Accounting for the R&D tax offset

A revised research and development (R&D) tax offset regime applies from 1 July 2021, introducing some additional accounting considerations

- A revised R&D tax offset regime, also known as the R&D Tax Incentive (RDTI), has taken effect for income years commencing on or after 1 July 2021, with the net tax benefit limited to an increased $150 million expenditure cap. The R&D tax offset is available as either a refundable or non-refundable tax offset, depending on whether the aggregated turnover of the claimant is less than $20 million (refundable) or $20 million and over (non-refundable)
- The refundable R&D offset premium is set at 18.5% above the prevailing corporate tax rate which is the base tax rate of 25%, resulting in an R&D rate of 43.5%. The non-refundable offset base premium is set at 8.5% above the prevailing corporate tax rate (of 25% or 30%), with a 16.5% premium above the prevailing corporate tax rate for eligible R&D expenditure exceeding a defined 2% 'R&D intensity threshold'
- General practice is to account for a refundable R&D tax offset as a government grant, with a credit recognised in profit before tax over the period necessary to match the benefit of the credit with the costs for which it is intended to compensate
- In contrast, a non-refundable R&D tax offset is generally accounted for as an income tax and a credit recognised within tax expense and a tax asset recorded when the entity satisfies the criteria to receive the credit. In addition, a deferred tax liability is recognised in relation to any related capitalised R&D asset
- 'Clawback' mechanisms may operate where the entity receives government grants or reimbursements, has 'feedstock adjustments' or sells assets used in R&D activities. The mechanism for government grant clawbacks has changed from 1 July 2021 meaning the clawback can be sheltered by or create tax losses, which may change accounting practices
- Entities eligible for the R&D tax offset need to ensure that appropriate and transparent disclosures are made in financial reports.

The new R&D tax offset regime applying from 1 July 2021 may change some existing accounting policies and introduce additional accounting issues

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Background

Tax technical summary

The key aspects to be aware of in the calculation of the R&D tax offset for income years beginning on or after 1 July 2021 are as follows:

- Eligible R&D expenditure is not tax deductible for tax purposes, and accordingly is not taken into account in the determination of taxable income[1]
- Instead of a tax deduction at the prevailing corporate tax rate, one of two R&D tax offsets can be deducted from the basic income tax liability. Eligible R&D expenditure must be at least $20,000 and the offset is calculated on the amount incurred on eligible R&D activities that have been carried on during an income year:
  - A **refundable R&D tax offset** is available where the aggregated turnover of the claimant is less than $20 million (referred to as 'small R&D entities') and is set at a premium of 18.5% over the prevailing corporate tax rate. By definition, small R&D entities will be base rate entities (subject to a 25% corporate tax rate) so the R&D offset rate will be 43.5% unless corporate tax rates are further reduced in the future. This offset is applied against any tax liability of the claimant subject to specific tax offset ordering rules, with any excess R&D tax offset being refundable
  - A **non-refundable R&D tax offset** is available where the aggregated turnover of the claimant is $20 million or more (referred to as 'large R&D entities') and can be applied against an entity's tax liabilities with any excess, carried forward to future years. The non-refundable base R&D premium is set at 8.5% above the prevailing corporate tax rate, with a premium tier of 16.5% if the claimant's 'R&D intensity' exceeds 2%. The R&D intensity is broadly calculated as the entity's eligible R&D expenditure as a proportion of the entity's total expenses. In summary:

Tier	R&D intensity range	R&D tax offset
1	Eligible R&D expenditure representing up to and including 2% of total expenses	8.5% over the corporate tax rate
2	Eligible R&D expenditure representing greater than 2% of total expenses	16.5% over the corporate tax rate

- There is a cap of $150 million per annum on eligible expenditure to which the R&D premium rates can be applied (increased from the $100 million per annum cap which previously applied). Any amounts over this limit are entitled to an R&D tax offset equal to the entity's prevailing corporate tax rate. Additionally, the numerator in the calculation of the entity's R&D intensity, being eligible R&D expenditure (notional deductions), is limited to the same $150 million threshold
- The total expenses to be included in the denominator of the intensity calculation is intended to reflect accounting expenses but must also include an R&D entity's eligible R&D expenditure included in the numerator. , Rules apply to prevent any double counting of amounts recognised at different times as notional deductions and total expenses. For instance, if R&D expenditure is capitalised for accounting purposes, total expenses used in the R&D intensity calculation are adjusted to increase total expenses in the year the expenditure is incurred, and reduced in subsequent periods when amortisation of the capitalised asset occurs
- There are specific 'clawback' rules which have the effect of eliminating all or part of the R&D net tax benefit obtained by including amounts in the entity's taxable income. These occur when an entity recoups amounts of R&D expenditure through government grants, or where the R&D activities result in tangible products that are sold or applied to the entity's own use ('feedstock adjustments'). Similarly, balancing adjustments arise where an asset used in eligible R&D activities is disposed to ensure the correct R&D tax benefit has been received based on the actual usage of the value of the asset during the period it was held
- The reduction in company tax payable resulting from claiming R&D tax offsets in an income year will reduce the franking credits available. In addition, the receipt of an R&D tax offset refund is defined to be a refund of income tax and will give rise to deferred franking debits which will reduce future franking credits that would otherwise arise on the payment of income tax.

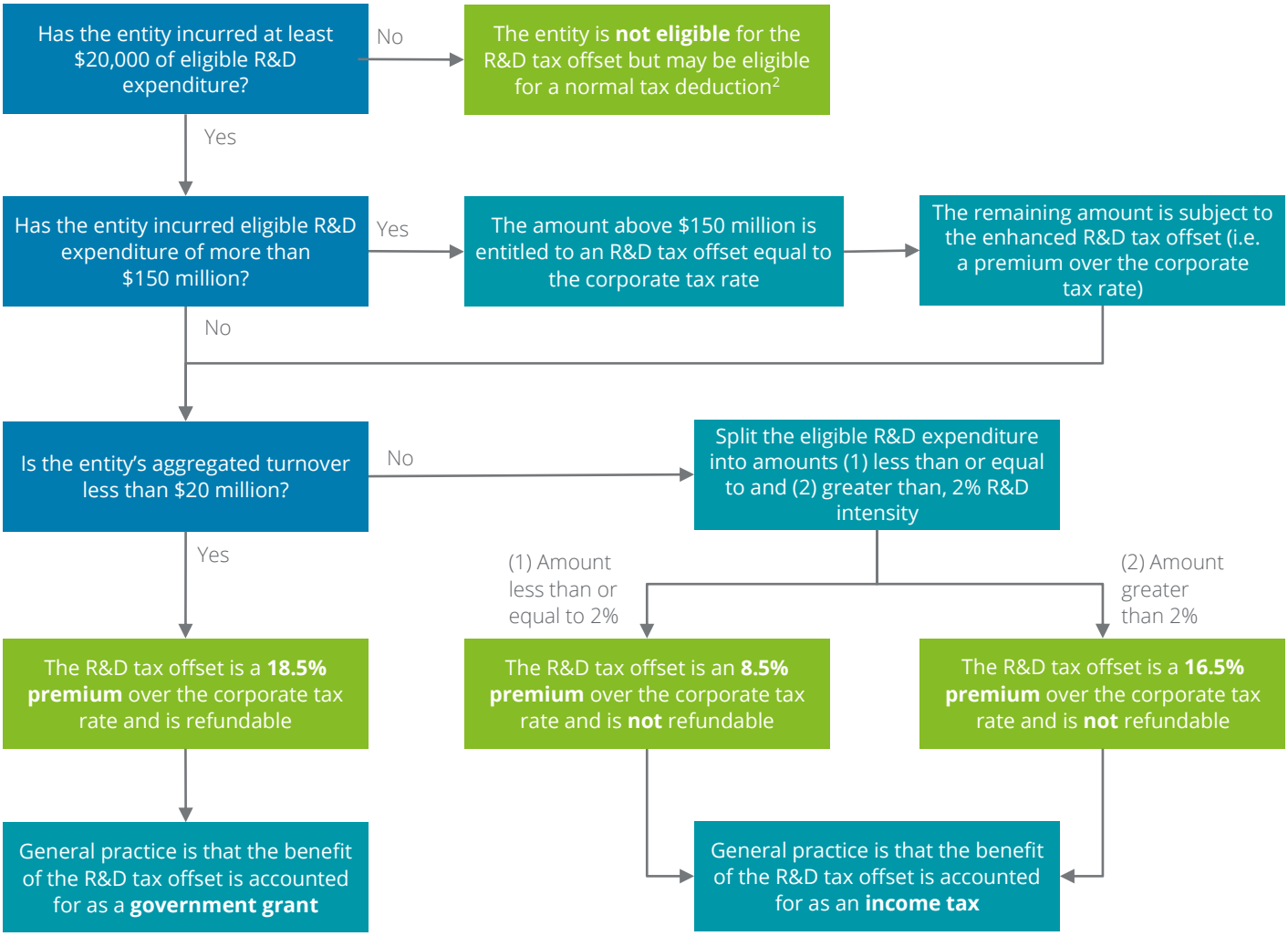
[1] The *Income Tax Assessment Act 1997* (ITAA 1997) refers to eligible R&D expenditure being "notionally deductible" even though it is not actually deductible in the determination of taxable income.

Understanding the tax aspects of the R&D tax offset

This publication is focused on the accounting implications of the R&D tax offset. For a better understanding of the tax aspects of the R&D tax offset, see our Tax Essentials publication *Understanding the R&D Tax Incentive Regime*. This publication explores which entities qualify as eligible R&D entities, what can be eligible R&D activities, the types of expenditures that can be claimed and various other corporate tax interaction matters.

Summary flowchart

The flowchart below summarises the R&D tax offset requirements and the preferred accounting treatments:



[2] Where expenditure is less than $20,000, the amounts may be eligible if the expenditure was incurred to a research service provider registered under Division 4 of Part III of the IR&D Act or was incurred under the Cooperative Research Centre Program. Other amounts less than $20,000 may be claimable as a normal deduction. This aspect does not arise often in practice and is not considered further in this publication.

Understanding how the R&D tax offset works in practice

The operation of the R&D tax offset from 1 July 2021 can be complex and depends on many factors, with many variables being linked to accounting concepts.

The example below seeks to provide clarity on how the R&D tax offset works in practice so that the accounting issues can be considered in context of the operation of the income tax law:

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Example – R&D tax offset for a large R&D entity[3]

Company A incurs $180 million of eligible R&D expenditure in the 2021-22 income year and these are 'notional deductions' for the purposes of the R&D tax offset. Company A has $1 billion in total expenses during the year (including the $180 million in eligible R&D expenditure), has aggregated turnover exceeding $20 million, did not capitalise any R&D expenditure for accounting purposes and is subject to a 30% corporate tax rate.

Company A has an overall R&D intensity of 15% ($150 million of eligible R&D expenditure divided by $1 billion in total expenses). The excess $30 million in eligible R&D expenditure does not attract an R&D intensity premium and is not taken into account when calculating an entity's R&D intensity due to the $150 million cap being exceeded. Additionally, eligible R&D expenditure which equates to the first 2% of the entity's total expenditure is subject to the lower R&D premium, even if the entity's overall R&D intensity exceeds 2%.

The amount of the R&D tax offset for the income year is calculated as follows:

Tier	Intensity range	R&D premium	Total R&D offset rate(1)	Eligible R&D expenditure ($000s)	R&D tax offset amount ($000s)(2)
1	0-2%	8.5%	38.5%	20,000(3)	7,700
2	>2%	16.5%	46.5%	130,000(4)	60,450
Excess	n/a	n/a	30.0%	30,000	9,000
Total				**180,000**	**77,150**

(1) The sum of the entity's corporate tax rate (in this case 30%) and the R&D premium applicable to the tier of expenditure.
(2) Calculated as the total R&D offset rate multiplied by the amount of eligible R&D expenditure in each tier.
(3) Calculated as 2% of the total expenses of $1 billion.
(4) The total amount subject to the R&D premium is capped at $150 million. As $20 million of eligible R&D expenditure is subject to the lower R&D premium, the maximum that can be subject to the higher rate is $130 million (i.e. $150 million less $20 million).

[3] This example is based on a similar example included in the Explanatory Memorandum for the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020* which gave effect to the new R&D tax offset regime from 1 July 2021.

Guidance in Australian Accounting Standards

AASB 112 *Income Taxes* (AASB 112) does not deal with accounting for 'investment tax credits', but it does address temporary differences that might arise in relation to assets and liabilities recognised from the receipt of such grants or investment tax credits.

Although Australian Accounting Standards more generally 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 tax deductions (within the scope of AASB 112) which are factored into the determination of taxable income. Despite being outside the scope of AASB 112, entities often analogise to the principles in AASB 112 when developing relevant accounting policies for investment tax credits.

AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance* (AASB 120) excludes from its scope government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability, which includes 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 Estimates and Errors* (AASB 108) to determine the most appropriate accounting treatment.

General practice for the refundable R&D tax offset

Basic principles

The R&D tax offset is administered through the company income tax returns system. Entities with less than $20 million in aggregated turnover are entitled to a refundable R&D tax offset, which is set at a 18.5% premium over the entity's corporate tax rate (which is 25% by definition for the 2021-22 and later income years).

Together with any other available tax offsets, the refundable R&D tax offset is first used to reduce the amount of any income tax payable by the entity. Any excess refundable R&D tax offset can then be refunded in cash to the claimant (ITAA 1997, s.67-30) subject to ATO refund retention powers. As such, the amount of benefit an entity can receive from the refundable R&D tax offset in an income year is not limited to, or determined by, the amount of tax paid or payable by the entity. Although the rate applied to eligible R&D expenditure is determined by reference to the entity's corporate tax rate (25%), the amount of the R&D tax offset that can be claimed and received in cash is only limited by the R&D expenditure cap of $150 million[4].

The refundable R&D tax offset will in many cases behave in the same way as a direct government grant in monetary terms, particularly for entities which have limited or no taxable profits as they will receive the R&D tax offset in cash. Because of this, most entities eligible for the refundable R&D tax offset analogise to AASB 120 when determining their accounting policy.

When analogising to AASB 120, the following approach is adopted:

- A credit is recognised in profit before tax (as part of earnings before interest and tax, EBIT) rather than as part of income tax expense:
  - To the extent the R&D expenditure which gave rise to the refundable R&D tax offset has been capitalised, the benefits of the R&D tax offset are initially deferred either by recognising a deferred income or reducing the carrying amount of the R&D asset. In this case, any deferred income is amortised to profit or loss in line with the associated R&D asset, or the amount of amortisation is reduced directly through the offset of amounts
  - Where the R&D expenditure which gave rise to the refundable R&D tax offset has been expensed, the benefits of the R&D tax offset are recognised direct in profit or loss, either as other income or as a deduction from the related expense
- As the R&D tax offset is not treated as an income tax, it will not directly result in current or deferred tax amounts and any eligible R&D expenditure recognised as an expense would be treated as a 'permanent difference' for income tax purposes.

[4] In the unlikely situation that a small R&D entity incurred expenditure over the $150 million cap, the amounts in excess of the cap would attract a non-refundable R&D tax offset at the entity's corporate tax rate.

Deferred tax accounting considerations

Eligible R&D expenditure capitalised as an R&D asset

When eligible R&D expenditure is capitalised as an R&D asset under AASB 138 *Intangible Assets* (AASB 138), a deferred tax liability will not be recognised at initial recognition of the asset.

As the R&D expenditure giving rise to the R&D asset is not deductible for tax purposes either at the time of the recognition of the asset or as it is amortised, the asset has no tax base. Because the R&D tax offset is treated as a government grant, no amount is recognised in the determination of taxable income (or tax loss) at the initial recognition of the R&D asset, nor is any amount recognised in profit or loss at the time of initial recognition.

Therefore, the initial recognition exception in AASB 112.15(b) is applied and no deferred tax is recognised.

Assets used in R&D activities

Where property, plant and equipment and other assets are the subject of or used to facilitate eligible R&D activities, the tax decline in value of those assets can be claimed as eligible R&D expenditure ('notional deductions') to the extent that the assets have been used for an R&D purpose[5]. This decline in value forms part of the eligible R&D expenditure ('notional deductions') that are eligible for the R&D tax offset and is not included in the determination of taxable income.

Where refundable R&D tax offsets are expected and the amount is accounted for as a government grant, the asset will not have a tax base to the extent the asset is expected to be used in R&D activities. This will result in the application of the 'initial recognition exception' in AASB 112 for the same reasons as noted for capitalised R&D assets above.

R&D tax offset receivable

Where the entity has incurred eligible R&D expenditure during the period and there is reasonable assurance that the entity has complied with the relevant R&D tax offset legal requirements and the R&D tax offset will be received, the entity will recognise a government grant receivable in accordance with the requirements of AASB 120.

The receipt of the R&D tax offset in cash (or by offsetting it against any tax liability) will not have any tax consequences (i.e. it is not assessable for income tax, but is instead a refundable tax offset). Accordingly, the tax base of the receivable will equal its carrying amount and no deferred tax arises.

Presentation and disclosure considerations

A number of disclosure considerations arise where an entity is eligible for the refundable R&D tax offset. These considerations are summarised below:

Area	Considerations
Net or gross presentation of refundable R&D tax offset	Refundable R&D tax offsets accounted for as government grants are recognised in profit and loss before tax. AASB 120 permits such amounts to be shown as 'other income' or deducted in reporting R&D expense. Similarly, where the refundable R&D tax offset relates to a capitalised R&D asset, the amount can be set up as deferred income or by deducting the grant from the carrying amount of the asset. In determining which approach to adopt, entities should consider: • Their existing accounting policies in relation to other government grants (including grants that may have been received in response to COVID-19 and other government programs) • The most transparent way in which to disclose the impact of the refundable R&D tax offset on the entity.

[5] In some cases, the entity may be eligible to immediately expense the cost of assets, or apply accelerated depreciation, when determining the 'notional deductions' to which the R&D tax offset rate will apply.

Area	Considerations
Presentation in the cash flow statement	The cash inflows from a refundable R&D tax offset accounted for as a government grant should be presented in a manner consistent with the associated R&D expenditure: • To the extent the R&D expenditure has been capitalised as an R&D asset, both the cash outflow from the expenditure and the cash inflow from the R&D tax offset should be shown as investing activities • To the extent the R&D expenditure has been expensed, both the cash outflow from the expenditure and the cash inflow from the R&D tax offset should be shown as operating activities • To the extent the R&D tax offset has been used to reduce current tax liabilities (and so not received in cash), additional disclosure (as a non-cash investing transaction) of the amount of the R&D tax offset applied should be considered.
Accounting policies	Notwithstanding the general practice of accounting for the refundable R&D tax offset as a government grant, given the lack of clear guidance, it is important to ensure that users understand how the refundable R&D tax offset has been accounted for. Some matters to highlight include: • That the R&D tax offset has been accounted for as a government grant • Whether the R&D expenditure incurred has been capitalised or expensed • Whether the grant has been offset against the relevant expense (or asset, where R&D is capitalised).
Uncertainties and judgements	Where the entity finds that there is significant judgement required in determining a refundable R&D tax offset claim, it may be necessary to consider relevant disclosures. For example, disclosure of significant judgements and sources of estimation uncertainty may be necessary under AASB 101 *Presentation of Financial Statements* (or, for entities applying Australian Accounting Standards – Simplified Disclosures, AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities*).
Refundable R&D tax offset receivable	The amount of the refundable R&D tax offset will generally be shown as a current asset and should be clearly differentiated from other receivables where material.
Income tax rate reconciliations	Although the R&D tax offset is referred to in the legislation as a "notional deduction" the amount is not deductible for income tax purposes. For refundable R&D tax offsets accounted for as a government grant, the entire expenditure amount will need to be shown as a reconciling item (on a tax-effected basis).
Franking credit disclosures	Since the receipt of a refundable R&D tax offset gives rise to deferred franking debits and therefore will reduce future franking credits, the impacts of accrued refundable R&D tax offset amounts should be considered when disclosing the amount of franking credits available (in accordance with AASB 1054 *Additional Australian Disclosures*, or for entities applying Australian Accounting Standards – Simplified Disclosures, AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities*). This may require additional narrative or other disclosure so that users understand the future impacts of the deferred franking debits.
Operating and financial review (OFR)	The impacts of the R&D tax offset should, where material, be clearly explained in the entity's operating and financial review (OFR) so that users understand the impacts of the incentive on the entity.

Example of accounting for the refundable R&D tax offset as a government grant

Appendix A illustrates how the refundable R&D tax offset is accounted for as a government grant, including the impacts on profit or loss, movements in key balance sheet amounts, tax effects and the income tax reconciliation.

General practice for the non-refundable R&D tax offset

Alternate accounting policies available in some cases

Appendix B sets out the various presentation choices that are potentially available when accounting for the non-refundable R&D tax offset. However, set out below is a summary of the general practice for accounting for non-refundable R&D tax offsets.

Basic principles

An excess non-refundable R&D tax offset cannot be refunded in cash. Where the R&D tax offset for a particular income year exceeds the entity's tax liability for the year, the excess is carried forward and can be used in subsequent income years subject to loss utilisation tests (ITAA 1997, s.65-30, s.63-10, s.65-40). The tax offset does not form part of carried forward tax losses, but is separately carried forward and is also reduced by any exempt income in the current or future income years (ITAA 1997, s.65-30(2), s.65-35(3)) before being applied to future tax liabilities.

Because the R&D tax offset is administered through the income tax system and is limited to the amount of tax payable under normal income tax rules, there is no directly attributable Australian Accounting Standard applicable due to the scope exemptions in AASB 112 and AASB 120 discussed earlier. Accordingly, entities must develop an accounting policy applying AASB 108.

In practice, the majority of entities eligible for the non-refundable R&D tax offset for income years commencing prior to 1 July 2021 analogised to AASB 112. We do not see any aspects of the revised R&D tax offset regime that would change this established practice. Accordingly, we believe it is appropriate for entities to continue to account for the non-refundable R&D tax offset as an income tax.

When analogising to AASB 112, the following approach is adopted:

- A credit is recognised in current tax expense or current tax income for the benefit of the R&D tax offset for each income year
- To the extent the eligible R&D expenditure is capitalised as an R&D asset for accounting purposes, the entity will recognise a deferred tax liability in respect of the capitalised amount. This will give rise to a deferred tax expense, offsetting the current tax benefit arising in the year the expenditure is incurred for tax purposes. The deferred tax liability will then reverse through deferred tax expense as the R&D asset is amortised for accounting purposes.

The recognition of the R&D benefit in profit or loss will be deferred where the R&D expenditure is capitalised, as a deferred tax liability arises in this situation.

Deferred tax accounting considerations

The R&D tax offset will usually have direct and indirect impacts on an entity's deferred tax accounting. Some of these consequences are explored below.

Eligible R&D expenditure capitalised as an R&D asset

When eligible R&D expenditure is capitalised as an R&D asset under AASB 138, a deferred tax liability will be recognised to the extent the eligible R&D expenditure capitalised has been effectively claimed for income tax purposes by being treated as a 'notional deduction' used to determine the R&D tax offset. This is because the R&D asset has no tax base as no further tax deductions are available to offset against the profits expected from recovery of the asset.

The profits expected from the use of the asset will be subject to tax at the entity's corporate tax rate, therefore the deferred tax liability is measured using that rate.

The 'initial recognition exception' in AASB 112.15(b) does not apply because at the initial recognition of the asset, it is effectively deducted in determining taxable profit (or tax loss) through the R&D tax offset. In other words, the 'notional deduction' is treated as if it were an actual deduction (because it achieves the same effect[6]).

Assets used in R&D activities

Where property, plant and equipment and other assets are the subject of or used to facilitate eligible R&D activities, the tax declines in value of those assets can be claimed as 'notional deductions' and included in eligible R&D expenditure to the extent that the assets have been used for an R&D purpose. This decline in value forms part of the 'notional deductions' that are eligible for the R&D tax offset rather than being included in the determination of taxable income.

The impacts on the determination of deferred taxes associated with the assets capitalised for accounting purposes depends on the entity's accounting policy. Where non-refundable R&D tax offsets are expected and the R&D tax offsets are accounted for as an income tax, a temporary difference will arise in respect of the difference between the carrying amount of the asset for accounting purposes and its tax base. The tax rate used to measure the deferred tax arising may need to take into account the expected R&D premium from using that asset in R&D activities (where the tax base of the asset is higher than its carrying amount)[7].

Further considerations arise when the entity is otherwise eligible for accelerated depreciation, instant asset write offs or temporary full expensing of assets utilised in eligible R&D activities as these reduce or eliminate the (notional) tax value of the asset and bring forward the R&D tax offset benefit compared to assets that are depreciated over longer time frames.

Carried forward non-refundable R&D tax offsets

Where an entity's non-refundable R&D tax offsets exceed the entity's basic income tax liability for the year, the entity is able to carry forward the R&D tax offset to be used in future income years, subject to loss utilisation tests. Amounts carried forward are first offset against any exempt income in the current and future years (but not against non-assessable non-exempt income, such as certain Federal and State government disaster payments).

Where an entity has carry forward R&D tax offsets, the entity will recognise a deferred tax asset which will be subject to the normal recognition criteria for deferred tax assets arising from unused tax losses and unused tax credits under AASB 112[8]. This will permit the entity to recognise a deferred tax asset only to the extent that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Because the R&D tax offset is applied against an entity's income tax liability, in making the assessment of probable profits, the entity needs to consider the use of available and anticipated revenue tax losses which are used to reduce taxable income before the income tax liability is determined. In making this assessment, the entity would also need to consider the likelihood it will receive amounts of exempt income in the periods between when the R&D tax offset arose and when it is expected to be utilised, since the offset amount will be extinguished by such income in the future. Therefore, any carried forward R&D tax offsets that are probable of being offset by future exempt income would not be considered to meet the recognition criteria.

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[6] This arises even where the R&D tax offset is carried forward to future tax accounting periods. Because non-refundable tax offsets are treated as income taxes, the R&D tax offset arises as a current tax amount in the year in which the eligible R&D tax expenditure is incurred for tax purposes, regardless of whether that expenditure is capitalised as an asset for accounting purposes or the resultant R&D tax offset is unable to offset against taxable amounts in that same income year (and so is carried forward).

[7] Where a deductible temporary difference arises in respect of an asset used in eligible R&D activities, the future (net) tax deduction will form part of the 'notional deduction' used to determine the R&D tax offset. This will give rise to a tax benefit equal to the entity's corporate tax rate plus the expected R&D intensity premium. Accordingly, a deferred tax asset recognised in these circumstances should be tax effected at the entity's expected total R&D tax rate. Conversely, where the asset expected to be utilised in eligible R&D has a carrying amount higher than the tax base, the taxable temporary difference will give rise to future (net) profits from recovering the asset and these profits will be taxed at the entity's corporate tax rate. Note that some argue that the entity's corporate tax rate should be used in both cases, because the R&D tax offset only arises once the asset is used in a particular period in eligible R&D activities and is 'one step removed' from the depreciation of the asset itself. Accordingly, there may be an accounting policy choice as to which rate is used.

[8] As the R&D tax offset is carried forward separately from carried forward tax losses and represents a tax offset to be used in future periods, the carried forward R&D tax offset is best described as an unused tax credit under AASB 112. There is no technical difference in the treatment of unused tax losses and unused tax credits in AASB 112, as the same principles apply to both. However, like the distinction between carried forward revenue tax losses and capital tax losses, there could be legislative differences between how such carried forward amounts are utilised, and these differences would need to be taken into account when applying the principles in AASB 112.

Disclosure of R&D tax offset amounts

Although the rates applied in determining the R&D tax offsets are higher than the corporate tax rates, the offsets are applied after the entity has determined its basic income tax liability for the period and operates to reduce the tax amount payable. Accordingly, any R&D tax offset carried forward is effectively stated at the amount of income tax that can be extinguished by applying the carry forward offset.

Amounts recognised as deferred tax assets

To the extent a carry forward R&D tax offset is recognised as a deferred tax asset, the amount recognised and disclosed as a deferred tax asset will be the 'face value' of the offset carried forward. This is because the amount is effectively already stated at a tax-effected amount (e.g. if an entity has eligible R&D expenditure of $1 million and is eligible for the 8.5% premium over its corporate tax rate of 30%, the R&D tax offset would be recognised as a deferred tax asset at an amount of $385,000, i.e. $1 million x 38.5%).

Amounts not recognised as deferred tax assets

To the extent a carry forward R&D tax offset is not recognised as a deferred tax asset, care needs to be taken in the disclosure of unrecognised deferred tax assets. Technically, AASB 112.81 requires the disclosure of the amount of the unused tax credits for which no deferred tax is recognised in the statement of financial position. This implies a 'gross' amount, i.e. the amount of taxable income that could be shielded from tax by the carry forward amount.

Practice varies in whether the disclosure of carry forward tax loss and tax credit amounts are made on a 'gross' or tax-effected basis. If the entity chooses to disclose the unrecognised R&D tax offset on a 'gross' basis, the amount to disclose would be the R&D tax offset grossed up by the entity's applicable corporate tax rate, i.e. excluding the impacts of the R&D premium[9]. For example, if an entity had carry forward R&D tax offsets of $9,000, the gross amount shown would be $30,000 ($9,000/30%), which is equivalent to the amount of taxable income that would give rise to a tax liability against which the R&D tax offset can be applied (in other words, $30,000 x 30% = $9,000 of tax payable, equal to the R&D tax offset available).

Entities with carry forward R&D tax offsets that are not recognised as deferred tax assets should:

- Disclose the amount of R&D tax offsets available separately from revenue tax losses, capital tax losses and other carry forward amounts
- Ensure that the amounts are disclosed on a consistent basis, i.e. all 'gross' or all tax-effected
- Make it clear whether the amounts are disclosed on a 'gross' or tax-effected basis.

[9] Because the R&D tax offset is used to reduce the entity's tax liability, the tax rate applicable in calculating the gross amount is the corporate tax rate applied to those profits regardless of how the tax offset itself is calculated.

Presentation and disclosure considerations

A number of disclosure considerations arise where an entity is eligible for the non-refundable R&D tax offset. These considerations are summarised below :

Area	Considerations
Accounting policies	Notwithstanding the general practices in accounting for refundable and non-refundable R&D tax offsets, given the lack of specific clarity on how the R&D tax offset should be accounted for, it is important to ensure that users understand how the R&D tax offset has been accounted for. Some matters to highlight include: • Whether the R&D tax offset has been accounted for as an income tax or government grant[10] • Whether the R&D expenditure incurred has been capitalised or expensed • Where government grant accounting has been applied, whether the grant has been offset against the relevant expense (or asset, where R&D is capitalised).
Uncertainties and judgements	Where the entity finds that there is significant judgement required in determining a R&D tax offset claim, it may be necessary to consider relevant disclosures, for example: • Uncertain tax positions under Interpretation 23 *Uncertainty over Income Tax Treatments* • Disclosure of significant judgements and sources of estimation uncertainty under AASB 101 *Presentation of Financial Statements* (or, for entities applying Australian Accounting Standards – Simplified Disclosures, AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities*).
Income tax rate reconciliations	Although the R&D tax offset is referred to in the legislation as a 'notional deduction', the amount is not deductible for income tax purposes. When the non-refundable R&D tax offset is treated as an income tax, this legal distinction is not relevant. However, due to the difference between the corporate tax rate and R&D tax offset rate, the amount of R&D premium (i.e. above the corporate tax rate) will be a reconciling item.
Operating and financial review (OFR)	The impacts of the R&D tax offset should, where material, be clearly explained in the entity's OFR so that users understand the impacts of the incentive on the entity.

Examples of accounting for the non-refundable R&D tax offset

Appendix B sets out examples of the various presentation choices that are potentially available when accounting for the non-refundable R&D tax offset, including the impacts on profit or loss, movements in key balance sheet amounts, tax effects and the income tax reconciliation.

[10] It may also be possible to adopt an accounting policy that applies a hybrid approach in limited circumstances. This is discussed in Appendix B.

Other considerations

Understanding aggregated turnover

Aggregated turnover is a complex defined term in the *Income Tax Assessment Act 1997* based on the annual turnover of the entity itself, as well as worldwide entities connected with the entity and worldwide affiliates (ITAA 1997, s.328-115). Broadly this will encompass the total ordinary income of these entities derived in the ordinary course of business in an income year (ITAA 1997, s. 328-120).

Accordingly, unlike total expenses used in the determination of an entity's R&D intensity threshold discussed herein, the turnover threshold used to determine whether an entity is eligible for the refundable R&D tax offset is based on income tax concepts, rather than accounting concepts.

More information about aggregated turnover can be found in our Tax Essentials publication *Understanding the R&D Tax Incentive Regime.*

Definition of 'total expenses' used to measure R&D intensity

General requirements

The initial aspects of the measures to calculate total expenses used in the determination of an entity's R&D intensity are linked to accounting concepts (ITAA 1997, s.355-115):

- Where the entity is subject to Australian Accounting Standards, total expenses are determined using those standards
- Where Australian Accounting Standards do not apply to the entity, 'commercially accepted accounting principles related to accounting' should be used[11].

Total expenses are those disclosed at Item 6 of an entity's company income tax return[12]. Discussion in the ATO guidance on the calculation of total expense confirms that this is intended to include items that form part of total profit or loss as disclosed in the entity's financial statements, including unrealised losses on revaluation of assets to fair value[13].

[11] This is similar to the rules for country-by-country reporting entities (CBC reporting entities) which are required to lodge general purpose financial statements (GPFS) with the Australian Tax Office under s.3CA of the *Tax Administration Act 1953*. These entities are also required to apply accounting concepts when determining annual global income and in the preparation of GPFS. More information about these requirements can be found in our Clarity publication *GPFS for CBC reporting entity requirements*.

[12] The Explanatory Memorandum for the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 2020* which gave effect to the new R&D tax offset regime from 1 July 2021 references the definition of expenses in the *Framework for the Preparation and Presentation of Financial Statements* in addition to the amount disclosed at Item 6 in an entity's income tax return. For annual reporting periods beginning on or after 1 July 2021, most for-profit entities will be required to apply the *Conceptual Framework for Financial Reporting* which contains a different definition of expenses, but this difference is not expected to have a material impact in practical terms. The Frameworks include a broad definition of expenses and as such, may include items that are included in other comprehensive income under Australian Accounting Standards. Given the Explanatory Memorandum refers to using the total expenses disclosed at Item 6 of an entity's tax return, the simplest approach may be to follow that guidance. However, entities should monitor this area, particularly in light of any interpretative guidance from the ATO.

[13] It is also noted that for the purposes of determining 'annual global income' for the purposes of determining whether an entity is a significant global entity or country by country reporting entity under income tax law, the ATO guidance on this measure indicates that such losses can be offset against income in some circumstances. In other words, some amounts may be treated as income for one tax measure (significant global entities) and as an expense for another (the R&D tax offset total expenses calculation).

Adjustments required to ensure consistency

To ensure that the intensity threshold is calculated on a consistent basis, an R&D entity's notional deductions (forming the numerator of the calculation fraction) must also be included in the total expenses denominator, which will in practice require adjustments to total expenses where capitalised expenditures or declines in value are included in R&D claims. Rules apply to prevent double counting of amounts recognised in different income years as notional deductions and total expenses. The example below illustrates how this works in practice:

Example – Adjustments to total expenses

Company B incurs $10 million in eligible R&D expenditure in the 2021-22 income year and capitalises these expenses under AASB 138 *Intangible Assets*. From the 2022-23 year, the asset is amortised on a straight-line basis over a five year period ($2 million expense per year) and no further R&D expenditure is undertaken. Assume for the purposes of this illustration that the total accounting expenses (before any R&D expenses) are $30 million in 2021-22 and 2022-23.

The total expenses and R&D intensity are calculated as follows:

Description	2021-22 ($000s)	2022-23 ($000s)
Total accounting expenses before R&D	30,000	30,000
R&D expense for accounting purposes	-	2,000(2)
Total accounting expenses	30,000	32,000
Adjustment for R&D expense related to prior period expenditure		(2,000)(3)
Adjustment for eligible R&D expenditure capitalised	10,000(1)	-
Total expenses used to calculate R&D intensity	**40,000**	**30,000**
Eligible R&D expenditure	10,000	-
R&D intensity	**25%**	**0%**

(1) Since the R&D expenditure was capitalised during the 2021-22 year, it was not included in expenses at Item 6 in the entity's tax return for that year. To ensure that there is consistency between the denominator and numerator used in the R&D intensity calculation, the 'notional deductions' are added to total expenses even though they are not treated as expenses for accounting purposes.

(2) Capitalised R&D expenditure of $10 million amortised over five years on a straight line basis.

(3) As the capitalised R&D expenditure was treated as a notional deduction in the 2021-22 year in the R&D intensity calculation, the amortisation of the asset in 2022-23 is removed from total expenses in the 2022-23 year.

Similar consistency adjustments may arise where property, plant and equipment and other assets are used in R&D activities. The decline in value of these assets is included in the 'notional deductions' used to determine the entity's R&D tax offset and will be depreciated for accounting purposes. Where the assets are depreciated at different rates for accounting and tax purposes, the total cost of the asset will be partially expensed for accounting purposes in periods that are different to when the tax declines in value of those assets are included in the total 'notional deductions' used to determine the entity's R&D tax offset. Accordingly, adjustments will need to be made to total accounting expenses to adjust for differences between tax and accounting depreciation of those assets.

Impacts of recoupments, feedstock adjustments and balancing adjustments

Background

Under the revised R&D tax offset regime applying from 1 July 2021, a number of changes have been made in relation to clawbacks of R&D benefits. The table below illustrates the three clawback situations:

Clawback situation	Examples
The entity receives a government grant in relation to expenditure incurred that is also eligible for the R&D tax offset ('recoupment')[14]	Specific grant from Federal, State or Territory government in relation to eligible R&D activities
The entity carries on R&D activities that produce tangible products that are sold or applied to the entity's own use ('feedstock adjustments' that eliminate all or part of the net tax benefit)	Sale of prototypes
The entity stops holding a tangible depreciating asset, through disposal or otherwise, where the declines in value of that asset have been partially or fully included in eligible R&D expenditure (notional deductions) for R&D tax offset purposes ('balancing adjustments')	Sale of testing equipment used in eligible R&D activities

The income tax law operates to ensure that in the above situations the R&D entity has an adjustment to its taxable position with clawback rules reversing net tax benefits to the extent the entity has received another benefit in connection with its R&D activity through an increase to its assessable or taxable income, or providing a catch up deduction on the disposal of under-depreciated assets.

In the case of government grant recoupments, unlike the R&D tax offset regime in place prior to 1 July 2021, the current law effectively includes a grossed up amount in taxable income. This occurs in the case of both refundable and non-refundable R&D tax offsets.

[14] The clawback rules also apply where a connected or affiliated entity receives the recoupment for the expenditure incurred (ITAA 1997, s.355-440(5)).

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Example – Clawback adjustment arising on a government grant

Company C incurs $10 million in eligible R&D expenditure in the 2021-22 income year. In the 2022-23 income year, the entity becomes eligible for a government grant of $1 million in respect of that expenditure. Assume that the entity is eligible for the non-refundable tax offset, has an R&D intensity in the 2021-22 income year of less than 2% and is subject to the 30% corporate tax rate.

Company C is required to include an amount in its assessable income for 2022-23 to effectively adjust the net benefit received from the R&D tax offset in the 2021-22 income year. The amount to include in assessable income is worked out using the following formula:

$$\textit{Assessable amount} = \frac{\textit{Starting offset} - \textit{Adjusted offset} - \textit{Deduction amount}}{\textit{R\&D entity's corporate tax rate in the current year}}$$

Applying this formula to Company C's situation:

Description		Notional deductions	Rate	Amount
Starting offset	(1)	10,000,000	38.5%	3,850,000
Less: Adjusted offset	(2)	(9,000,000)	38.5%	(3,465,000)
Less: Deduction amount	(3)	(1,000,000)	30.0%	(300,000)
Subtotal	(4)			**85,000**
Dividend by: Tax rate in the current year				30%
Assessable amount	(5)			**283,333**

(1) As the entity had an R&D intensity of less than 2%, the 8.5% R&D premium would apply when calculating both the original R&D tax offset and the revised R&D tax offset. Where the entity's R&D intensity is greater than 2%, the calculation of the R&D tax offset would be more complex (as illustrated in the example on page 5). In this case, the adjusted offset would be recalculated such that it effectively claws back the highest intensity expenditure first.

(2) The adjusted offset is calculated as if the $1 million government grant was received in the prior year and so would reduce the notional deductions from $10 million to $9 million. The R&D tax offset is then notionally recalculated as if notional deductions for the prior period were the revised amount.

(3) By allowing an adjustment for the amount of the expenditure that is no longer eligible for the R&D tax offset, this effectively notionally permits the entity to a deduction at the corporate tax rate (30%). In other words, the overall calculation determines the amount of the R&D premium that has been received in respect of the government grant.

(4) This amount represents the R&D premium that was received in respect of the $1 million of expenditure that was subsequently reimbursed by the government grant ($85,000 = $1,000,000 x 8.5%). Whilst in this simple example the end result can be directly calculated, as explained in note (1) above, where the entity's R&D intensity changes, the detailed steps will be required.

(5) This is calculated by dividing the $85,000 amount by the entity's corporate tax rate (30%) and represents the amount of taxable income included in the entity' income tax return for 2022-23. When the tax rate of 30% is applied, an income tax payable equal to the R&D premium originally received arises (i.e. $85,000).

Accounting implications

Clawback adjustments may occur in a different income year to when the original R&D expenditure giving rise to the notional deductions for the purpose of the R&D tax offset occurred.

Unlike under the R&D tax offset regime in place prior to 1 July 2021, all of the clawback adjustments arising in income years beginning on or after 1 July 2021 are reflected through an entity's income tax return. Under the prior regime, the government grant clawback adjustment gave rise to an additional and separate tax liability. That is, where a government grant was received, it was subject to a separate 10% tax that may have been payable regardless of whether the entity had a current year tax loss or carry forward tax losses.

A further change from 1 July 2021 is that any additional catch up deductions on the disposal of under-depreciated assets used wholly for R&D purposes are now treated as real tax deductions (rather than included in eligible R&D expenditure). This means that these deductions can only create tax losses rather than a refundable tax offset.

Entities may have anticipated clawback amounts when determining the amount of R&D tax offset to recognise in the past, particularly where refundable R&D tax offsets were expected. This is because the entity's measurement of a government grant receivable when applying AASB 120 may have previously anticipated that a clawback was probable and would therefore result in a partial refund of the grant received through the clawback mechanism. In these cases, the government grant may have been recognised at a net amount.

Under the revised clawback mechanism, there is more accuracy in calculating the net tax benefits of the R&D tax offset and the amount of any subsequent clawbacks and catch up deductions. However, where an entity has been eligible for the refundable R&D tax offset, any amount received in cash will not change if a subsequent clawback occurs. This is because the clawback is effected through the entity's tax return rather than through a separate calculation which results in a cash flow separate from the entity's tax liabilities.

In addition, for all clawbacks included in taxable income, the entity may incur an overall tax loss or have carried forward tax losses which can be applied to any assessable amounts, and so will not result in cash flow in the form of the payment of a current tax liability. Accordingly, the clawback adjustments are administratively distinct from the R&D tax offset calculation, and their tax effects should be included in income tax expense. Such amounts would be shown as 'permanent differences', regardless of whether the original R&D tax offset has been treated as a government grant or income tax.

This accounting for the clawbacks may change from previous practice where any clawback was not previously treated separately from the R&D tax offset, e.g. where anticipated clawbacks in future periods were taken into account in the measurement of government grants or income tax amounts by reducing the amount recognised.

Broader issues

The table below summarises some broader considerations as a result of the R&D tax offset:

Area	Considerations
Impairment	• As the timing of recognition of amounts for tax and accounting purposes may differ, the impacts of these differences need to be considered when developing impairment models. In other words, amounts included in accounting-based budgets and forecasts may need to be adjusted to reflect the receipt of the R&D tax offset • Models need to be updated for changes in the R&D Tax Incentive (e.g. increased R&D limit of $150 million and changes to clawback provisions).
Banking and remuneration arrangements	• The changes in the regime may impact profitability, cash flows and other covenants included in banking and employee arrangements.
Liquidity	• Changes in cash flows resulting from the R&D tax offset may impact the entity's liquidity assessment • Where the entity is unfavourably affected by the changes, additional considerations about the entity's going concern may be necessary.
Patent box	• As part of the 2021-22 Federal Budget, the government announced an intention to implement a 'patent box' for eligible corporate income associated with new patents in the medical and biotechnology sectors (with a possible extension to the clean technology energy sector). The patent box would apply a 17% corporate tax rate to eligible profits from eligible patented inventions and is expected to apply to companies for income years commencing on or after 1 July 2022[15] • The patent box may, once implemented, indirectly impact R&D tax offset accounting, e.g. the tax rate used to measure deferred tax liabilities associated with capitalised R&D assets may change to the patent box 17% rate to the extent the carrying amount of the R&D asset is expected to be recovered within the patent box and subject to the lower tax rate. The patent box is not expected to directly impact the R&D tax offset rate • Entities that may be eligible to take advantage of the patent box should carefully monitor developments to ensure that accounting implications are considered once any enabling legislation is enacted.

Conclusion

The revised R&D tax offset regime applying from 1 July 2021 presents some complexities in both tax and accounting terms. Entities seeking to take advantage of the R&D tax offset need to carefully consider the associated accounting issues and ensure that their financial reports clearly reflect how the R&D tax offset has impacted the entity.

[15] At the date of this publication, the design of the legislation to give effect to the patent box is still under consultation.

Appendix A: Illustrative example of accounting for the refundable R&D tax offset

The following example illustrates how accounting for the refundable R&D tax offset as a government grant impacts the financial statements.

Example 1: R&D expenditure is expensed for accounting purposes

Fact pattern

In this example, the following fact pattern has been applied:

- Company D which has an aggregated turnover of $10 million (and is a base rate entity) incurs $330,000 of eligible R&D expenditure in 2021-22
- The expenditure is immediately expensed for accounting purposes
- The entity is eligible for the refundable R&D tax offset and so is eligible for an R&D premium of 18.5% over its corporate tax rate of 25%. The entity is therefore eligible for an R&D tax offset of $143,550 (i.e. $330,000 x 43.5%)
- Other than the impacts of the R&D tax offset, there are no other adjustments to accounting profit to determine taxable income. Accounting profit before R&D expenses is $1 million
- The refundable R&D tax offset is treated as a government grant

Financial impacts

Description		2021-22
Current tax		
Accounting profit before R&D		1,000,000
Current tax expense at 25%		**250,000**
Less: R&D tax offset available	(1)	(143,550)
Current tax liability		**106,450**
Profit or loss		
Accounting profit before R&D		1,000,000
R&D expense (accounting)	(2)	(330,000)
Government grant	(3)	143,550
Profit before tax		**813,550**
Income tax expense:		
- Current tax	(4)	(250,000)
Total income tax expense		**(250,000)**
Profit after tax		**563,550**
Effective tax rate		***30.7%***
Income tax reconciliation		
Profit before tax		**813,550**
Prima facie income tax at 25%		(203,387)
Non-deductible R&D expenditure	(2)	(82,500)
Non-assessable government grant	(3)	35,887
Income tax expense		**(250,000)**

Notes to Example 1

(1) As the full amount of the R&D tax offset is being treated as a government grant, current tax expense is not impacted (even though the government grant is not received in cash, but instead used to reduce taxable income).

(2) The R&D expenditure of $330,000 is recognised as an expense for accounting purposes. As this amount is not deductible for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax-effected basis ($82,500 = $330,000 x 25%).

(3) The total government grant of $143,550 is immediately recognised as the R&D expenditure has also been recognised immediately in profit or loss. As the amount received is non-assessable for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax effected basis ($35,887 = $143,550 x 25%)

(4) As there are no assets or liabilities recognised in relation to the R&D expenditure or the government grant, there are no deferred tax impacts to consider in this instance.

Example 2: R&D capitalised as an asset

Fact pattern

In this example, the following fact pattern has been applied:

- Company D which has an aggregated turnover of $10 million (and is a base rate entity) incurs $330,000 of eligible R&D expenditure in 2021-22
- Unlike in Example 1 above, the entity capitalises the expenditure for accounting purposes and amortises the R&D asset over the following three years ($110,000 per year)
- The entity is eligible for the refundable R&D tax offset and so is eligible for an R&D premium of 18.5% over its corporate tax rate of 25%. The entity is therefore eligible for an R&D tax offset of $143,550 (i.e. $330,000 x 43.5%)
- Other than the impacts of the R&D tax offset, there are no other adjustments to accounting profit to determine taxable income. Accounting profit before R&D expenses is $1 million each period
- The refundable R&D tax offset is treated as a government grant.

Financial impacts

Description		2021-22	2022-23	2023-24	2024-25
Current tax					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
Current tax expense at 25%		**250,000**	**250,000**	**250,000**	**250,000**
Less: R&D tax offset available	(1)	(143,550)	-	-	-
Current tax payable		**106,450**	**250,000**	**250,000**	**250,000**
Deferred tax liability (DTL)					
Carrying amount of R&D asset		330,000	220,000	110,000	-
Tax base	(2)	-	-	-	-
Taxable temporary difference		330,000	220,000	110,000	-
Less: initial recognition exception	(3)	(330,000)	(220,000)	(110,000)	-
Temporary difference recognised as a DTL		-	-	-	-
Deferred tax liability at 25%		**-**	**-**	**-**	**-**
Deferred tax movement		**-**	**-**	**-**	**-**

Description		2021-22	2022-23	2023-24	2024-25
Deferred government grant					
Opening balance		-	143,550	95,700	47,850
Deferral of government grant	(5)	143,550	-	-	-
Amortisation of deferred grant		-	(47,850)	(47,850)	(47,850)
Closing balance		**143,550**	**95,700**	**47,850**	**-**
Profit or loss					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
R&D expense (accounting)	(4)	-	(110,000)	(110,000)	(110,000)
Government grant	(5)	-	47,850	47,850	47,850
Profit before tax		**1,000,000**	**937,850**	**937,850**	**937,850**
Income tax expense:					
- Current tax		(250,000)	(250,000)	(250,000)	(250,000)
- Deferred tax		-	-	-	-
Total income tax expense		**(250,000)**	**(250,000)**	**(250,000)**	**(250,000)**
Profit after tax		**750,000**	**687,850**	**687,850**	**687,850**
Effective tax rate		***25.0%***	***26.7%***	***26.7%***	***26.7%***
Income tax reconciliation					
Profit before tax		**1,000,000**	**937,850**	**937,850**	**937,850**
Prima facie income tax at 25%		(250,000)	(234,463)	(234,463)	(234,463)
Non-deductible R&D expenditure	(4)	-	(27,500)	(27,500)	(27,500)
Non-assessable government grant	(5)	-	11,963	11,963	11,963
Income tax expense		**(250,000)**	**(250,000)**	**(250,000)**	**(250,000)**

Notes to Example 2

(1) As the full amount of the R&D tax offset is being treated as a government grant, current tax is not impacted (even though the government grant is not received in cash, but instead used to reduce current tax payable).

(2) There are no future tax deductions arising and the tax base is zero.

(3) Under this approach, the initial recognition exception applies as the R&D tax offset has not impacted current tax (as noted in (1) above) or accounting profit or loss at the initial recognition of the R&D asset for accounting purposes.

(4) The total capitalised R&D expenditure of $330,000, amortised over three years. As this amount is not deductible for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax-effected basis ($27,500 = $110,000 x 25%).

(5) The total deferred government grant of $143,550, amortised over three years. As the amount received is non-assessable for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax effected basis ($11,963 = $47,850 x 25%).

Appendix B: Alternate accounting policies used to account for the non-refundable R&D tax offset

Summary

There are three possible approaches for the accounting and presentation of the non-refundable R&D tax offset, summarised in the table below. As noted in the main body of this publication, established practice favours the income tax approach, but the other approaches are possible (though not recommended) given the lack of clarity in Australian Accounting Standards for accounting for these types of investment tax credits.

Aspect	Income tax approach	Government grant approach	Hybrid approach
Analogous Australian Accounting Standard	AASB 112	AASB 120	AASB 112 and AASB 120
Basis of approach	Accounted for as an income tax, i.e. the 'notional deductions' are effectively treated as 'super-deductions' for income tax purposes, as they achieve the same effect	Accounted for as a government grant as the objective of the R&D Tax Incentive is to provide support to entities undertaking R&D activities	The benefit is 'split' into amounts that are effectively tax deductible (i.e. the entity's corporate tax rate) as an income tax, and the R&D premiums which are the incentive provided as a government grant
Recognition of benefit	Income tax expense	Other income or offset against the expense compensated for (in profit or loss before tax)	Each component is treated separately in accordance with the previous two columns
Current tax impacts	The R&D tax offset is included in current tax based on the total R&D tax offset rate (i.e. including the R&D premium)	The R&D tax offset has no impact on current tax, any expenses treated as R&D notional deductions are treated as 'permanent differences'	The R&D tax offset is included in current tax based on the entity's corporate tax rate
Deferred tax impacts	Any claimed R&D amounts capitalised will result in a deferred tax liability	No deferred taxes would be recognised in respect of capitalised R&D assets to the extent those assets arose from eligible R&D expenditure treated as notional deductions in the determination of the R&D tax offset	Any claimed R&D amounts capitalised will result in a deferred tax liability
Impacts on income tax rate reconciliation	The amount of the R&D tax offset premium will be shown as a reconciling difference	The total R&D tax offset amount will be shown as a reconciling difference	The amount of the R&D tax offset premium will be shown as a reconciling difference
R&D benefits associated with assets	A deferred tax liability will arise to the extent that eligible R&D expenditure included in notional deductions for the R&D tax offset have been capitalised into an R&D asset for accounting purposes	Deferred and matched against the amortisation and/or impairment of the related R&D asset to which the expenditure was capitalised	Each component is treated separately in accordance with the previous two columns
Impacts of clawbacks	Adjusts income tax expense	Adjusts income tax expense (as clawback adjustments adjust taxable income)	Adjusts income tax expense

Examples

Fact pattern

The fact pattern below applies to the three examples that follow:

- Company E which has an aggregated turnover of $60 million (not a base rate entity) incurs $600,000 of eligible R&D expenditure in 2021-22
- The entity capitalises the expenditure for accounting purposes and amortises the R&D asset over the following three years ($200,000 per year)
- The entity is not eligible for the refundable R&D tax offset, has an overall R&D tax intensity of less than 2%, and accordingly is eligible for an R&D premium of 8.5% over its corporate tax rate of 30%. The entity is therefore eligible for an R&D tax offset of $231,000 (i.e. $600,000 x 38.5%)
- Other than the impacts of the R&D tax offset, there are no other adjustments to accounting profit to determine taxable income. Accounting profit before R&D expenses is $1 million each period.

Example 1 – Treat the R&D tax offset as an income tax

Description		2021-22	2022-23	2023-24	2024-25
Current tax					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
Current tax at 30%		300,000	300,000	300,000	300,000
Less: R&D tax offset available	(1)	(231,000)	-	-	-
Current tax payable		**69,000**	**300,000**	**300,000**	**300,000**
Deferred tax liability					
Carrying amount of R&D asset		600,000	400,000	200,000	-
Tax base	(2)	-	-	-	-
Taxable temporary difference		600,000	400,000	200,000	-
Less: initial recognition exception	(3)	-	-	-	-
Temporary difference recognised as a DTL		600,000	400,000	200,000	-
Deferred tax liability at 30%		**180,000**	**120,000**	**60,000**	**-**
Deferred tax movement		**(180,000)**	**60,000**	**60,000**	**60,000**
Profit or loss					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
R&D expense (accounting)	(4)	-	(200,000)	(200,000)	(200,000)
Government grant		-	-	-	-
Profit before tax		**1,000,000**	**800,000**	**800,000**	**800,000**
Income tax expense:					
- Current tax		(69,000)	(300,000)	(300,000)	(300,000)
- Deferred tax		(180,000)	60,000	60,000	60,000
Total income tax expense		**(249,000)**	**(240,000)**	**(240,000)**	**(240,000)**
Profit after tax		**751,000**	**560,000**	**560,000**	**560,000**
Effective tax rate		***24.9%***	***30.0%***	***30.0%***	***30.0%***

Description		2021-22	2022-23	2023-24	2024-25
Income tax reconciliation					
Profit before tax		**1,000,000**	**800,000**	**800,000**	**800,000**
Prima facie income tax at 30%		(300,000)	(240,000)	(240,000)	(240,000)
R&D benefit	(5)	51,000	-	-	-
Income tax expense		**(249,000)**	**(240,000)**	**(240,000)**	**(240,000)**

Notes to Example 1

(1) The full amount of the R&D tax offset ($600,000 x 38.5%) can be offset against the income tax liability in the first period.

(2) As the tax benefit of the R&D expenditure has effectively been obtained in the first year, there are no future tax deductions arising and the tax base is zero.

(3) Under this approach, the initial recognition exception does not apply as the R&D tax offset has impacted current tax at the initial recognition of the R&D asset for accounting purposes.

(4) The total capitalised R&D expenditure of $600,000, amortised over three years.

(5) Represents the R&D premium amount, calculated as $600,000 x 8.5%, all recognised in the initial period.

Example 2 – Treat the R&D tax offset as a government grant

Description		2021-22	2022-23	2023-24	2024-25
Current tax					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
Current tax expense at 30%		**300,000**	**300,000**	**300,000**	**300,000**
Less: R&D tax offset available	(1)	(231,000)	-	-	-
Current tax payable		**69,000**	**300,000**	**300,000**	**300,000**
Deferred tax liability					
Carrying amount of R&D asset		600,000	400,000	200,000	-
Tax base	(2)	-	-	-	-
Taxable temporary difference		600,000	400,000	200,000	-
Less: initial recognition exception	(3)	(600,000)	(400,000)	(200,000)	-
Temporary difference recognised as a DTL		-	-	-	-
Deferred tax liability at 30%		**-**	**-**	**-**	**-**
Deferred tax movement		**-**	**-**	**-**	**-**
Deferred government grant					
Opening balance		-	231,000	154,000	77,000
Deferral of government grant	(4)	231,000	-	-	-
Amortisation of deferred grant		-	(77,000)-	(77,000)	(77,000)
Closing balance		**231,000**	**154,000**	**77,000**	**-**

Description		2021-22	2022-23	2023-24	2024-25
Profit or loss					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
R&D expense (accounting)	(5)	-	(200,000)	(200,000)	(200,000)
Government grant	(4)	-	77,000	77,000	77,000
Profit before tax		**1,000,000**	**877,000**	**877,000**	**877,000**
Income tax expense:					
- Current tax		(300,000)	(300,000)	(300,000)	(300,000)
- Deferred tax		-	-	-	-
Total income tax expense		**(300,000)**	**(300,000)**	**(300,000)**	**(300,000)**
Profit after tax		**751,000**	**577,000**	**577,000**	**577,000**
Effective tax rate		***30.0%***	***34.2%***	***34.2%***	***34.2%***
Income tax reconciliation					
Profit before tax		**1,000,000**	**877,000**	**877,000**	**877,000**
Prima facie income tax at 30%		(300,000)	(263,100)	(263,100)	(263,100)
Non-deductible R&D expenditure	(5)	-	(60,000)	(60,000)	(60,000)
Non-assessable government grant	(4)	-	23,100	23,100	23,100
Income tax expense		**(300,000)**	**(300,000)**	**(300,000)**	**(300,000)**

Notes to Example 2

(1) As the full amount of the R&D tax offset is being treated as a government grant under this approach, current tax expense is not impacted (even though the government grant is not received in cash, but instead used to reduce current tax payable).

(2) As the tax benefit of the R&D expenditure has effectively been obtained in the first year, there are no future tax deductions arising and the tax base is zero.

(3) Under this approach, the initial recognition exception applies as the R&D tax offset has not impacted current tax (as noted in (1) above) or accounting profit or loss at the initial recognition of the R&D asset for accounting purposes.

(4) The total deferred government grant of $231,000, amortised over three years. As this the amount received is non-assessable for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax effected basis ($23,100 = $77,000 x 30%).

(5) The total capitalised R&D expenditure of $600,000, amortised over three years. As this amount is not deductible for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax-effected basis ($60,000 = $200,000 x 30%).

Example 3 – Treat the R&D tax offset partially as an income tax and partially as a government grant (hybrid approach)

Description		2021-22	2022-23	2023-24	2024-25
Current tax					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
Current tax at 30%		300,000	300,000	300,000	300,000
Less: R&D tax offset treated as an income tax	(1)	(180,000)	-	-	-
Current tax expense		**120,000**	**300,000**	**300,000**	**300,000**
Less: R&D tax offset treated as a government grant	(1)	(51,000)	-	-	-
Current tax payable		**69,000**	**300,000**	**300,000**	**300,000**
Deferred tax liability					
Carrying amount of R&D asset		600,000	400,000	200,000	-
Tax base	(2)	-	-	-	-
Taxable temporary difference		600,000	400,000	200,000	-
Less: initial recognition exception	(3)	-	-	-	-
Temporary difference recognised as DTL		600,000	400,000	200,000	-
Deferred tax liability at 30%		**180,000**	**120,000**	**60,000**	**-**
Deferred tax movement		**(180,000)**	**60,000**	**60,000**	**60,000**
Deferred government grant					
Opening balance		-	51,000	34,000	17,000
Deferral of government grant	(4)	51,000	-	-	-
Amortisation of deferred grant		-	(17,000)	(17,000)	(17,000)
Closing balance		**51,000**	**34,000**	**17,000**	**-**
Profit or loss					
Accounting profit before R&D		1,000,000	1,000,000	1,000,000	1,000,000
R&D expense (accounting)	(5)	-	(200,000)	(200,000)	(200,000)
Government grant	(4)	-	17,000	17,000	17,000
Profit before tax		**1,000,000**	**817,000**	**817,000**	**817,000**
Income tax expense:					
- Current tax		(120,000)	(300,000)	(300,000)	(300,000)
- Deferred tax		180,000	60,000	60,000	60,000
Total income tax expense		**(300,000)**	**(240,000)**	**(240,000)**	**(240,000)**
Profit after tax		**700,000**	**577,000**	**577,000**	**577,000**
Effective tax rate		***30.0%***	***29.4%***	***29.4%***	***29.4%***

Description		2021-22	2022-23	2023-24	2024-25
Income tax reconciliation					
Profit before tax		**1,000,000**	**817,000**	**817,000**	**817,000**
Prima facie income tax at 30%		(300,000)	(245,100)	(245,100)	(245,100)
Non-deductible R&D expenditure	(5)	-	-	-	-
Non-assessable government grant	(4)	-	5,100	5,100	5,100
Income tax expense		**(300,000)**	**(240,000)**	**(240,000)**	**(240,000)**

Notes to Example 3

(1) The full amount of the R&D tax offset ($600,000 x 38.5%) is offset against the current tax liability in the first period. However, under the hybrid approach, the R&D expenditure is partially treated as an income tax amount based on the entity's corporate tax rate ($180,000 = $600,000 x 30%), with the remainder attributable to the R&D premium being treated as a government grant ($51,000 = $600,000 x 8.5%).

(2) As the tax benefit of the R&D expenditure has effectively been obtained in the first year, there are no future tax deductions arising and the tax base is zero.

(3) Under this approach, the initial recognition exception does not apply as the R&D tax offset has impacted current tax at initial recognition of the R&D asset for accounting purposes.

(4) The deferred government grant of $51,000 represents the R&D premium ($51,000 = $600,000 x 8.5%), which is amortised over three years for accounting purposes. As the amount is non-assessable for tax purposes, it is shown as an adjustment in the income tax reconciliation on a tax effected basis ($5,100 = $17,000 x 30%).

(5) The total capitalised R&D expenditure of $600,000, amortised over three years. As this amount has been treated as deductible for tax purposes, no adjustment is made in the income tax reconciliation.

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