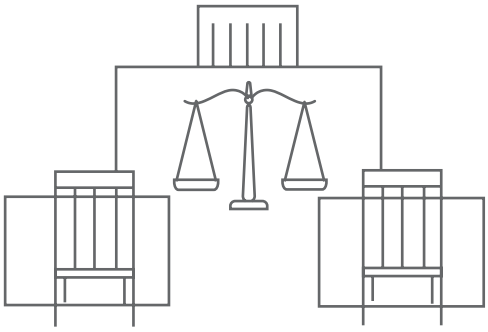
TAX **INSIGHT**

THE MORETON RESOURCES CASE

Finally certainty amongst the uncertainty for the **R&D tax incentive in Australia**, but only if you know how to find it.

The morning of Thursday, 25 July 2019 became a significant day for the R&D tax incentive in Australia, as the landmark decision of Moreton Resources Ltd v Innovation and Science Australia [2019] FCAFC 120 ("Moreton") was handed down by the Full Bench of the Federal Court. The Moreton judgement became the first judicially binding precedent in relation to the meaning of "eligible R&D activities" contained within Division 355 of the Income Tax Assessment Act 1997 ("Cth") ("ITAA 1997") and indeed, the first in relation to the R&D tax incentive legislation. The decision provided a departure from the manner in which some of the concepts were being applied within industry and by the AAT prior to this matter. Further, critically as this is a decision of the Full Federal Court, generally speaking, this is the final court of appeal in taxation matters and the principles which are established can only be appealed to the High Court in very exceptional circumstances.

On the day of release, RSM Australia was one of the first firms to discuss the case and share our preliminary views on the significant impact of the decision. This publication will seek to dig deeper to address some of these critical issues to provide the full context regarding what this decision really means, including the positions adopted in prior Administrative Appeals Tribunal ("AAT") decisions.



SUMMARY OF **BACKGROUND**

A brief summary of the background facts are as follows:

- Moreton had previously lodged its R&D tax claims for a number of income years, including the years ended 30 June 2012, 2013 and 2014 which were the subject of the dispute. Innovation and Science Australia ("ISA") subsequently found through initial assessment and through internal review that the R&D activities which were undertaken by Moreton on the pilot plant for Underground Coal Gasification ("UCG") were neither eligible core nor supporting R&D activities under Division 355 of the Income Tax Assessment Act 1997 ("Cth").
- Moreton brought this matter to the AAT for merits review, where the AAT found in favour of ISA and affirmed the internal review decision.
- Moreton then appealed the AAT decision on matters of law directly to the Full Bench of the Federal Court.

SUMMARY OF **KEY FINDINGS**

A summary of the key findings from the Full Federal Court are as follows:

- **On statutory interpretation, the role of the legislative text and the EM –** From the perspective of statutory interpretation, including the relevance of content from the Explanatory Memorandum ("the EM"), the Court provided similar commentary to relatively recent High Court decisions (e.g. see Alcan below). In discussing the role of both the text of the legislation and from the EM, the Court found that the process of statutory interpretation must always lead one back to the text of the legislation, regardless of the wording in any extrinsic materials.

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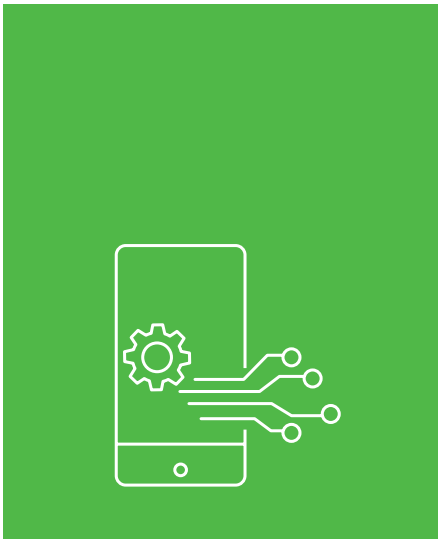

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For example, in addressing whether "location specific" matters would preclude a particular activity as being undertaken for the purpose of generating new knowledge, the Court assessed that the legislative text did not impose such a restriction and that the AAT had erred in holding that such restrictions may exist based on text extracted from extrinsic materials such as the EM.

Secondly, the Court again re-affirmed prior commentary from the High Court that the EM had a very limited, if any, role to play in guiding interpretation. A key learning from this is that the wording of the legislation is paramount and other concepts and interpretations that stray from or try to extend that text can be overreach and invalid.

These findings are critical given the overuse of EM materials in recent AAT R&D cases, which is not surprising given limited judicial precedents in the R&D tax space. Further, using extrinsic materials such as the EM or Second Readings Speeches to guide interpretation to ascertain "legislative intention" is allowable under Statute as covered under the Acts Interpretation Act 1901 (Cth). Notwithstanding this, in cases such as Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (2009) 239 CLR 27 ("Alcan"), the High Court had previously stated that extrinsic materials can never displace the clear meaning of the text and that while allowable, the weighting to be placed on extrinsic materials such as the EM should be very low. In light of the Moreton decision, significant caution is urged on any reliance on the text of the EM or similar extrinsic materials.

- **On "purpose to generate new knowledge" —** Perhaps most critically and in direct contrast to prior AAT decisions (see DBTL case) on the meaning of "purpose of generating new knowledge', the Court found that application of existing technologies or methods to a new site will not be precluded from meeting the definition of a "core R&D activity". Applying the "text, context, purpose" trinity approach as part of the basic tools of statutory interpretation, the Court found that nothing in the words of the law would suggest these types of activities are excluded.
- **On "experimental activities" —** Equally as significant, the initiating words of Section 355-25 of the ITAA 1997 in relation to eligible core R&D activities, being the requirement that they must be "experimental activities", were applied by the Court much more broadly than recent administrative applications and from prior AAT cases. Recent examples of applying the words "experimental activities" have focused on a narrow approach (including Moreton in the AAT), whereby a number of additional conditions were layered on top of the dictionary meaning of the words "experimental activities" to modify its meaning. In this decision, the Court held that these words had very little work to do and that the main substantive rules to be applied were contained within Sub-paragraphs 355-25(1)(a) and 355-25(1)(b). This can be contrasted to prior decisions such as DBTL or Moreton in the AAT which held that the words "experimental activities" were the 'gateway' into eligibility and this threshold test is critical prior to considering other eligibility limbs. The Court found this was an error in approach.
- **On "applying the eligibility criteria as a whole" —** In applying the eligibility rules within Sub-paragraphs 355-25(1)(a) and 355-25(1)(b) (i.e. purpose of generating new knowledge, unknown outcomes, experimental process etc.), the Court crucially found that these criteria may be applicable to aggregate activities, rather than individual 'siloed' experiments.

In lay terms, Moreton had submitted that the words of the law stated: "core R&D activities are experimental activities" (rather than "activity") which are then led into the other eligibility conditions within the aforementioned Sub-paragraphs. This use of plural form suggests aggregation is possible prior to applying the subsequent rules. The Court's decision would suggest that this approach is possible, evidenced by the fact that the Court held that evidence provided by Moreton on the whole UCG pilot project and how this differentiated to other examples in the world should be relevantly considered. Moreton submitted that this could be relevantly contrasted with the words of the IR&D Act, which references an individual 'registered activity'.

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IMPACT OF THE **DECISION** AND DID **MORETON REALLY 'WIN'?**

While the Moreton decision has been widely heralded as a significant "win" for industry and Moreton, it is important to explore the actual conclusion of the case as the matter has been referred back to the AAT (i.e. Moreton has not achieved a victory in the sense of a positive concluding outcome). To properly do so, brief comments must be made with regard to the role of the Courts versus the role of the AAT, where there have been prior decisions in relation to the R&D tax incentive and eligible activities. This key difference between the Tribunal and the Court is a commonly raised topic within the broader tax system. However, there has been scant mention of this key difference in relation to R&D tax decisions. In our view, for taxpayers to fully understand the certainty provided from the Moreton decision, it is critical to understand the framework of the Australian judicial system.

The AAT versus the judicial system – where does this leave Moreton?

Put simply, the Administrative Appeals Tribunal is not a court and the historical role of the AAT is to provide a cheaper, faster alternative for applicants to resolve factually-based disputes. Leading on from this, the Tribunal member's role is to stand in the shoes of the original decision maker and to re-make the original decision based on the evidence available before him or her. Critically, the AAT does not have powers of issuing judicially binding precedents and are broadly a body whose decisions are made on matters of disputes in fact. This can be relevantly contrasted with the judicial system, where decisions made by Courts are generally judicially binding on all lower courts.

In the Moreton case, its appeal to the Full Federal Court was based on a submission premised in the fact that the AAT had erred in this application of the law. With the Court having held in favour of Moreton, the legal principles established by the Court will now be binding back in the AAT, whereby the matter must be re-heard in light of these new definitions. In this regard, the Court's decision has simply shifted the definitions, which must be relied upon by the AAT to re-make its decision, rather than an outright win for Moreton from a practical perspective.

Impact for Industry and Existing Guidance Materials

While Moreton must now continue its journey back in the AAT, the Court's decision does represent a significant milestone for industry, R&D tax practitioners and other stakeholders within the R&D tax incentive program. Prior to this decision, the last significant matter which caught the attention of industry was the AAT decision in Mt Owen Pty Limited (DBTL) v Innovation Australia [2013] AATA 573. That decision, whereby the AAT found in favour of ISA, was subsequently widely used by industry in interpreting the R&D tax legislation, including the application of the terms dealt with in the current Moreton case. While the DBTL AAT decision in relation to the application of legal terms did not produce any judicially binding precedents, the manner in which the AAT applied the law was followed in subsequent matters and guidance from the administrators (see Department of Industry website).

The Moreton decision has now provided certainty in how these terms ought to be interpreted and the principles in prior AAT cases such as DBTL ought to have very little weight on the interpretation of the R&D tax legislation, where the Federal Court has now dealt with the respective terms. In fact, the Court's critique of the manner in which the AAT applied legal principles in Moreton prior to the appeal illustrates the grave danger of following AAT decisions when interpreting legislation (for example, the misuse of the 'dictionary method' by the AAT in Moreton leading to the incorrect outcome). Moreover, the manner in which Moreton appealed this matter (i.e. directly to the Full Bench of the Federal Court) means the words of the law has now been interpreted by what is widely regarded as the highest court in Australia for taxation matters. While ISA may now appeal for Special Leave to the High Court, historically civil and taxation matters must be of exceptional significance for the High Court to entertain the thought of allowing for Special Leave to be granted.

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CONCLUDING STATEMENTS

The landmark decision in Moreton has provided a win to the business itself, but more importantly for industry in Australia. Being the first judgement in relation to the R&D tax incentive which is judicially binding and being issued from what is widely regarded as the highest court for taxation matters, industry can now rely on the definitions with much greater certainty than the previous commentary from the AAT and other non-binding sources. This is a significant development at a time where Australia's private sector R&D investment is dropping and where neighbouring countries such as New Zealand have introduced comparable but more favourable R&D programs to entice businesses currently undertaken R&D in Australia. Two immediate examples are that the New Zealand legislation allows for "resolving scientific or technological uncertainty" in contrast to the current Australian program which restricts the analysis to only scientific uncertainty, and that in New Zealand eligible entities are not merely limited to incorporated entities.

> The Moreton case provides useful guidance to the resources and engineering industries, particularly where the outcomes of experimental activities are unknown due to "site specific" uncertainties. A purpose of generating "site specific" new knowledge was found to be sufficient to satisfy the core R&D activity eligibility requirements by applying known technologies in a new environment.

There is also significance in that the Moreton Full Federal Court's decision is not limited to the Resources sector. In fact, the Moreton decision may lead to greater certainty in relation to eligible R&D activities for sectors such as the technology sector. Some of the common dispute areas have been around what constitutes an "experiment" and to what extent something constitutes "new knowledge". Having said that, the binding principles outlined in Moreton simply provides a starting point, how impactful the decision is will ultimately depend both on how the program's administrators choose to apply the principles from the decision, and how well taxpayers are able to understand the impact of this decision in application to their own circumstances.

FOR FURTHER INFORMATION

For more information on the R&D tax incentive in Australia, contact your local expert today.

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