

## New tax incentive for research and development

On 24 August 2011 the Australian Parliament approved legislation to change the taxation incentive regime for companies conducting research and development (R&D) activities in Australia. Effective for income years commencing from 1 July 2011, the new provisions provide an increased level of financial assistance to an expanded range of companies. The downside for existing claimant companies is that the legislation defining what is 'research and development' for tax purposes has been changed considerably and has introduced uncertainty as to how the scheme will be administered.

### FROM TAX DEDUCTIONS TO TAX CREDITS

One of the fundamental changes to the R&D tax incentive regime involves changing the nature of the tax benefit from additional tax deductions to a tax credit. Under the existing incentive, companies are allowed a 125% tax deduction on eligible R&D expenditure with up to 175% tax deduction on increased R&D expenditure. For tax loss companies with group turnover under \$5m and R&D expenditure under \$2m, the R&D tax deductions were refundable at the 30 cents in the dollar company tax rate.

Under the new credit regime R&D expenditure will become non tax deductible, though subject to a tax credit at either the 45% or 40% rate. The rate of tax credit will depend on whether company group turnover is less than \$20m (45% credit), or more than \$20m (40% credit).

This equates to 150% and 133% rates of tax deductions under the current scheme, hence the increased level of headline financial assistance.

For companies with less than \$20m group turnover, the 45% credit is refundable if the companies are in a tax loss position. Unlike the existing tax concession rules, access to the refundable tax credit is not restricted by a maximum R&D expenditure threshold. Further, there is no limit to the amount of R&D expenditure for which the R&D tax credit can be claimed. This will be of particular benefit to start up technology companies that will now be able to effectively 'cash out' their R&D expenditure at the 45% rate. Many of these companies were previously precluded from the refundable benefit because of the previous \$2m R&D expenditure thresholds applied to the refund criteria.

### ACCESS FOR FOREIGN COMPANIES

The new regime also expands the range of entities that can access the R&D tax benefit. The concession will be expanded to encompass foreign companies operating in Australia through a permanent establishment. This will bring in foreign companies carrying on R&D through a branch in Australia. Foreign ownership of the results of the R&D activity is specifically accommodated under the new regime.

### CHANGES TO THE R&D ACTIVITIES ELIGIBILITY CRITERIA

While the benefits of the new regime are obvious, there are also a number of areas where the eligibility criteria has been tightened to potentially exclude a range of activities that are currently eligible for the tax incentive. The definition of what constitutes R&D for tax purposes has been completely overhauled with the introduction of new terminology. The previous focus for 'core R&D' on systematic, investigative and experimental activities involving innovation or high levels of technical risk has been replaced with experimental activities for the purpose of creating new knowledge. While there would appear to be little substantive difference in the application of the new terminology, it will be in the administrative interpretation where uncertainty is likely to be introduced, with the Government flagging the intent for a tighter interpretation of eligibility.

Areas targeted for specific tightening are those where the Government considers the activities were part of 'business as usual' for certain businesses. Businesses engaged in some form of production such as manufacturers and mining companies, along with certain computer software developments are targeted.

Changes to the definition of supporting R&D in the new R&D tax credit will subject companies to a 'dominant purpose' test if they conduct activities that produce, or are directly related to producing goods or services. Such activities will need to support core experimental development. Production activities that are core experimental activities will continue to be eligible R&D.

New feedstock rules will also be applied to producers where R&D results in the production of goods of value. The new rules do not impact on the deductions for material inputs, however, there may be deemed assessable income, depending on the value of the output of the R&D. There is concern among the business community that an unsupportable and narrow interpretation of the new legislation will confine assistance to companies whose R&D is a failure, with limited entitlement for successful R&D conducted by productive companies. While the terms of the legislation are fairly innocuous, based on the Government's stated position in published material associated with the new legislation, there is an intent to move away from supporting applied 'industry R&D' toward supporting more basic and early stage development activities.

## COMPUTER SOFTWARE

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Computer software developers are also subject to a new 'dominant purpose' test applying to their core experimental activities. Computer software development that is for the dominant purpose of performing internal administrative functions, including the administration of business functions, is precluded from eligibility as 'core R&D activities'. This test replaces the 'multiple sale' criteria as a means of excluding development of 'internal' software from the scope of the R&D tax incentive.

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