



Heads Up

Presentation of Research & Development (R&D) tax offset

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“In summary”

- The R&D Tax Offset, also known as the R&D Tax Incentive, replaced the R&D Tax Concession for research and development expenditure incurred in income years commencing on or after 1 July 2011. It provides for a 45% refundable tax offset for eligible R&D entities with an aggregated turnover of less than \$20 million per annum that are not controlled by exempt entities (refundable R&D credit); or a non-refundable 40% tax offset for all other eligible companies
- For financial reporting purposes, the R&D tax offset can be analogised as a government grant or an income tax, although the interpretation of accounting standards varies among accounting professionals and in determining an accounting policy an entity should consult with its auditor
- General practice is that refundable R&D credits are accounted for as government grants
- For a non-refundable 40% R&D tax offset accounted for as a government grant two alternative practices have emerged. Firstly, that only the incremental tax credit of 10% in excess of the corporate income tax rate of 30% is recognised as a government grant with the balance accounted for as income tax; and a second, alternative view, that the entire offset can be accounted for as a government grant
- To the extent that government grant accounting is applied, a credit will be recognised in profit before tax over the periods necessary to match the benefit of the credit with the costs for which it is intended to compensate
- If analogised as an income tax, a credit will be recognised within tax expense and a tax asset recorded when the entity satisfies the criteria to receive the credit. This accounting is expected to be the prevailing practice in Australia for the non-refundable R&D tax offset.

Background

The key technical tax issues to be aware of in this calculation of the R&D tax credit are as follows:

- Eligible R&D expenditure is not deductible for tax purposes (and the total amount will need to be added back to profit before tax in arriving at taxable income)
- Instead an R&D tax offset can be claimed after the basic income tax liability has been calculated as follows:
 1. Clients with an aggregated annual turnover of less than \$20m will be entitled to a tax offset equal to 45% of the eligible R&D expenditure. Any excess offsets will be refundable (on a quarterly basis from 1 January 2014) but this refund will be treated as a refund of income tax. Although a franking debit will not arise, the refund amount will absorb franking credits that arise on the payment of income tax in the future until the refund amount is exhausted.
 2. Clients with an aggregated annual turnover of \$20m or more will be entitled to a tax offset equal to 40% of the eligible R&D expenditure. Any excess offsets can be carried forward to future income years and utilised subject to satisfying the “continuity of ownership test” or the “same business test”. Like tax losses, such carry forward amounts may also be absorbed by the presence of any net exempt income.
- The R&D tax offset is used after franking credits and foreign income tax offsets but before franking deficit tax offsets. If there are both carry forward and current year amounts in a category, they are used on a FIFO basis.
- It is possible that there may be a claw-back of the additional tax benefit in future income years since:
 1. Assessable income can be increased where an R&D tax offset was claimed for certain expenditures on R&D activities which produced tangible products that are sold or supplied to another entity or have a market value and are used by the entity itself (known as feedstock adjustments), and
 2. An additional tax of 10% can be payable where the entity is entitled to or receives a government grant where the R&D tax offset has also been claimed (the tax may be payable even if in a tax loss position where there are no tax offsets to shelter the tax payable).

Guidance in Accounting Standards

AASB 112 *Income Taxes* does not deal with the methods of accounting for investment tax credits, but it does address the temporary differences that may arise from such grants or investment tax credits.

Although the accounting standards do not define ‘investment tax credits’, tax credits which are outside the scope of AASB 112 generally provide a reduction to taxes payable and can be distinguished from a tax deduction (which is within the scope of AASB 112) which is factored into the determination of taxable income. Despite being outside the scope of AASB 112, entities often analogise to the principles of AASB 112 when developing relevant accounting policies for accounting for investment tax credits.

AASB 120 *Accounting for Government Grants* also excludes from its scope investment tax credits. Tax credits can be viewed as Government assistance that is provided to an entity in the form of benefits that are available in determining taxable income or are determined or limited on the basis of income tax liability. Nevertheless,

despite their exclusion from scope, entities also analogise to the principles of AASB 120 when developing relevant accounting policies for investment tax credits.

When a tax credit is determined to be an investment tax credit and consequently outside the scope of AASB 112 and AASB 120, it is a matter of judgement under AASB 108 *Accounting Policies, Changes in Accounting Policies and Errors* to determine the most appropriate accounting treatment.

Presentation choices and impact on financial statements

In respect of the non-refundable tax offset there are three possible approaches for the accounting and presentation of the R&D tax credit:

1. Income tax approach (AASB 112) - the tax incentive reduces the tax liability of the entity, and AASB 112 is applied by analogy. Applying AASB 112, the tax benefit is presented within the tax line (below EBIT) in the Statement of Comprehensive Income
2. Government Grant approach (AASB 120) - a credit will be recognised in profit before tax (in EBIT) over the periods necessary to match the benefit of the credit with the costs for which it is intended to compensate. Such periods will depend on whether the R&D costs are capitalised or expensed as incurred.
3. Split approach (AASB 112/120) - recognise the 30% incentive (that corresponds to the corporate tax rate) in tax expense by AASB 112 analogy; and the incremental portion (10% in the case of the 40% incentive) as a form of government grant. The portion recognised under AASB 112 is presented within the tax expense (below EBIT) and the portion recognised under AASB 120 is presented in profit before tax (in EBIT).

As illustrated below, the accounting policy selected can impact both earnings before tax and the effective tax rate.

Illustrative example

The following examples illustrate the impacts of the above options for non-refundable R&D tax offset where the entity has expensed its R&D costs and it is assumed that the entity is generating taxable income.

Income Tax approach (AASB 112) (assumes R&D expense is not capitalised)			Government Grant approach (AASB 120) (assumes R&D expense is not capitalised)			Split approach (AASB 112/AASB120) (assumes R&D expense is not capitalised)		
Gross margin		100	Gross margin		100	Gross margin		100
Expenses (excluding R&D)		(30)	Expenses (excluding R&D)		(30)	Expenses (excluding R&D)		(30)
	[C]	70		[C]	70		[C]	70
R&D Expense	[A]	(20)	R&D Expense	[A]	(20)	R&D Expense	[A]	(20)
	[B]	50		[B]	50		[B]	50
EBIT		50	EBIT		58	EBIT		52
Tax (30% x [C])		(21)	Tax (30% x [C])		(21)	Tax (30% x [C])		(21)
R&D Tax Benefit (40% x [A])		8	R&D Tax Benefit (40% x [A])		8	R&D Tax Benefit (10% x [A])		2
Profit after tax		37	Profit after tax		37	Profit after tax		37
effective tax rate		26%	effective tax rate		36%	effective tax rate		29%

Other considerations

As the accounting for non-refundable R&D tax offset is an accounting policy choice the entity should consider disclosing this accounting policy choice in accordance with paragraphs 117 and 119 of AASB 101 *Presentation of Financial Statements*. This assessment may be impacted by the materiality of the R&D tax offset. If the accounting policy selected is a change to existing practice the entity should consider whether its new accounting policy provides information that is more relevant and reliable to the users of its financial statements. Should the entity change its accounting policy comparative financial statements will need to be restated to reflect this change in accounting policy. The entity should also consider whether any restatement needs to be reflected in other financial information provided by the entity, for example financial information presented to investors in investor presentations.

Furthermore, if government grant accounting is adopted, either the full government grant election or the split method, the entity will need to consider its accounting policy under AASB 120 for the tax benefit recognised as a government grant as AASB 120 allows for-profit entities a choice of accounting policy under AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance*. This accounting may also be impacted by the whether R&D expenses are capitalised in accordance with AASB 138 *Intangible Assets* or expensed as incurred. If R&D expenses are capitalised the entity can either account for the tax benefit as deferred income that is recognised in EBIT on a systematic basis over the useful life of the asset, or through adjustment to the carrying value of the asset which is therefore effectively recognised in EBIT through a reduced amortisation charge over the life of the asset. The entity should consider its existing accounting policy choice for government grants if

appropriate. If only part of R&D expenditure incurred is capitalised in additional tracking of the release of the tax benefit may be required which may result in an additional reporting burden.

Where the R&D offset is to be accounted for under AASB 112, any excess will be carried forward representing a deferred tax asset (DTA) which will be subject to the normal recognition criteria for deferred tax assets arising from unused tax credits within AASB 112 which requires an assessment that it will be probable that future taxable profit will be available against which the unused tax credit can be utilised. This assessment should take into consideration other tax losses available for utilisation and should be reassessed at each financial reporting date.

Additional considerations which may be appropriate when accounting by analogy to AASB 112 include those in respect of potential feedstock adjustments and those arising in the event that additional tax at 10% may be payable in the event of receipt of other government grants. There may be future taxable income where a feedstock adjustment applies across multiple income years. This can be deferred when there are tax losses. Consideration will need to be given to whether the benefit of a current R&D offset should be booked when it is expected that there will be a future feedstock adjustment or whether the transaction giving rise to the obligation for the additional tax is the earning of the feedstock revenue and should not be anticipated. A tax at the rate of 10% on entitlement to related government grants may arise after the basic income tax liability has been calculated, and can be payable in cash even if the entity is in a tax loss situation. Consideration will need to be given to whether the benefit of an R&D tax offset should be booked when it is expected that future government grants will result in a claw back of the offset or whether the tax consequence of the government grant should only be recognised when the government grant itself is recognised

Where the R&D offset is accounted for by analogy to AASB 120 an assessment will likewise be required as to whether there is a reasonable expectation that the entity will be able to realise the benefit being recognised as a government grant. To the extent that this assessment changes amounts recognised as benefits may need to be reversed.

Management will also need to consider the extent to which the accounting policy selected may have follow on consequences, for example impacting EBIT measures which may be used for employee remunerations purposes or in respect of banking covenants.

Disclosure

Entities with a significant level of additional R&D activities and future feedstock adjustments should consider disclosing in their financial statements:

- The chosen accounting policy
- The amount of the additional tax benefit recognised in any particular period
- Any significant judgments made, e.g. whether or not there are likely to be any claw backs of the tax benefits claimed in future income years.

How Deloitte can help

Please contact one of the experts below to see how we can help you:



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