VOLUME 1

THE PLAIN ENGLISH GUIDE TO UNDERSTANDING THE R&D TAX INCENTIVE

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QUESTION:

WHAT IS THE R&D TAX INCENTIVE?

ANSWER:

The Federal Government's headline industry assistance program designed to assist and encourage research and development activities across all industry sectors in Australia for the purpose of creating new jobs through the generation of new innovative products, processes and services.

QUESTION:

WHAT CONSTITUTES ELIGIBILITY UNDER THE R&D TAX INCENTIVE?

ANSWER:

Experimental activities conducted in Australia that seek to provide a technical or scientific advancement through the generation of new knowledge which is not freely available anywhere in the world OR could not be developed by an expert in the field without undertaking experimental and investigative R&D activities.

QUESTION:

WHAT % RETURN CAN I EXPECT BY CLAIMING MY ANNUAL R&D EXPENSES UNDER THE R&D TAX INCENTIVE?

ANSWER:

A 43.5% refundable tax offset (payable in cash) for companies with annual R&D aggregated turnover of less than $20m – this applies to either start-ups with no income OR existing companies with sufficient accumulated tax losses to cash out against their R&D expenses

A 13.5% refundable tax offset (payable in cash after any taxes are offset by the ATO at time of lodgement) for companies with annual R&D aggregated turnover of less than $20m who are trading in profit

A non-refundable tax offset (to reduce company tax payable) equal to 8.5% of annual R&D expenses claimed for companies with annual

QUESTION:

WHAT ARE THE 4 PILLARS OF ELIGIBILITY REQUIRED TO OBTAIN A BENEFIT UNDER THE RESEARCH & DEVELOPMENT TAX INCENTIVE SCHEME?

ANSWER:

1. Eligible entity –

Only incorporated entities are eligible to make claims i.e. Pty Ltd or Ltd or a Body Corporate acting as a trustee of a public trading trust (i.e. public companies).

Individuals, trusts, sole traders and partnerships are not eligible.

Action: register a Pty Ltd or Ltd entity, inject loan or equity working capital into the entity to cover R&D expenses and commence undertaking R&D activities and incurring R&D expenses.

2. Eligible project activities –

Must be experimental for the purposes of generating new knowledge on a technical or scientific basis for which the R&D entity must also own or control the resultant IP.

Action: research the current state of knowledge in your field, develop your hypothesis, and design your set of experiments to address the technical or scientific problem you seek to overcome before undertaking and recording your pathway of experimental activities.

3. Eligible expenditure –

Is the financial risk incurred by the claimant entity which is associated with its technical risk. The majority of your claim will be made up of the direct labour (salaries or contractor) and other direct costs involved with undertaking the experimental activities (e.g. parts, materials, hosting etc.) plus an apportionment of indirect overheads which are expensed in the P&L and the annual depreciation allocated to the use of any R&D assets which reside on the balance sheet.

Action: prepare an annual R&D budget, use an accounting package like XERO to record your transactions, register and lodge your BAS returns on time, incur and pay for R&D costs throughout the year and don't forget to pay yourself a wage to properly value your contribution and maximise your benefit.

4. Eligible record keeping –

Maintain weekly timesheets for labour to substantiate the apportionment of annual wages to be claimed and record the conduct of your R&D activities using the scientific method (i.e. hypothesis, experiment, observation, evaluation, leading to logical conclusions). Maintain a R&D file containing project plans, design drawings, minutes of R&D meetings, photos of prototypes, contracts for outsourcing of R&D etc.

Action: Establish and maintain contemporaneous records using the scientific method.

QUESTION:

WHAT ARE THE 21 MOST COMMON MISTAKES MADE BY FOUNDERS OF TECH START-UPS OR INVENTORS WANTING TO CLAIM THE R&D TAX INCENTIVE?

ANSWER:

1. **Not establishing a company to undertake, fund and own the IP generated from the R&D activities.**

   Action: register a Pty Ltd or Ltd entity, invest shareholders loans or working capital to cover R&D expenses.

2. **Not paying yourself a salary** if you are devoting a large proportion of your time on R&D on an annual basis (NB: only applies to founders not drawing any income and paying personal tax from other sources).

   Action: register for PAYG, pay yourself an appropriate market salary, pay tax and super and claim a 43.5% benefit of the annual gross salary plus super paid. As you will probably be funding your own project you should value your contribution as you can always elect to loan the net proceeds of your annual wage back to the company.

3. **Selling 40% or more of the shareholding to high wealth investors** who also own and control other companies (anywhere in the world) whose annual turnover when aggregated with the start-up is greater than $20m per annum – thus invoking the "R&D Tax aggregated turnover rule" which negates the R&D entity for being eligible to claim a refundable 43.5% benefit, instead it is only eligible to receive a non- refundable tax offset equal to 8.5% of R&D expenses claimed.

   Action: check out the local and international business ownership structure and annual turnover of the potential investor before agreeing to sell 40% or more OR, limit any single high wealth investors to a 39% shareholding.

4. **Believing that the** research and development activities involved with developing a new business model is eligible to claim in absence of a technical or scientific advancement which requires experimental work to resolve.

   Action: take advice and confirm eligibility before factoring in the benefit.

5. Not realising that the costs involved with a **failed project are eligible to claim** if they have met the requirements of the scheme.

   Action: true R&D carries the inherent risk of failure, don't be shy and claim it NOW.

6. **Entering into a "sweat for equity" arrangement with your external software developer because you think you can't afford to pay him.**

   Action: pay your developer his fees so you can claim back 43.5%, and have them buy the shareholding with the funds you paid them and possibly take advantage of the new Early Stage Investor (ESIC) tax incentives.

7. **Believing you can't claim the R&D Tax Incentive if you have received other grants like Accelerating Commercialisation** (formerly known as Commercialisation Australia).

   Action: You may also claim benefits under the R&D Tax Incentive when receiving any other type of grant support as long as the activities being undertaken are eligible under both programs. In this instance the R&D Tax clawback provisions will apply whereby a 10% tax is payable on expenses that are claimed under each program. An additional benefit of 3.5% or 33.5% (dependent on tax position) is still available for claimants eligible for the refundable tax offset with annual turnover less than $20m but it is unlikely that any real benefit will exist for companies with annual turnover of $20m or more as the additional 8.5% benefit will be negated by the 10% clawback.

8. **Believing that routine business establishment expenses like the registration of an entity, legal fees and patenting costs are eligible to claim if the entity is undertaking R&D activities.**

   Action: isolate routine business costs from R&D costs to determine the potential benefit. Overseas patenting costs may be claimed under the Export Market Development Grant scheme if done in tandem with export marketing activities.

9. **Sub-contracting R&D without ensuring you own or control the IP,** have overall control of the project, and bear the financial risk.

   Action: register your IP first OR establish an agreement with the sub-contractor that clearly states that you own the resultant IP that you are paying them to generate.

10. **Not recording the creative development process or failed development attempts.** Often small teams working together forget to commit the development process to writing.

    Action: maintain code repositories, task tracking programs, weekly timesheets, specifications, take photos of white-boards planning sessions, keep emails and record the conduct of your R&D activities using the scientific method.

11. **Believing you need to spend a huge amount of money on R&D activities using "men in white coats doing experiments" in labs to be eligible.** The minimum annual threshold of R&D costs that can be claimed is $20,000 and over 35% of all claims lodged are in the ICT industry generated by software engineers.

    Action: Don't be shy, check your eligibility and claim NOW - **call TCF Services.**

12. **My local subsidiary company can't make claims because I am owned by foreign corporation –** if your company is registered and carrying on business in Australia it is eligible to make claims, even if the overseas parent owns the Australian subsidiary and the resultant IP.

    Action: prepare a written agreement between the offshore owner and local subsidiary which clearly states that the offshore owner owns the IP and assigns the control over the conduct of the R&D project to its 100% owned Australian R&D entity.

13. Entering into a fixed price contract when outsourcing your R&D to another party.

Action: If an external contractor offers you a fixed price, this either indicates that they know how to do the work without undertaking experimental activities and/or **they** are taking the financial risk if the cost exceeds the price. Under either scenario, the R&D company engaging the contractor may find itself ineligible to claim the expenditure dependent on the exact wording of the agreement. On the other hand, if the quotation for work was an open-ended hourly rate, this would generally indicate that the work is experimental by nature and proves that the financial risk is being borne by the R&D company which pays the expenses and holds the IP.

14. Capitalising your R&D expenses so you don't show any losses on your Profit & Loss statement.

Action: for SME's and start-up R&D companies most external accountants only prepare one set of Financial Statements for both accounting and tax purposes unless they apply "tax effective accounting". Whilst you can still claim the R&D if it is capitalised, you must ensure that you do not 'double dip' and re-claim the accounting depreciation in later years which may invoke penalties from the ATO. To avoid this issue we believe it is simpler to expense your R&D.

15. Not paying your associated R&D contractor each financial year.

Action: the rules governing the program require all eligible R&D expenses incurred from associated or related parties MUST be paid by 30th June each year before the benefit can be claimed. If they are unpaid they must be preserved and carried forward in the tax return so that the benefit can be accessed in the following year after payment is made, otherwise the benefit is lost forever. You cannot allocate this fee to a loan account as evidence of payment; an actual payment must be made through the bank account after which the amount can be loaned back to the entity if necessary.

16. Mark-ups or profit margins for R&D services between associated entities

Action: entities within a consolidated tax group cannot add any mark-up or margin on R&D services or supplies provided within the group, however associated entities who do not form part of a consolidated group for tax purposes may add a small margin if it can be justified on an arm's length basis.

17. Believing that Founders of companies performing R&D duties can claim 100% of their time because they work an 80 hour week and perform R&D for 40 hours per week.

Action: Founders can only claim the apportionment of time they are actually paid for so if they work 40 hours a week on R&D over an 80 hour working week they can only claim 50% of their apportioned paid time.

18. Believing that company directors can claim Director's fees and dividends paid to them through family trusts.

Action: Director's fees are paid for the purpose of directing the company's affairs and franked dividends are paid as a distribution of profit, neither are eligible to be claimed under the R&D Tax Incentive as there is no nexus to R&D.

19. Believing that principals of R&D companies can claim associated contractor payments made to their family trust which are not shown on their personal tax return.

Action: only the portion of the contractor payment distributed to the Director through their trust structure which is shown on their personal tax return is eligible to claim under the program. Distributions to other family members are not eligible.

20. Claiming R&D activities and wanting to pay fully franked dividends if the R&D company is trading in profit.

Action: in this instance you should not worry about making any R&D Tax claims as all you are doing is reducing your ability to drawdown fully franked dividends by the same benefit provided by the scheme.

21. Believing your company must be trading in profit before it can receive a benefit under the R&D Tax Incentive.

Action: this assumption only applies to companies with a R&D aggregated turnover of $20m or more who receive a non refundable tax offset. For start ups and companies under $20m you need tax losses to cash out against R&D expenses claimed to receive the 43.5% cash reimbursement benefit.

7 POINT R&D TAX INCENTIVE ELIGIBILITY CHECKLIST: IF YOU ANSWER YES TO ALL OF THESE QUESTIONS, YOU MAY BE ELIGIBLE TO CLAIM A CASH BENEFIT UNDER THE R&D TAX INCENTIVE

- Do you have an incorporated Australian company?
- Will your company carry out an experiment or set of related experiments to achieve a technical advancement in your industry sector?
- Will the experiment(s) investigate and test a hypothesis?
- Will the new knowledge being sought be new to the world or at minimum be unavailable in the public arena?
- Will you own or control the resultant IP generated from the R&D activities?
- Will the R&D activities be conducted in Australia?
- Will the annual costs for undertaking R&D meet the minimum threshold of $20,000?

GERRY FRITTMANN

Managing Director

Since launching TCF Services in 1991, Gerry has overseen the delivery of over $2 billion in Government grants and tax incentives for Australian companies. With experience in delivering assistance across many sectors including software and digital technology, automotive, food, apparel and general manufacturing. Gerry leads an exceptional team of consultants who will work closely with you to deliver a positive outcome for your organisation.

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