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R&D Tax Incentive prepayment loans - the benefit of a rigorous due diligence process.

Over the past 4 years or so the ability for R&D Tax Incentive claimants to use their resultant R&D Tax cash reimbursement as collateral to unlock much needed funding has become more and more common with over 12 lenders now providing varying levels of this service.

Debt finance is a good option if used strategically as it allows early stage technology companies to:

- push back equity raising until they have achieved an equitable valuation;
- use debt finance in tandem with equity finance to reduce the quantum of shareholding dilution or;
- use debt funding as a bridge to achieve sales traction to either reduce or even negate the need to raise any capital at all.

The issue for R&D Tax borrowers is that most of these lenders are not R&D Tax experts and may not fully understand the current level of detail of the risks associated with the security underpinning the loan. In TCF's opinion they should not simply rely on a "hold harmless letter" provided by the borrowers R&D Tax agent stating that the borrower is claiming R&D Tax benefits, the expected value of those benefits and evidence of any existing ATO debt which could be netted off the return. After some financial checks on the company's financial position and any prior defaults involving the Directors, some lenders simply turnaround and pay the loans within 48 hours charging very low establishment fees, reflective of their lack of proper process in approving these loans in the first place.

The ease with which these loans can be obtained is extremely worrying particularly given the current environment governing the program, let's unpack why:

- the R&D Tax Incentive is a self-assessment program with many complex legislative requirements;
- with up to 80% of all fully audited ATO claims having been rejected over the past 18 months, most claimants (especially in software) cannot be sure they will pass a

full review on the eligibility of their activities, expenses and the records kept for substantiation purposes;

- with scheme administrators also attempting to tighten up the interpretation of various aspects of the program and very few legal precedents established under the current program, claimants are in a weak position if rejected as it's often not worth taking the matter to the Administrative Appeals Tribunal due to cost/return.
- in the May budget the Government announced that additional resources will be engaged to ensure that all claims are reviewed with a more rigorous approach to complying with the black letter of the law, this will undoubtedly lead to further reductions or rejections;

Given this backdrop, should a responsible R&D Tax claimant who uses this form of debt finance be worried and ask themselves the following questions:

- Are my claims defensible and should I borrow funds against them if I'm not sure?
- Am I dealing with a "responsible lender" who understands the risk and will advise me accordingly even if that means rejecting my loan application?
- Am I drawing down on loans which would default if claims are later overturned and affect the ongoing viability of my business?
- Am I placing at risk the support of my fellow founders and investors by borrowing against an uncertain asset?

The bottom line is that R&D companies are well served by a rigorous due diligence process when applying for a R&D Tax prepayment loan as it identifies risk at an early stage. If a loan is paid against a claim which is rejected, then embarrassing questions may be asked by the investors around the governance and risk management practices of the management team as it may impact the ability for the company to keep trading.

An example of the real dangers involved where a company takes out large loans not expecting its R&D claim to be challenged has recently emerged and is reported in the link below:

[Strike Energy Limited Quarterly Report Q4 - 2018 \(refer page 8\)](#)

R&D Capital is not suggesting that all the dangers and pitfalls mentioned above apply to Strike Energy and it may very well successfully defend its entitlement to the R&D Tax prepayment. Time will tell.