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R&D Tax Incentive: Quarterly credits submission

Ernst & Young welcomes the opportunity to comment on the Treasury Exposure Draft Consultation Guide R&D Incentive: Quarterly Credits, issued in April 2013.

We support the Government's Initiative for refundable quarterly credits which is an important part of the R&D Tax Incentive for SMEs. It provides a valuable incentive and allowing claims on a quarterly basis will provide very real benefits to a range of R&D focused SMEs. Checks and balances are required to ensure that quarterly payments are administered fairly, while protecting the revenue, and the integrity of the tax system.

In this submission we have set out a number of comments and suggestions in relation to the proposed arrangements to improve the efficiency and effectiveness of the proposals for small business.

Complying taxpayer test

Established history of compliance – less onerous that it appears – clarification for start-up companies

The exposure draft legislation imposes a requirement under *sub-section 48-110(2)(b)* for taxpayers who wish to access quarterly credits to "...have an established history of compliance with its obligations under those laws over the last 5 income years". The reference to "those laws" meaning "taxation laws" and Part III of the *AusIndustry Research and Development Act 1986. sub-section 48-110(2)(a)*. An initial reading of this sub-section may lead the reader to believe that the proposed law requires five years of incorporation and compliance with taxation laws before a taxpayer can become eligible for quarterly payments (a "five year existence rule"). This interpretation is fostered by the requirement to have an "established history of compliance". In our opinion, this is an onerous burden that would exclude all start-up companies from accessing quarterly credits and indeed many of the companies that require the support of the quarterly R&D payment system. This uncertainty requires clarification given the examples provided in the exposure draft and public statements suggest there is no intent for the system to be limited by a "five year existence rule".

There is significant evidence that the intent of the proposed law is not to impose a "five year existence rule". The EM to the exposure draft explains at [1.27] that an "entity would comply with its obligations so long as it meets every obligation imposed on it by a 'taxation law'. These are Acts of which the Commissioner of Taxation (the Commissioner) has the general administration (such as the income tax law, the GST law and the fringe benefits tax law)..." At [1.28], the EM provides examples of compliance including lodging tax returns on time, complying with requests for information and paying tax debts in a timely manner. A company which is not yet in existence cannot be said to have failed to meet these obligations – these obligations simply do not apply. In other words, the test would be failed where a company has demonstrated non-compliance over the last five income years. The test is not failed simply where a company has not been subject to those obligations for part of the last five income years (due to non-existence or any other reason). Further, the situation is even more illogical from an administrative perspective – a company would be excluded from quarterly credits if any entity "connected with" it or an "affiliate" are less than five years old: *ss488-110(2)(a), (b) and ss488-110(3)*.

The Treasury Exposure Draft Consultation Guide R&D Incentive: Quarterly Credits also makes reference to quarterly credits being applied to support start-up companies, which suggests that indeed the test is a "five year compliance rule" rather than a "five year existence rule". For example, on page 5, it states "It is important to note that start-up companies may be eligible for the R&D refundable tax offset received at the end of the year, just not on a quarterly basis. When such a company has established at least

one year of R&D tax incentive history, it can opt-in to quarterly credits (providing all other eligibility tests are met).” A five year existence rule would, by its nature, exclude all start-ups from claiming quarterly credits just at a time when cash-flow is critical. At no other point in the EM or the Treasury Exposure Draft Consultation Guide R&D Incentive: Quarterly Credits is the exclusion of companies less than five years old discussed, despite the significance of such exclusion should it exist. This lends weight to the view that the “five year existence rule” is an unintended misinterpretation of the proposed law.

A “five year compliance rule” which does not impose a requirement for five years of existence does not open the gates for exploitation by phoenix companies. To participate in the quarterly credits system, a company must have been entitled to a tax offset for at least one year of the last five income years: item 20 in the table to *s48-100* (the “history test”). As noted by the EM at [1.44], this requirement reduces the risks that can arise through the activities of “phoenix” companies.

Finally, example 1.8 in the EM which deals with compulsory withdrawal makes reference to a company which has been participating in the quarterly credits system despite having been incorporated fewer than five years. By necessary implication, in this example the corporation was not excluded from the quarterly credits regime by mere reason of time since incorporation. It is also interesting to note that the example treats the “history test” as providing protection against the mischief perpetrated by the company implicit in the example.

Suggested Action

In order to promote clarity in the law and ensure that start-up companies do not fail to access the quarterly credit due to misapprehended readings of the legislation, it is suggested that *sub-section 48-110(2)(b)* be rephrased in the negative – that is:

“each of those entities must not have demonstrated non-compliance with its obligations under those laws at any time over the last 5 income years...”

Alternatively, a note should be added in the legislation providing clarity that a company that has not existed for five years may still be eligible, provided it otherwise meets the complying taxpayer test.

In the event that our view is incorrect and the exposure draft seeks to implement a “five year existence rule”, it is nevertheless submitted that the change suggested above is still desirable for various reasons, including:

- A “five year existence rule” would unduly restrict many start-up and SME companies from accessing the R&D quarterly credit system because they are unlikely to have the requisite five year compliance history. Exclusion of start-ups and SME’s is contrary to stated policy objectives. The quarterly payments system would benefit start-ups less than five years old the most, as it is at this time when cash-flow is often critical to the survival of such companies; and
- This change does not increase the risk of mischief by “phoenix” companies due to the continued application of the “history test”.

Excusing instances of noncompliance – clarification of scope and application

Whilst the draft legislation provides that the Commissioner may excuse an instance of noncompliance pursuant to proposed *sub-section 48-115*, it is not clear how this may be applied in relation to the multitude of tests proposed per *sub-section 48-110(2)*.

Suggested Action

We would suggest that Treasury clarify the level of severity of an instance of noncompliance and provide some examples of what would be considered a minor infraction versus a major infraction in the EM. This would be helpful as it will assist SMEs to self-assess eligibility to participate and provide a greater level of certainty around the likelihood to be excused.

Withdrawing participation - harsh penalties for oversight - high administrative burden

Section 48-405 of the proposed legislation sets out the consequences for an entity’s failure to withdraw from the quarterly credit system within 28 days of failing one of the tests necessary for it to participate. Such a failure constitutes an offence of strict liability with a maximum penalty of 60 penalty units: *s48-405(2)*. In the alternative, the entity will be liable to pay the Commissioner an

administrative penalty of up to 20 penalty units: *ss48-405(3)*. As of the date of writing, one penalty unit is \$170: *s4AA Crimes Act 1914*.

The offence specified in *ss48-405(2)* is one of strict liability which means that an entity cannot shield itself from liability by pointing to a lack of intention to commit the offence. This is problematic as the quarterly credit eligibility tests lack clarity (evinced by the discussion above) and have yet to be judicially tested. In addition, because of the inclusion of various other entities in complying taxpayer test (e.g. entities “connected with” and affiliated entities) it is easy to envisage a situation where an entity fails one of the participation tests without any knowledge of the failure, and is therefore unable to withdraw from the quarterly payments system within 28 days. In the current drafting of the proposed legislation, such an entity would unknowingly have committed a strict liability offence. This entity would also be liable to pay the general interest charge: *ss48-420(3)*, EM at [1.93].

Suggested Action

Remove the offence of strict liability imposed by *sub-section 48-405(2)*. The administrative penalty imposed by *sub-section 48-405(3)* is sufficient to deter entities from participating in the quarterly credit system where they fail an eligibility requirement.

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In summary we are supportive of this policy and believe that providing timely access to cash flow for SMEs that are in the early stages of development as a desirable policy outcome and we hope our comments in this submission will help Treasury to improve the effectiveness of the policy by reducing the administrative burden for SMEs.

Thank you, once again, for the opportunity to present our submission. Should you have any questions in relation to the above, please contact me on (08) 9429 2251, Mark Chan on (02) 9248 4442 or Ezra Hefter on (08) 9429 2293.

Yours sincerely



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