
R&D Tax Incentive – Taxpayer alerts issued

28 February 2017

In brief

Recently, the Commissioner of Taxation (the Commissioner), in conjunction with the Department of Industry, Innovation and Science (AusIndustry), have issued four Taxpayer Alerts addressing concerns regarding taxpayers claiming the Research & Development (R&D) Tax Incentive. The four Taxpayer Alerts (the Taxpayer Alerts) are as follows:

- TA2017/2 – Claiming the Research and Development Tax Incentive for construction activities
 - TA2017/3 – Claiming the Research and Development Tax Incentive for ordinary business activities
 - TA2017/4 – Claiming the Research and Development Tax Incentive for agricultural activities
 - TA2017/5 – Claiming the Research and Development Tax Incentive for software development activities
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In detail

Taxpayer Alerts are warnings about activities of concern for the Australian Taxation Office (ATO). Taxpayer Alerts are principally designed to target significant and emerging aggressive tax planning arrangements that the ATO has under risk assessment.

Broadly, the recent Taxpayer Alerts outline the Commissioner's and AusIndustry's concern that:

- Activities may not fit within the stringent requirements of the laws that govern the R&D Tax Incentive,
- Expenditure claimed may not relate to eligible R&D activities, and
- Taxpayers may not be applying adequate levels of governance and review to the activities registered and claims made for the R&D Tax Incentive.

The Taxpayer Alerts set out the need to have adequate levels of corporate governance in place to review the registered R&D, as well as the claims subsequently made for the R&D Tax Incentive.

Each of the individual Taxpayer Alerts raise further specific concerns in line with the focus of that individual alert. An overview of the specific concerns of each Taxpayer Alert is provided below.

2017/2 Claiming the Research and Development Tax Incentive for construction activities

The ATO and AusIndustry are reviewing the arrangements of certain building and construction industry participants that are claiming the R&D Tax Incentive.

The arrangements under review concern claimants of the R&D Tax Incentive who are involved in either: acquiring buildings, or extensions, alterations or improvements thereto (the acquirer); or whose business it is to construct, extend, alter or improve buildings (the builder). These types of arrangements exhibit some or all of the following features:

- A contract is entered into between the acquirer and the builder to construct, extend, alter or improve a building or buildings (construction).
- The contract is a standard construction contract and is not for the provision of R&D services and does not specify that R&D will be carried out by the builder.
- The acquirer or the builder registers one or more activities associated with the construction of the building for the R&D Tax Incentive, identifying the structure or construction techniques as purportedly involving untested or novel elements.
- Some or all of the activities registered are broadly described and non-specific. For example, whole construction projects may be registered rather than the specific activities which are being undertaken.
- Some or all of the registered activities are ordinary construction activities that are directed to fulfilling the requirements of the building or construction contract, or relate to expenditure that is expressly excluded from being taken into account in calculating an R&D Tax Incentive.
- Frequently, the expenditure which is incurred relates to construction methods or techniques that are already known within the building industry, or involve the mere adaptation or integration of existing technology.
- The acquirer or the builder claims the R&D Tax Incentive for expenditure that is not on eligible R&D activities, or for expenditure which is expressly excluded.

TA2017/2 provides examples of cases where ineligible activities or expenditure was claimed – some examples are provided below (please refer to the Taxpayer Alert for the complete list):

- The activities are not experimental but rather involve solving issues by applying existing knowledge or methodologies and a suitably qualified and competent professional in the building and construction industry could have known or worked out the outcomes without conducting an experiment. For example, using and applying existing (even if they are quite new) building materials, designs, processes or modelling techniques to the local conditions or customer requirements.
- The activities are undertaken by the builder in the ordinary execution of the construction contract and are not undertaken for a significant purpose of generating new knowledge.
- The expenditure is specifically excluded from the R&D Tax Incentive, on the basis that it is incurred to acquire or construct:
 - a building or part of a building, or
 - an extension, alteration or improvement to a building.
- The expenditure included in the calculation of the R&D Tax Incentive is not for amounts incurred on eligible R&D activities; for example production costs of products sold to the market in the ordinary course of business.
- The activities are conducted under contract for the acquirer or owner of the building, not for the builder itself, resulting in activities not conducted on the builder's own behalf. Consequently, the expenditure incurred by the builder may not be at risk, as is required under the legislation.

TA2001/3 – Claiming the Research and Development Tax Incentive for ordinary business activities

The ATO and AusIndustry are reviewing arrangements of companies claiming the R&D Tax Incentive where some (or all) of the expenditure that is incurred relates to their ordinary business activities and not to eligible R&D activities.

The types of arrangements under review exhibit some or all of the following features:

- A company registers one or more activities for the R&D Tax Incentive.

- Some or all of the activities registered are broadly described and non-specific. For example, projects may be registered instead of the specific activities undertaken.
- Some or all of the activities registered are ordinary business activities that are not eligible for the R&D Tax Incentive.
- Some or all of the activities were undertaken in the course of their ordinary business activities and recharacterised as R&D activities at a later time.
- The company claims the R&D Tax Incentive for expenditure that is not on eligible R&D activities.

TA2017/3 provides examples of cases where ineligible activities or expenditure has been claimed – some examples are provided below (please refer to the Taxpayer Alert for the complete list):

- No R&D activities are being conducted at all; only ineligible ordinary business activities are being conducted.
- The scope of claimed activities includes a mixture of eligible R&D activities and ineligible ordinary business activities.
- R&D activities which were being carried on have transitioned into ordinary business activities but claims for the R&D Tax Incentive are still being made.
- Activities may not be eligible for the R&D Tax Incentive because their purpose is not sufficiently concerned with the generation of new knowledge.
- Expenses included in the calculation of the R&D Tax Incentive claim are not for amounts that relate to eligible R&D activities, for example, ordinary production costs of products sold to the market in the ordinary course of business.
- Expenditure is being claimed under the R&D Tax Incentive even though no R&D activities are being conducted.
- Expenditure is being apportioned between R&D activities and ineligible business activities in an unreasonable manner.

TA2017/4 – Claiming the Research and Development Tax Incentive for agricultural activities

The ATO and AusIndustry are reviewing the arrangements of entities claiming the R&D Tax Incentive in respect of agricultural activities where some (or all) of the expenditure incurred is on activities which are not eligible R&D activities.

TA2017/4 extends the concerns of TA2015/3 in relation to broadacre farming and identifies concerns that other entities engaged in agricultural activities, such as those operating orchards, vineyards, olive groves, forestry operations and fibre growing businesses, may be inappropriately claiming the R&D Tax Incentive under similar circumstances.

The types of arrangements under review exhibit some or all of the following features:

- An agricultural business is being carried on, often by an entity that is not eligible for the R&D Incentive, for example a family trust.
- The operators of the agricultural business are approached by a promoter/R&D consultant advising that the farming activities being carried on are eligible for the R&D Tax Incentive.
- Where necessary, a new special purpose R&D company may be incorporated in order that the activities are conducted by an entity that is able to claim the R&D tax offset.
- A company registers one or more activities for the R&D Tax Incentive.
- The registered activities involve the application of farm products or practices across all or a significant part of a farm or farms.
- Some or all of the registered activities have the character of ordinary farming activities whose main purpose is the production of crops.
- The company claims the R&D Tax Incentive for expenditure that is not on eligible R&D activities.

TA2017/4 provides examples of cases where ineligible activities or expenditure has been claimed – some examples are provided below (please refer to the Taxpayer Alert for the complete list):

- The activities form part (or all) of the entity's ordinary business activities, such as the production of agricultural goods, and are not for the purpose of generating new knowledge or for the dominant purpose of supporting core R&D activities.
- The activities involve the application of established products and existing methodologies and a competent professional in the field could have known or worked out the outcomes without conducting an experiment. For example, applying different irrigation or pruning methods, commissioning new equipment or applying soil improvers in different concentrations.
- The activities are not experimental and are not undertaken to prove a hypothesis right or wrong. This is evidenced by the scale of the activities which is disproportionate with the scale of any data collection, observation and evaluation.
- The activities are replicated across several farms to test the suitability on different soil types and the activities involve products and techniques that are known to work and are not for the purpose of developing new knowledge.
- Expenses included in the calculation of the R&D Tax Incentive claim are not for amounts that relate to eligible R&D activities; for example, ordinary production costs of products sold to the market in the ordinary course of business.

Other specific concerns raised in the Taxpayer Alert relate to:

- Whether the activities are being conducted by the company on its own behalf or for the entity carrying on the agricultural business.
- Whether arrangements between related entities are conducted on an arm's length basis.
- Whether amounts billed to the R&D company by related entities are paid.
- Whether the documentation between related entities adequately demonstrates who is undertaking the activities, who has paid for the activities and who benefits from the results of the activities.

TA2017/5 – Claiming the Research and Development Tax Incentive for software development activities

The ATO and AusIndustry are reviewing the arrangements of companies claiming the R&D Tax Incentive on software development projects where some (or all) of the expenditure incurred is on activities which are not eligible R&D activities.

The types of arrangements under review exhibit some or all of the following features:

- A company undertakes a software development project that involves one or more of the following:
 - developing new software,
 - modifying, customising or upgrading existing software, and
 - acquiring and modifying off-the-shelf software.
- The software development project includes one or more of the following:
 - undertaking activities that use existing software development knowledge and expertise to achieve the required technical outcomes,
 - undertaking activities that involve business risk rather than technical uncertainty,
 - undertaking activities to replace manual work processes using software technologies that are available in the market and adapted to the requirements of the company, and
 - using existing software technologies as they were intended to be used.
- Some or all of the registered R&D activities are broadly described and non-specific. For example, they may describe project objectives or business and system requirements that the company is seeking to design and implement.
- All of the project, or a substantial part of it, is registered as R&D activities.

- The company includes the whole, or a large proportion, of their expenditure on the software development project in the calculation of their R&D Tax Incentive claim.

TA2017/5 provides examples of cases where ineligible activities or expenditure has been claimed – some examples are provided below (please refer to the Taxpayer Alert for the complete list):

- The software development project was registered on a whole of project basis, without distinguishing eligible R&D activities from ineligible activities. For example, developing and rolling out a new online customer platform may be incorrectly identified as a single eligible R&D activity.
- The activities do not have the purpose of generating new knowledge. The purpose of generating new knowledge must be substantial enough to characterise the activity as being conducted for that purpose.
- There is no clearly identified technical uncertainty being addressed by the activity. The software development lifecycle can be complex and highly technical. While this complexity poses risks, it does not mean that all activities involve a specific technical knowledge gap that requires the formulation of a hypothesis and the undertaking of experimental activities to test that hypothesis.
- Project management, commercial or economic risks are mistaken for technical risks.
- The activities involve the purchase of 'off-the-shelf' software and subsequent modification to integrate it into the existing environment. Most or all of the activities involve the application of existing knowledge and expertise rather than the generation of new knowledge through experiments.
- Expenditure incurred in acquiring, or in acquiring the right to use, technology cannot be claimed as a notional deduction.
- The expenditure included in the calculation is not for amounts that are incurred on one or more eligible R&D activities; for example production costs of software sold to the market in the ordinary course of business.
- Expenditure is incurred on R&D activities that have, to a significant extent, been 'conducted for' another entity. Where the company undertaking the activity is recompensed by another entity under a contract, the expenditure may also not be at risk as required by legislation.
- Expenditure is claimed twice, that is, it is claimed as a notional deduction under the R&D tax incentive and also as an actual deduction in the calculation of taxable income.

The takeaway

In light of the Taxpayer Alerts, if you feel that your previous or current R&D Tax Incentive claims are impacted, please reach out to PwC.

We also recommend you review your internal R&D governance and ensure all processes are accurate, compliant and up to date. This includes your corporate governance policies, the procedures in place to ensure claims are reviewed, the knowledgeable technical personnel, and record keeping.

Let's talk

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

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