Michael Johnson Associates

Suite 4, 332 Darling St, Balmain
PO Box 542 Balmain NSW 2041
W mjassociates.com.au
T 02 9810 7211
F 02 9818 2297

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General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

RE: R&D Tax Incentive: Quarterly Credits Exposure Draft May 2013
Submission of Michael Johnson Associates Pty Ltd

Michael Johnson Associates (MJA) welcomes the opportunity to provide this response to the Quarterly Credits Exposure Draft (the ED). MJA is a specialist service provider in the area of government support for innovation. We have provided services to Australian companies in respect of the former R&D Tax Concession (the Concession) since its inception in 1985. We now assist organisations ranging from start-ups to ASX Top 100 companies in claiming the new R&D Tax Incentive (the Incentive).

In summary, we believe that the draft legislation delivers a workable system for the delivery of the quarterly credits but one that, by necessity, imports a great deal of complexity by way of the integrity mechanisms built into the program design. It will be incumbent on the Australian Taxation Office (ATO) to present and operate the system for taxpayers in such a way that makes this complexity comprehensible and doesn't end up as a "trap" that sees taxpayers inadvertently misuse the program resulting in crippling imposts in terms of repayments, interest and penalty obligations. The lessons need to be learned from the experiences associated with the R&D Tax Rebate under the old R&D Tax Concession regime. Design features from that program sent legitimate R&D companies to the wall. There is a risk that program complexity may lead to similar results with the new quarterly credits option.

A major shortcoming that is associated with the proposed package is the fact that the welcome conditions and timeframes imposed on the ATO in terms of payment of quarterly credits is not matched with regards to payment of annual credits. As such, taxpayers that take the more conservative option of the *post facto* annual payment are put at a distinct disadvantage.

We also wish to take this opportunity to voice our strong opposition and concern about significant additional changes to the Incentive contained in the ED, namely:

- Provision of new powers to Innovation Australia to make advance findings of its own volition or at the request of the Commissioner at any time in respect of any taxpayer, not just those seeking to access quarterly credits
- The "clarification" that R&D entities controlled by exempt entities *"at any time"* in the income year are only entitled to the 40% non-refundable R&D tax offset

The above issues both have impacts that reach far beyond the quarterly credits system. Both measures were not apparently contemplated in the previous discussion paper and have not been tested prior to their inclusion in the

ED. Unsurprisingly, stakeholders that we have consulted with in respect of the ED have focused on the intended design and operation of the quarterly credits system and have not appreciated the actual consequences of the above changes as they are presented in the Explanatory Memorandum as being measures mainly about facilitating the more efficient operation of the new quarterly credits system. We submit that the current package is an inappropriate mechanism for the making of these changes and that they should be removed from the current proposal and be pursued in a subsequent bill that has followed due process in terms of public presentation and consultation.

Quarterly Credits System

Reflecting on the package contained in the ED, we can see value in the quarterly option for taxpayers with simple fact situations and could see us recommending its use, particularly on the "safe harbour" basis.

The draft legislation has sought to address integrity risks by detailing a series of procedures and discretions by which the ATO (without the direct involvement of AusIndustry) is able to keep a relatively tight rein on program use while keeping the progressive payments option viable. We see this as understandable but, in viewing the proposed package as a whole, we are left with an overall impression that taxpayers using the system do expose themselves to a series of user tax risks that will require very careful management. Given that the draft legislation seeks to put measures in place for any future types of offsets that can be accessed quarterly, there is a need to ensure that the ATO delivers a crystal clear guide to potential claimants of this precedent offset as to how the legislation works so taxpayers can make an appropriate assessment of the value in using the quarterly system and have robust methodologies for managing issues in their claims as circumstances inevitably change over relevant income years.

As a result, we will be approaching the program cautiously with our clients and we feel that many may choose to opt for the more straightforward annual option.

A key concern that we have identified in the ED is that the introduction of strict time limits on the ATO in terms of paying quarterly instalments has not been matched by matching obligations with respect to those taking the annual payments option. Currently, the timing of the payment of the refund is not subject to any legislative requirements or regulator guidelines. Rather, it appears to be somewhat at the discretion of the ATO. Given that the annual option is the more conservative approach, we submit that additional legislation needs to be passed to provide definitive guidance as to payment deadlines on the ATO in respect of annual refunds so taxpayers aren't effectively penalised for taking the more conservative (and, arguably, prudent) approach.

Turning to the specifics of the package, we would like to make some additional comments:

- We are somewhat bemused by the reference in Paragraph 1.8 in the draft EM that the new Incentive has cut red tape. The new Incentive has definitely increased the paperwork burden on all taxpayers and those using the quarterly option will need to manage a range of 'red tape' issues as their R&D and their associated claims progress.
- The 'reasonable receipt' and 'complying taxpayer' tests regarding eligibility are examples of areas where taxpayer beliefs need to be in alignment with ATO views and where the ATO has a great deal of apparent discretion to allow or disallow access to the program. The principles and guidelines by which the discretions are determined and operated need to be publically available and readily accessible.
- As indicated earlier in this response, our impression is that the 'safe harbour' option is the one that most taxpayers will gravitate towards unless they have a very high degree of confidence about an increasing R&D expenditure scenario for their business in a particular year.
- The circumstances in which the Commissioner can disallow applications to vary amounts because of unacceptable risks to the Commonwealth (Paragraphs. 1.67 – 1.75 of the EM) should be better spelt out.
- An example of program complexity and tax risk can be seen in the discussion contained in Paragraphs 1.102 to 1.112. If a taxpayer becomes ineligible for reason of failing one of the relevant necessary tests, the onus is on the taxpayer to be aware of the failure and withdraw in time or face the prospect of possibly being charged with a strict liability offence. This underlines the need for the ATO to provide sound guidance as to the basis on which program participation is conferred to interested taxpayers.

Subdivision 48-C provides for three tests for participation in the program. These are:

1. The reasonable receipt test (s48-105),
2. The complying taxpayer test (s48-110), and
3. Any extra test listed in the table for the tax offset being currently 1 year history of offset eligibility under s355-100 in the last 5 years.

Section 48-405 requires the taxpayer to actively withdraw from participating in the quarterly credits system within 28 days of failing any one of these three tests. This requirement to withdraw is in addition to revocation by the Commissioner for failing to meet the tests or as a result of Innovation Australia refusing to make an advance finding for reasons in accordance the decision making principles.

Failure by the taxpayer to withdraw for reasons in addition to the required revocation within a month will result in penalties being applied. This is harsh as a common reason for a taxpayer to no longer be eligible other than by revocation would be failure of the reasonable receipt test. This test requires that it is reasonable to expect that the taxpayer would be entitled to the offset (ie. it is undertaking eligible R&D activities) and these will be subject to the refundable rules. In regards to the entitled part, the withdrawal should be prior to the payment for the next quarter after it is reasonable to determine that R&D activities have ceased rather than within 28 days.

In regards to the refundable expectation, this should be clarified as whether this merely means the R&D entity is eligible for the 45% refundable offset (ie. below $20 million group turnover; not controlled by exempt entities etc.). If this rule requires all quarterly payment participants to determine both ongoing 45% refundable eligibility and whether they should be in tax loss by the end of the accounting period throughout that period or suffer penalties, then this is an onerous requirement. This requirement will at best discourage participation or, at worst, put a taxpayer into the penalty regime unreasonably.

Increased Powers for Innovation Australia

The ED indicates that the reason that Innovation Australia is not to play a direct role in the application for quarterly payments is to streamline program access. This certainly reduces the paperwork in an initial application but the increased powers conferred to Innovation Australia to make advance findings at any time that can directly affect (including halting) quarterly payments adds a significant measure of volatility to the program for end users. In other words, you don't have to notify AusIndustry upfront as to the R&D being conducted but they can call it into question at any apparent time without any apparent basis for doing do. Some form of notification may add to paperwork in the short term but would lead to better targeting of claims of concern. The 'ATO only' nature of the application appears to streamline the process but it, in fact, ramps up attendant program uncertainty.

Our concerns about the impact on the value of the quarterly credits system about the proposal that Innovation Australia will now be able to make advance findings about activities and R&D entities at any time of its own volition or at the request of the Commissioner are dwarfed by those relating to the fundamental alteration of the fabric of the Incentive represented by the change.

Advance findings were put forward as a means of adding certainty to taxpayers seeking to plan for support through the Incentive for their R&D over a time period of up to three income years. The application process has proved to be a demanding one as there is a high hurdle to establish a finding of binding eligibility for R&D activities yet to be performed and taxpayers can only reasonably make such an application when they have supporting arguments and evidence of a high quality. The fact that the option has not been available to Innovation Australia has protected program users from being put into audit situations at the discretion of the regulators involving future work where the requisite level of information quality is not available.

Unfettered, Innovation Australia could make use of the mechanism to eliminate potential R&D claims in future years because the taxpayer can't satisfactorily establish a case in the present about activities that are yet to occur. On its face, this is most alarming. What has been a shield for taxpayers now appears to be a sword for the Government. Unfortunately, the ED provides no guidance as to the circumstances and guidelines by which advance findings can be initiated by Innovation Australia and the ATO. These matters need to be tabled, scrutinised and debated before such a legislative reform could be supported.

This radical change in the overall philosophy of the Incentive has not been tested at all in the crucible of public opinion and we oppose the proposed provisions in the strongest possible fashion. As the proposal stands, Innovation Australia has the power to effectively eliminate the claims of tomorrow on the basis that the evidence of today is insufficient. We accept that Innovation Australia would seek to exercise the powers responsibly at all times but it does not obviate the fact that, should the excluded activities prove to be eligible in the fullness of time, the taxpayer will have a mountain to climb in the face of an adverse advance finding. The ED raises too may unaddressed questions and this change **should not** be made.

On the positive side, the extension of the timeframe in which an advance finding application can be made from the last day of the income year to the closing date for lodgement of a registration application (ie. 10 months after the end of the income year) is welcomed (Paragraph 1.131).

Exempt Entities Technical Clarification

At Paragraph 1.161 of the EM, it is noted that doubts have been raised about whether the reference to an R&D entity being controlled by exempt entities requires the entity to have been controlled for the whole year, only at the end of the year, or at any time during the year. The amendments seek to remove the legitimately-held doubts by enshrining the strictest interpretation so that the provisions apply to an entity controlled by an exempt entity *at any time* during the year.

This is another example of legislative reform without the application of due consultative process. Our position is that the encouragementnfor companies to meet the control test is diluted by the fact that the refundable component only becomes available in the year after you make the change rather than in some form in the year in which you actively respond and that this position could be supported by a promotional interpretation of the existing provisions. Unfortunately, this is the first opportunity afforded us to make the case with respect to the clarification.

Further, the basis for this dilution of the attractiveness of the refundable offset remains undisclosed in the solitary paragraph contained in the ED.

We submit that the issue should be put into public consultation and that the clarification **should not** form part of the current package.

Should you wish to discuss any aspect of this response, please contact Kris Gale, Managing Partner, MJA on (02) 9810 7211 or kris.gale@mjassociates.com.au

Yours Sincerely,

Kris Gale
Managing Partner

Michael Johnson Associates

Suite 4, 332 Darling Street Balmain NSW 2041; PO Box 542 Balmain NSW 2041
ABN 65 003 644 657
Website mjassociates.com.au
Email kris.gale@mjassociates.com.au
Phone 02 9810 7211 Mobile 0411 171 596