Swanson Reed
Specialist R&D Tax Advisors

R&D Tax Incentive: Basics of Eligibility and Calculation of Offsets

Basis for Presentation

This presentation has been based on ATO guidance documents:

- https://www.ato.gov.au/Business/Research-and-development-tax-incentive
- https://www.ato.gov.au/Business/Research-and-development-tax-incentive/In-detail/Fact-sheets/Refundable-and-non-refundable-tax-offsets
- https://www.ato.gov.au/Business/Research-and-development-tax-incentive/In-detail/Guides/Amounts-you-can-claim

Current R&D Tax Incentive

SWANSON REED
SPECIALIST R&D TAX ADVISORS

- The current R&D Tax Incentive has been in place since the YE 30 June 2012, and superseded the previous R&D Tax Concession.

- Programme is dually administered by two government agencies:
    - AusIndustry assess whether activities registered meet legislative definition;
    - ATO assess tax structural issues and substantiation of expenditure claimed;

Aim of the program is to encourage business (particularly small firms) to conduct R&D Activity that they may not otherwise have conducted.

Eligible R&D Entities

SWANSON REED
SPECIALIST R&D TAX ADVISORS

An R&D eligible entity is a corporation and any of the following:

- Incorporated under an Australian law
- Incorporated under a foreign law but an Australian resident for income tax purposes
- Incorporated under a foreign law and is are both:
  - a resident of a country with which Australia has a double tax agreement that includes a definition of 'permanent establishment'; and
  - carrying on business in Australia through a permanent establishment as defined in the double tax agreement.

Ineligible R&D Entities

The following entities are not able to register R&D Activities:

- An individual/Sole Trader;
- A partnership;
- A tax exempt entity;
- A trust (with the exception of a public trading trust with a corporate trustee).

Rules apply for tax consolidated groups:

- Subsidiary members are treated as part of the head company for as long as they remain part of the consolidated or MEC group for income tax purposes.
- The R&D tax incentive applies to the consolidated group or MEC group as if it is a single entity conducting all R&D activities within the group. Only the head company of the group should register R&D activities conducted across the group.

R&D Tax Rates

The rate of the R&D tax offset and whether it is refundable depends primarily on the R&D entity's aggregated turnover.

<u>Companies with an aggregated turnover <$20M:</u>

- a 43.5 per cent refundable tax offset (provides a $0.435 refund up to the volume of tax losses the entity has OR a $0.16 tax benefit).

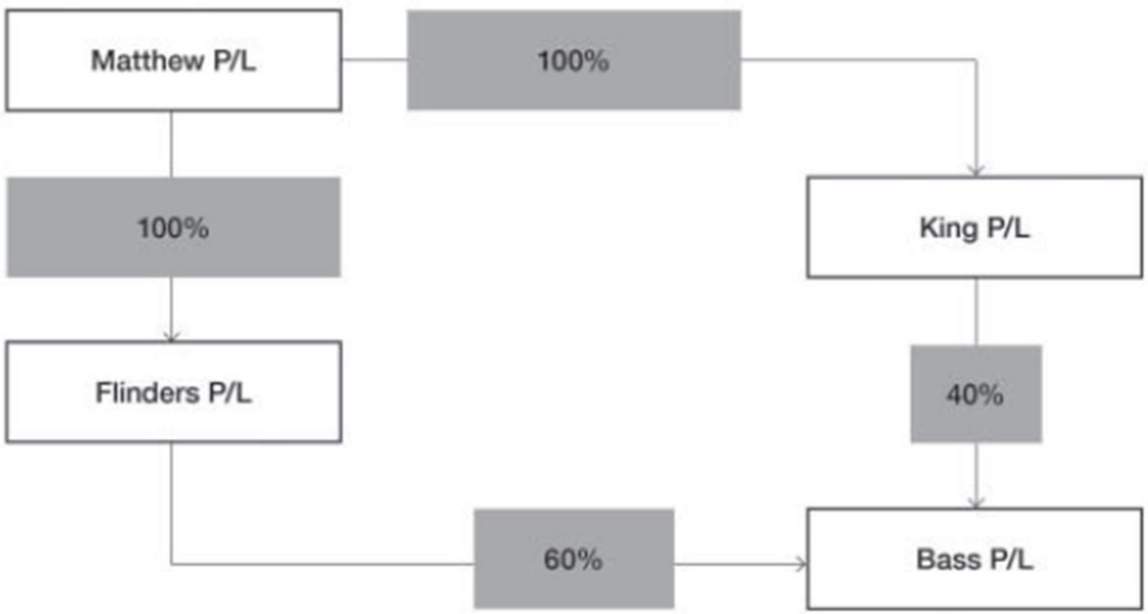
<u>Companies with an aggregated turnover >$20M</u>

- a non-refundable 38.5 per cent tax offset (equivalent to $0.11 or $0.085 tax benefit) to all other eligible entities. Note if entities are in tax loss, R&D tax benefit is carried forward until the entity is in a taxable position.

Grouping for Aggregated Turnover

Scope of entities included within group turnover calculation:

- Grouping for these purposes is required when entities have a common ownership of 40% and over
- Grouping also applies when entities are qualitatively affiliated (principles derived from STS Rules)
- Example:



Grouping for Aggregated Turnover (Cont'd)

SWANSON REED
SPECIALIST R&D TAX ADVISORS

Aggregated turnover is the sum of the annual turnover for all of the following:

- the R&D entity
- any entity connected with the R&D entity
- any entity affiliated with the R&D entity.

Scope of Transactions included within group turnover calculation:

- AUD conversion of foreign turnover included;
- Passive income *usually* excluded (interest/dividends);
- Inter-group transactions between grouped entities are excluded;

R&D Tax Offset - Mechanics

SWANSON REED
SPECIALIST R&D TAX ADVISORS

- R&D Tax Offset operates whereby a company claiming notional deductions for R&D Expenditure forgoes (adds back) a general tax deduction, and instead claims R&D Tax Offsets determined by the aggregate turnover;
- The net impact on a company's tax position during the year is a function of:
  - The R&D Expenditure amount;
  - The aggregate turnover and rate of R&D Tax Offset;
  - The company tax rate;
  - The general tax position, including any accumulated tax losses;
- The permanent tax benefit of a company's R&D Claim (<u>excluding</u> the timing impact from refundability by utilising losses) is simply the difference between:
  - the company's R&D Tax Offset rate; and
  - the general Company tax rate applied against notional deductions foregone and added back.

R&D Tax Offset and Corporate Tax Rates FY19 – Current Legislated Rates

Swanson Reed
Specialist R&D Tax Advisors

*****Note there are proposed and legislated changes to R&D Offset and tax rates – below represents current legislated rates.**

From 1 July 2018 for year ended 30 June 2019	Refundable Offset (Turnover <$20M)	Non-Refundable Offset (Between $20M to $50M)	Non-Refundable Offset (Turnover >$50M)
R&D Tax Offset Rate	43.5%	38.5%	38.5%
Corporate Tax Rate	27.5%	27.5%	30%
Permanent R&D Tax Benefit (R&D Tax Offset – Tax Rate)	16%	11%	8.5%
Refundable/ Non-Refundable	Refundable	Non-Refundable	Non-Refundable
Cash Refund when in Tax Loss	43.5%	Nil – Offset Carried Forward	Nil – Offset Carried Forward

Eligible Expenditure

Eligible R&D expenditure may include:

- contract expenditure incurred to an RSP or other parties for undertaking R&D Activities
- salary expenditure for personnel engaged by the company undertaking R&D Activities
- other R&D expenditure, including apportionment of overhead costs
- feedstock input expenditure – materials used in R&D Activity
- R&D expenditure paid to an associate in the claim year
- Decline in value of R&D Assets

Ineligible Expenses

Swanson Reed
Specialist R&D Tax Advisors

Ineligible expenses are those without sufficient link to the R&D activities, particularly where they relate to general company operating or marketing expenditure that would be incurred regardless of the R&D activities.

These ineligible expenses may include:

- Advertising/marketing
- Accounting and Audit Fees and Bad Debts
- Company Establishment Costs and Administration Fees
- Directors' Fees
- Distribution and Selling Expenses
- Employee benefits such as canteen and recreational facilities
- Entertainment Expenses
- Insurance premiums on matters unrelated to R&D (e.g product liability)
- Interest
- Legal Expenses, Patents and trademarks
- Rent paid for premises not used in R&D activities
- Support staff not linked to R&D
- Tender costs

Record Keeping

- Substantiation of the incurrence of R&D Expenditure and nexus with registered R&D Activities has been a large focus for ATO compliance activity over recent years;
- Additional information on the requirements for record keeping (including apportionment methods) are detailed in our presentation on substantiation of R&D Expenditure

Tax Treatment Depreciating Asset Provisions

SWANSON REED
SPECIALIST R&D TAX ADVISORS

- Important to note that just because an item is R&D in nature or specifically for R&D purposes (eg a novel plant used in experimental process trials over numerous years), it does not mean the outright cost is claimable as R&D Expenditure: Expenditure on a tangible deprecating asset is specifically ineligible under the R&D Tax Incentive;
- Tax deprecation on tangible depreciating assets may be able to be claimed as R&D Expenditure to the extent that the assets are used in R&D Activities;
- Tax depreciation must be calculated using the depreciating asset provisions (Division 40)
- Concessional method depreciation on assets such as low value pool, or instant write off is not eligible for R&D;

Feedstock Adjustments

Division 355-H ITAA 1997 operates to adjust the R&D Tax Incentive benefit for companies in receipt of feedstock revenue on certain Feedstock inputs.

- A feedstock adjustment is an amount included in a company's assessable income. It applies when a company obtains an R&D tax incentive offset for feedstock expenditure incurred on R&D activities, if those activities produce either:
  - marketable products
  - products you apply to your own use
- The feedstock adjustment applies to expenditure on:
  - goods or materials (feedstock inputs) that are transformed or processed during R&D activities in producing one or more tangible products (feedstock outputs)
  - energy that is input directly into that transformation or processing.

- The additional amount to include in the company's assessable income (the feedstock adjustment) in the trigger year, is determined by calculating an amount of 1/3 the <u>lesser</u> of:
  - expenditure in acquiring or producing feedstock inputs and energy inputs for which you have claimed the incentive, to the extent that it is reasonably attributable to the production of the relevant feedstock output (feedstock expenditure); or
  - feedstock revenue.

Grant Monies Received – Clawback of R&D Expenditure

A clawback adjustment applies if:

- A company receives a government recoupment (such as a grant or reimbursement) for eligible R&D expenditure.
- The company claims a R&D tax incentive tax offset for this eligible R&D expenditure ;

The Grant Clawback Adjustment operates to include additional income tax of 10% of the expenditure related to a grant, that the company has claimed as a notional deduction under the R&D Incentive.

Franking Account Considerations

As a general principal, R&D Claims reduce tax payments and the capacity for companies to frank dividends.

There is also franking considerations for companies receiving net R&D Tax Offsets, and who do not yet pay tax.

Under old R&D Concession, no entry to franking account from receipt of Refundable R&D Tax offset, however this has changed under the R&D Tax Incentive.

- Generally, a franking debit arises in a company's franking account when it receives a refund of income tax which includes a refunded amount from a tax offset.
- However, special rules ensure that where a R&D tax offset refund is received, is not immediately reduced as a result of the entity becoming liable to franking deficit tax. The franking debit that usually arises when a refund of income tax is received is effectively deferred in relation to refundable tax offset amounts.
- Where a debit has been deferred for this reason, a franking credit will not arise as a result of income tax or PAYG instalments your entity pays until it recovers these deferred franking debits.

Programme Administrator Contact

- https://www.business.gov.au/assistance/research-and-development-tax-incentive

- https://www.ato.gov.au

Swanson Reed Contact

SWANSON REED
SPECIALIST R&D TAX ADVISORS

1800 SWANSON

www.swansonreed.com.au

facebook.com/swansonreed

twitter.com/swansonreedAU

linkedin.com/in/swansonreed