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RESEARCH & DEVELOPMENT

ELIGIBLE VERSUS INELIGIBLE EXPENSES



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ELIGIBLE EXPENDITURE UNDER THE R&D TAX INCENTIVE

If you are an R&D entity your notional deductions may be for:

- Expenditure incurred on R&D activities, including expenditure on overseas activities covered by an advance finding from Innovation Australia, amounts paid to associates and expenditure to an RSP.
- The decline in value of assets used for conducting R&D activities (including R&D partnership assets).
- Balancing adjustments for assets used only for conducting R&D activities (including R&D partnership assets).
- Expenditure in relation to goods and materials transformed or processed during R&D activities to produce marketable products (feedstock expenditure)
- Monetary contributions under the CRC program.

You are entitled to a notional R&D deduction in relation to expenditure described above to the extent that:

- Your expenditure is of a kind eligible for the R&D tax incentive.
- You incur expenditure during the income year (other than an amount you incur to an associate but do not pay until a later income year) on one or more registered R&D activities.

As a result, the general rule is that expenditure on R&D activities is claimable in the income year it is incurred. The exceptions to this rule are when:

- An amount of expenditure is incurred but not paid to an associate.
- The prepayment rules apply in relation to expenditure for services to be provided over a period.

Your entitlement to a notional deduction for 'expenditure incurred' does not arise until you are registered for the income year in which the related R&D activities are conducted.

However, the year of registration does not, of itself, affect the income year for which you are entitled to a notional deduction.

Once registration occurs, the entitlement to the R&D tax incentive is for the income year in which the expenditure is incurred, subject to the associate and prepayment rules referred to above.

EXPENDITURE INCURRED ON R&D ACTIVITIES

To claim the R&D tax incentive your total notional deductions must be greater than \$20,000 (unless the expenditure is incurred to an RSP or is a monetary contribution to a CRC under the CRC program).

[Subsection 355-205\(1\)](#) of the ITAA 1997 provides the legal basis for when notional deductions for R&D expenditure arise. It says:

An R&D entity can deduct for an income year (the present year) expenditure it incurs during that year to the extent that the expenditure:

- (a) is incurred on one or more R&D activities:(i) for which the R&D entity is registered under [section 27A](#) of the Industry Research and Development Act 1986 for an income year; and(ii) that are activities to which [section 355-210](#) (conditions for R&D activities) applies;



- (b) if the expenditure is incurred to the R&D entity's associate – is paid to that associate during the present year.

Expenditure you incur in relation to [subsection 355-205\(1\)](#) could therefore fall into these broad categories:

- Contract expenditure you incur to an RSP.
- Expenditure you incur under contract to other parties.
- Salary expenditure for people employed by your company.
- Other R&D expenditure.
- Expenditure on overseas activities.
- R&D expenditure paid to your associate in your claim year, unless already claimed under another provision in the year the amount was incurred.

In general, R&D expenditure consists of amounts incurred on core R&D activities and supporting R&D activities.

See also:

- [business.gov.au](#) for information about core R&D activities and supporting R&D activities.

CONTRACT EXPENDITURE YOU INCUR TO AN RSP

A Registered Service Provider (RSP) is an organisation that is registered by Innovation Australia under section 29A of the IR&D Act as an RSP. It has appropriate scientific or technical expertise and resources to perform research and development on behalf of companies.

Expenditure on R&D activities you incur to an RSP, where that RSP isn't an associate of the R&D entity, is not subject to the \$20,000 notional deduction threshold (if the services on those activities are in a research field for which the RSP is registered under the IR&D Act). This means that you can claim an R&D tax offset for this type of expenditure, regardless of the amount you have incurred.

While it is possible for an RSP to perform R&D services through an agent the RSP will not be considered to perform such services where it does not choose the agent, supervise performance of the services and take responsibility to the R&D entity for the agent's performance of the services. In such a case the payments would not be expenditure to an RSP and will be subject to the \$20,000 notional deduction threshold.

You are not limited to contracting out your R&D activities to an RSP. You may contract out some, or all, of your R&D activities to any person, company or other body, but if you do so, and this other entity is not an RSP, the expenditure incurred will be subject to the \$20,000 expenditure threshold.

Some RSPs have been established to carry out activities, including R&D activities that are solely related to particular industries. Where a levy is imposed on industry members as a means



of raising the funds to support its various activities, the levy payments incurred by members who are R&D entities may qualify for a notional deduction to the extent that the moneys are expended on eligible R&D activities (as defined in [section 355-20](#) of the ITAA 1997) for the members.

It is up to you (in consultation with the RSP) to determine the extent to which your payments have been expended on R&D activities. This may include asking your RSP for a breakdown of R&D and non-R&D activities (and related expenditure) to assist you in your determination.

In some instances, an RSP's R&D activities are also supported by government grants. Because those grants are received by the RSP and not the member companies, [Subdivision 355-C](#) of the ITAA 1997 would not ordinarily apply to impose an extra income tax on the portion of the recoupment (which includes a grant) that relates to notional deductions claimed by the member.

A key issue for R&D entities who make voluntary contributions or levy payments is the requirement that the R&D activities must be conducted for itself. As R&D activities funded from voluntary contributions or levy payments are invariably contracted to another party, you must show that you:

- Bear the financial risk associated with the R&D
- Have control over the R&D projects/activities
- Effectively own the project results.

Consider whether or not you receive the major benefit from your expenditure to an RSP. Further information on determining who receives the major benefit from the R&D activities is available from: [For whom are the R&D activities conducted?](#)

In addition, the voluntary contributions or levies may only be notionally deducted under the R&D tax incentive to the extent that they relate to expenditure on eligible R&D activities. Where the voluntary contribution or levy is wholly for R&D activities as defined in the legislation, this may not be an issue. However, levies frequently support other activities, such as marketing, best practice projects and quality assurance. Where this occurs, the eligible expenditure must be apportioned.

Eligible companies may seek a private ruling from us to clarify their tax position. Your RSP may also apply for a class ruling from us to provide certainty for its members.

EXPENDITURE YOU INCUR UNDER CONTRACT TO OTHER PARTIES

This type of R&D expenditure covers any eligible expenditure on R&D activities incurred under a contract to another party (other than an RSP). You cannot claim this type of expenditure on R&D activities unless your total notional deduction amount is at least \$20,000. Contract expenditure may include contracts for:

- Labour hire
- Provision of services
- Consultants working on R&D activities.

The contracts should show the nature of the work and its relation to your R&D activities. However, you may need to keep further records to show how work under the contract relates to your R&D activities. Although not exclusive, this may include:



- Minutes of any meetings between yourself and the contractor
- Progress reports from the contractor for the R&D activities.

To adequately establish the relationship between your R&D activities and the expenditure you have incurred under the contract, the Commissioner may need to look through the contract to establish the extent of the work done by the contractor on your behalf, particularly where you are not contracting at arm's length. You must keep sufficient records for this purpose.

If you have entered into a contract with your associate, you are only eligible to claim the amount incurred as a notional R&D deduction at the time that the amount is paid.

An R&D entity is only entitled to a notional deduction for R&D activities that are conducted 'for' itself. Consider whether or not you receive the major benefit from your expenditure under each contract.

See also:

[*•For whom are the R&D activities conducted?*](#)

SALARY EXPENDITURE

This type of R&D expenditure includes expenditure to the extent that it is incurred on eligible R&D activities for those of your employees engaged directly in carrying out an eligible R&D activity. The expenditure may consist of:

- salaries
- wages
- allowances
- bonuses
- overtime and penalty rate payments
- annual, sick and long service leave
- superannuation fund contributions (which are otherwise deductible under [section 290-60](#) of the ITAA 1997)
- payroll tax and workers compensation insurance premiums.

The relevant employees may include:

- researchers undertaking the conception and/or creation of new knowledge and products
- employees undertaking technical tasks in support of the R&D activities, such as persons keeping records, preparing charts and graphs, operating equipment and writing computer programs
- supervisors of researchers and technical staff.

In addition, salary expenditure may also be deductible expenditure incurred by an R&D entity to provide benefits (including fringe benefits) in lieu of paying such employees a cash salary because of an eligible salary sacrifice arrangement.



Where only part of your expenditure is on the relevant R&D activities, apportionment is necessary. You should keep appropriate records, such as time sheets or job cards, to demonstrate the extent to which an employee's services are on eligible R&D activities. Claims for salary expenditure should be based on actual expenditure and not upon standard salary rates developed for internal costing purposes.

Salaries (and on costs) of support staff, for instance, general supervisors or administrative staff, who do not actually conduct the R&D activities, should not be included in the R&D tax incentive schedule as salary expenditure. If you determine that this expenditure was incurred on R&D activities, a portion of this expenditure may qualify as other expenditure (see also the section on Other R&D expenditure) depending on the extent to which the expenditure was on the R&D activities conducted.

Expenditure must be incurred before it may be claimed as a notional R&D deduction.

If you have incurred salary expenditure to your associate, you are only eligible to claim the amount incurred as a notional R&D deduction at the time that the amount is paid.

The salaries (and on costs) of your employees whose only connection with R&D activities is clearly indirect – for example, management staff who recruit other company employees for general duties not necessarily related to R&D activities – would not qualify as R&D expenditure.

Some types of salary expenditure incurred on the construction of depreciating assets, structural improvements or buildings are not eligible to be notionally deducted under the R&D tax incentive due to specific exclusions in section 355-225 of the ITAA 1997.

Apportionment

Expenditure on salaries, wages, bonuses, overtime and penalty rate payments is salary expenditure to the extent that it is incurred on R&D activities. Expenditure on annual, sick and long service leave or superannuation contributions is deductible in the proportion that reflects the extent to which your employee was engaged in R&D activities in the year.

Where your employee performs other activities in addition to work on eligible R&D projects, you must apportion that employee's salary amount between the extent to which it was incurred on R&D and non-R&D activities. You must keep appropriate records, such as timesheets, job cards or diaries, so you can demonstrate the amount of time spent on R&D activities.





Superannuation fund contributions

Superannuation fund contributions must first meet all legislative requirements to be generally deductible under [section 290-60](#) of the ITAA 1997 before they can be notionally deducted as R&D expenditure.

Deductible contributions to a superannuation fund must be clearly identifiable from staff records and the relevant amounts added to the amount of R&D salary expenditure.

Workers' compensation insurance and payroll tax

Premiums for workers' compensation insurance and payroll tax are salary expenditure to the extent they are considered to be incurred on R&D activities, taking into account the amounts deductible as salary expenditure for salaries and leave, and the total expenditures on these amounts, and other matters that are relevant. Such other matters would include any payroll tax exemptions or concessions available to the company.

Similarly, in the case of worker's compensation premiums, any increased or decreased rate of premiums applicable to the employees carrying out the company's R&D activities would be taken into account in determining the deductible expenditure. Where payroll tax and workers' compensation premiums paid for R&D staff are known, the amounts should be added to the amount of R&D salary expenditure.

However, if the amounts cannot be separately identified, you will need to determine a reasonable basis of apportionment when calculating your claim.

OTHER R&D EXPENDITURE

You may incur a number of administrative costs and overheads as a result of conducting R&D activities and employing R&D staff. For example, you may have overheads, such as rent, light and power, property rates and taxes, cleaning and certain types of insurance, to the extent they are expenditure incurred on eligible R&D activities.

The expenses which you can claim as R&D expenditure are limited to the extent they are incurred on R&D activities. The type of expenditure that qualifies for a notional deduction under [Division 355](#) of the ITAA 1997 depends on the facts of each particular case. Administrative costs and overheads may be incurred on R&D activities where there is a direct link between the R&D activities and the expenditure incurred.

INELIGIBLE EXPENSES

Ineligible expenses are those without sufficient link to the R&D activities, particularly where they relate to general company operating or marketing expenditure that would be incurred regardless of the R&D activities.

These ineligible expenses could include:

- advertising (for instance, of a company's product)
- audit fees
- bad debts
- company establishment and other fees incurred under the companies code in relation to the administration of the company
- costs incurred in preparing taxation returns
- decline in value of a depreciating asset
- directors' fees
- distribution and selling expenses
- donations
- employee benefits such as canteen and recreational facilities



- entertainment expenses
- grounds and garden maintenance costs
- insurance premiums on matters unrelated
- to R&D such as loss of profits and product liability
- legal expenses not associated with any approved research project, for example, legal expenses for a patent search before undertaking a research project or in taking out a patent after a successful project
- patents and trademarks in marketing a new product or technology, or as a result of R&D activity
- rent paid for premises that are not used in R&D activities
- salaries, associated costs and on-costs of support staff not linked with R&D activities and of staff employed in areas such as distribution, sales, marketing and debt collection

In addition to those expenses listed above, certain expenditure is specifically excluded under [section 355-225](#) of the ITAA 1997 from being eligible for a notional deduction.

LEASED PLANT AND BUILDINGS

Rent or lease payments for equipment or buildings used in your R&D activities would constitute R&D expenditure. Such equipment or buildings need not be used exclusively in your R&D activities, but if the use is not exclusive, the expenditure would only qualify for notional deduction to the extent that it is on R&D activities. You must determine a reasonable basis of apportionment which produces an allocation of expenditure to R&D activities with a reasonable degree of accuracy.

Where you use leased equipment or buildings to carry out R&D activities for yourself, as well as for other persons, the proportion of the relevant lease payments incurred on your own R&D activities would potentially qualify for a notional deduction under [Division 355](#) of the ITAA 1997.

ACCOUNTANTS' AND CONSULTANTS' FEES

Whether expenditure incurred on accountant's and consultant's fees is notionally deductible under [Division 355](#) of the ITAA 1997 depends upon whether:

- the activities associated with the work undertaken by the accountant and/or consultant, to which the fee relates, are R&D activities
- the extent to which the expenditure was incurred on those R&D activities.

Generally, activities associated with work by accountants and consultants are ineligible activities under the R&D tax incentive. Such ineligible activities include:

- the activities associated with the work undertaken by the accountant and/or consultant, to which the fee relates, are R&D activities
- the extent to which the expenditure was incurred on those R&D activities.

Where an activity is considered an R&D activity, such activities must be registered with Innovation Australia.

Expenditure incurred on R&D activities is notionally deductible under [section 355-205](#) of the ITAA 1997.

Tax related expenses incurred for the management of a company's tax affairs may be deductible under [section 25-5](#) of the ITAA 1997. Eligibility of R&D activities is determined by Innovation Australia and should not be confused with eligible expenditure, which is determined by us.



EXPENDITURE ON OVERSEAS ACTIVITIES

To claim a notional deduction for overseas R&D activities under [Division 355](#) of the ITAA 1997 you must first get a positive overseas finding from Innovation Australia. [Sections 28C](#) and [28D](#) of the IR&D Act provide information on findings about activities to be conducted outside Australia, including conditions you must meet.

Overseas findings

You can only claim expenditure on an R&D activity carried out overseas if the activity is registered and is covered by a finding that it meets the following four conditions:

- the overseas activity is covered by an advance finding that the activities are eligible R&D activities
- the overseas activity has a significant scientific link to Australian core activities
- the overseas activity cannot be conducted in Australia or the external territories for a reason listed in the legislation
- the expenditure on the overseas activity and certain other overseas activities is less than the expenditure on the related core R&D activities and supporting R&D activities conducted in Australia.

An overseas finding is in force from the start of the income year in which the application is made.

Incidental expenditure on overseas activities

We will accept notional deductions of minor amounts of expenditure on overseas R&D activities as deductible without an overseas finding from Innovation Australia. The kind of expenditures accepted for this purpose are those on overseas R&D activities that are insignificant in the context of an Australian R&D project.

An example of incidental expenditure is expenditure incurred by an R&D entity in sending R&D staff overseas to observe techniques used in other countries or attend relevant seminars, where those activities are directly related to the company's core R&D activities in Australia, and the amount of the expenditure is very minor in relation to the total expenditure on those activities.

See also:

- [business.gov.au](https://www.business.gov.au) for more information about conducting R&D activities outside Australia





R&D EXPENDITURE PAID TO YOUR ASSOCIATE IN YOUR CLAIM YEAR

If you incur an amount of expenditure to an associate and you pay the amount in the same year, you can claim a notional deduction for that amount in that year (provided you meet all other eligibility requirements for the R&D tax incentive).

Paying an amount to an associate can include making a constructive payment. A constructive payment is where you apply or deal with the amount on their behalf or as they direct.

Therefore, in working out whether you have paid an amount to another entity, and when the payment is made, the amount is taken to be paid to the other entity when you apply or deal with the amount in any way on the other's behalf, or as the other directs.

In broad terms, associates are those entities which, by reason of family or business connections, might appropriately be regarded as being associates of a particular entity.

For the definition of 'associate', refer to [section 318](#) of the ITAA 1936.

Some examples of an associate of a company, other than a company in the capacity of trustee, include:

- a partner of the company or a partnership in which the company is a partner
- a trustee of a trust estate under which the company or associate benefits
- another entity (including a natural person) that, acting alone or with another entity or entities, sufficiently influences the company
- an entity (including a natural person) that, either alone or together with associates, holds a majority voting interest in the company
- a second company that is sufficiently influenced by the company or the company's associate
- a second company in which a majority voting interest is held by the company or the company's associate.

If you do not pay the amount until a later income year, you can choose to either:

- claim a deduction under the normal income tax provisions – for example, the general deduction provision, [section 8-1](#) of the ITAA 1997 – for the income year in which the amount was incurred.
- claim a notional R&D deduction in the year you make the payment.

You must make the choice by the time you lodge your income tax return for the most recent income year, before the income year in which you paid the amount. This choice cannot be reversed, for example, by later requesting an amendment of the assessment to disallow the deduction claimed.

An example of how the rules work in relation to amounts incurred to associates is provided in our fact sheet, [Expenditure incurred to an associate](#). This fact sheet also explains the terms 'sufficiently influence' and 'majority voting interest'.



DECLINE IN VALUE OF ASSETS USED FOR CONDUCTING R&D ACTIVITIES (DEPRECIATION)

You can notionally deduct the decline in value of a tangible depreciating asset used for R&D activities (if certain other conditions are satisfied, as outlined below).

If a balancing adjustment event later happens for the asset, you may be able to notionally deduct a further amount under [Division 355](#) or deduct a further amount under [Division 40](#) (depending on how the asset has been used). Alternatively you may need to include an amount in your assessable income.

R&D Partnerships

As a partner in an R&D partnership, you are entitled to a notional deduction for your proportion of the amount that the partnership would have been able to deduct under the depreciating asset provisions, provided the conditions listed below have been met.

Conditions to be met to claim a notional deduction for decline in value

To be eligible for an R&D notional deduction for a decline in value of a depreciating asset, you must be:

- registered for the income year in which you hold the asset for conducting R&D activities
- conducting your R&D activities in Australia (unless you have a positive overseas finding from Innovation Australia using the asset during the income year for conducting R&D activities)
- entitled to deduct an amount under the depreciating asset provisions ([Division 40](#)) if those provisions applied with certain changes.

Once an asset is pooled, its tax identity and its adjustable value are lost, and the asset can no longer be distinguished from other assets in the pool. As a result you cannot notionally deduct an amount if either:

- the asset has been pooled with other assets for working out deductions for depreciating assets
- you have allocated a depreciating asset to a low value pool or one of the small business pools after the R&D depreciating asset provisions have applied to the asset.

Relationship between R&D decline in value rules and R&D expenditure rules

The R&D decline in value rules apply to the exclusion of the R&D expenditure rules. Where you incur an amount of expenditure that is included in the cost of a depreciating asset working out any notional deduction for decline in value occurs under [Subdivision 355-E](#).





Your notional deduction in relation to this expenditure, and therefore the R&D tax offsets, is spread over the effective life of the assets.

Notional application of Division 40

Under the R&D tax incentive deductions for depreciating assets (as defined in [Division 40](#) of the ITAA 1997, but excluding intangible assets) used in carrying on R&D activities will be worked out under sections [355-305](#) and [355-310](#) of the ITAA 1997. These sections require that the amount allowable on the decline in value of those assets for the period of R&D use be calculated notionally under the rules set out in [Division 40](#) of the ITAA 1997, as applied with certain modifications.

Working out whether you would be entitled to deduct an amount under the depreciating asset provisions ([Division 40](#)) if those provisions were applied with certain changes, is called the 'Notional application of [Division 40](#)'. This notional application of Division 40 is for the purpose of working out the notional R&D deduction for the decline in the value of a depreciating asset and any balancing adjustment for a depreciating asset used only for R&D activities (and also amounts excluded from deduction as R&D expenditure).

The modifications made in notionally applying the [Division 40](#) decline in value rules to R&D assets require that:

- the asset be used for the purpose of carrying on R&D activities, rather than for a taxable purpose
- the same method of calculating depreciation and effective life be used as applied before the R&D use, if relevant.

Purpose of conducting R&D activities

The main change made to Division 40 in working out the notional Division 40 deduction is that references to a taxable purpose are replaced with references to the purpose of conducting one or more R&D activities. For balancing adjustment calculations, references to a taxable purpose are replaced with a reference to the purpose of conducting one or more of the R&D activities to which the R&D deductions relate. The object is to work out the notional Division 40 deduction based on its use for R&D activities.

Buildings and capital works other than buildings

The second change made to Division 40 in working out the notional Division 40 deduction is to assume that Division 40 does not apply to a building (or an extension, alteration or improvement to a building) for which you can deduct an amount under the capital works provisions in Division 43, or could have deducted an amount under Division 43, if you had started work before a particular date or used the building for R&D activities.





The object is to replace the rule in Division 40 that excludes capital works for which you can deduct amounts under Division 43. The result is that you can get a notional R&D deduction (and therefore, a tax offset) for the decline in value of capital works that are not buildings used in R&D activities.

'Uses' to ignore

In working out the notional deduction for decline in value of a depreciating asset, it is necessary to ignore 'uses' of the asset that would not satisfy the various conditions. In particular, it is necessary to ignore uses for R&D activities that:

- are not registered for the income year in which they were conducted
- do not meet conditions about where activities must be conducted
- do not satisfy the 'on own behalf' test

Effective life

The capital allowance rules in Division 40 of the ITAA 1997 allow you either to use the Commissioner's estimates of effective life for your depreciating assets, or to work it out yourself under the rules in Division 40. In working out the effective life of a depreciating asset, you must estimate the period that the asset can be used by an entity for one or more of these:

- a taxable purpose
- the purpose of producing exempt income or non-assessable non-exempt income
- the purpose of conducting R&D activities, assuming that this is reasonably likely.

This applies both for self-assessing effective life and for the Commissioner making a written determination of effective life.

Where it is reasonably likely that an asset will be used for the purpose of conducting R&D activities, it is also necessary to have regard to the period within which the asset is likely to be scrapped or abandoned, ensuring you disregard reasons attributable to technical risk in conducting R&D activities.

In the event that the technical risk in the R&D activities does in fact lead to the early scrapping of the plant, the balancing adjustment provisions ensure that the appropriate write-off is given.

No change in decline in value method

You generally have a choice of two methods - the prime cost method and the diminishing value method - in working out the decline in value of a depreciating asset. You cannot change methods. If an R&D entity has previously worked out actual deductions under Division 40 for an asset, it must use the same method in working notional deductions under Division 40, and vice versa.



R&D depreciating assets rules and the depreciation rules in Subdivision 328-D for small business entities

Division 328 provides certain concessions for small business entities (SBEs). If you meet certain eligibility requirements, you can take advantage of the simpler depreciation rules under Subdivision 328-D of the ITAA 1997. One of these rules is an immediate deduction for low cost assets (costing less than \$1,000) under [section 328-180](#) of the ITAA 1997.

SBEs generally calculate capital allowances under Subdivision 328-D instead of Division 40 of the ITAA 1997. However, subsection 328-175(9) says that you cannot deduct amounts for a depreciating asset for any period under Subdivision 328-D if you are entitled under section [355-100](#) to a tax offset for a notional deduction (under section [355-305](#)) for the asset for the same or an earlier period.

Subsection 355-310(4) of the ITAA 1997 says that to notionally apply Division 40 (to calculate the decline in value amount notionally deductible under the R&D tax incentive) you should assume that Subdivision 328-D has not been enacted. This means that low cost assets immediately deducted under 328-180 are not eligible for a notional deduction under the R&D tax incentive for their cost. However, if you choose not to use Subdivision 328-D for that asset, you can notionally deduct your decline in value amount calculated under Division 40 under the R&D tax incentive.

ASSETS USED FOR BOTH R&D ACTIVITIES AND NON-R&D ACTIVITIES

The notional deduction is reduced to the extent that the asset is used for a purpose other than R&D activities. The R&D entity may be entitled to an actual Division 40 deduction for that other use (for example, the other use is in carrying on a business for the purpose of producing assessable income).

BALANCING ADJUSTMENTS FOR ASSETS USED FOR CONDUCTING R&D ACTIVITIES

A notional R&D deduction for a balancing adjustment may be claimed where:

- an R&D entity has used a depreciating asset only for R&D activities
- it is or has been entitled to R&D decline in value deductions
- a balancing adjustment event happens (for example, the entity sells or scraps the asset)

This adjustment ensures your income tax position over time reflects the actual decline in value of the assets, rather than the estimates on which your decline in value deductions were based. When an asset is disposed of, its value at the time of disposal may vary from its adjustable value (which is the original cost of the asset less its decline in value). Where this occurs for a depreciating asset used to carry on R&D activities, the tax treatment for the profit or loss (balancing adjustment) derived on disposal must be determined.

Where a balancing loss is made (that is, the adjustable value exceeds the termination value), the loss is allowable as an additional deduction (and in some circumstances a notional R&D deduction) to the extent that the asset was used in deriving assessable income or conducting R&D activities over its life.



Similarly, where a balancing profit is made (that is the termination value exceeds the adjustable value), the profit is included in assessable income to the extent that the asset was used in deriving assessable income or conducting R&D activities over its life.

Example: Balancing adjustment

A new item of equipment costing \$1,000,000 is used during the year for a purpose described in subsection 40-25(7) of the ITAA 1997. Assuming that the effective life is 10 years, the decline in value allowable as a deduction for the year is calculated as follows:

$$\$1,000,000 \times (365/365) \times (100\%/10) = \$100,000$$

If the equipment is disposed of for the sum of \$850,000 at the end of the year, a balancing loss on disposal of \$50,000 is incurred, calculated as follows:

Cost			\$1,000,000
minus	decline in value	-	\$100,000
equals	adjustable value	=	\$900,000
minus	termination value	-	\$850,000
equals	balancing adjustment	(loss)	\$50,000

If the equipment had been disposed of for \$925,000 rather than \$850,000, a balancing adjustment profit of \$25,000 would have been made.

Where such a balancing adjustment occurs for an asset that has at some stage been used for R&D activities, a further adjustment may be required. The amount of this adjustment depends on whether or not the:

- asset is a dedicated R&D use asset
- company was otherwise entitled to claim the R&D tax offset in the year of disposal.

Where such a balancing adjustment occurs for an asset that has at some stage been used for R&D activities, a further adjustment may be required. The amount of this adjustment depends on whether or not the:

Balancing adjustments for assets used for conducting R&D activities			
Asset use	Conditions	Treatment of balancing adjustment loss	Treatment of balancing adjustment profit
Asset used solely for R&D activities and not a taxable purpose described in subsection 40-25(7) of the ITAA 1997	Both: <ul style="list-style-type: none">• registered in the event year• otherwise eligible for a notional R&D deduction.	355 applies Adjustment loss included as a notional R&D deduction.	355 applies Balancing adjustment profit uplifted by one-third and included in assessable income.



Balancing adjustments for assets used for conducting R&D activities			
Asset use	Conditions	Treatment of balancing adjustment loss	Treatment of balancing adjustment profit
Asset used solely for R&D activities and not a taxable purpose described in subsection 40-25(7) of the ITAA 1997.	Either: <ul style="list-style-type: none"> not registered in the event year otherwise ineligible for a notional R&D deduction. 	No taxation treatment	No taxation treatment

Balancing adjustment for depreciating assets used only for R&D activities (including partnerships)			
Asset use	Conditions	Treatment of balancing adjustment loss	Treatment of balancing adjustment profit
Asset used for both R&D activities and a taxable purpose described in subsection 40-25(7) of the ITAA 1997.	Both: <ul style="list-style-type: none"> registered in the event year otherwise eligible for a notional R&D deduction. 	Division 40 applies No notional R&D deduction. R&D portion of balancing adjustment loss, calculated under section 40-285, claimed as an increased deduction amount.	Division 40 applies R&D portion of balancing adjustment profit, calculated under section 40-285, uplifted by one-third and included in assessable income.
Asset used for both R&D activities and a taxable purpose described in subsection 40-25(7) of the ITAA 1997.	Either: <ul style="list-style-type: none"> not registered in the event year otherwise ineligible for a notional R&D deduction. 	Division 40 applies No notional R&D deduction. R&D portion of balancing adjustment loss calculated under section 40-285, no increased deduction amount claimable (unless the R&D activities have been conducted by an R&D partnership and you are claiming your proportion of this amount).	Division 40 applies R&D portion of balancing adjustment profit, calculated under section 40-285, uplifted by one-third and included in assessable income.





Balancing adjustment for depreciating assets used only for R&D activities (including partnerships)

Where you have used an asset solely for R&D activities, the balancing adjustment results in either a further (catch-up) notional R&D deduction, or an increased amount being included in assessable income (to recover excessive deductions).

For this notional balancing adjustment deduction to apply, you must register for the income year in which the balancing adjustment event happens and be otherwise eligible for the R&D tax incentive. Where you have ceased R&D activities in a previous income year and scrap an asset in the current income year, you cannot claim the enhanced benefits of the R&D tax incentive provisions for the decline in value that may have occurred (in whole or part) after R&D activities ceased. In these circumstances, an uplifted amount is not required to be included in assessable income.

If you would have been entitled to a balancing deduction under the standard balancing adjustment provision of section 40-285, and the asset has been used solely for R&D activities, you are entitled to a notional R&D deduction of an equivalent amount, provided you are registered for one or more R&D activities for the balancing adjustment event year. That notional R&D deduction is included in the calculation of your R&D tax offset.

Conversely, if an amount would have been included in your assessable income under the standard balancing adjustment provision of [section 40-285](#), the sum of that amount (the section 40-285 amount) plus an additional amount is included in your assessable income.

The additional amount reflects the enhanced benefits that you have obtained through the offset for the decline in value. The additional amount is equal to one-third of so much of the section 40-285 amount as does not exceed the total decline in value. For income years starting before 1 July 2016, the factor of one-third was based on an offset rate of 40% (rather than the higher 45% rate that generally applied to R&D entities with an aggregated turnover of less than \$20 million). For simplicity, no change was made to the calculation of the additional amount when the rates of the refundable and non-refundable tax offsets were reduced for income years starting on or after 1 July 2016.

Note, if an entity's notional R&D deductions exceed \$100 million for an income year, the entity may reduce the adjusted section 40-285 amount in calculating the balancing adjustment.



Example

Balancing adjustment for depreciating assets used only for R&D activities – notional deduction

B Pty Ltd was incorporated in Australia and carries on a business in Australia that includes R&D activities that it conducts wholly in Australia. Its aggregated turnover for each income year is under \$20 million. B Pty Ltd has a standard income year ending on 30 June.

On 1 July 2014, B Pty Ltd purchases a mass spectrometer for use in its R&D activities. The unit costs \$30,000. B Pty Ltd assesses the effective life of the unit as five years and chooses the prime cost method for calculating its decline in value.

During 2014-15 and 2015-16, B Pty Ltd uses the unit only in carrying on its R&D activities. It sells the unit on 31 December 2015 for \$15,000.

As B Pty Ltd only used the unit for R&D activities, it will work out a balancing adjustment under section 355-315 of the ITAA 1997. It is entitled to a notional R&D deduction equal to the amount calculated under subsection 40-285(2), which is equal to the termination value less the adjustable value. The termination value is \$15,000. The adjustable value as at 31 December 2015 is equal to the opening adjustable value at 1 July 2015 less the part year decline in value during 2015-16. The opening adjustable value is \$24,000. The part year decline in value is \$3,000. Accordingly, the adjustable value is \$21,000.

B Pty Ltd is entitled to a notional R&D deduction of \$6,000 (\$21,000-\$15,000) under subsection 355-315(2). Assuming B Pty Ltd has total notional R&D deductions over \$20,000 for 2015-16, B Pty Ltd is entitled to an offset of \$2,700 (45% of \$6,000) for the sale of the unit.

Balancing adjustment for depreciating assets used only for R&D activities- extra amount included in assessable income.

If the termination value in the example above was \$27,000 rather than \$15,000, B Pty Ltd would be required to include an uplifted amount in its assessable income. This would be calculated by the termination value (\$27,000) less the adjustable value (\$21,000), uplifted by one-third. Accordingly, \$8,000 would be included in the assessable income of B Pty Ltd.





Partners in an R&D partnership

As a partner in an R&D partnership, you may also be able to claim a notional deduction for a balancing adjustment where:

- a balancing adjustment event happens (for example, the R&D partnership sells or scraps the asset) for an asset held by the partnership in an income year
- the asset was used for R&D activities
- you are (or were) entitled to R&D decline in value deductions or notional deductions for the asset.

You are entitled to a notional R&D deduction for your proportion of the balancing deduction under the standard balancing adjustment provision of section 40-285, and this amount is included in the calculation of your tax offset.

Conversely, if an amount would have been included in the assessable income of the R&D partnership under the standard balancing adjustment provision of section 40-285, your proportion of the sum of that amount (the section 40-285 amount) plus your proportion of an additional amount is included in your assessable income. As above, the additional amount is equal to one-third of so much of the section 40-285 amount as does not exceed the total decline in value.

Balancing adjustment for depreciating assets used for R&D activities and a taxable purpose described in subsection 40-25(7) of the ITAA 1997

A balancing adjustment must also be worked out where you have used a depreciating asset partly for R&D activities and partly for another taxable purpose (for example, producing assessable income) under the capital allowance provisions. Taxable purpose is defined in [subsection 40-25\(7\)](#) of the ITAA 1997.

In working out reductions in the balancing adjustment amount for non-taxable use, use for the purpose of conducting R&D activities is assumed to be use for a taxable purpose.

If you are entitled to a balancing deduction under the standard balancing adjustment provision of [section 40-285](#) of the ITAA 1997, and are entitled under [section 355-100](#) of the ITAA 1997 to a tax offset for the event year, the amount of the balancing deduction is increased. The amount is increased by half if your aggregated turnover is less than \$20 million and one third in other cases. The factors by which the deduction amount is increased are equivalent to the 45% and 40% rates at which R&D tax offsets were calculated in the income years starting before 1 July 2016.





For simplicity, no change was made to the calculation of the additional amount when the rates of the refundable and non-refundable tax offsets were reduced for income years starting on or after 1 July 2016.

If you are not entitled under section 355-100 of the ITAA 1997 to a tax offset for the event year, the amount of the balancing deduction is not increased.

If an amount is included in your assessable income under section 40-285 of the ITAA 1997, the amount assessable is increased by one third of an amount worked out under the formula provided in [subsection 40-292\(5\)](#) of the ITAA 1997. Note, if an entity's notional R&D deductions exceed \$100 million for an income year, the entity may reduce the adjusted section 40-285 amount in calculating the balancing adjustment.

The formula adjusts the amount worked out under section 40-285 of the ITAA 1997 so that it does not exceed the asset's total decline in value. It then applies a factor so that the amount being taken back reflects the proportion of the decline in value of the asset represented by total notional R&D deductions.

Balancing adjustment loss amounts, where the depreciating asset has been used partly for R&D activities and partly for another purpose, do not form part of the calculation of your R&D tax offset. These amounts are treated separately for income tax purposes.

Subsection 40-292(5) of the ITAA 1997 provides a formula for ensuring that the increased balancing adjustment amount deductible or assessable reflects the proportion of the decline in value of the asset used for R&D activities, as follows:

$$\frac{\text{Sum of your R\&D deductions}}{\text{Total decline in value}} \times \text{Adjusted section 40-285 amount}$$

For this formula:

- 'adjusted section 40-285 amount' means
 - if the section 40-285 amount is a deduction – the amount of the deduction
 - if the section 40-285 amount is an amount included in your assessable income – so much of the section 40-285 amount as does not exceed the total decline in value
- 'total decline in value' means the cost of the asset less its adjustable value

Example: Balancing adjustment for assets used partly for R&D activities

C Pty Ltd was incorporated in Australia and carries on a business in Australia that includes R&D activities. Its aggregated turnover for each income year is under \$20 million.

On 1 July 2014, C Pty Ltd purchases a heating unit for use in its business at a cost of \$30,000. C Pty Ltd assesses the effective life of the unit as five years and chooses the prime cost method for calculating its decline in value. C Pty Ltd uses the unit 50% of the time for carrying on ordinary business activities and 50% of the time for carrying on R&D activities.

On 31 December 2015, C Pty Ltd sells the unit for \$15,000. C Pty Ltd is entitled to a deduction under subsection 40-285(2) of the ITAA 1997 which is equal to the termination value less the adjustable value. The termination value is \$15,000. The adjustable value is equal to the



opening adjustable value less the decline in value during 2015–16. The opening adjustable value is \$24,000. The decline in value is \$3,000. Accordingly, the adjustable value is \$21,000. C Pty Ltd is entitled to a deduction of \$6,000 (\$21,000–\$15,000) under section 40–285 of the ITAA 1997.

C Pty Ltd is entitled to an additional deduction under section 40–292 of the ITAA 1997. As a result of the use of the asset in R&D activities for 50% of the time it has been held by C Pty Ltd, C Pty Ltd is entitled to notional deductions of \$4,500 (50% (\$6,000 + \$3,000)) under section 355–305. Subsection 40–292(2) requires the company to calculate an amount under subsection 40–292(5) as follows:

$$\frac{\text{Sum of your R\&D deductions}}{\text{Total decline in value}} \times \text{Adjusted section 40-285 amount}$$
$$\frac{\$4,500}{\$9,000} \times \$6,000 = \$3,000$$

Subsection 40–292(3) provides that a company is entitled to increase its section 40–285 deduction by half of the amount worked out under subsection 40–292(5) (because it has an aggregated turnover of less than \$20 million).

C Pty Ltd is therefore entitled, under subsection 40–292(3), to increase its section 40–285 deduction by \$1,500 (half of \$3,000).

Its increased section 40–285 deduction is therefore \$7,500 (\$6,000 + \$1,500).

Balancing adjustment for depreciating assets used partly for R&D activities– extra amount included in assessable income

Assuming that the termination value in the example above was \$27,000 rather than \$15,000, C Pty Ltd would include an uplifted amount in its assessable income. This would be calculated by the termination value (\$27,000) less the adjustable value (\$21,000), this being \$6,000. However, as this asset has been used partly for R&D activities, the amount calculated under subsection 40–292(5) is uplifted by one-third and also included in assessable income. The total amount included in the assessable income of C Pty Ltd would be:

\$1,000 (one-third of \$3,000) plus \$6,000 = \$7,000 included in the assessable income of C Pty Ltd.

R&D partnerships

As a partner in an R&D partnership, you may also be required to calculate a balancing adjustment if:

- a balancing adjustment event happens (for example, the R&D partnership sells or scraps the asset) for an asset held by the partnership in an income year
- the asset was used for both R&D activities and general tax purposes
- you have, or have been, entitled to R&D decline in value deductions or notional deductions for the asset.



If the R&D partnership is entitled to a balancing deduction under the standard balancing adjustment provision of section 40-285, the amount of the balancing deduction for the partnership is increased by one-third. As the partner in the R&D partnership, you are entitled to a notional deduction for your proportion of the increased amount.

If an amount is included in the R&D partnership's assessable income under section 40-285, the amount assessable is increased by one third of an amount worked out under a formula. You include your proportion of this increased amount in your assessable income.

Unlike the rules for you as a single R&D entity, if you are conducting R&D in a R&D partnership and it has used the asset for R&D activities and another taxable purpose, the deductible and assessable amount is uplifted, regardless of whether the partner is otherwise eligible to claim an R&D tax offset in the event year.

FEEDSTOCK EXPENDITURE

A feedstock adjustment is an amount you include in your assessable income. It applies when you obtain an R&D tax incentive offset for your feedstock expenditure incurred on R&D activities, where those activities also produce tangible products that are supplied to someone else, or applied to your own use (other than in transforming such products for supply).

For the purposes of the feedstock adjustment, supply or use of the product by your affiliate, or an entity of which you are an affiliate, or a connected entity is taken to be supply or use of the product by you and will attract a feedstock adjustment.

The feedstock adjustment applies to expenditure on:

- goods or materials (feedstock inputs) that are transformed or processed during R&D activities in producing one or more tangible products (feedstock outputs)
- energy input directly into that transformation or processing.

A feedstock adjustment may also apply for amounts claimed for the decline in value of assets used in acquiring or producing feedstock inputs.

The feedstock provisions apply to both core R&D activities and supporting R&D activities that transform or process feedstock inputs. The provisions are not confined to mass production activities.

Although this type of expenditure may not form part of any feedstock adjustment in the year it is incurred, it will represent expenditure on feedstock inputs and should be recorded separately from the other expenditure types.

Where a feedstock adjustment is triggered, you must include an amount in your assessable income. This may be in the current or future years, depending on when the output is sold or applied.

See also:

- [Feedstock adjustments](#)
- [TR 2013/3](#) Income Tax: research and development tax offsets: feedstock adjustments



CONTRIBUTIONS UNDER THE CRC PROGRAM

Generally, you must incur at least \$20,000 worth of expenditure on R&D activities to be eligible for a notional deduction under subsection 355-100(1) of the ITAA 1997. Subsection 355-100(2) provides an exception to this requirement for monetary amounts contributed under the CRC program, where all other eligibility criteria have been met.

You are entitled to a notional deduction for expenditure incurred as a monetary contribution under the CRC program, if you are registered for the R&D activities on which the contribution is spent. The notional deduction does not arise until you are registered, which in some cases could be for an income year after you incur the contribution. However, the notional deduction for the monetary contribution still applies to the income year in which the contribution was incurred.

You are not entitled to a notional R&D deduction for any expenditure the CRC incurs from Commonwealth funding.

To prevent double benefits in respect of the same amounts, you cannot obtain a notional R&D deduction for:

- a monetary contribution made to a CRC, other than under the specific rule about monetary contributions to a CRC
- the decline in value of an R&D depreciating asset whose cost has been incurred under the CRC program.

Where you incur a non-monetary contribution but the contribution is in money's worth (for example an employee's time or plant used in the R&D activities), that contribution should be valued and this value will also constitute expenditure incurred by you. The normal R&D tax incentive provisions apply in these circumstances and any notional deduction is subject to the rules in [Subdivision 355-D](#) of the ITAA 1997, including the requirement that at least \$20,000 of expenditure be incurred.

Example:

Company A incurs \$100,000 of expenditure as a monetary contribution under the CRC program in the year ending 30 June 2015. The CRC does not spend Company A's contribution on an R&D activity until the year ending 30 June 2016. To be eligible for a notional deduction for this amount, Company A must register the R&D activity for the year in which the R&D activity is conducted (the income year ending 30 June 2016). Company A's registration of the relevant R&D activity will trigger eligibility (provided all other criteria are also met) for Company A to have a notional deduction equal to the amount it incurred to the CRC, in the year ending 30 June 2015



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