Australia* [2015] AATA 973) in December 2015. The JLSP win was the first against AusIndustry for a while but equally, it was the first case in some time where the applicant has been able to adduce contemporaneous evidence to support its claim. It also considered duality of purpose and found that a commercial purpose did not prevent the R&D purpose and the eligibility of the activities.

See below for summaries of these cases.

AAT case: The JLSP case

On 23 January 2016, Deputy President Frost of the Administrative Appeals Tribunal set aside an internal review decision made by the Board of Innovation Australia (AusIndustry) in the matter of JLSP and Innovation Australia [2016] AATA 23.

The internal review decision made by AusIndustry included a finding that:

- Activity 1 was not a "core R&D activity" within the meaning of section 355-25(1) of the *Income Tax Assessment Act 1997* (the Act) and;
- Activities 3 and 5 were not "supporting R&D activities" within the meaning of section 355-30(1) of the Act.

Deputy President Frost found, based on the documents and evidence before him, that the relevant statutory definition of "core R&D activity" had been satisfied with respect to Activity 1.

With respect to section 355-25(1)(b) of the Act which requires the activity to be "conducted for the purpose of generating new knowledge", the Tribunal accepted AusIndustry's view that the relevant purpose must be held by the Applicant R&D entity. However, the Tribunal found that in this case, a "substantial purpose" would suffice in satisfying the statutory requirement and a dominant or prevailing purpose was not required. Deputy President Frost also held that the question of whether the Applicant R&D entity subsequently uses the new knowledge generated is irrelevant to the enquiry.

The Tribunal also clarified that the R&D Tax Incentive regime set out in Division 355 of the Act involves two distinct and separate questions. The first enquiry (which is an exercise to be undertaken by AusIndustry) is "definitional" and concerns whether the activity registered satisfies the definition of "R&D activity" (which includes both "core R&D activity" and "supporting R&D activity"). The second enquiry (which is an exercise to be undertaken by the Commissioner of Taxation) is "operational" which concerns whether expenditure incurred is "eligible R&D expenditure". Deputy President Frost held that this second enquiry is not to be regarded when considering whether the definition of "core R&D activity" is met.

This case demonstrates the importance of contemporaneous documentation regarding the R&D activities.

AAT case: Docklands Science Park

The success of the Applicants in the JLSP case can be distinctly contrasted with the Applicant in the earlier matter of Docklands Science Park Pty Ltd and Innovation Australia [2015] AATA 973, where the absence of documentation was what ultimately led to the finding that there was no "core R&D activity" conducted. Senior Member Egon Fice of the Tribunal noted that "documentation is necessary to substantiate the R&D activities claimed by an applicant. It is the absence of documentation which has resulted in my findings".

Introducing PwC's R&D Cloud

The R&D landscape is changing. Higher levels of review activity and scrutiny by the governing bodies means businesses need an efficient process for assessing, documenting and substantiating their R&D tax incentive claims. In response, PwC Australia have developed an online R&D claim management and assessment tool which can be tailored to your business and its R&D compliance. R&D Cloud helps you prepare and substantiate R&D claims, leveraging PwC specialists' knowledge and delivered to you using market leading technology.

R&D Cloud brings you:

- Full flexibility in the process so your business can take ownership of your compliance commitment to the degree that you are comfortable with.
- Process transparency to all levels of your business, from claim completion to substantiation.
- Digital traceability to promote substantiation and clarity of company R&D.

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- The ability to manage confidentiality as you feel appropriate with flexible authorisation.

Reach out to your usual PwC adviser if you would like to set up a time to discuss.

The takeaway

With higher levels of review activity and scrutiny by AusIndustry and the ATO, businesses need to place greater focus on documenting and substantiating their R&D tax incentive claims. The recent AAT cases further highlight the importance of contemporaneous documentation regarding the R&D activities.

If you require assistance in this regard, including reviewing and developing a more efficient R&D claim documentation and preparation process, please reach out to your usual PwC adviser.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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