Core R&D activity decision tree

Section 355-25 Income Tax Assessment Act 1997

Are the activities experimental?

No \[\rightarrow\] Not core R&D activities

Yes \[\downarrow\]

Could the outcome be known in advance based on current knowledge, information or experience?

Yes \[\rightarrow\] Not core R&D activities

No \[\downarrow\]

Can the outcome ONLY be determined by applying a systematic progression of work that:

- is based on the established principles of science; and
- proceeds from hypothesis to experiment, observation and evaluation; and
- leads to logical conclusions.

No \[\rightarrow\] Not core R&D activities

Yes \[\downarrow\]

Were the activities conducted for the purpose of generating new knowledge? This includes new or improved materials, products, devices, processes or services.

No \[\rightarrow\] Not core R&D activities

Yes \[\downarrow\]

Are the activities excluded^ from being core R&D activities?

No \[\downarrow\] Core R&D activities

Yes \[\rightarrow\] Not core R&D activities

^ Activities excluded from being core R&D activities are:

- Market research, testing or development
- Sales promotion (including surveys)
- Prospecting, exploring or drilling for minerals or petroleum in order to:
  - discover deposits
  - determine locations of deposits
  - determine the size and quantity of assets.
- Management studies
- Efficiency surveys
- Research in sciences, arts or humanities
- Commercial, legal and administrative aspects of patenting, licencing or other activities
- Activities associated with complying with statutory requirements and standards
- Activities related to the reproduction of a commercial product or process by:
  - Physical examination of an existing system; or
  - From plans, blueprints, detailed specifications or publically available information.
- The development, modification or customisation of computer software for the dominant purpose of the internal administration of an entity (or any entity connected of affiliated with that entity).

These can be supporting R&D activities if undertaken for the dominant purpose of supporting core R&D activities.
The Australian Research and Development Tax Incentive (RDTI) regime has been in place since 1 July 2011, for income years ending 30 June 2012 (FY12) onwards.

Instead of a tax deduction at the prevailing corporate tax rate, one of two R&D tax offsets or credits is available for eligible R&D expenditures incurred on eligible R&D activities that have been carried on during an income year.

The two R&D tax offsets available are either a refundable tax offset or a non-refundable tax offset, depending on whether the defined aggregated turnover of the claimant is less than $20 million (refundable), or $20 million and over (non-refundable).

The R&D tax offset rates and expenditure caps have changed over time, and there are long-standing proposals to further reduce the effective rates:

- **Currently legislated to end on 30 June 2024**

The R&D tax offset is calculated by applying the relevant rate to the total amount of eligible R&D expenditure for the income year and is then deducted from the tax liability. If the offset exceeds the tax liability, it is either refunded or carried forward to be used in future income years (subject to satisfying continuity of ownership or business tests).

The net tax benefit of making an R&D claim for an income year will therefore depend on the difference between the rate of the R&D tax offset available on the expenditure claimed, and the prevailing rate of the company tax deduction forgone.

See our Deloitte Tax Essentials publication on “Understanding which corporate tax rate to use” for a detailed explanation of the corporate tax rates applying to base rate entities and other corporate taxpayers for different income years.
What qualifies as an eligible R&D entity?

A company or body corporate is the only type of entity that can be an eligible R&D entity. However, companies acting in the capacity of a trustee of any entity (other than a public trading trust) and corporate limited partnerships cannot be an eligible R&D entity.

A company that is resident in Australia either due to incorporation or by way of central management and control can be an eligible R&D entity. A company that is a treaty resident in another country can also be an eligible R&D entity to the extent that it carries on business in Australia via a treaty permanent establishment (PE).

Where a company carrying on R&D activities is a subsidiary member of a tax consolidated group (TCG), it is the Head Company that must both lodge the annual registrations with AusIndustry and claim the R&D expenditure in the TCG company income tax return.

Aggregated turnover threshold

To qualify for the refundable R&D tax offset rather than the non-refundable R&D tax offset, an eligible R&D entity must have an aggregated turnover below a $20 million threshold. A company’s aggregated turnover is the sum of:

- The claimant company’s own annual turnover; and
- The annual turnover of entities worldwide “connected with” the company; and
- The annual turnover of any worldwide “affiliate” of the company.

Broadly, annual turnover is the total ordinary income derived that income year in the ordinary course of carrying on the business. There are rules to exclude certain amounts including intra-group transactions and to account for entities that were connected or affiliated with the R&D entity for only part of an income year.

Broadly, an entity is “connected with” the claimant company if either entity controls the other entity, or both entities are controlled by the same third entity. A company is connected with an R&D entity by owning at least 40% of the interests or having the right to receive at least 40% of its distributions. An application for the Commissioner’s discretion is available where a relevant shareholding is more than 40% and less than 50%.

An “affiliate” is any person or entity other than a trust that broadly acts or could reasonably be expected to act in accordance with the company’s directions or wishes, or in concert with the company.

What qualifies as eligible R&D activities?

The core R&D activity decision tree on page 2 sets out the key legislative requirements for activities to be eligible core R&D activities.

Supporting R&D activities are also eligible activities. These are defined as activities which are ‘directly related’ to one or more eligible core R&D activities – these can be carried on in different income years.

Some activities are specifically excluded from qualifying as core R&D activities but can still be supporting R&D activities if they are undertaken for the ‘dominant purpose’ of supporting core R&D activities. This dominant purpose test also needs to be satisfied where a supporting activity produces goods or services or is directly related to such production.
What expenditures can be claimed?
Expenditure incurred on eligible registered R&D activities can be notionally deducted and claimed provided that they are not precluded from being deductions under the wider tax laws (e.g., fines and penalties). The most common types of expenditures claimed are wages and salaries, contractor costs, and a proportion of overheads.

Certain expenditures are specifically excluded such as interest, expenditure on buildings and core technology, and expenditure included in the cost of a tangible depreciable asset.

Expenditure incurred to defined associates must also be paid in the income year to be eligible. If the expenditure is incurred but has not yet been paid, R&D entities must choose to either claim a tax deduction in the income year incurred or include the amount in eligible R&D expenditure in the future income year it is paid.

Depreciating assets used to carry on R&D activities
Amounts included in the cost of certain tangible depreciable assets cannot be claimed outright. Instead, the decline in value of these assets can be claimed to the extent the assets are used to carry on, or are the subject of, R&D activities.

This can include most instant asset write-offs and accelerated depreciation amounts, but excludes write-offs for small business entities.

Other capital expenditure may also be included in eligible R&D expenditure to the extent it is incurred on or directly related to R&D activities; for example, project pool and primary producer costs.

Cross-border aspects
The RDTI was specifically designed to attract inbound R&D expenditure. As such, under certain circumstances, an R&D entity can claim for R&D activities conducted overseas provided that they are linked to Australian core activities, and that at least 50% of the anticipated total R&D expenditure will be in Australia.

The rules also allow an Australian R&D claimant to carry out R&D activities in Australia on behalf of a connected foreign entity in certain circumstances, including situations where the activities are fully funded from overseas.

Importantly these two overseas aspects cannot be combined. That is, activities done on behalf of an overseas entity can only be claimed when carried on in Australia.

Integrity measures
There are several integrity measures which ensure that:

- Activities must be carried on for the claimant entity—generally known as the on own behalf rule;
- Expenditure is not eligible where an entity is paid regardless of the outcome of the R&D, known as the not-at-risk rule;
- Clawbacks in the form of additional income tax will apply where government grants have funded any part of claimed R&D activities. Importantly though, the underlying expenditure covered by the grants can still be claimed;
- Feedstock adjustments will claw back some of the net tax benefit where the R&D activities produce tangible goods of value that are sold or used in the business;
- Any group mark-up amounts are excluded from eligible R&D expenditure; and
- Expenditures in excess of market value are reduced if transactions are not at arms’ length.

Franking effects
The reduction in company income tax payable resulting from claiming R&D tax offsets in an income year will naturally reduce the franking credits available. In addition, the receipt of a R&D tax offset refund is defined to be a refund of income tax and will give rise to deferred franking debits which will reduce future franking credits that would otherwise arise on the payment of income tax.

Administrative aspects
There are two separate regulatory bodies responsible for administering the Australian R&D Tax Incentive regime. Eligible R&D activities must be registered with Innovation & Science Australia (ISA) within 10 months of the end of the income year in which the activities are carried on. The ISA registration number and the eligible expenditures on registered activities are then lodged with the Australian Taxation Office (ATO) as part of the company income tax return for the income year in which the expenditures are incurred.

Documentation and substantiation critical
Case law shows that many R&D claims can fail on audit or review due to insufficient documentation attesting to the satisfaction of the key legislative requirements. It is critical to maintain robust governance procedures and documentation that can substantiate the activities claimed were carried on, that each aspect of the legislative requirements is satisfied, and the nexus of the expenditures claimed to the activities.
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