Chapter 1
Research and development (R&D) tax incentive - targeting access

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to deny access to the R&D tax incentive for companies with aggregated assessable income of $20 billion or more for an income year. The amendment better targets the R&D tax incentive to businesses that are more likely to increase their R&D spending in response to Government incentives, delivering a greater return for taxpayer funds.

1.2 All references are to the ITAA 1997 unless otherwise specified.

Context of amendments

1.3 The R&D tax incentive replaced the previous scheme (the R&D tax concession) from 1 July 2011. The R&D tax incentive provides more generous benefits, particularly for small and medium companies, and a clearer definition of research and development activities that better targets activities that are likely to deliver wider benefits than the R&D tax concession did.

1.4 The two components of the R&D incentive are:

- a 45 per cent refundable R&D tax offset for eligible entities with a turnover of less than $20 million; and
- a non-refundable 40 per cent R&D tax offset for all other eligible entities.

1.5 On 17 February 2013, the Government announced changes to better target the R&D tax incentive to businesses that are more likely to increase their R&D spending in response to Government incentives. The change adds a third tier to the eligibility requirements, with very large companies no longer being eligible for the offset.

1.6 Internationally, there is broad support for the view that small firms are more responsive than large firms to increasing their R&D

spending as a result of Government incentives. The Government has taken a decision to better target the R&D tax incentive to small and medium companies where it will stimulate behavioural change and deliver a greater return for taxpayer funds.

1.7 Part of the savings from this measure will be used to fund other Government priorities including reforms announced in the Government's Industry and Innovation statement, 'A Plan for Australian Jobs'.

Summary of new law

1.8 This Schedule prevents an entity from claiming the non-refundable R&D tax offset if its assessable income for an income year, when aggregated with the assessable income of its affiliates, entities it is affiliated with and connected entities, is $20 billion or more.

1.9 Although the entity would not be able to claim the non-refundable tax-offset, it will be able to treat the R&D expenditure for tax purposes in the same way as other expenditure, for example, as a deduction.

Comparison of key features of new law and current law

New law	***Current law***
An entity with an aggregated turnover of more than $20 million is only able to claim the R&D non-refundable tax offset if its assessable income is less than $20 billion. If it cannot, the entity will treat the R&D expenditure in the same way as any other expenditure.	Any entity with an aggregated turnover of more than $20 million is able to claim a non-refundable R&D tax offset.

Detailed explanation of new law

1.10 These amendments limit the R&D tax incentive to entities with aggregated assessable income of less than $20 billion in an income year. An entity with higher aggregated assessable income would then treat the expenditure in the same way as other expenditure, for example, as a deduction. This denies access to the R&D tax incentive for entities that are less likely to engage in additional R&D in response to Government incentives. ***[Schedule #, item 1, subsection 355-103(1)]***

Aggregated assessable income

1.11 'Assessable income' has the meaning that it is given in the ITAA 1997, which includes an entity's ordinary and statutory income according to the residence of the entity and the source of the income. Australian residents include their ordinary and statutory income from all sources in their assessable income.

1.12 Foreign residents include in their assessable income their Australian sourced ordinary and statutory income (unless it is assessed on some basis other than source). If a foreign resident has a permanent establishment in Australia that is subject to a tax treaty, then its assessable income includes the income which is attributable to the permanent establishment from all sources. Assessable income, in general terms, is the amount of assessable income that the entity reports to the tax office.

1.13 The entity's assessable income is aggregated with the income of its affiliates, entities that it is affiliated with and entities connected with it so that the rules cannot be easily circumvented by diverting income to an associated entity. ***[Schedule #, item 1, subsection 355-103(2)]***

1.14 An entity (the relevant entity) will be 'connected with' or an 'affiliate' of another entity in accordance with the existing definitions of these terms in sections 328-125 and 328-130. Broadly, these entities include entities that are controlled by the relevant entity or that can reasonably be expected to act in accordance with its wishes.

Example 1.1

GJP Pty Ltd is an Australian resident company that wishes to claim the R&D tax incentive. GJP earns $12 billion of assessable income in the 2013-14 income year. This includes statutory and ordinary income from both Australian and foreign sources.

GJP has a wholly owned subsidiary, CJE Pty Ltd, which is therefore connected with GJP. CJE has assessable income from all sources of $7 billion for the 2013-14 income year. This $7 billion will be aggregated with GJPs assessable income to determine whether GJP's aggregated assessable income exceeds $20 billion for the 2013-14 income year.

GJP is expected to act in accordance with the wishes of a foreign resident company, Goji Pty Ltd, with respect to its business decisions. GJP is therefore an affiliate of Goji. Goji has $10 billion of income for the 2013-14 income year. This includes $3 billion of Australian sourced income which is assessable income in Australia including $2 billion from trading through a permanent establishment in Australia and a $1 billion net capital gain from the sale of an Australian factory and associated land. Only the $3 billion of income that is assessable in Australia will be included in GJP's aggregated assessable income.

GJP has aggregated assessable income of $22 billion (= $12 billion + $7 billion + $3 billion) and therefore will not qualify for the R&D tax incentive.

GJP will, however, be able to claim deductions in relation to the R&D expenditure it has incurred during the relevant income year. For example, its borrowing expenses will be deductible under section 8-1, the decline in value of depreciating assets it holds may be deductible under Division 40 and some capital expenditure may be included in the cost base of an asset or be deductible under section 40-880 as black hole expenditure.

Application and transitional provisions

1.15 The measure applies to an R&D entity's income year that starts on or after 1 July 2013. This means that, in aggregating the R&D entity's assessable income, you look at the assessable income of entities that is it connected or affiliated with, along with entities that it is an affiliate of, for the same income year, even if their corresponding income year starts before 1 July 2013. ***[Schedule #, item 2]***

Example 1.2

In the example above, GJP and CJE both have income years that start on 1 July. However, Goji has a substituted accounting period that starts on 1 January. Goji's 2013-14 income year therefore starts on 1 January 2013. It is Goji's assessable income for this income year (running 1 January 2013 to 31 December 2013) that is used to work out GJP's aggregated assessable income for the-2013-14 income year.