Australian
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Bulletin

Amendments to the research and development tax incentive scheme

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Introduction

Considerable changes to the research and development (R&D) tax incentive scheme were introduced by the Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020 (Cth) (the 2020 Act). The Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 (Cth) received Royal Assent on 14 October 2020 and implements announcements from the 2020 Federal Budget in which the government committed $2 billion to the R&D tax incentive scheme.

These amendments are aimed at helping businesses that invest in R&D manage the impact of the COVID-19 pandemic while providing incentives for businesses to undertake additional R&D investments.

Key points:

- Companies can benefit from recent reforms to the R&D tax incentives.
- In particular, large companies with aggregated turnover of $20 million or more can benefit from the incremental tax offset of 16.5% on each additional dollar spent on R&D which is an increase of 8.5% under the previous scheme. In other words, the higher a large company's level of R&D intensity, the more generous the R&D tax incentive.
- Practitioners advising companies should explore whether the companies committed to increased investment in new technologies and products can receive greater R&D tax offsets.
- The 2020 Act has provided certainty about R&D tax offsets following the protracted history of the R&D tax incentives scheme.
- In light of the impact of the COVID-19 pandemic, the reforms would generally be welcomed by businesses.

History of the 2020 Act

By way of background, several of the R&D tax incentive measures in the 2020 Act have regard to recommendations in the 2016 *Review of the R&D Tax Incentive*[1] that was commissioned as part of the government's National Innovation and Science Agenda, and the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (Cth).

The Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill lapsed on the calling of the federal election and was replaced by the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 (Cth) (the 2019 Bill).

The 2019 Bill was passed by the House of Representatives on 10 February 2020 and referred to the Senate Economics Legislation Committee for a report by 12 October 2020, however the report was not distributed.

Initially, the government was to impose an annual cap on R&D tax offset refunds of $4 million with any remaining offset amounts being treated as non-refundable carry forward tax offsets. However, the government rolled back this controversial plan and made refinements to the 2019 Bill.

Amendments by the 2020 Act

The amendments introduced by the 2020 Act are as follows.

Expenditure threshold

The R&D expenditure threshold is increased from $100 million to $150 million,[2] and the R&D expenditure threshold is a permanent feature of the law.[3]

R&D tax offset rate for small R&D entities

R&D entities with aggregated turnover of less than $20 million are generally entitled to a refundable R&D tax offset equal to the R&D entity's corporate tax rate plus a 18.5% premium.[4]

R&D tax offset for large R&D entities

R&D entities with aggregated turnover of $20 million or more are entitled to an R&D tax offset equal to the

R&D entity's corporate tax rate plus a premium based on the incremental R&D intensity of its R&D expenditure.[5]

The intensity premiums in the table below will apply to notional deductions within a range of R&D intensity. The R&D intensity is the proportion of the R&D entity's total expenses spent on R&D expenditure for the income year,[6] as reported in the company income tax return and taken from the company's financial statements.[7]

Tier	R&D intensity range	Intensity premium
1	Notional deductions representing up to and including 2% of total expenses	8.5% points
2	Notional deductions representing greater than 2% of total expenses	16.5% points

As indicated in the table above, there is marked support for incremental R&D expenditure by large companies that devote a significant portion of their overall operations to R&D eligible for the R&D tax incentive.

Under the government's reforms to corporate tax rates, the tax rate for companies with an aggregated turnover of less than $50 million will be further reduced from 26% to 25% from 1 July 2021. The tax rate for companies with an aggregated turnover of more than $50 million remains at the 30% corporate tax rate.

Example 4.2 in the Explanatory Memorandum to the Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 (the Explanatory Memorandum) demonstrates how the R&D tax offset for large R&D entities apply:[8]

Example 4.2 The R&D tax offset for large R&D entities
Contrast Industries has notional deductions of $160 million in the 2021–22 income year, exceeding the $150 million expenditure threshold. In the same income year, Contrast Industries had expenditure of $1 billion. Its aggregated turnover exceeds $50 million, meaning it is subject to the 30 per cent corporate tax rate.
Contrast Industries has an R&D intensity of 15 per cent ($150 million divided by $1 billion). The portion of the R&D expenditure in excess of the $150 million expenditure threshold ($10 million) is calculated separately (see below). Contrast Industries' R&D tax offset for the income year is calculated as follows:

Tier	*Intensity range*	*R&D premium*	*Notional deductions applied*	*Offset amount*
Tier 1	0-2%	8.5%	$20m	$7.7m[9]
Tier 2	>2%	16.5%	$130m	$60.45m[10]
Excess	NA	Nil	$10m	$3m[11]
		Totals:	**$160m**	**$71.15m**

Enhancing the integrity of the R&D tax incentive

The integrity of the R&D tax incentive is enhanced by clawing back the benefit of the R&D tax incentive to the extent an entity has received another benefit (eg a government grant or reimbursement) from an R&D activity.[12]

Recoupments

The clawback is composed of a 10% additional tax on the recoupment and any other expenditure required as a condition of the recoupment.[13]

Example 5.1 in the Explanatory Memorandum illustrates how the recoupment rules apply:

Example 5.1 Recoupments
Cross Innovations is committed to spending $2 million to undertake R&D activities, regardless of whether it is successful in obtaining a grant.
During the 2020-21 income year Cross Innovations receives a $1 million grant to undertake R&D activities. In addition to the grant, Cross Innovations must spend an additional $1 million of its own money as a condition of the grant. Cross Innovations receives an offset of $870,000 (applying the 43.5 per cent offset rate to the $2 million expenditure). Cross Innovations would have otherwise been entitled to a deduction worth $520,000 at the 26 per cent corporate tax rate.[14] Therefore, the incentive component of the offset is the difference of $350,000.[15]
In the same income year, the recoupment rules clawback only 10 per cent of the total $2 million spent under the terms of the grant, which is $200,000. Cross Innovations keeps the remaining $150,000 of the offset incentive. However, the grant alone is intended to constitute sufficient incentive without the additional $150,000 from the R&D tax incentive.[16]

Feedstock adjustments

Feedstock adjustments apply to recoup the benefit of the R&D tax incentive to the extent it relates to goods, materials or energy used to produce marketable products sold or applied to the R&D entity's own use.[17] The R&D tax incentive is effectively enjoyed on feedstock expenditure to the extent that it is not offset by feedstock revenue. The adjustment is one-third of the lesser feedstock expenditure or feedstock revenue in the R&D entity's assessable income.[18]

Example 5.2 in the Explanatory Memorandum demonstrates how the adjustment provisions apply to both a large R&D entity and a small R&D entity:

Example 5.2 Feedstock adjustments
In the 2020–21 income year, Wayland Enterprises, a large R&D entity, spends $100,000 on the development of a new product, producing one tangible product, which it then sells for $110,000. Wayland Enterprises is entitled to a $38,500 offset (with an incentive component of $8,500).

> $33,333 is included in Wayland Enterprises' assessable income (one third of the feedstock expenditure). After applying the corporate tax rate to the amount included in assessable income, the feedstock adjustment would claw back 10 per cent: $10,000, which is more than the incentive component.
> However, if Wayland Enterprises was a small R&D entity in the same position, it would claim an offset of $43,500 (with an incentive component of $17,500).
> The $33,333 would be included in assessable income and taxed at the 26 per cent corporate tax rate. The feedstock adjustment would claw back just $8^2/_3$ per centage of the offset: $8,666.58.[19]

Example 5.3 in the Explanatory Memorandum shows how the clawback amounts are determined in relation to feedstock adjustments:

> **Example 5.3 Clawback amounts**
> In a previous example, Contrast Industries had the following amounts for the 2021–22 income year (the offset year):
> - aggregated turnover in excess of $50 million;
> - expenditure of $1 billion;
> - notional deductions of $160 million; and
> - a non-refundable R&D tax offset of $71.15 million.
>
> Further to this example, in the 2023–24 income year, Contrast Industries sells a tangible product developed during its 2021–22 income year R&D activities. The tangible product is sold for $20 million but cost $25 million to develop. All of the costs were included in Contrast Industries' notional deductions for the 2021–22 income year.
> The clawback amount is the lesser of the market value of the tangible product on sale (feedstock revenue) and the tangible product's cost. Here, Contrast Industries has a clawback amount of $20 million.[20]

Balancing adjustment clawback amounts

The clawback amounts that relate to assessable balancing adjustments which clawback the incentive component of the R&D tax offset are as follows:

- For R&D assets held only for R&D purposes, the clawback amount is the balancing adjustment amount capped at the asset's total decline in value (its tax cost less its adjusted value).[21]
- For R&D assets held partially for R&D purposes, the clawback amount is reduced in proportion to its non-R&D use.[22]

The provisions that clawback the deduction component of the R&D tax offset (ie the amount of the offset that reflects the R&D entity's corporate tax rate) continue to operate where appropriate.[23] Feedstock revenue and government grants are generally assessable as ordinary income.[24]

The Commissioner may apply the general anti-avoidance rule in Pt IVA of the Income Tax Assessment Act 1936 (Cth) to prevent R&D entities from obtaining tax benefits by accessing a refundable or non-refundable R&D tax offset from a tax avoidance scheme.[25]

Improving the administration and transparency of the R&D tax incentive

The administrative framework is improved by making information about R&D expenditure claims transparent, enhancing the guidance framework to provide greater certainty to applicants, and streamlining administrative processes.

Amendments include:

- publishing information about the amount of notional deductions claimed by R&D entities for R&D activities[26]
- allowing the Board of Innovation and Science Australia (the Board of ISA) to make binding determinations about how it will exercise its powers and perform its functions and duties in relation to the R&D tax incentive[27]
- broadening the scope of the Board of ISA's and its committees' delegation powers to include delegating not only to Senior Executive Service employees but also to members of Australian Public Service staff assisting the Board and
- imposing a 3-month limit on extensions of time, unless the extension is granted to allow an applicant to wait for the outcome of a separate pending decision[28]

Practical implications:

- Increase in the expenditure threshold will lead to companies receiving increased refunds from R&D expenditure.
- Companies are more likely to increase R&D investment from 1 July 2021 thus impacting on the 2021–22 income year.
- As R&D investment and trials interrupted or delayed due to the COVID-19 pandemic are recommenced or renewed, there will be an increase in R&D tax incentive offset claims in the next few years.

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Footnotes

1. B Ferris, A Finkel and J Fraser *Review of the R&D Tax Incentive* (4 April 2016).
2. Income Tax Assessment Act 1997 (Cth), s 355-100(3).
3. Above n 2, s 355-750 is repealed by the Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020 (Cth).
4. Above n 2, s 355-100(1) (item 1 in the table). Currently, the R&D tax offset rate is 43.5% and can be refunded as a cash payment to an R&D entity if the offset exceeds the entity's income tax liability.
5. Above n 2, s 355-100(1) (item 3 in the table) and 355-100(1A). Currently, the R&D tax offset rate is 38.5%, is non-refundable, and may be used to reduce the R&D entity's income tax liability for an income year but any remaining excess must be carried forward to be applied to future income years.
6. The R&D intensity is equal to the R&D entity's notional deductions divided by total expenses.
7. Above n 2, s 355-115.
8. Explanatory Memorandum, Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 (Cth) 76.
9. The offset amount is composed of $20 million multiplied by the 38.5% (being the corporate tax rate of 30% plus the R&D premium of 8.5%).
10. The offset amount is composed of $130 million multiplied by the 38.5% (being the corporate tax rate of 30% plus the R&D premium of 16.5%).
11. The offset amount is composed of $10 million multiplied by 30% (being the corporate tax rate). Notional deductions in excess of the $150 million expenditure threshold do not attract an intensity premium and are not counted for the purposes of calculating an R&D entity's R&D intensity: see above n 2, s 355-100(3)(a).
12. Above n 2, new s 355-440.
13. Income Tax Rates Act 1986 (Cth), ss 12B and 31.
14. The deduction is composed of $2 million multiplied by the 26% corporate tax rate.
15. The incentive component of the offset is composed of the offset of $870,000 less the deduction of $520,000.
16. Above n 8, at 81–82.
17. Above n 2, Subdiv 355-H.
18. Above n 2, s 355-465(2) and new s 355-445.
19. Above n 8, at 83.
20. Above n 8, at 88.
21. Above n 2, new s 355-446.
22. Above n 2, new s 355-447.
23. See above n 2, ss 355-315, 40-292, 355-525 and 40-293.
24. Above n 2, s 6-5.
25. See Income Tax Assessment Act 1936 (Cth), ss 177C(1)(bd) and (h), 177C(2)(f), 177C(3)(cc) and (i), 177CB(1)(f), 177F(1)(f), 177F(3)(g) and 177C(3).
26. Taxation Administration Act 1953 (Cth), s 3H(1) and (2), see also the note to s 355-50 in Sch 1.
27. Industry Research and Development Act 1986 (Cth), ss 31C, 31D(1) and (2). In addition to the Board of Innovation and Science Australia (the Board of ISA) making findings about whether an R&D entity's activities are R&D activities which bind the Commissioner for the purpose of working out an R&D entity's R&D tax offsets, the Board of ISA may also make determinations about the circumstances and ways in which it will exercise its powers, or perform its functions or duties in relation to the R&D tax incentive which are binding on the Board of ISA thus providing certainty to R&D claimants: above n 2, s 355-705. These amendments commenced on 1 January 2021.
28. Industry Research and Development Decision-making Principles 2011 (Cth), s 3.2(3) and (4).