

# Optimising Value

## From Your R&D Investment

Presented to 'What's New in Laboratory Technology', Royal Australian Chemical Institute  
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### Abstract

The RACI symposium is discussing new techniques being developed in analytical science. Much of this work and the new science to be developed using these techniques, is likely to be classified as eligible R&D under the Federal Government's Research and Development Tax Incentive programme.

The R&D Tax Incentive has been designed to provide generous rebates or tax breaks to support and encourage Australian R&D of this nature. With the first full year of the programme now complete (financial year 2011-12), many companies are still struggling to adjust to the new system. Under this system, Australian companies are able to recapture 40-45% of their eligible R&D expenditure, either as a cash rebate or an enhanced tax deduction, depending on their circumstances.

This presentation will outline the rigorous application of the scientific method to R&D projects, both from the point of view of maximising the technical and business outcomes of the projects themselves, and also for maximising the direct benefits to companies available through AusIndustry's R&D Tax Incentive programme.

Topics to be covered will include: identifying the "*new knowledge*" to be generated via your R&D project; structuring your R&D testwork according to the scientific method; categorising 'core' and 'supporting' activities; identifying eligible expenditures; and the benefits available to companies through the R&D Tax Incentive programme.

### Introduction

Following a review of the former R&D Tax Concession programme, a new system was implemented in the 2012-13 financial year.

The new system offers a 'better fit' to the natural practices of companies doing R&D as an ongoing enhancement to their products and services, maintaining their competitive edge in a fast-paced environment.

Most particularly, the new programme has the advantage that the planning and record keeping requirements are better suited to standard laboratory practice.

In the past, many companies have rejected applying for their entitlements under the former concession. The new R&D Tax Incentive is worth a fresh look.

### The R&D Tax Incentive

**45%** refundable tax offset  
for turnover less than \$20m

**40%** non-refundable tax offset  
all other eligible entities

In effect, this is a 133-150% improvement over the existing 30% tax deduction for business expenses.

For profitable companies, this can appreciably reduce a tax liability, as shown in Table 1. For loss making companies, the benefit of an immediate cash rebate is often more attractive than the future benefit foregone of accumulating tax losses.

Indeed, for some small companies, this can mean the difference between having to raise capital, or not.

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**ACCESS RnD TAX SOLUTIONS PTY LTD**

ABN 58 154 585 734

Level 16, 1 Market Street, Sydney NSW 2000 Australia

Tel: 61 (2) 9241 5900 Fax: 61 (2) 9241 5966 email: emdg@busgrant.com.au

**Table 1: An example of the benefits available to an Australian company**

Turnover (increasing)	Total Expenses	Profit Before R&D Incentive	Notional Tax Payable	R&D Expense	Actual Rebate/Tax Payable
\$1,200,000	\$1,500,000	(\$300,000)	\$0	\$1,000,000	<b>\$240,000 cash rebate (\$150,000 improvement + immediate cash benefit)</b>
\$1,800,000	\$1,500,000	\$300,000	\$90,000	\$1,000,000	\$60,000 cash rebate (\$150,000 improvement)
\$2,400,000	\$1,500,000	\$900,000	\$270,000	\$1,000,000	\$120,000 tax payable (\$150,000 improvement as a reduction in tax payable)

**What is Eligible R&D?**

Under AusIndustry’s definition, R&D must include a “core activity”, which is:

- An experimental activity,
- Where the outcome cannot be known in advance,
- Following the scientific method,
- For the purpose of generating “new knowledge”

“Supporting” activities can also be claimed as R&D, if they were “directly related to” or “for the dominant purpose of” the “core” R&D.

In short, much of the experimental design and testing conducted by scientific companies will quite naturally fall into AusIndustry’s definition.

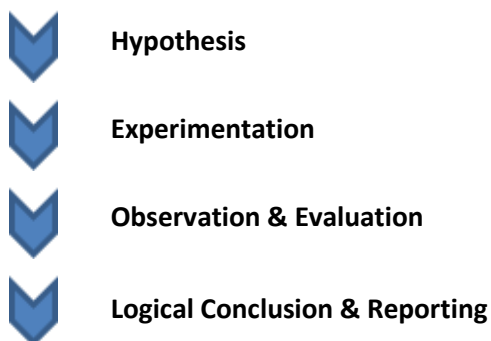
And the conventional practices of planning and documenting the work – would typically be done anyway as part of maximising the value of R&D conducted.

So – taking the experimentation and the scientific method as ‘given’ for a typical scientific company, the key to defining core R&D activity then falls to the other two components.

**Risk:** Put simply, there has to be an element of ‘risk’ in the R&D for it to qualify as “core activity”.

**“AusIndustry loves failure...”**  
 [because it denotes uncertainty in R&D]  
 (AusIndustry representative, May 2013)

**The Scientific Method**



This is just good practice for experimental R&D

Can the outcome be predicted in advance by a competent professional? Most likely, you are either testing whether an idea can be done at all, or if this is known, then you are experimenting to determine *how* the idea can be achieved.

A clear imperative in describing your R&D to AusIndustry is to also note the setbacks, dead-ends and hurdles in your work. By demonstrating the **systematic** progression of your R&D through the scientific method, you demonstrate that your work adheres to three of the four criteria for “core activity”.

*Who Owns the IP?*

Another good question on risk is “who owns the resulting intellectual property”. It can be important to have clear documentation to show who is taking the risk, and who the reward. If you are using a contractor for your R&D, then the contact should specify that you own the resulting IP.

## New Knowledge

A key task for all applicants is clearly defining their R&D testwork is establishing that they are developing “new knowledge” – for new or improved materials, products, devices, processes or services. Importantly, this means “new” on a worldwide basis, not just in Australia.

The R&D needs to be more than “a simple progression from what is already known” or “applying existing knowledge in a different context or location”.

Best practice recommends that you thoroughly identify the “**knowledge gap**” before embarking on the expense of R&D. However, while this may have been performed and/or documented somewhat informally, the onus is on the company to be able to supply evidence in relation to the R&D’s “new knowledge”.

Clearly also, the issue of “new knowledge” is also inextricably linked to the concept that “the outcome cannot be predicted in advance”. Together, these include both technical and commercial risk.

So a key task here, and possibly the single most important step, is complying with AusIndustry’s requirements for **identifying and documenting the “knowledge gap”**. While this would be done as part of good R&D practice, for many, it might not be done as thoroughly as AusIndustry would prefer.

## Some Examples

So what is eligible “core” R&D activity? Here are some examples from our own clients:

- Developing (via experimentation) faster, more accurate, more sensitive and/or cheaper tests for new and existing chemicals using established analytical techniques.
- Developing (via experimentation) new instrumental analytical techniques to replace LD<sub>50</sub> biological testing on live animal subjects.
- Developing (via experimentation) new processing technology to extract and recover metals from mineral and waste feedstocks.
- Developing (via experimentation) new engineering designs and tools for practical industries, like fisheries or hospitals.
- Developing (via experimentation), new software algorithms to analyse financial markets faster than any competitors.

## Supporting Activities

There are no fixed definitions, but as a guide an activity might be a “supporting activity” if:

- it is in addition to routine activities;
- it would not have occurred in the absence of the core activity;
- normal production practices are extensive disrupted; or
- there is a risk that production outcomes will be compromised.

Table 2 shows a list of ‘typical’ activities in an experimental R&D programme.

## Record Keeping and Evidence

“The R&D Tax Incentive is an elective program. If you elect to register your R&D, you elect to comply with the procedural and record-keeping requirements..... of course, we’re always here to help you.”

(Rod Campbell, Access RnD)

The R&D Tax Incentive programme, like company tax in general, is a self-assessment system. As with any Government programme, and particularly any programme linked to taxation, the onus is on the entity to maintain appropriate records as evidence in the event of a future audit.

And to make the situation more complex, there are no ‘hard and fast’ rules on precisely what constitutes “evidence”. Fortunately, good business practice is once again on your side.

Clearly, your company is almost certain to keep detailed financial records of its expenses, invoices, payroll and transactions. The main addition required is that some form of time accounting (such as timesheets), while not universal, can be particularly helpful for identifying and proving costs associated with the R&D activities.

More widely, the types of documents that you would prepare and retain as part of good experimental process also serve to act as evidence of your R&D “core” and “supporting” activities.

Table 2 also suggests some forms of evidence that could be useful.

Overall, we recommend collating examples of this evidence in an “audit file” associated with your R&D claim for each year.

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## ACCESS RnD TAX SOLUTIONS PTY LTD

ABN 58 154 585 734

Level 16, 1 Market Street, Sydney NSW 2000 Australia

Tel: 61 (2) 9241 5900 Fax: 61 (2) 9241 5966 email: emdg@busgrant.com.au

**Table 2: Allocation of 'Typical' R&D Tasks, and Examples of Records & Evidence**

Activity	Allocation	Example Records / Evidence
Identify an industry need, research client(s) to determine requirements	Supporting	Emails, client specs, meeting notes
Research existing solutions, and document existing state of knowledge	Supporting	Literature reviews, patent searches, technology reviews, trade journals
Develop a hypothesis and experimental design, procedures and/or test methods	Supporting	Experimental procedures, project planning documents
Prepare, purchase and set-up equipment and materials for the experiment. Plant changeover (production environments).	Supporting	Invoices, timesheets Work orders, safety evaluations
Test the hypothesis via an experimental procedure	Core Activity	Timesheets (useful, not absolute) Invoices, emails, lab notes, photos & videos, samples and prototypes Collated data (eg Excel) Lab reports, meeting notes, internal reports
Collect data and evaluate results	Core Activity	
Refine or reject hypothesis, and continue iterative experimentation	Core Activity	
Prepare internal and/or external reports	Supporting	Published papers, client reports, patent applications
Management, oversight and administration	Supporting	Emails, meeting notes, timesheets, asset usage logs, management accounts

### Eligible R&D Expenses

Table 2 shows that any single project might have multiple core and supporting activities. However, it is not necessary to separate all of the R&D costs down to the level of each activity.

The best way to determine R&D costs is to start with the company's payroll, timesheets, Profit & Loss statement and general ledger. Labour is the most common driving factor for R&D.

#### Potentially Eligible Activity Expenses\*

- Direct R&D and total Payroll - including wages, superannuation, contractual entitlements (eg motor vehicle, LAHFA), payroll tax, workers compensation insurance.
- Direct R&D contractor costs.
- Consumables, minor equipment and other costs directly for core R&D activity.
- A proportion of payroll for management &

administration.

- A proportion of site overheads, such as rent, outgoings, electricity, cleaning.
- A proportion of general office overheads, such as computer equipment, telephone, internet, certain insurances, bookkeeping.
- A proportion of depreciation on assets used for core R&D.
- A proportion of travel directly related to R&D.
- A proportion of recruitment and training costs for R&D staff.
- A proportion of memberships and subscriptions, such as to industry associations, scientific databases, industry journals.
- BUT NOT: R&D conducted overseas (except via an "Overseas Finding").
- AND NOT: Directors fees, legal/accounting fees, interest (as example on hire purchase), staff amenities, fines, patenting costs, marketing.

Supporting activity expenses can only be claimed if they were "directly related to" core R&D, or for the proportion of the supporting activity expense that was "for the dominant purpose of" the core R&D.

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## Claiming Your Entitlements – The Process

Step 1: Register your R&D with AusIndustry. This needs to be submitted within 10 months of the end of the reporting year.

A specific electronic 'SmartForm' is obtained from the AusIndustry web site. This includes:

- information about the company (including employee, revenue and export data);
- text descriptions of the company's project(s), including overview, new knowledge, core and supporting activities; and
- total costs for core activities and supporting activities for each project

After submitting the form electronically, AusIndustry should respond with a registration number in 1-4 weeks (depending on time of year).

AusIndustry will then provide a unique registration number for your R&D. This, and the financial data, are used to complete an ATO Tax Schedule form, which is included as part of your company's normal tax return. Your refund (if you are due one) should take 2-6 weeks, as normal.

## Summary

The R&D Tax Incentive programme has been established by AusIndustry and the ATO with the aim of helping more businesses do R&D and innovate. The programme is open to firms of all sizes in all sectors who are conducting eligible R&D.

Most importantly, the new R&D Tax Incentive represents a clear improvement over the former *R&D Tax Concession*. Now that it has had a full year for both industry and the regulators to develop some experience, the particular complexities of implementation are much better understood by all of the participants.

Overall, the R&D Tax Incentive is much better suited to the 'natural' business practices of scientific companies performing experimentally-based R&D. Much of the required reporting, documentation and evidentiary processes should follow along the same lines that most companies would have already adopted. One of the few major differences to common practices is a greater emphasis on the identification and documentation of the "**new knowledge**" component of a company's R&D project.

However, as with any Government funding programme, there is always a certain degree of complexity in the detail of implementation. A registered tax agent specialising in the R&D Tax Incentive can help ensure that your SmartForm complies with AusIndustry's best practice, and can help identify your full suite of R&D expenses for your claim.

You can learn more from AusIndustry: [www.ausindustry.gov.au](http://www.ausindustry.gov.au), or feel free to contact us for a free assessment of your R&D status.

## Using a Registered Tax Agent

AusIndustry provides support for companies to prepare their own SmartForms. However, it has also stated (May 2013) that it uses automatic algorithms to conduct an initial review of R&D Tax Incentive claims, conducting "Level 1" audits on claims that trigger certain criteria.

Quite simply, it is still a Government programme, and that means at least a degree of complexity.

A specialist tax agent can help ensure that your SmartForm complies with AusIndustry's best practice. Our role is to:

- Understand your R&D, and to advise you on the identification, allocation, and description of your R&D in a form that AusIndustry should recognise and understand;
- Ascertain and/or advise on the calculation of eligible R&D expenditures, both core and supporting;
- Prepare and lodge your completed SmartForm;
- Prepare the ATO Tax Schedule for you;
- Represent your company in your dealings with AusIndustry and the ATO in relation to your R&D claim.