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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Company Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re: The R&D Tax Incentive**

The R&D Tax Incentive provides Australian resident companies and corporate trustees of public trading trusts (and foreign companies operating a business via an Australian permanent establishment) with a tax offset in respect of qualifying expenditure incurred on R&D activities that have been registered with AusIndustry. These rules also apply to partnerships of eligible R&D entities where each partner is entitled to an R&D tax offset based on the partner’s proportional entitlement to qualifying expenditure in respect of eligible R&D activities.

This letter outlines both the key features of the current R&D Tax Incentive and recently enacted changes announced in the 2020/21 Federal Budget.

**Companies with aggregated turnover of less than $20 million**

A company with an aggregated turnover of less than $20 million per annum is entitled to a refundable tax offset equal to 43.5% of R&D deductions notionally available under Division 355 of the *Income Tax Assessment Act* *1997* (**ITAA 1997**) for the year ended 30 June 2020.

As discussed in the Federal Budget amendments section below, legislation has been enacted which will see the refundable R&D tax offset rate set at a rate of 18.5% above the claimant’s company tax rate for income years starting on or after 1 July 2021.

A company’s aggregated turnover will comprise the annual turnover of the company derived in the ordinary course of carrying on its business during the year (excluding GST) and the annual turnover of any affiliate or entity connected with that company for that year.

Companies in a tax loss position for an income year are entitled to receive a refundable tax offset (i.e. obtain a cash rebate in lieu of the tax loss for that year) if they are otherwise eligible for that offset.

**Companies with aggregated turnover of $20 million or more**

A company with an aggregated turnover of $20 million or more is entitled to a non-refundable tax offset equal to 38.5% of its notional R&D deductions for the year ended 30 June 2020.

As discussed in the Federal Budget amendments section below, legislation has been enacted which removes the 38.5% non-refundable R&D tax offset rate and replaces it with an R&D premium rate. This rate will apply to income years starting on or after 1 July 2021.

Any unutilised tax offset is non-refundable but is able to be carried forward to future income years.

**Rate of offset if notional deductions are less than $20,000**

Where an R&D entity’s total notional deductions are less than $20,000 it is only entitled to the applicable rate of R&D offset to the extent the expenditure is incurred in relation to a non-associated registered Research Service Provider or under the Co-operative Research Centres (CRC) program.

**Tax offset where notional deductions exceed $100 million**

Where an R&D entity’s notional deductions are in excess of $100 million for an income year, the applicable R&D tax offset rate will only apply up to $100 million of qualifying expenditure on eligible R&D activities. To the extent that the company has notional deductions in excess of $100 million, that amount will only be eligible for the tax offset at the entity’s prevailing company tax rate.

As discussed in the Federal Budget amendments section below, the maximum amount of R&D expenditure eligible for concessional R&D tax offsets will be increased to $150 million for income years starting on or after 1 July 2021.

**R&D activities**

Eligible R&D activities continue to be categorised as either core or supporting R&D activities. However, an activity will only be regarded as an eligible supporting activity if it relates to a core R&D activity.

Core R&D activities are experimental activities carried out systematically applying established scientific principles which proceed from hypothesis to experiment, observation and evaluation until logical conclusions are reached. It is also necessary that the activities be undertaken for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).

That is, in order for a taxpayer to qualify for the R&D offset, the R&D must be focussed on the pursuit of new knowledge and the taxpayer needs to systematically undertake experiments to discover that knowledge.

In addition, activities excluded from being a core R&D activity may qualify as supporting R&D activities. Such activities fall into two types. Those that are directly related to core R&D activities and others which would only be supporting activities where a dominant purpose test is satisfied.

**Advance finding**

Under the R&D Tax Incentive, applicants can obtain an advance finding of whether their activities are eligible R&D activities by submitting a completed Advance Finding Application. The advance finding can be applied for prior to the commencement of R&D activities and will determine whether an activity is a core R&D activity, a supporting R&D activity or neither of the two. The finding will bind AusIndustry to register activities that the finding has determined as eligible and (if favourable) also binds the ATO to treat the activities as R&D activities when making a decision whether expenditure is eligible R&D expenditure.

Applications are due before the end of the income year in which the R&D activity was first conducted or commenced and will apply to that income year and the next two income years.

**Overseas R&D**

Applicants can access the R&D Tax Incentive where parts of the R&D activities are conducted overseas, subject to the following conditions being met:

* the company received an advance finding that the activity is an eligible activity;
* the overseas activity must have a significant scientific link to one or more core R&D activities solely conducted in Australia, which are registered or reasonably likely to be conducted and registered in the future;
* the overseas activity cannot be conducted solely in Australia because conducting it requires access to a facility, expertise or equipment not available in Australia, would contravene a law relating to quarantine, requires access to a population (of living things) not available in Australia or requires access to a geographical or geological feature not available in Australia; and
* the total amount to be spent in all income years on the R&D overseas activities is less than the total amount to be spent on R&D in Australia.

**Computer software**

In-house software development is excluded from being a core R&D activity if it is being developed for the internal administration of business functions of the software developer or an affiliate of the developer or an entity connected with the developer.

However, in-house software development may be regarded as a supporting R&D activity if it is undertaken for the dominant purpose of directly supporting an eligible core R&D activity.

**Feedstock adjustment**

The feedstock adjustment rules apply to include an amount in an R&D entity’s assessable income where it has obtained the R&D tax offset in respect of goods, materials or energy which have been transformed or processed by the R&D activities into feedstock outputs, being tangible product(s) which are either sold or applied for the R&D entity’s own use (or that of an affiliate or connected entity).

The purpose of these rules is to clawback the R&D Tax Incentive where feedstock expenditure has been effectively recouped as a result of the feedstock outputs having been sold or used, regardless of whether that sale or use occurs in the same year as the expenditure is incurred or in a subsequent year.

Where the adjustment rules apply, the R&D entity is required to include one-third of the lesser of the feedstock expenditure or the revenue from the sale or use of the feedstock outputs in its assessable income. As discussed in the Federal Budget amendments section below, legislation has been enacted which will see changes to the way feedstock adjustments are calculated for income years starting on or after 1 July 2021.

**Federal Budget amendments**

The 2020/21 Federal Budget introduced a number of changes to the R&D Tax Incentive program, with these changes applying to income years starting from 1 July 2021. These changes provide a number of refinements to the amendments previously proposed under the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019* which was referred to the Senate Economics Legislation Committee for inquiry.

These amendments have been enacted in the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* which received Royal Assent on 14 October 2020. As stated previously, the amendments apply to income years starting from 1 July 2021.

Key aspects of the Federal Budget amendments include:

* for companies with an aggregated annual turnover below $20 million, the refundable R&D tax offset will be set at a rate of 18.5% above the claimant’s company tax rate, rather than the previously proposed 13.5%. It is important to note that many R&D claimants obtaining refunds will have their income tax rate reduced to 25% for the 2021 income year. The increase to 18.5% therefore ensures that the existing net R&D benefit is maintained. In addition, the previously proposed $4 million cap on annual R&D refunds has been abandoned.
* for companies with an aggregated annual turnover of $20 million or more, the Federal Government has introduced an R&D premium rate that ties the rate of the non-refundable R&D tax offset to the incremental intensity of R&D expenditure as a proportion of the company’s total expenditure for the year. The intensity threshold for the non-refundable R&D Tax Offset will now introduce two levels of R&D tax offset rate:
* 8.5% above the claimant’s company tax rate for R&D expenditure between 0% and 2% of total company expenditure; and
* 16.5% above the claimant’s company tax rate for R&D expenditure above 2% of total company expenditure.
* the maximum amount of R&D expenditure eligible for R&D tax offsets has been increased from $100 million to $150 million of qualifying expenditure on eligible R&D activities.
* a number of changes have been introduced to enhance the integrity of the R&D Tax Incentive program. These include:
* the inclusion of R&D tax offsets in the definition of “tax benefit” in the general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936*; and
* the introduction of a uniform clawback rule for feedstock, government grants and balancing adjustments. This aims to give rise to an assessable income amount equal to the grossed up value of the incentive component of the associated amounts of the R&D tax offset.
* a number of changes have been introduced to improve the administration of the R&D Tax Incentive program, including:
* amendments to the *Industry Research and Development Act 1986* to allow the Board of Innovation and Science Australia to make determinations. This has been introduced to streamline compliance and reduce administrative workloads;
* limiting the period of extension to register R&D activities to three months. There is an exception where the extension request relates to a pending decision on another matter such as an ATO review of a previous year’s R&D claim; and
* the publishing of information about R&D Tax Incentive claimants and R&D expenditure registered. There will be a two year delay between when an R&D claim is registered and when it is reported.

**New guidance**

AusIndustry published a new Guide to Interpretation in November 2020. The refreshed Guide uses clearer language, has less duplication and is designed to help R&D claimants plan, conduct and register eligible R&D.

**In conclusion**

Whilst the eligibility criteria to claim the R&D Tax Incentive are reasonably complex, the incremental benefits for eligible R&D entities available via the R&D tax offset are considerable, especially for small to medium sized claimants whose aggregated turnover is less than $20 million per annum.

We recommend that all existing R&D claimants review their systems and processes to ensure that all eligible R&D activities are identified, tracked and documented properly.

If you are currently conducting R&D or are considering conducting R&D in the future and have not previously claimed the R&D Tax Incentive, we would be pleased to arrange a meeting to discuss any of the above changes or any other tax planning issues. Please do not hesitate to contact me on [insert telephone number of partner].

Yours faithfully

**[Insert name of Partner]**