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The New Research and Development Tax Incentive.
Submission re Exposure Draft Legislation Tax Laws Amendment (Research and Development) Bill 2010.

Dear Sir,

My position is not to query the desirability or otherwise of the content of the proposed legislation as it may affect particular sectors of the business community but to highlight some perceived drafting inconsistencies or omissions in the legislation itself or descriptive inconsistencies between the legislation and the explanatory memorandum.

Section 355-35 Supporting R&D activities
(r) computer software services not otherwise covered by this subsection

EM. Any other computer software services are also excluded.

Comment;
There is no prior mention of computer software services in either the legislation or the EM. The legislation is focussed on “developing computer software” and the acceptable form of commercialisation. It then identifies two types of development activities that are specifically excluded.
There is then a conceptual shift away from development to a service.
The terms “not otherwise” and “any other” imply that there are computer software services that are eligible.
The confusion arises in that on the one hand the Section is focussed on R&D activities and suddenly switches its eligibility criteria to focus on a method of delivery that is undefined.
It is assumed that a software service that meets the commercialisation criteria in para (O) is not excluded. However, this is not clear.

Section 355-215 R&D activities conducted for a foreign entity.
Section 355-405 Expenditure not at risk.

Comment;
The context of Section 215 is not in question per se. The Australian R&D entity is required to perform “eligible” R&D activities under a binding agreement. Presumably under such a binding agreement the Australian R&D entity will require payment. Such payment is normally on a “time and charge basis” or full cost recovery with monthly payments and annual adjustments for overs and unders. From experience it would be a rare Australian subsidiary of a foreign entity that would undertake R&D activities on behalf of that entity without some arrangement for full cost recovery.

Section 405 would effectively deny the deduction of expenditure by the Australian R&D entity under sections 355-200 or 355-480 as the reimbursement of expenditure, under whatever guise or descriptive formula, by the foreign entity makes the expenditure by the Australian R&D entity not at risk.

It is my understanding that the intent of the legislation is to encourage the undertaking of R&D activities in Australia and that the perceived flow on benefit to Australia is the building of a skill base and the generation of technical knowledge that would otherwise have resided overseas.

Section 355-215 makes no mention of restrictions as to the payment arrangements of the binding agreement. If the intention is to allow only that expenditure that is at risk, this should be defined within the section.

Alternatively and preferably a para should be inserted into Section 355-405 that the provisions of the section are not applicable to expenditure incurred as a result of arrangements entered into in Section 355-215

Section 355-220 Expenditure that cannot be notionally deducted.
Expenditure on Core technology.

(b) the R&D activities were or are an extension, continuation, development or completion of the activities that produced the technology.

EM. This exclusion is aimed at expenditure incurred by an R&D entity in “bringing in” technology that is already developed and does NOT extend to expenditure that the entity incurs in developing technology itself.

Comment;
The legislation and the EM appear to be at odds.
It is understood and accepted that the purchase of core technology itself is to be excluded. However, it should not be assumed that core technology is complete technology. Core technology may provide a technical leverage point just as one uses a piece of machinery to dig a large hole rather than using a teaspoon or ones bare hands.

For example, in researching a cure for cancer, one may become aware of a piece of third party technology that is a stepping stone in the discovery process. There are associated and non associated avenues of work and in the process the third party technology will be transformed or merged into other in-house developed technologies.

Under the new legislation the expenditure relating to the initial core technology cannot be notionally deducted.

A reading of the EM would indicate that all the surrounding R&D activity related expenditure incurred by the R&D entity could be notionally deducted.

A reading of para (b) would indicate a need to isolate any activities that could in any way be linked to the core technology that has been purchased. This would be virtually an impossible task.

If the intention is to disallow core technology expenditure this could be achieved by placing a full stop after the word activities on the last line of section 355-220 (2) and deleting the word “if” and sub paras (a) and (b).

Any R&D activities whether related to core technology or not would need to pass the criteria set in section 355-20.

Section 355-450 Feedstock adjustments

Comment;
The explanation of the operation of this section in the EM goes to great lengths but somehow sidesteps a simple example. The wording of the method statement in the legislation is in such shorthand that it actually makes difficult something that for the majority of R&D entities who may be affected by the provisions, is quite simple.

Surely a logical first step is to identify and isolate quarantined expenditure.

Could we please have a clear definition of the terms that impact on the value of the feedstock amount and then the application of the KISS principle to its application.

A simple example. I develop an “R&D box”. I place a market value of $100 on it. It took $20 for conceptual design and $60 to prototype and test. (Assume all eligible R&D)
Using a common sense approach I claim $80 as a notional deduction for R&D and record the expenditure in the appropriate account codes in my P and L
The $100 will be recorded as income in my P and L.
Had I no prototyping and testing and the $60 was simply for construction, I would have a notional deduction of only $20 and record all expenditure as cost of sales

Using the Method statement
Step 1. Output value is $100.
Step 2. (a) Output cost is $60 (Less quarantined expenditure)
(b) $0
Step 3. Lesser of Output value and output cost $60
Step 4. $60
I am assuming that this answer is the feedstock amount .

I deduct the feedstock amount from my R&D notional deduction of $80 and I am left with a notional deduction of $20. If correct I have just wiped out my entitlement for a notional deduction for all my R&D activities other than the quarantined activities.

If not correct and I should deduct the feedstock amount from the output value, I would have a retained notional deduction of $40. In this case the impact of the feedstock amount is controlled by an output value rather than an output cost. It takes little ingenuity to realise that the notional deduction can thus be easily manipulated via adjustments to the output value.

I have obviously missed a logic step but then so too has the Method statement or the remaining text of section 355-450.

Section 355-600 Head company treated as registered.

Under Part 3-90 of the ITAA 1997 subsidiary members of a consolidated group or multiple entry consolidated group (MEC group) are treated as part of the head company of the group for income tax purposes.

The purpose of consolidation was to simplify reporting and compliance .

Under the terms Industry Research and Development Act registration of R&D activities is on an R&D entity basis. Hence a consolidated group with ten subsidiaries is treated as a single entity for tax purposes but, assuming all subsidiaries undertake eligible R&D activities, would require ten separate registrations. In groups where there is a sharing of R&D activities within a single project, the single entity registration requirement results in reporting duplication and added administrative costs.

In many consolidated groups the head entity is also the principal performer of the R&D activities with lesser inputs from the subsidiaries. From a taxation perspective, whether the costs related to the R&D activities were incurred in the subsidiary or head entity is immaterial. Similarly, whether the R&D activities are registered in the name of the subsidiary or the head entity should also be immaterial. The requirement is that the activities are registered.

Section 355-600 sets out the terms applicable to the head company of the group where those conditions are predicated on the status of a subsidiary member of the group. The section does not seem to envisage that the head company of the group be afforded the same treatment where the head company is itself an R&D entity and registered.

The inclusive treatment of the head company could be achieved by the insertion of the words “the head company or” in the third to last line of the section after the phrase “during any period that”…..

I propose that the legislation be further amended to allow the head company of a consolidated group to elect for a single annual group registration. This would bring the registration into line with the taxation treatment of the associated expenditure.

It is recognized that a single registration of the group would mean that the subsidiary entities of the group have no R&D history. With the changes in the legislation from a taxation concession to a taxation credit and the repeal of the premium concessional rate of 175%, the requirement for an R&D history is no longer justified. Arguments that individual entity registrations impact or are needed to determine aggregate turn over and minimum levels of R&D expenditure are plain untruths. The consolidated group is treated as a single entity for tax purposes. There is no reason why a consolidated group should not be offered a single registration and that the expenditure threshold to access the notional R&D deduction be based on group expenditure rather than individuals within the group.

Submitted for consideration

QuickTime™ and a
TIFF (Uncompressed) decompressor
are needed to see this picture.

Rudolf Werner

Managing Director

5 February 2010