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Our ref Quarterly Credits - Exposure Draft Submission

10 May 2013

Dear SirDear Sir

R&D Tax Incentive - quarterly credits

Please find enclosed KPMG's submission in respect of the Exposure Draft of the proposed legislation on the R&D Tax Incentive quarterly credits system, released April 2013.

We welcome the opportunity to comment on the draft legislation and support its intention to enable small and medium sized companies to access funding for R&D activities on a timely basis.

We recognise the need to manage and minimise the risk to the Commonwealth and whilst we commend the draft legislation for the most part, we still retain some reservations that the process imposes additional and undue compliance obligations on the very companies which it is endeavouring to help.

Key concerns are:

- Administrative and reporting obligations imposed on participants
- New and unrelated powers granted to Innovation Australia
- The requirements of the complying taxpayer test
- Creation of a strict liability offence.

The attached submission provides further information on our concerns and recommendations for improvements for further consideration by Government.

We would be pleased to work with you to enable the Government's stated policy to be achieved.

Yours faithfully

David Gelb
National Partner, R&D Incentives

KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

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Enclosures:
Submission to Exposure Draft - R&D Tax Incentive - Quarterly Credits

R&D Tax Incentive - quarterly credits

The Government has released an Exposure Draft (***ED***) of the proposed Bill along with an Explanatory Memorandum (***EM***) and Consultation Guide (***CG***). Having reviewed these materials, the following issues are identified for the Government's consideration.

Administrative and reporting obligations imposed on participants

The use of two quarterly credit amount options offers some advantages. The standard (safe harbour) amount gives companies surety and protects them from liability for the general interest charge (***GIC***) which might otherwise be imposed (CG at 3.3.1). The varied amount allows a company to deviate from the standard amount, typically where it believes the standard amount would be less.

However the standard amount will only accurately reflect a company's R&D tax offset entitlement where the company is consistently in a tax loss position and has a fixed R&D budget. This is because if the company was in a taxable position in the most recent income year, the standard amount will be zero, necessitating the use of a 'varied amount' to access quarterly credits. Further, if a company anticipates increasing its R&D spend, it will also need to use a varied amount if it wishes to gain access to the benefit of that increase in the quarterly credits.

The R&D Tax Incentive and quarterly credits system is intended to encourage investment in R&D activities; however those that increase their investment or become profitable are more likely to be subject to the GIC. It is anticipated that the majority of participants will choose the varied amount and as such, there is little administrative saving actually involved in offering the second option.

One of the concerns raised in response to the consultation paper was the administrative burden of the application process. At the time, the Consultation Paper envisaged that participants would apply through both the Australian Taxation Office (***ATO***) and Innovation Australia (***IA***). Following concerns raised by KPMG and others, the ED consolidates the application process with the Commissioner. This will alleviate some of the administrative burden, but relies upon information sharing between IA and the Commissioner (CG at 3.1.2). However, the proposed amendments to the *Industry Research and Development Act 1986* (***IR&D Act***) to enable this, go beyond what is necessary and in fact grant powers not related to information sharing.

New and unrelated IA powers

The ED gives IA new powers; not to provide information to the Commissioner, but to initiate advance findings about activities and R&D entities before registration, of its own volition or at the request of the Commissioner (ED, items 5-12). Further, these new powers may be exercised against all R&D entities, not just those seeking to participate in the quarterly credits system (EM at 1.128). This means that regardless of whether a R&D entity wishes to participate in the quarterly credits system, it will be subject to new investigative powers and advance findings about activities it has not sought an advance finding on. The CG does not discuss this broader application and limits its discussion to granting IA the ability to initiate a finding about activities before registration (CG at page 3). Without further explanation, it is recommended these powers be removed from the ED until such time as a case is made for them.

Complying taxpayer test

The quarterly credits system should only be open to companies that have complied with their taxation and lodgement obligations (CG at page 4). This is reasonable, although as noted by others, the minor nature of what constitutes non-compliance and the 5 year history seems

somewhat excessive. Further, this actually extends beyond taxation and lodgement obligations to obligations under other laws and the views of any agencies administering those other laws (EM at 1.33). At present this seems to be limited to the IR&D Act and IA (ED, 48-110(4)), but terminology and framework suggests this will be extended in the future.

Nonetheless, the Commissioner's power to excuse non-compliance (ED, 48-115) does much to ameliorate this, but it should be noted that the Commissioner's power may only be exercised where the company applies for the Commissioner to do so; either at the time of its application to join the system or if later, within 14 days after the day the non-compliance occurred or commenced (ED, 48-120). It is foreseeable that a company may not be aware of a minor non-compliance within 14 days of its occurrence or commencement. Some companies may be unfairly disadvantaged by their lack of tax knowledge or administrative resources.

A significantly bigger issue is the inclusion of a number of other entities in the complying taxpayer test. For a company to meet this test, both it and the entities listed in section 48-110(3) must have a 5 year history of total compliance. As noted above, this could be difficult for one company to ascertain, let alone ensure, for all the entities which may be included based on the list in section 48-110(3). This is intended to prevent a taxpayer who would not pass the test from using a related entity to do so (EM at 1.31). Again, this will unfairly disadvantage companies which, through no fault of their own, fail this test due to non-compliance by a related entity over which they have no control or even perhaps knowledge.

Creation of a strict liability offence

The above test leads to one of the most significant issues for companies in the ED; the creation of a strict liability offence. A company will commit an offence of strict liability if, at any time during its participation in the quarterly credits system:

- It fails any of the three tests currently contained in the ED;
- Its participation is not revoked under section 48-410; and
- It does not withdraw from the scheme of its own accord within 28 days after failing one or more of those tests.

The penalty is 60 penalty units or $10,200 based on the current penalty unit of $170. For a company in a refundable R&D tax offset position (i.e. tax loss), this is not an insignificant sum.

Moreover, as already identified, a company may not be aware of its non-compliance or non-compliance by a related entity. Whilst the defence of mistake of fact is still available (EM at 1.110), it remains an overly punitive approach and highlights the difficulties inherent in such a broad 'complying taxpayer requirement'.

It is likely that the creation of a strict liability offence will dissuade companies from participating in the quarterly credits system, not due to any lack of compliance or other eligibility, but because they cannot guarantee the compliance of related entities over which they have no control or limited knowledge of. It is recommended this not be an offence of strict liability and/or be limited to the company's own non-compliance and not those of others.