



# Reform in Focus

Implications of tax reforms for Australian business

TAX

09 TiF-027 New R&D Tax Incentives Consultation Paper - KPMG 21 September 2009  
Observations

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## Executive summary

The Government has now released its Consultation Paper for the new Research and Development (R&D) tax credit regime.

The new regime will apply from 1 July 2010 to new and existing R&D activities. There will be a period of public consultation ending 26 October 2009.

The Consultation Paper contains the following key issues.

- R&D eligibility criteria will require activities to exhibit both innovation and high levels of technical risk
- Supporting activities that can be claimed will be limited
- Software claims will be subject to tighter eligibility requirements
- The scope of eligible R&D activities will be narrowed through the implementation of other options detailed in the Consultation Paper.

KPMG will actively participate in the consultation process and encourages companies and industry bodies to make submissions.

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## Timing

The new R&D tax credit system will begin in less than a year, which is a short time for the fundamental changes propounded.

### 40 percent R&D tax credit

A 40 percent R&D tax credit will apply to Australian incorporated companies with greater than \$20million turnover. Companies will not be able to claim a tax deduction for R&D expenditure claimed, resulting in a net tax saving of 10 cents in the dollar.

Any unused credit amounts can (subject to integrity rules) be carried forward to be applied against future income tax liabilities in accordance with Division 65 of the *Income Tax Assessment Act 1997* (ITAA 1997). Carried forward credits will result in a similar outcome to a carry forward loss arising from a tax deduction under the existing R&D tax concession.

The 40 percent R&D tax credit will be applied after ‘use it or lose it’ tax offsets (such as the tax offset for foreign income tax under Division 770 of the *ITAA 1997*) and before refundable tax offsets (including the Refundable R&D tax credit).

The Consultation Paper states foreign-owned companies can access the 45 percent R&D tax credit, in contrast to the 2009-10 Federal Budget announcement and innovation policy publication *Powering Ideas: An Innovation Agenda for the 21st Century*.

### 45 percent refundable R&D tax credit

The 45 percent refundable R&D tax credit will be available to Australian incorporated companies with a R&D company group turnover of less than \$20 million. Companies with Australian tax losses can therefore receive a cash refund of up to 45 cents in the dollar for qualifying R&D expenditure in any year. Companies will not be able to claim a tax deduction for the R&D expenditure claimed, resulting in a net tax saving of 15 cents in the dollar.

If a taxpayer’s income tax liability is reduced to zero, the unused refundable tax credit amount can be applied to reduce other tax liabilities (such as GST). Any residual unused amounts can be refunded to the company.

Companies can only access refunds after their tax assessment is completed. The Australian Taxation Office (ATO), in conjunction with AusIndustry, will apply appropriate risk management procedures before issuing refunds.

Integrity measures will include limiting deductions for expenditure accrued but not paid (especially with related entities).

## Treatment of R&D expenditure that is currently deductible at 100 percent

The Government has yet to decide how the new R&D tax incentive will treat expenditure on R&D that currently receives a non-enhanced (100 percent) deduction (namely, interest, residual feedstock, allowable core technology and expenditure that is not 'at risk').

### Who can claim

The new R&D tax credit will be available to companies incorporated in Australia for R&D conducted in Australia.

Location of ownership of the resulting intellectual property (IP) will not be relevant where the R&D is done for a group member.

### Grouping rules

Grouping rules will apply in the context of relevant thresholds for the R&D tax credit, as they do under the current scheme. References to a 'company' in this context should be read as 'company group'. In summary, a company group for R&D is one where a company controls more than 50 percent of another company. In addition, de facto control could also create a company group for R&D.

### Tax exempt entities

The new Refundable R&D tax credit will be available to companies with up to 50 percent ownership by exempt entities (such as universities). This is double the 25 percent cap that exists under the current R&D Tax Offset. This will encourage collaboration between such entities and small firms. There will be administrative mechanisms to prevent the R&D tax credit being used to fund R&D that receives public support through other programs.

## R&D definition changes

### Core R&D

The R&D definition will be changed to require activities to exhibit both innovation and high levels of technical risk and to exclude from R&D eligibility certain supporting activities which might previously have been eligible for R&D. The consultation process will focus on the nature of these exclusions.

The Consultation Paper advises that more extensive guidance material will be available to assist companies in self-assessing their R&D activities.

### Restrictions on supporting R&D

Supporting R&D will continue to be recognised under the new R&D tax credit, but claims will be significantly restricted.

The Consultation Paper suggests a range of options to restrict the eligible claims:

- a cap for supporting R&D, as a proportion of expenditure on core R&D
- supporting activities should only be eligible where they are for the sole or dominant purpose of supporting core R&D activity
- exclude production activities or dual role (i.e. commercial/business-as-usual) activities

- certain costs of supporting activities should only be eligible on a net expenditure basis (e.g. sale of product or prototype reduces the credit)
- supporting activities should attract a lower rate of assistance than core R&D
- preventing named non R&D activities of a marketing/routine nature being claimable as supporting activities.

## Software

The Government is also seeking to limit software claims by tightening or modifying the multiple sale criteria or restricting the type of claims that the R&D credit should support. Submissions are being sought on the type of claims that the R&D credit should support.

## The 'on own behalf' rules

The new R&D tax credit will retain the rule that a company can only claim eligible R&D conducted by the company or on its behalf.

This will be tested by reference to whether, on balance, the claimant company:

- bears the financial risk associated with a R&D project
- has control over the R&D project
- effectively owns the project results.

The new scheme will also retain the exception to the 'on own behalf' rules that currently exist for foreign-owned R&D. An Australian company will, subject to certain requirements being met, claim the R&D tax credit for R&D carried out on behalf of a grouped foreign associate in a treaty country. The new R&D tax credit will also retain the rule that where R&D is exploited, it must be done so on commercial terms.

## Increased compliance and monitoring

Monitoring and audit will increase significantly to ensure the new R&D tax credit is not subject to excessive claims. It is important the compliance framework will be transparent, consistent and ensure timely service delivery.

The R&D tax credit will continue the current joint administration model, where the Innovation Australia Board (a group of independent experts assisted by AusIndustry) will continue to assess whether an activity is eligible R&D. The ATO will continue to determine whether an amount of expenditure is validly incurred on that activity as well as other tax interpretation issues.

## Participating in the consultation process

The Consultation Paper does not cover all aspects raised in the Federal Budget announcement of May 2009. Stakeholders are encouraged to raise issues not covered in the paper. Such issues may include:

- treatment of activities conducted overseas
- removal of the unlimited time frame for amendment of assessments relating to R&D by the Commissioner
- whether the credit will be treated as above the line

- the treatment/eligibility of payments to associates
- recoupment of expenditure.

Companies should consider making submissions directly or through their industry bodies. The deadline for submissions is 26 October 2009 and submissions can be either public or confidential.

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