

Supporting and empowering
you every step of the way



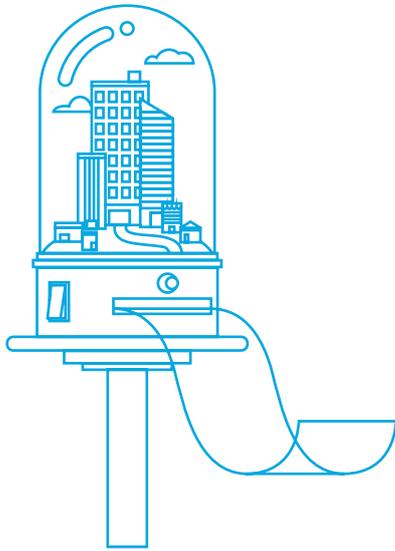
THE R&D TAX INCENTIVE AND YOUR BUSINESS

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THE R&D TAX INCENTIVE AND YOUR BUSINESS

The Research and Development Tax Incentive is a Federal Government initiative to encourage companies to invest in innovation that benefits Australia. It is jointly managed by the Department of Industry, Science, Energy and Resources and the Australian Tax Office.

While it is widely acknowledged that innovation and the need for change is imperative for economic advancement, there are a myriad of eligibility and compliance requirements that underpin the incentive.

But it's worth it.

Companies can make the most of this initiative by understanding how the incentive is delivered and the steps involved in making a claim.

This guide will walk you through the legislation, the nuances of definition and the claim process.

This guide is the start to understanding your R&D Tax journey.

THE BENEFIT

“What’s in it for me?”



Under \$20m grouped turnover

If your grouped turnover is less than \$20m (refer below) and your R&D expenditure is at least \$20,000 in the income year (or if you spend less than \$20,000 on R&D in the income year it must be with a registered research agency to qualify), you can claim the 43.5% Refundable R&D tax credit.

- Gross refund = 43.5c per \$1 spent, which is equivalent to a net tax benefit of 16c per \$1 spent.

What this means is that if you are in a tax loss position (including carry forward tax losses) and the tax losses are at least equal to your R&D spend, you will receive a cash rebate of 43.5% of your R&D spend and forgo the future tax losses of the R&D spend. The net tax effect is the difference between the R&D rate of 43.5% and the corporate tax rate of 27.5%, which means that for every \$1 of R&D spent you will reduce your tax liability by 16c. Following are two examples.

R&D Expenditure	\$100,000	\$100,000
Total Expenditure (including R&D)	\$300,000	\$300,000
Income	\$0	\$400,000
Tax position (no R&D claim)	Tax loss = \$300,000	Taxable income = \$400,000 - \$300,000 = \$100,000 Tax payable = \$100,000 x 27.5% = \$27,500
R&D Rebate	\$43,500	\$43,500
Tax deductions (after R&D claim)	(Total deductions - R&D deductions) \$300,000 - \$100,000 = \$200,000	(Total deductions - R&D deductions) \$300,000 - \$100,000 = \$200,000
Tax position (after R&D claim)	Tax loss = \$200,000 Tax refund = \$43,500	(Income - Deductions) = \$400,000 - \$200,000 = \$200,000 Gross tax payable = \$200,000 x 27.5% = \$55,000 Less R&D Rebate = \$55,000 - 43,500 Tax payable = \$11,500
Tax saving		Reduction in tax payment = \$27,500 - \$11,500 = \$16,000 This demonstrates the net tax benefit is 16% of the R&D expenditure.



Greater than \$20m grouped turnover

If your grouped turnover is at least \$20m, you can claim the 38.5% non-refundable R&D tax credit. What this means is that you reduce your tax liability because the R&D rate is 8.5% larger than the 30% corporate tax rate; therefore you pay 8.5c (per \$1 of R&D expenditure) less in tax (noting that this applies in your current tax return or can be carried forward if you are in a tax loss position).

The following assumes the Aggregate turnover > \$20M

R&D Expenditure	\$100,000	\$100,000
Total Expenditure (including R&D)	\$300,000	\$300,000
Tax position (no R&D claim)	Tax loss = \$300,000	Taxable income = \$400,000 - \$300,000 = \$100,000 Tax payable = \$100,000 x 30% = \$30,000
R&D Non-Refundable Rebate	\$38,500	\$38,500
Tax deductions (after R&D claim)	(Total deductions - R&D deductions) \$300,000 - \$100,000 = \$200,000	(Total deductions - R&D deductions) \$300,000 - \$100,000 = \$200,000
Tax position (after R&D claim)	Tax loss = \$200,000 Carry forward R&D Rebate = \$38,500	(Income - Deductions) = \$400,000 - \$200,000 = \$200,000 Gross tax payable = \$200,000 x 30% = \$60,000 Less R&D Rebate = \$60,000 - \$38,500 Tax payable = \$21,500
		Reduction in tax payment = \$30,000 - \$21,500 = \$8,500 This demonstrates the net tax benefit is 8.5% of the R&D Expenditure.

ELIGIBLE ENTITY

“Who can get it?”

Put very simply, the R&D Tax Incentive is for incorporated Australian companies, that is a Propriety Limited or Limited company. In addition, an R&D entity can be:

- incorporated in another country but be an Australian resident for tax purposes
- incorporated in a country with which Australia has a double tax agreement and undertakes R&D activities through a permanent establishment in Australia

Please note that the R&D activity and expenditure between entities must take place within the eligible entity. Inter-entity and pre-incorporation issues are very common and care must be taken.

We recommend you seek experienced R&D Tax advice if you have questions on eligible R&D entity qualifications.

“What are the grouping rules?”

In order to assess if a company exceeds the \$20M turnover test you need to understand grouping rules and what entities will be connected to the R&D entity in order to aggregate the turnover of each of the grouped entities.

Grouping rules can be very complex and you should always seek professional advice to confirm your aggregate turnover amount.

The fundamental grouping rule is that entities are connected when either entity owns at least 40% of the other entity's equity. This is expanded beyond simple equity ownership to be the rights to receive at least 40% of any distribution of income of the other entity, any distribution of capital by the other entity or has the rights to exercise or control the exercise of at least 40% voting power of the other entity.

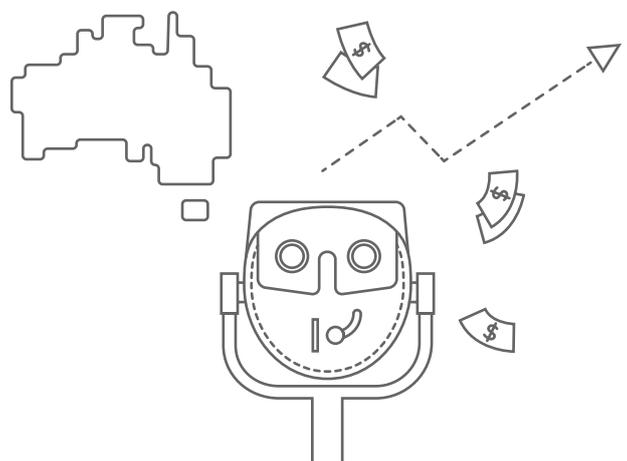
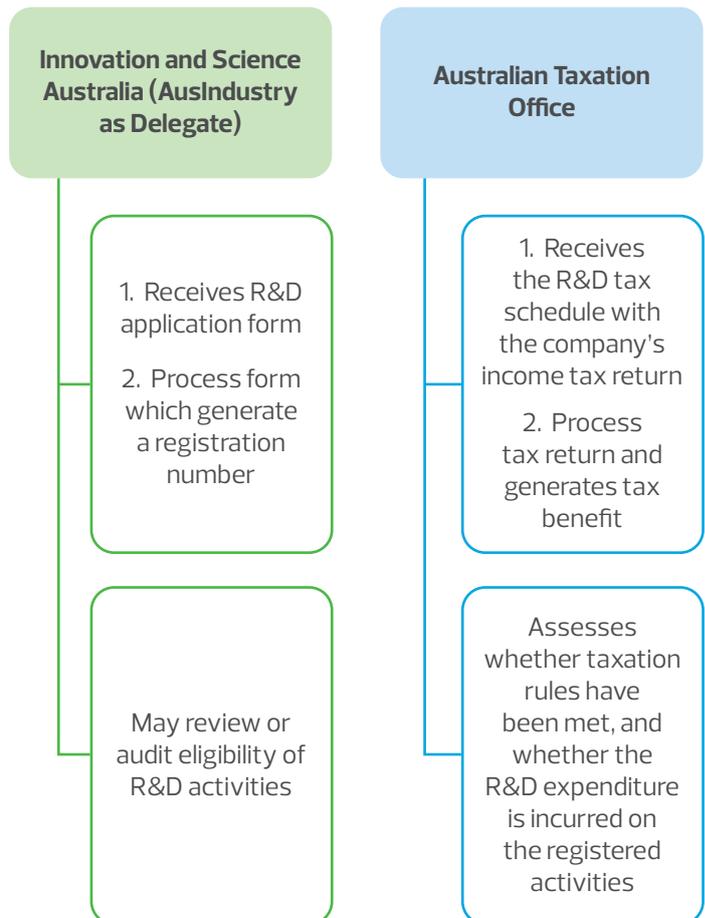
When exempt entities (such as universities) are related to the R&D entity the grouping rules change such that the exempt entity is grouped with the R&D entity when it owns at least 50% of the R&D entity's equity, plus the expanded consideration as provided above.

Affiliates

In addition to the above grouping rules an R&D entity must also consider its affiliates. Entities are affiliates of one another when they can reasonably control the actions of each other. Common examples of affiliates are husband and wife business owners, individually they may own less than 40% of an entity but if their combined ownership is at least 40% they will be grouped with the entity.

DUAL AGENCY ADMINISTRATION

“How is it administered?”





CLAIM PROCESS

“How do I get my money?”

Conduct R&D activities and incur the costs in the Australian R&D entity during the financial year.

Maintain appropriate records of the R&D activities, such as: project plans, technical papers, experimental result, data analysis, technical investigations, etc.

Comply with corporate and tax compliance needs (see RSM Australia's, “A Guide to Doing Business in Australia”).

If overseas R&D activities are taking place that involve technical requirements that are not available in Australia, lodge an Advanced Finding before the end of the relevant financial year.

After financial year end, register the R&D activities, with AusIndustry. This deadline is ten months after the end of financial year.

After lodging the R&D registration with AusIndustry, the R&D entity will receive a Notification Letter with R&D Tax Incentive registration number.

Lodge the annual income tax return with the Australian Taxation Office, which will include the R&D Tax Incentive registration number in the ATO's R&D tax schedule

1 July – start of the Australian financial year

30 June – end of the Australian financial year

Note: the above must be done every financial year, R&D activities and costs that span multiple years will need to be lodged and claimed every year.

“What's the catch?”

When companies receive the AusIndustry Registration number and the tax office processes their tax return, this does not mean that the claims have been assessed as eligible. As the claims process is based on a self-assessment, unless formal reviews or audits are undertaken the claims have simply been processed.

Documentation

As R&D Tax is based on self-assessment, it is a fundamental and non-negotiable requirement that all R&D claims are supported by appropriate contemporaneous documents. The documentation is required to provide evidence of each of the R&D eligibility criteria. The criteria is discussed below and includes examples of required documentation.

With regard to financial records, documentation and evidence is required that links the R&D costs to the R&D activities, examples of these are also provided below.

Records should be kept for an appropriate period to support potential future reviews or audits by either AusIndustry or the ATO. As stated above, receipt of an AusIndustry registration number and processing of the Tax Return does not mean that the claim is approved; a review or audit can take place in following years and therefore the documentation must be maintained. In the case that documents are not provided as evidence during reviews or audits, a most likely outcome will be disallowance of a claim and a requirement for the company to pay back the benefit (probably with interest and penalties).

ELIGIBLE ACTIVITY

“What qualifies?”

CORE R&D ACTIVITY

An eligible R&D project must contain at least one “core” R&D activity which must be an activity:

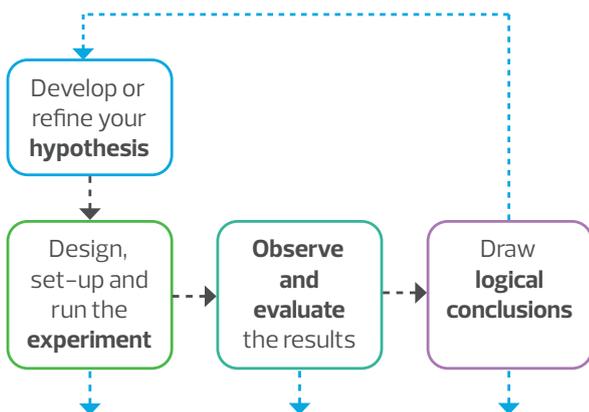
1. Whose outcome cannot be known or determined in advance; but can only be determined by
 - i. Applying a systematic progression of work that proceeds from hypothesis to experiment, observation and leads to logical conclusions; and are
 - ii. Conducted for the purpose of generating new knowledge

1 This refers to a knowledge gap that exists and the activity aims to resolve through a scientific process. That is, that the outcome of the hypothesis, explained in (2), is not known without conducting the experiment. To determine if a knowledge gap exists, consider the following (taken from AusIndustry’s ‘Guide to Interpretation’):

- whether a competent professional in the field knows or can determine the outcome (i.e. whether the hypothesis is true or false), without conducting an experiment as part of a systematic progression of work
- on the basis of knowledge, information or experience that is publicly available or reasonably accessible, anywhere in the world

2 An R&D activity must be performed following a scientific process progressing through four key stages:

Key parts of a systematic progression of work



Source: AusIndustry Guide to Interpretation

Hypothesis

A hypothesis is specific and details the technical and scientific “idea” that will be developed and tested to generate the technical objective. The hypothesis is commonly expressed as a relationship between variables which can be proven or disproven. In some cases, there is a high-level hypothesis with a number of specific sub-hypotheses that are required to create the total result.

An example from AusIndustry guidance: *Compression Algorithm v1 will compress a 12-megapixel image without exceeding the limits of the low-power processor.*

A common mistake is using a technical objective statement as the hypothesis, for example, I hypothesise that we can develop a new technical solution to do xx. This is a technical statement **NOT** a hypothesis.

Experiment

In order to determine if the hypothesis is correct, an experiment is required. The experiment is what you do to test the hypothesis. The experiment is set up so that the relationship between relevant variables can be tested and the hypothesis proven right or wrong. Experiments are conducted in a wide variety of project relevant situations, such as the laboratory, a workshop, simulation, acceptance tests, commission tests, site test to name a few.

Reasons and excuses are NOT evidence, evidence requires documents and no documents equals no claim.



A common mistake made is assuming that because a test or study has been carried out, an R&D activity must have occurred. This is incorrect, the experiment (which may include tests and studies) must follow from identifying a hypothesis and then a progression to evaluation and conclusions (as well as all other limbs of a qualifying R&D activity).

Observations

The observations, measurements, recording of information and results related to experiments must be captured. Observations should include an assessment of the running of the experiments, the outcomes and whether they worked as expected and were thereby able to test the hypothesis/es or the requirement for modifications/new hypotheses.

Conclusions

To draw logical conclusions is to bring together results of experiments to form a considered view on whether the experiments showed the hypothesis to be right or wrong. State the specific new knowledge outcomes that been achieved during the conduct of the experiments and as a result of the project.

3 It is important that core activities are required to create new knowledge and the 'new knowledge' purpose has a requirement to be significant to the intention of the activity.

New knowledge includes the following; form of new or improved materials, products, devices, processes or services. However, it should be noted that new knowledge in the form of a new service can be very hard to qualify so it is recommended to seek professional advice on this issue.

Similar to the test above, 'new' knowledge is knowledge that is not already publicly available and it is not knowledge that could be reasonably expected to be created by a competent relevant professional.

In order to assess this a company can consider the difference between the new knowledge sought to be developed and what already exists in the market; also why existing and available knowledge (and experts) cannot be used. New knowledge needs to be very specific about the technical outcomes being sought, it is not about market and user issues. For example, it is a common mistake to consider user acceptance as the new knowledge being sought and this is not correct for a core R&D activity.

ELIGIBLE R&D EXPENDITURE

In its simplest form, R&D expenditure are costs incurred “on” R&D activities. Therefore, costs that have a direct nexus to the conduct of the registered R&D activities are eligible R&D costs.

Specific examples of R&D expenditure:

- wages and salaries
- costs of items and tasks directly related and required for the R&D activities to be carried out
- contract expenditure
- decline in value on plant and equipment used in R&D activities

Evidence

Evidence, not reasons, are required in order to substantiate why an R&D cost was incurred on an R&D activity.

Specific examples of R&D expenditure documentation include:

- For salary it is expected that timesheets are kept that differentiate staff time across R&D and non-R&D activities
- Contractor invoices contain references to specific R&D tasks and often contract agreements will also be available that support what work is being undertaken on the R&D activity
- Allocation of depreciating assets between R&D activities and non-R&D tasks based on time records or other operational evidence that can support the allocation of time use of the asset on R&D versus non-R&D
- Direct costs, such as travel, can be specifically coded to R&D activities at an invoice level and where appropriate the cost will have internal records, for example a trip to a conference required for establishing the hypothesis of an R&D activity would have a trip report that substantiates the outcome of the trip and the input into the R&D activity

Overseas R&D costs

When R&D activities are conducted overseas, the activity (and therefore the costs) are not eligible. If not more than 50% of the R&D costs are to be incurred overseas a company may seek approval, in the form of an 'Advanced Finding' from AusIndustry to register the activities and claim the costs.

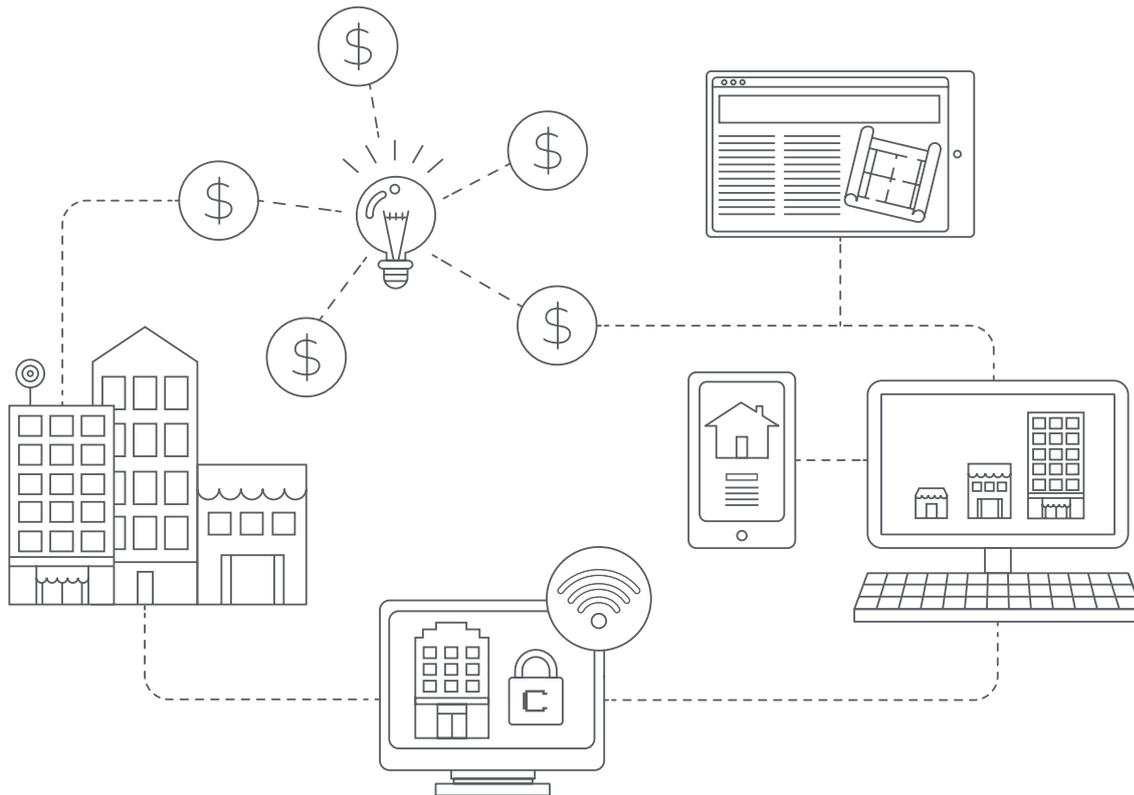
In order to apply for an Advanced Finding for overseas activities the company must demonstrate that the activity will meet either the core or supporting eligibility requirements, it must also demonstrate that the technical capability to conduct the overseas activity is not available in Australia.

An Advanced Finding must be lodged before the end of the financial year that the activity takes place, it cannot be lodged in the year after the activity takes place.



Thinking of your business
is a big part of ours





COST CONSIDERATIONS

Following are some of the more common complex R&D tax cost considerations.

Experienced R&D Tax advice is recommended for further detail with relevance to your specific needs:

- R&D tax costs are fundamentally aligned with tax legislation and therefore it is important to understand the tax eligibility of costs before considering the R&D tax opportunity, for example, time that business owners spend on their R&D is not eligible if they are not invoicing the company for that time
- Business owners (associates) must be paid (not just incur a liability) those costs are to be included as R&D costs in the claim
- Construction of prototype may need to be considered as assets that must be depreciated and therefore tax depreciation must be included in the R&D claim, not the cost to construct the prototype
- If you are selling R&D “outputs” it may be necessary to apply feedstock provisions to reduce the net benefit of the R&D claim
- If you have a grant you must consider the R&D Tax impact through Clawback provisions
- If you are being paid to do the R&D on behalf of someone else you will not be eligible for the amount that you are “guaranteed” to receive consideration for
- Intercompany invoices may fall within associate payment requirements in order for the costs to be included in the R&D claim and any markup between related parties must be removed from the R&D claim

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