What does Australia need to do to stay ahead?

27 years of uninterrupted economic growth, that is what Australia has achieved and the rest of the world wonders how have we achieved this. Some of this is luck, some location and some intelligence.

As we look towards the future, it is broadly agreed that Australia cannot continue to rely on luck and location alone. The most recent economic survey by Credit Suisse placed Australian's as the second wealthiest people on the planet, closely behind Denmark. We are blessed with free public education and health care, an aged pension, subsidised tertiary education and a government that will lend up front to those who can't afford it, clean air, good food and relative affordability (although some in the East Coast capitals may argue on that last point).

To maintain this standard of living, the Australian government is acutely aware that we need to do something different going forward. The rhetoric from industry and government has for some time stated, "we can't just keep digging it up and selling it, if we want to maintain our standard of living."

For this reason, the Australian government introduced Research and Development (R&D) incentives many years ago (similar to other countries). The major change occurred from 1 July 2011, when Australia replaced the R&D Tax Concession and introduced the R&D Tax Incentive in the form of a cash refundable tax offset for qualifying small companies and a non-refundable tax offset for larger qualifying companies. By doing this, the Australian government has chosen to link R&D spend to government funding through the tax system, rather than throwing money at industry without a link to outcomes (an example could arguably by the car industry, which enjoyed government support for years and whilst it created employment, the car giants rarely made a profit from manufacturing in Australia).

We have summarised below the **potential benefits** that are available through the program, the **meaning of 'Research and Development'**, the **types of costs** that can be claimed through the program and how we can **help in this process**.

What is the benefit of claiming with the R&D Tax Incentive?

Current program

The R&D Tax Incentive was introduced to encourage companies to engage in R&D benefiting Australia, by providing a tax offset for eligible R&D activities.

The current tax offset rates and additional tax benefits are as follows:

Aggregated Turnover (incl. connected and affiliated entities)	R&D Tax Offset Rate Available	Corporate Tax Rate (dependent on base rate entity (BRE) status)	Resulting R&D Net Tax Benefit on Eligible R&D Expenditure
Less than $20m & not controlled by tax-exempt entity	43.5% (refundable)	27.5% (BRE)	16%
		30% (non-BRE)	13.5%
$20m or more or controlled by tax-exempt entity	38.5% (non-refundable)	27.5% (BRE)	11%
		30% (non-BRE)	8.5%

For eligible R&D entities entitled to the refundable R&D Tax Offset, a cash refund for the entire 43.5% of eligible R&D expenditure is possible, depending on the tax losses available.

For eligible R&D entities entitled to the non-refundable R&D Tax Offset, to the extent that tax payable is reduced to nil, the remaining portion can be carried forward for use in future income years to offset future tax payable. To claim these offsets in future years, the usual loss recoupment rules must be satisfied.

For eligible R&D expenditure exceeding $100 million, a tax offset is only available at the applicable corporate tax rate, resulting in a nil R&D benefit.

Example:

*If a company is performing eligible R&D activities, their aggregated turnover is below $20m, they are a base rate entity and they have eligible **R&D expenditure of $500,000**:*

- *They will have a resulting **net tax benefit of $80,000.** This will either reduce their tax payable or will be refunded as a cash benefit.*

*If a company is performing eligible R&D activities, their aggregated turnover is above $20m, they are a non-base rate entity and they have eligible **R&D expenditure of $1,000,000**:*

- *They will have a resulting **net tax benefit of $85,000.** This will either reduce their tax payable or will be carried forward as a tax loss (subject to carry-forward tax loss rules for companies).*

Proposed Changes

On 8 May 2018, the Government announced that they would amend the R&D Tax Incentive, to encourage additional investment in R&D, while also ensuring the integrity and fiscal affordability of the program.

These changes are expected to apply from 1 July 2019. If passed as proposed, eligible R&D entities entitled to the non-refundable R&D tax offset, receive an R&D premium (i.e. net tax benefit) that ties the rate of non-refundable R&D tax offset available to the proportion of R&D expenditure for each year as follows:

R&D expenditure as a proportion of total annual expenditure	R&D premium (calculated as relevant % plus claimant's company tax rate)
0 to 2%	4%
>2% to 5%	6.5%
>5% to 10%	9%
>10%	12.5%

For eligible R&D entities entitled to the refundable R&D tax offset, the R&D offset will be the claimant's company tax rate plus a 13.5% premium, a decrease from the 16% R&D uplift applying to base rate entities in the 2017/18 year. Cash refunds will be capped at $4 million per annum. R&D tax offsets which cannot be refunded are to be carried forward as non-refundable R&D tax offsets for use in future income years, with the usual loss recoupment rules needing to be satisfied for use.

The maximum R&D expenditure threshold will be increased from $100 million to $150 million per annum.

In addition, increased resources will be made available to the ATO to ensure compliance with the integrity of the R&D measures.

This bill was in progress within parliament. However, it was put on hold due to the election. As the same government has been re-elected, it is expected that this will be revisited when parliament resumes.

Example:

*If a company is performing eligible R&D activities, their aggregated turnover is below $20m, they are a base rate entity and they have eligible **R&D expenditure of $500,000**:*

- *They will have a resulting **net tax benefit of $67,500.** This will either reduce their tax payable or will be refunded as a cash benefit (the cash refund cannot be higher than $4m).*

*If a company is performing eligible R&D activities, their aggregated turnover is above $20m, they are a non-base rate entity and they have eligible **R&D expenditure of $1,000,000 (this is 15% of total annual expenditure)**:*

- *They will have a resulting **net tax benefit of $125,000.** This will either reduce their tax payable or will be carried forward as a tax loss (subject to carry-forward tax loss rules for companies).*

What is Research and Development?

R&D incentives are available in many countries and are designed to attract talent and foster innovation. For that reason, Australia arguably has the most compelling incentive for "small" companies in the form of cash refundable tax incentives (unlike the non-refundable credit offered in most other countries).

The important question is, what is considered R&D?

The answer to this question may surprise you and R&D may be broader than you think. Below are some of the criteria for R&D:

- New activities that haven't been done before, where the process for completing these activities and their outcome is unknown, even through extensive research, and the use of internal and external expertise.
- R&D is not industry specific. It can include the development of anything that is new to the industry, as long as an experimental process is required to develop the solution.
- New knowledge is the outcome and can be in various forms (i.e. products, processes and services), as long as it did not exist prior to the R&D activity being undertaken, either in Australia or overseas.

Before you embark on R&D, there are some things you need to be aware of:

- There must be an intention to carry out the R&D activities through the documenting of a hypothesis or aim. This will identify a specific outcome that will be achieved using a specific combination of variables.

- This hypothesis or aim can only be proved through undertaking a scientifically ordered or systematic process that creates the necessary test conditions to prove the combination of variables.
- The process undertaken then tests those variables to form observations, an evaluation and logical conclusions that will lead to a result, a new activity entirely or a new phase.
- Eligible R&D activities require sufficient documentation, proving each aspect of the R&D activities undertaken, including the hypothesis (intention), the process undertaken, the tests carried out and the results achieved.

The above reads very "scientifically" and leads to notion that documenting how you undertake your R&D is very important.

Below are some examples of possible R&D within industry:

- Raw materials industry:
  - Developing a new reaction process through the development of improved reactor technology. The existing process for this may release harmful gases into the environment. However, through experimentation to create a new scientific reaction using novel catalyst agents and improved reactor technology, the business can produce the original raw material and a usable by-product, without releasing harmful gases into the environment.
- Software development:
  - Design and construction of a new algorithm for a large services provider that has no similarly sized competitors and needs to create a software solution for finding internal search results within a few seconds across multiple states and branches via external cloud storage for its remote staff.
- Agriculture:
  - Creating a new blending agent chemical that will combine with the specific formula within a merlot red wine varietal to reduce harmful bacteria to a few percent. Additionally, the novel blending agent will improve wine's preservation life when exposed to elements from two days to three weeks.

You may already be conducting R&D in your business and not realise it. Remember, R&D is broader than you think.

What type of costs can be claimed?

If you have determined that you have performed eligible R&D activities; then the eligible type of expenses that can be claimed that specifically relate to R&D include:

- Salaries and wages, including on-costs, such as payroll tax, superannuation, FBT, etc
- Contractor, consultant and technical advisory costs
- Direct material costs, such as materials, consumables, parts, travel, etc
- Depreciation of assets used in R&D activities
- Overheads, such as indirect salaries, rent, overheads, etc
- Research service providers fees
- Corporate research centre fees

It is important to note that where costs from an associate have been on-charged to the company claiming R&D, the costs must be paid before year end i.e. the costs cannot be recognised through loan accounts or creditors. This is specific to the R&D provisions.

What should I do next?

1. If you think you are already conducting R&D, contact us and we can discuss our thoughts on your eligibility and what you may need to do to claim the incentives.
2. If you are thinking of conducting R&D, we should discuss your activities going forward. We will need to ensure you are in the correct structure for accessing the incentives and the contemporaneous documentation needed is on file to evidence the potential R&D activities planned.

In the past months certain high-profile advisers have been under the microscope for what the ATO believes were overly aggressive R&D claims. The most recent budget highlights the importance of "getting your claim right". The forward estimates for R&D Tax Incentive funding are being decreased, along with ATO audit resources being increased, suggesting that claims will be scrutinised more rigorously going forward. Based on this, it is important to make sure your R&D claims are correct and that you have used a trusted provider that can verify this through an in-depth understanding of the requirements.

We would be happy to have a chat with you to explore this opportunity further.