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## FEDERAL BUDGET IMPLICATIONS FOR THE RESEARCH AND DEVELOPMENT TAX INCENTIVE

The Australian Federal Budget was handed down on 6 October 2020, and outlined various economic stimulus measures with the intent to support Australia's economic recovery through the COVID-19 pandemic and beyond.

Several key measures of the Federal Budget passed through both houses of Parliament on 9 October 2020 as the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020* which has been sent to the Governor General of Australia for Royal Assent.

Previous attempts by the Australian Government to reform the Research & Development Tax Incentive (R&DTI) and its administration were widely scrutinised, as the potential harm and uncertainty on eligible taxpayers was deemed by many to outweigh any potential benefits. With this Bill, the Government has amended its position to one that has been far more widely embraced, receiving greater industry support as it provides certainty and assistance to taxpayers who seek to undertake R&D activities and intend to claim the R&DTI.

*For detailed analysis of the R&DTI-specific measures found in the Bill, in addition to the various other measures resulting from the 2020-2021 Federal Budget, please refer to RSM's [2020-21 Federal Budget analysis](#).*

Given the intricacies with which the R&DTI and Division 355 of *Income Tax Assessment Act 1997* (ITAA 1997) interacts with other Divisions, particularly Division 40 and Division 328 ITAA 1997, RSM further highlight the implications of technically complex elements of the budget measures, including the R&D Tax Offset Rate, Instant Asset Write Off (IAWO) and Loss Carry Back.

Specifically, this article will seek to provide clarity on how the new measures will interact with the R&DTI and how this may affect the taxpayers' ability to incorporate deductions

as R&D eligible expenditure. Additionally, RSM will provide comment on the release of further guidance from upcoming Federal Court cases and its future impact on the application of the R&DTI.

### R&D tax offset rate

The main difference under the Bill is that from 1 July 2021 the R&D tax offset rate is now based on the company's corporate tax rate plus the addition of an R&D premium, where for large companies an R&D intensity calculation is necessary to determine the premium amount. Claimants will also benefit from the cap on eligible R&D expenditure being increased from \$100m to \$150m.

Companies with aggregated annual turnover below \$20m are entitled to the refundable R&D tax offset, where the offset rate is equal to their corporate tax rate plus a 18.5% premium. Because the corporate tax rate for these companies (assuming they are base rate entities) from 1 July 2021 will be 25%, the resulting 43.5% R&D tax offset rate is identical to that received under the previous legislation. With the proposed \$4m annual cap on R&D tax offset refund payments being abolished, the financial benefit received is essentially unchanged for refundable claimants accessing the R&DTI.

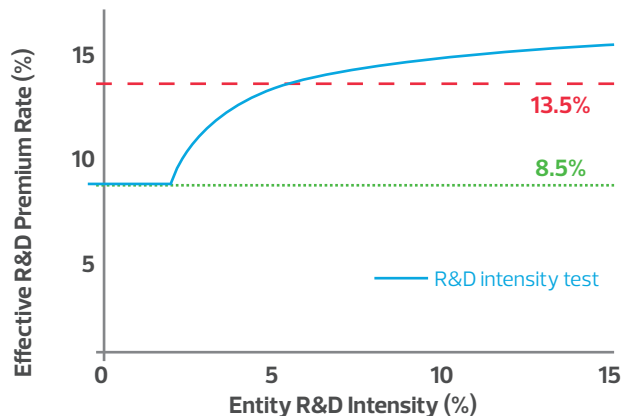
For larger companies, the Bill's reformulation of the non-refundable R&D tax offset via an entity-based R&D intensity test has introduced complexity towards its application and instances where the tax benefit received is diminished. The R&D intensity is the proportion of the entity's total expenses spent on R&D expenditure for the income year.

Companies with annual turnover of \$20m or more receive the non-refundable R&D tax offset, where the offset rate is equal to their corporate tax rate plus a premium based on the level of their incremental R&D intensity for their R&D expenditure. It should be noted that R&D expenditure above the \$150m cap is not included in the intensity calculation's numerator. The premium amount applied is based on a two-tiered system, wherein:

- For R&D expenditure representing up to and including 2% of the entity's total expenses, the premium is 8.5%
- For R&D expenditure representing greater than 2% of the entity's total expenses, the premium is 16.5%

Due to the incremental nature of the premium applied, the effective R&D premium rate becomes a function of the R&D intensity once the latter exceeds 2%, as shown in Figure 1. From the shape of the curve, it is evident that once the R&D intensity passes the 2% threshold, more significant enhancements to the effective R&D premium rate are achieved at lower R&D intensities, relative to higher R&D intensities.

For example, elevating the R&D intensity from 2% to 3% raises the effective R&D premium rate from 8.5% to 11.17% (a 2.67% increase), whereas elevating the R&D intensity from 3% to 4% raises the effective R&D rate from 11.17% to 12.5% (a 1.33% increase).



**Figure 1: Effective R&D premium rate for the non-refundable R&D tax offset as a function of an entity's R&D intensity.**

Because a variance exists between the aggregated annual turnover threshold that determines when a company receives the non-refundable R&D tax offset (\$20m) and when it no longer qualifies as a base rate entity (\$50m), two regimes are created for non-refundable claimants.

For companies with aggregated annual turnover of \$20m or more, but below \$50m, and are base rate entities, the previous legislation would have them receiving an R&D after-tax net benefit of 13.5% (38.5% R&D tax offset coupled with a 25% corporate tax rate from 1 July 2021), which is directly comparable to the R&D premium rate.

Under the Bill, at a minimum an 8.5% premium is received, with an R&D intensity greater than 5.33% needed to exceed the previous 13.5% after-tax net benefit mark (see Figure 1).

Therefore, non-refundable claimants in this group with low R&D intensities will be penalised under the Bill.

For companies with aggregated annual turnover of \$50m or more, the previous legislation would have translated to them receiving an R&D after-tax net benefit of 8.5% (38.5% R&D tax offset coupled with a 30% corporate tax rate). Under the Bill, an identical after-tax net benefit of 8.5% is achieved at a minimum for these companies, with higher effective R&D premium rates able to be realised once the R&D intensity exceeds 2% (see Figure 1). Therefore, non-refundable claimants in this group will be no worse off under the Bill, with those possessing a high R&D intensity in a position to substantially increase their R&D after-tax net benefit.

The introduction of the R&D intensity calculation for companies entitled to the non-refundable R&D tax offset presents a new range of issues that must be considered.

As the capitalisation of in-house software costs is common amongst companies undertaking R&D, with the entire cost able to be immediately claimed as notional R&D deductions, it is important to understand how this affects the total expenses denominator in the R&D intensity calculation.

Although the Bill states that the total expenses for the financial year are worked out in accordance with accounting principles, where the full capitalised amount of the in-house software will not appear (only the annual decline in value amounts) further provisions are also included to ensure any amount present within the R&D expenditure numerator is replicated within the total expenses denominator and amounts are only ever counted once.

As such, decisions regarding the capitalisation of in-house software should not influence the R&D intensity, but the amounts included in the intensity test across financial years will need to be tracked. However, the hybrid mixture of accounting and tax rules may lead to some atypical effects that need further consideration (e.g. accounting standards do not require transactions to be measured on an arm's length basis and allow for a wider array of depreciation methods).

Several complexities are also generated from larger companies having to calculate their R&D intensity to access the R&DTI. For example, as companies will only be able to determine their R&D tax offset rate after the scientific activities have ended for that financial year, this introduces significant uncertainty into the R&D planning process. Additionally, elevated compliance costs for companies to record the expenditure of the entity's economic group in an accurate and timely manner may occur.

Although the application of an R&D intensity test in the Bill admirably intends to incentivise and reward companies for carrying out higher levels of R&D, the mechanism may lead to detrimental outcomes that are a product of a company's intrinsic characteristics, disconnected from the magnitude of scientific endeavour:



- Companies that are in high-turnover, low-margin industries, such as mining or manufacturing, will be biased towards lower R&D intensities due to higher cost of goods sold, relative to industries such as software development
- The amount of expenses linked to an R&D performing company may be influenced by the elected corporate structure (e.g. a tax consolidated group)
- The highly non-linear profile of the effective R&D premium rate once the R&D intensity is above 2% (see Figure 1) may lead to strategic decisions being made by companies that distort the timing of R&D investments to maximise the tax benefit

### Instant asset write-off

The Bill extends and enhances the existing IAWO and Accelerated Depreciation measures which were enacted in *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) to stimulate business spending in the short and medium term:

- Companies with aggregated annual turnover less than \$500m that hold eligible assets, acquired between 12 March and 30 June 2020, for the enhanced \$150,000 IAWO that are not first used, or installed ready for use, by 31 December 2020 will have an extra 6 months to 30 June 2021 to first use, or install those assets ready for use to claim an immediate deduction
- Companies with an aggregated annual turnover of less than \$5 billion are eligible to immediately deduct the full cost of new depreciable assets and improvements to existing depreciable assets held on or after 7:30pm on 6 October 2020, if that asset has been first used or installed for use prior to 30 June 2022. The threshold of \$150,000 for assets eligible for the IAWOs has been removed
- Small and Medium Enterprises (SMEs) with aggregated annual turnover of less than \$50 million are eligible to fully deduct the cost of second-hand depreciable assets held on or after 7:30pm on 6 October 2020, if that asset has been first used or installed for use prior to 30 June 2022

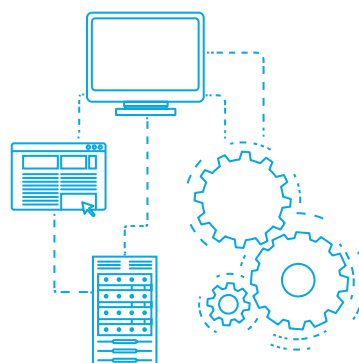
- Small businesses entities (SBEs) with aggregated annual turnover of less than \$10m will be able to deduct the balance of their simplified depreciation pool at the end of the income year while full expensing applies

The new temporary expensing measures above will be included in Subdivision 40-BB of *Income Tax (Transitional Provisions) Act 1997* (ITTP 1997). For SBEs that choose to use the simplified depreciation rules in Division 328 of ITAA 1997, the new temporary expensing rules legislated in section 328 181 of the ITTP Act will be applicable for the application of the simplified depreciation rules.

As with the previous measures, the Bill's interaction with the R&DTI provisions contained in Division 355 of *Income Tax Assessment Act 1997* (ITAA 1997), Division 40 and Division 328 is critical to understanding and determining whether taxpayers undertaking eligible R&D activities are entitled to notionally deduct the decline in value when calculating the R&D offset they are entitled.

In our view, given the manner in which the new IAWO measures have been legislated, it appears that R&DTI claimants will again benefit from the measures in conjunction with the specific R&DTI targeted measures introduced in the Bill. This is consistent with the understanding of the measures which were originally enacted in *Coronavirus Economic Response Package Omnibus Act 2020* specifically para 2.25 of the Explanatory Memorandum to the amending Bill which explicitly confirmed the interaction between Accelerated Depreciation rules and the R&DTI:

"For the avoidance of doubt, the amendments will apply to entities that are eligible for the Research and Development Tax Incentive. This means that the amount of the deduction for the decline in value of a depreciable asset calculated under the accelerated depreciation measure will be used for calculating the notional deductions that can be claimed under the R&DTI, providing the asset meets the requirements set out in section 355-305 of the ITAA 1997. This is consistent with current arrangements."



The interaction between s 355–305 and 355–310, Division 40 of the ITAA 1997 and Subdivision 40–BA and 40–BB of the ITPP 1997 allow that where tangible depreciating assets are the subject of, or used to facilitate, eligible R&D activities, the relevant s 40–25 decline in value is included in R&D expenditure under s 355–305 and 355–310 of ITAA 1997 to the extent it is used for R&D activities for the income year. The implications of the new legislation for FY21 and FY22 are:

- For businesses with an aggregated annual turnover of less than \$5 billion, the amount of IAWOs or Accelerated Depreciation calculated for eligible new assets and improvements to existing depreciable assets under Subdivision 40–BB of ITPP 1997 can potentially be included in eligible R&D expenditure under s 355–305 of ITAA 1997 to the extent that the assets are utilised in that income year for the purposes of eligible R&D activities that will be appropriately registered
- SMEs with aggregated annual turnover of less than \$50 million are eligible to fully deduct the cost of second-hand depreciable assets under Subdivision 40–BB of ITPP 1997 and include these amounts in eligible R&D expenditure under s 355–305 of ITAA 1997, unless they elect into Division 328 of ITAA 1997, to the extent that the assets are utilised in that income year for the purposes of eligible R&D activities that will be appropriately registered
- For businesses with aggregated annual turnover of \$5 billion or greater, there are no changes to application of IAWO or Accelerated Depreciation measures as previously understood

## Loss carry back

The loss carry back regime is governed by a new division 160 in the Income Tax Assessment Act 1997. Section 160–10 limits the amount of the “Loss Carry Back Tax Offset” to the lesser of:

- The sum of the “Loss Carry Back Tax Offset Components” for the 2019, 2020 and 2021 income years
- The entity's franking account at the end of the current year

“Loss Carry Back Tax Offset Component” is defined in para 160–10(2)(b) as so much of the entity's “income tax liability” as does not exceed the amount given by the method statement in that paragraph. The method statement takes the loss amount carried back, reduces it by any exempt income in the year to which it is carried back, then multiplies it by the tax rate.

The concept of “income tax liability” is defined by reference to section 4–10 of the ITAA 1997, which looks at how much income tax a taxpayer pays. Sub-s 4–10(3) specifies that

Income Tax = (Taxable Income x Rate) – Tax Offsets. This “income tax liability” is the final amount the taxpayer paid for the given year – i.e. after all other tax offsets applicable for that year.

As a result, the existence of any R&D offsets for a year to which losses were carried back would limit the ability of a taxpayer to carry back a loss to that year.

In other words, there is no apparent benefit relative to R&D claims in prior years that can be derived from the loss carry back provisions.

## Federal Court R&DTI Guidance

Accompanying these recent budget and policy changes, several cases have been heard by the Federal Court of Australia resulting in the issuance of further guidance to assist in the application of the legislation. In the most recent decision from the Federal Court pertaining to the R&DTI in *Commissioner of Taxation v Bogiatto [2020] FCA 11139*, the Federal Court issued guidance which provides greater clarity and certainty to taxpayers around the standard of proof required to evidence a R&D claim and the level of documentary evidence required to substantiate a R&D claim and relevant expenditure. Furthermore, as the case relates to the Promoter Penalty rules and application to advisors for the R&D Tax Incentive, there is useful guidance on the professional behaviour required from R&D advisors. It is encouraging to see that the ATO has actively pursued actions against unprofessional and predatory behaviour from some R&D advisors.

In addition to the most recent guidance, several more cases, concerning the R&D eligibility of software and mining activities are scheduled for the Federal Court before year end. For example, the appeal from the Administrative Appeals Tribunal case of *Coal of Queensland Pty Ltd v Innovation and Science Australia [2020] AATA 126* is set to be heard in the Federal Court in mid-November 2020. RSM anticipates that these decisions will provide further binding precedents in understanding the complexity and intricacies when assessing the eligibility of software and mining R&D activities and look forward to reviewing these decisions.

If you are unsure of your business' eligibility to claim the R&DTI or would like more information/assistance with the R&DTI or to stay informed and up to date with R&DTI guidance, please visit:

[www.rsm.com.au/service/tax-services/rd-tax-incentive](http://www.rsm.com.au/service/tax-services/rd-tax-incentive)