What Does the Government's Focus on Innovation Mean For CRCs & R&D?

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Topics

- Background
  - Government Review Findings
- R&D tax incentive overview – Basic Framework
  - Who can claim
  - Activities
  - Expenditure
- Applicability to CRCs
- Spinning out IP & impact of incentives.
- Early Stage Investor Tax Credit

Recent Reviews

The Government's focus on Innovation provides opportunities for CRCs. Recent reviews highlight challenges & opportunities.

- ISR System Review from Feb 2016 found:
  - Knowledge creation above average but knowledge transfer below average
  - Knowledge application does not match knowledge creation
- How to improve knowledge transfer and application?
  - Increased collaboration with industry through research services
  - Licensing IP to commercialise
  - Spinning out IP to commercialise

Recent Reviews

In addition to the ISR Review, the Ferris, Finkel, Fraser Review of R&D tax Incentive:

- Also highlighted need to focus of collaboration between research and industry.
- **Recommendation 2** - *Introduce a collaboration premium of up to 20 % for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations. The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment.*
- No recommendations from this review were taken up in Budget – the Government’s response is still pending.

Government’s Innovation Assistance

So how can the Government’s existing innovation Programs help to improve collaboration between CRC and industry?

There any many Government innovation programs; Industry Growth Centres, Accelerating Commercialisation Programs, Overseas Landing Pads

The two we are focusing on today to encourage knowledge transfer & application are:

- The R&D Tax Incentive – the key program for businesses engaging in R&D activities
- The Early Stage Investor Tax Credit – a new tax incentive to encourage investment in innovative entities

CRCs can leverage these incentives to encourage collaboration with industry and to facilitate the spinning out of IP.

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Basic Framework

- Two tiered benefit for companies
  - A 43.5 cent R&D offset for eligible entities with a turnover of less than $20 million, refundable if the entity is in a tax loss position.
  - A non-refundable 38.5 cent R&D offset for eligible entities with a turnover of greater than $20 million on all eligible expenditure on eligible R&D activities.

Eligible R&D activities include:

  - Core activities, experimental activities; and
  - Supporting activities, activities which are conducted to support the core activities.
- Eligible R&D activities must be registered with AusIndustry within 10 months of the end of the R&D entity's financial year;
- The R&D tax offset is claimed income tax return.

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Basic Framework – who can claim?

- Eligible entity to claim is a company – not an individual, partnership or trust
- Must be a tax paying entity.
- To be eligible to claim the entity needs satisfy the "For" test in relation to who the activities are conducted for.
- Three limb test:
  - Bears the financial burden
  - Controls R&D activities
  - Has *effective* ownership of IP – ie leverage benefits from the results

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Eligible activities – Core Activities

Core R&D activities are experimental activities:

- whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:
  - is based on principals of established science; and
  - proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusion; and
- that are conducted for the purpose of acquiring new knowledge (including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services).

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Eligible activities – Supporting activities

Supporting activities are:

- Activities directly related to the core activities; or
- Where the activity is listed on the exclusions list, the activities must be for the dominant purpose of supporting the core R&D
- The Exclusions lists includes, among other things:
    - Market research,
    - Management studies or efficiency surveys;
    - Commercial, legal and administrative aspects of patenting or licensing;
    - Complying with statutory requirements or standards
    - Software developed purely for internal administration
- Again it is important to document the supporting activity's relationship to the core activity and why you are undertaking it

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Eligible Expenditure

Costing of R&D expenditure

- Internal salary based on hours spent on eligible R&D activities - use existing job & time tracking system if possible – need to be able to substantiate R&D hours (& therefore cost)
- Sub-contractor costs may be eligible but must have clear a link to the activities (experimental or supporting)
- ***Payments to CRC's or Research Institutes if on eligible activities***.
- Direct costs relating to R&D activities - consumables
- Percentage of overheads relating to R&D
- Depreciation of assets used wholly or partly for R&D activities

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Ineligible Expenditure

- Core technology costs – licenses or buying technology upon which the experimental activity is based.
- Ordinary business expenditure
  - Sales and marketing
  - ASIC and other fees
- Compliance costs
- Exclusions for building and construction costs.
- Expenditure not at risk
- In-kind contributions

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Applicability to CRCs

Participants to CRC

- CRCs are tax exempt entities and therefore will not be claiming the R&D tax incentive, however, under certain circumstances the CRC's tax paying participants contributions may be eligible and participants may wish to claim

Business contracted R&D to the CRC

- For businesses contracting CRCs to do R&D the payments made to CRC can be eligible for the R&D tax incentive. However they are still required to substantiate R&D activities

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Information required to claim

Claimants need to substantiate the experimentation with supporting documentation that establishes the technology gap being addressed and details of the experiments conducted.

Thus they will potentially need information from the CRC related to the financial year that they are claiming including:

- the hypothesis – the technical variables that are being tested
- the experiments conducted,
- the outcome of those experiments, and
- the breakdown between the core and supporting activities.

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Spinning out IP

- CRC may spin out IP into a tax paying entity (R&D entity).
- R&D activities are now conducted in the new R&D entity
- The new R&D entity, as a tax paying company, is an eligible entity and, if conducting eligible activities, can claim the R&D tax incentive.
- However, can the new entity eligible to claim the 43.5% refundable tax credit or must it claim the 38.5% non-refundable tax credit?
- Although the R&D entity turnover may be below $20 million the ability to claim the 43.5% will depend upon the ownership structure and the resultant aggregate turnover threshold tests.

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Spinning out IP

Aggregated turnover test

- Sum of annual turnover for all of the R&D entity, any connected and affiliated entities
- Connected entity Rules – if the shareholder has greater than 40% ownership requires aggregation

Tax exempt Entity Ownership rules –

- Connected Entity rules, but adopt 50% as the control percentage, instead of 40%.
- If the CRC holds greater than 50% of the R&D entity when it is spun the R&D entity will only be able to claim the 38.5% non-refundable tax credit

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Structuring a spin out

- Examples of impact of Aggregate Turnover
  1. One shareholder owns more than 40% of shares in the R&D entity, therefore shareholder's turnover would need to be aggregated with the R&D entity's
  2. Several unrelated shareholders with individual holdings of less than 40% each in the R&D entity but a together combined shareholding is greater than 40%. No need to be aggregated
  3. There are several *potentially* related parties with shareholdings in the R&D entity that individually are less than 40% but if combined will result in a shareholding of greater than 40%. These parties may be required to aggregate their turnover with the R&D entity depending upon the degree of affiliation or connection between these related parties (Connected Entity rules).

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Early Stage Investor Tax Credit

- Available on purchases new shares in a "Early Stage Innovation Company".
- The ESITC provides eligible investors with a:
  - **20% tax credit** - to a maximum per year of $200,000 (ie $1 million investment) for "sophisticated investor" or $10,000 (ie $50,000 investment) for investors who don't meet the sophisticated investor test.
  - **Modified capital gains tax (CGT) treatment** - capital gains on qualifying shares that are continuously held for at least 12 month and less than 10 years may be disregarded. (Capital losses on shares held less than 10 years must be disregarded).

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Early Stage Investor Tax Credit

Early Stage Innovation Company

- **Early Stage** - determined against criteria related to expenditure, assessable income, stock exchange listing and incorporation.
- **Involved in innovation** - determined by allowing the company to self-assess against either:
  - principles-based test or
  - A 100 points-based gateway test
- Alternatively an ESIC can apply for a determination from the Australian Tax Office.

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Early Stage Investor Tax Credit

Relevance to CRC and spin out R&D entities

- R&D entity likely to be able to satisfy the 100 point test to be an Early Stage Innovation Company
- May be desirable to encourage a broader range of potential investors in the R&D entity.
- Result could assist the shareholding structure vis-a-vis the aggregated turnover requirements to be eligible for the refundable tax credit.

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AusIndustry Guidance on activities

- Fact sheets
  - Guide to the R&D tax incentive
- Industry specific guidance, for example:
  - Biotechnology
  - Energy Sector
- Specific Issue guidance for following sectors:
  - Software
  - Building and Construction
  - Farming
  - Mining

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ATO Guidance

- R&D record keeping & apportionment methods
- Taxpayer Alert 2017/3 – Claiming R&D for ordinary business expenditure
- Taxpayer Alert 2017/5 – Claiming R&D for software development activities

Guidance available on:

AusIndustry website www.business.gov.au

ATO website www.ato.gov.au