Institute of Chartered Accountants Australia

21 May 2013

General Manager
Small Business Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: randdtargetingaccess@treasury.gov.au

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000

GPO Box 9985
Sydney NSW 2001

Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601

GPO Box 9985
Canberra ACT 2601

Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street,
Brisbane Qld 4000

GPO Box 9985
Brisbane Qld 4001

Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L29, 91 King William Street
Adelaide SA 5000

GPO Box 9985
Adelaide SA 5001

Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000

GPO Box 9985
Melbourne Vic 3001

Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
L11, 2 Mill Street
Perth WA 6000

GPO Box 9985
Perth WA 6848

Phone 61 8 9420 0400
Fax 61 8 9321 5141

Dear Sir / Madam

Submission on Exposure Draft: 'Targeting R&D tax incentive to small and medium business'

The Institute of Chartered Accountants in Australia (the Institute) appreciates the opportunity to comment on the Exposure draft (ED) legislation and explanatory materials: 'Targeting R&D tax incentive to small and medium businesses'.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

The proposed amendments will, as stated in the explanatory materials, "deny access to the R&D tax incentive for companies with aggregated assessable income of $20 billion or more for an income year."

Our submission below sets out some high-level comments on the proposed measure, as well as a number of technical comments on the law design aspects of the proposed amendments which we believe warrant closer consideration.

High-level comments

While the Institute's submission to the Business Tax Working Group last year acknowledged that there may be merit in restricting the R&D tax incentive for larger companies, we note that this was put forward:

- *subject to the need for further work to be done to assess the effect of the new R&D tax incentive on large firms*; and

- *on the proviso that any cost savings helped fund a reduction in the company tax rate*.

We are unaware of any such further work being undertaken to assess the effect of the new R&D tax incentive on large firms (as it has also only been in place for one year). Moreover, the company tax rate is not being reduced. Accordingly, it is unclear to the Institute whether the benefits of the proposed amendment will outweigh any potential detriment caused in removing the tax incentive for large companies to invest in innovation. The net economic impact of this change is unknown, and therefore we are concerned that it may present an unquantified risk to the economy.

Overall recommendations

We caution the government against proceeding with this proposed measure in the absence of detailed work to assess the net economic impact.

If the government decides that the restriction is to be implemented, then we consider that the proposed ED legislation should be amended in the following ways:

- A definition based on turnover should be used, as is done elsewhere in the R&D tax incentive (and it should be limited to Australian sourced amounts only), and indexed.

- Grouping provisions should only apply where companies own greater than 50% of each other. This is consistent with the historical law, and with the common commercial understanding of control.

- All R&D amounts should be claimable under the current division, but should only be claimable at the 30% (i.e. normal corporate tax rate) for companies over $20 billion in aggregated assessable income. This avoids the imposition of a bias against R&D under the tax laws, and is consistent with previous announcements.

Specific technical comments

1. ‘Assessable income’ rather than Australian turnover (as originally announced):

(i) unfairly targets Australian resident companies

The announcement of 17 February 2013 referred only to “very large business with annual *Australian turnovers* of $20 billion or more.”

Assessable income for an Australian resident includes its global income. For non-resident companies, it only includes income derived in/connected with Australia. Therefore, large foreign residents with global income over $20 billion can access the Australian R&D tax incentive, while Australian residents will not be able to.

(ii) departs from the established and well-understood concept of turnover

The concept of ‘turnover’, as originally announced, and as currently used in the *Income Tax Assessment Act*[1] (including in the R&D tax incentive in determining eligibility for the refundable tax offset versus the non-refundable tax offset), is a concept quite different from that of assessable income. The turnover concepts that are included in Subdivision 328-C[2] include the concepts of turnover and aggregated turnover which:

- *are based on ordinary income derived in the ordinary course of carrying on a business*[3]**.** In this way, this concept reflects the ‘ordinary business’ turnover of the entities, untainted by extraordinary and unusual events or transactions (including one-off asset sales). As such, this concept reflects the true and consistent ‘size’ of the business, as measured by its turnover,

[1] For a multitude of purposes that are concerned with distinguishing the turnover ‘size’ of an entity or group of entities
[2] *Aggregated turnover* in section 328-115, and *annual turnover* in section 328-120
[3] Subsection 328-120(1)

and it provides a high degree of certainty to business. Based on the statements made in the joint media release above, it is apparent that this concept is an appropriate measure.

- *do not include amounts derived from the sales of retail fuel* [4]*.* Our understanding is that this exclusion exists because retail fuel sales are characteristically high in volume and low in profit margin.

- *exclude amounts derived from dealings with connected entities and affiliates*[5]**.** This adjustment prevents double counting of income amounts relating to transactions between entities that are grouped together, when aggregating their turnovers. It is essential to ensure that an aggregated turnover amount is not overstated.

(iii) inflates the amount compared to normal 'turnover' and may exclude otherwise eligible entities

The use of 'assessable income' as the basis for determining the aggregated turnover of the relevant entities will result in the inflation of that amount over normal 'turnover' concepts, and, given that the Division 328 turnover concept is already used in the R&D tax incentive, no policy justification for this departure is apparent.

Assessable income includes:

- *Ordinary income, and statutory income*[6] (but excludes exempt income). Statutory income includes a multitude of amounts, as listed in section 10-5. A notable inclusion in this category is capital gains, pursuant to section 102-5. Inclusion of capital gains in this 'turnover' concept has the potential to reclassify a medium 'turnover' company to a high (>$20 billion) 'turnover' company, simply because of the sale of a part of this business or some of its assets. We do not consider that such one-off, extraordinary transactions that do not reflect the business size should be included.

- *Sales of retail fuel.* The rationale which operated in removing these sales from the Division 328 concept of turnover is equally valid and relevant to the R&D tax incentive turnover concept (note that the Division 328 turnover concept is already used in the R&D tax incentive, in section 355-100).

- *Amounts derived from dealings with connected entities and affiliates*. As we note above, failure to eliminate intercompany transactions between entities whose 'turnovers' are being aggregated results in an immediate distortion (inflation) of the aggregate turnover.

As such, it will introduce uncertainty for claimants and may have the effect of excluding entities that from year to year would otherwise be able to claim.

(iv) includes different amounts for different industries

As indicated above, the inclusion of statutory income in determining whether the exclusion applies may capture some companies unintentionally, e.g. insurance companies who are required to include all funds under management as assessable income, when in reality only the fees earned constitute funds available or turnover of the company.

Similarly, the inclusion sales of retail fuel[7] (which are excluded from turnover) is likely to exaggerate or distort the amount for this industry, compared to other industries.

[4] Subsection 328-120(3)
[5] Subsection 328-115(3)
[6] Division 6 ITAA 1997
[7] Subsection 328-120(3)

(v) creates practical difficulties – does an entity keep records or not?

As the exclusion is based on assessable income, companies will not know if they can access the R&D tax incentive system until they complete their income tax return, generally sometime after year end.

2. Appropriate threshold (turnover) should be indexed

We are of the view that the appropriate threshold (i.e. turnover) should be subject to indexation each year. The consequences of 'creeping' over this cap through normal inflationary movements are severe, and will result in companies that are still of 'medium' size, relative to their larger counterparts, also being excluded, contrary to the announced policy (which was to ensure the incentive is targeted towards small and medium companies). Failure to implement indexation will mean that the announced 'less than 20 companies' affected by the measure will quickly increase to much larger numbers as each year passes.

3. Certain connected entities – 40% Grouping test too low

There will be some instances where the application of this law will be exceptionally difficult and problematic to apply. An R&D entity may be connected with an entity in whom it holds an interest, or who holds an interest in it, as low as 40%, or may be an affiliate of, or affiliated with another entity, both of whom conduct completely separate operations. In such circumstances, the R&D entity may often have no 'right' or ability to obtain comprehensive, confidential information about the assessable income of that other entity, in order to assess its own entitlement to the R&D tax incentive.

Many companies that are 40% owned by another entity would not consider themselves grouped / connected with, and may not be able to access detailed tax and accounting information required by these calculations. We note that in other parts of the R&D Tax rules (and in a historical context under the R&D tax concession) that a "greater than 50% test" is used.

4. What happens to the underlying tax deduction i.e. the timing benefit?

The determination as to whether expenditure on R&D activities is capital or revenue in nature has not been required since the introduction of the R&D tax concession in 1985.

Evaluation is now required of:

- immediately deductible under section 8-1;
- deductible over the life of the project under the project expenditure provisions in section 40-830;
- deductible over 5 years under the black hole expenditure provisions in section 40-880;
- capitalised into the cost base of a wasting asset and depreciated over the effective life of the relevant assets under Division 40; or
- capitalised into the cost base of a CGT (with tax relief only being available when/if the asset is subsequently disposed of and only if capital gains are available for offset).

Beyond the uncertainty, we are concerned that the proposed changes appear to introduce a bias against R&D only evident by broader consideration of corporate deductibility rules.

For certain non-plant expenditure (including expenditure on intellectual property and other intangible assets that are particularly relevant to companies performing R&D), deductions will not be accessible under the R&D rules and will consequently only be claimable under other provisions. These provisions, including project pooling provisions in Division 40 ITAA 1997, do not allow for an immediate deduction, instead providing only for depreciation over long periods (some as long as 15 years), which is much less attractive for companies.

As companies engaged in R&D have disproportionate spend on such expenditure, this deferral in deduction will generate an economic bias against R&D. We believe that this disincentive to perform R&D may be prevented by continuing to allow the expenditure to be claimed at a non-incentivised tax offset rate of 30%.

If you would like to discuss any aspect of this submission or require any further information, please contact Donna Bagnall in the first instance on (02) 9290 5761 or me on (02) 9290 5609.

Yours sincerely

Paul Stacey CA
Head of Tax Policy
Institute of Chartered Accountants Australia