R&D in Australia — what next?

By **Peter Gell**, Partner, and **Robert Picone,** Special Counsel, Hunt & Hunt

- ***Eligibility criteria for R&D tax concessions likely to be tightened***
- ***New tax credit system to benefit companies that invest in R&D but not all will gain***
- ***Consultation in progress as to scope of approved activities***

Many firms of all sizes in all sectors of the economy invest in research and development (R&D) every year. As a result of this year's Federal Budget, the most expansive reforms to the tax treatment of R&D since the 1980s is planned to take place in Australia.

The announcements in the Federal Budget in relation to this area of tax reform stem from the Federal Government's innovation policy, which attempts to provide a plan for the next ten years with respect to the development of Australia's innovation system.

This policy agenda is called 'Powering Ideas: An Innovation Agenda for the 21st Century'. This policy originated from recommendation of 'Venturous Australia — Building Strength Innovation: Review of the National Innovation System'.

This review, among others, was instituted by the Federal Government soon after it came into office pursuant to an announcement in January 2008 by Senator Kim Carr, Minister for Innovation, Industry, Science and Research, and an expert panel was established and chaired by Dr Terry Cutler with support from relevant international experts. Aside from making recommendations with respect to such areas as the development of skills, research, barriers to innovation, efficiency of current programs, public sector and business innovation, the Review also examined tax reform, which led to the announcements in the Federal Budget.

Current system

The current tax treatment of R&D in Australia is contained in s 73B of the *Income Tax Assessment Act 1936* (ITAA 1936). The system allows Australian companies to claim some tax relief. Under the current provisions there are four tax concessions.

1. A tax deduction of 125 per cent is available to companies whereby their expenditure in R&D is at least $20,000 in an income year.
2. In addition to the abovementioned tax deduction of 125 per cent, there is a further 50 per cent deduction available to certain companies which have, in a particular year, increased their expenditure over and above the average expenditure on R&D over the previous three years.
3. A tax deduction of 175 per cent applies to foreign-owned companies spending on R&D activities in Australia. An additional 75 per cent deduction is available to these companies if their expenditure in a particular year is greater than their average spend over the previous three years.
4. As an alternative to deductions, a refundable tax offset or a rebate can apply in certain circumstances. The offset is available pursuant to s 73I of the ITAA 1936. To qualify there has to be an aggregate R&D amount which exceeds $20,000 and a 'grouped research and development aggregate amount' for the year not exceeding $1 million. In addition, R&D group turnover of the group is less than $5 million. If expenditure is less than $20,000, a company can claim the tax offset if it has incurred expenditure with a registered research

agency. Grouping provisions apply in relation to determining the group R&D aggregate amounts. The group turnover is equal to the aggregate value of taxable supplies as defined in the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act).

The essential administrative role in determining the application of s 73B is now undertaken by Innovation Australia which operates as a part of Australian Industry in the Department of Innovation Industry Science and Research.

New system

As mentioned, the new tax system which recommends the introduction of a tax credit system to replace existing alternative tax concessions is planned to commence from 1 July 2010. The main features of the proposed tax credit were announced by the Treasurer's press release on 12 May 2009.

The stated intentions outlined in the press release were:

- the simplification and enhancement of the R&D tax concessions to provide better incentives and support for Australian jobs on the face of the global recession
- the boosting of investments and strengthening of Australian companies.

Features of the new tax credit rules

The following is a broad outline of the main points in the package.

The R&D tax credit will be available to companies undertaking 'eligible research and development activities'. The eligibility requirements for this are yet to be developed and are only the subject of the current consultation process.

A 45 per cent refundable tax credit will be available for all companies with a turnover of less than $20 million, which is equivalent to a tax concession of 150 per cent. This would translate to a tax refund of 45 per cent of the total R&D expenditure when a tax return is filed.

A 40 per cent non-refundable tax credit will be available for companies with a turnover of greater than or equal to $20m, which is equivalent to a tax concession of 133 per cent.

The transitional measure shall result in the increase of the R&D expenditure threshold from $1 million to $2 million, which applies to eligible activities undertaken in the first income year commencing on or after 1 July 2009. This has now been effected by the Tax Laws Amendment (2009 Measures No 4) Bill 2009 which was passed on 10 September 2009.

The essential difference between the refundable tax credit and a non-refundable tax credit is that tax credits are applied directly to a company's income tax liability to reduce the amount of tax the relevant companies have to pay. A 45 per cent tax credit will be a refundable tax offset which means that once a company's tax liability is reduced to zero, companies can access a cash refund for any unused offset amount.

The 40 per cent R&D tax credit will be non-refundable. Companies cannot access a cash refund for any unused offset amount once their liability has been reduced to zero. The tax credits however can be carried forward by the relevant companies.

These features of the new tax credit system provide greater financial benefits to companies that invest in R&D. Not all companies will benefit from the tax reforms but generally a positive financial result will be obtained in this area. Those companies that took advantage previously of the wider than 75 per cent premium tax deduction will lose. There is also the category of companies that own foreign intellectual property assets; if these companies happen to be in a tax loss position, the excess R&D tax credits are not convertible to losses for these companies.

There is not sufficient detail yet on the approved R&D activities or expenditures at the time of writing this article as the consultation process is currently under way. Presumably the three primary categories of expenditure currently covered by the definition will continue to apply:

- contract and expenditure
- salary expenditure
- other expenditure incurred directly in respect of R&D activities carried on by or on behalf of the relevant company.

The new tax credit system provide greater financial benefits to companies that invest in R&D. Not all companies will benefit from the tax reforms but generally a positive financial result will be obtained in this area. Those companies that took advantage previously of the wider than 75 per cent premium tax deduction will lose.

What seems guaranteed though is that the eligibility criteria will be more stringent as previously applicable. As mentioned, a review of the eligibility criteria was recommended by Venturous Australia's report on the basis that the current applicable criteria are somewhat outdated with respect to the present business landscape in Australia. By its own figures, the Federal Government states that approximately 8,000 companies of all sizes from all sectors access the current R&D tax concession system. These companies are expected to access the new system which will mean the new R&D tax credit system will have the largest reach of any such program in Australia.

The government has estimated that more than 5,500 small companies will benefit from the refundable 45 per cent tax credit. The flat rate of 40 per cent is seen to generate certainty which should benefit larger companies. All this must be balanced by the government's stated aim, as mentioned, of restricting the eligibility criteria. The previously mentioned consultation process shall allow companies of all sizes to comment on the new scheme and therefore a clearer picture should emerge with respect to the eligibility criteria.

Conclusion

Although the changes to the tax treatment of R&D are generally positive to Australian companies, the question still remains as to which Australian companies will benefit. The Federal Government's clear objective with respect to its consultation process on this part of the reform was to provide an outcome where 'only genuine research and development' is supported. What this phrase means is yet to be clarified. However, the Federal Government has publicly stated that it expects the benefits to be better targeted.

This should result in the number of Australian companies benefiting from the new system being fewer than the number of Australian companies that have benefited from the present system. Despite this, the new R&D scheme which is to commence in the 2010–2011 financial year is expected to deliver over $1.4 billion in tax benefits to corporate Australia and is promised to provide real reform in the area of R&D.

Peter Gell can be contacted on (02) 9391 3125 or by email at pgell@hunthunt.com.au. Robert Picone can be contacted on (02) 9391 3160 or by email at rpicone@hunthunt.com.au.