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12 April 2007

To whom it may concern

**Tax Laws Amendment (2007 Measures No. 2) Bill 2007
Research and Development ("R&D") Tax Concession
Submission in Respect of Changes to the Incremental Concession**

Please find set out below our submission in relation to the Tax Laws Amendment (2007 Measures No. 2) Bill 2007 ("the Bill"). Our submission relates to the R&D Tax Concession aspects of the Bill, in particular the changes to the Incremental Concession.

Executive Summary

This submission arises out of certain changes to the R&D Tax Concession introduced by the Bill in respect of the 175% Premium Deduction. In particular, the submission relates to Items 19 and 20 of Schedule Three of the Bill.

Item 19 will change the operation of the Incremental Concession such that it operates fairly and as the legislature originally intended. Item 20, sets out the date from when the change will apply and provides that the change will apply to income years commencing the year after the Bill receives Royal Assent.

It is our opinion, for the reasons set out in greater detail below, that applying the changes to section 73(X) only to prospective income years is unfair and that the changes should operate retrospectively as they are aimed at correcting an acknowledged technical drafting error in the original legislation.

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Current Legislation

In general terms, the legislation to which the Item 19 applies relates to the operation of the Incremental Concession. The Explanatory Memorandum to the Taxation Laws Amendment (Research and Development) Act 2001 ("the 2001 EM") states the following in respect of the introduction of the Incremental Concession

" [the incremental concession] will induce additional R&D whilst increasing certainty for R&D decision makers and improving access to the concession for companies."

"The incremental concession is designed to encourage additional business investment by eligible companies in R&D over and above prior year levels of spending on R&D."

"Generally, a company works out the amount that will be subject to the additional 50% deduction by subtracting its average incremental expenditure over the past 3 years from its current year incremental expenditure ..."

Broadly speaking, the mechanism by which the incremental concession is executed is by allowing a deduction equal to 50% of the amount defined as the "Premium Amount". As explained in the 2001 EM, in the most general terms, the Premium Amount is equal to the current year R&D Spend minus the average of the prior 3 years' R&D Spend¹.

In order to ensure that groups of companies were not advantaged or disadvantaged by the new concessional deductions, complex grouping provisions were also introduced at the time.

The section which applies relevantly in the current context is section 73(X). Section 73X:

- "The premium amount is distributed between each of the group members (the **increasing members**) that increased its incremental expenditure incurred during its group membership period for the Y_0 year of income over its incremental expenditure incurred during its group membership period for the Y_{-1} year of income"

¹ It is acknowledged that various provisions operate such that the Premium Amount is not always calculated in this manner, this example is for illustrative purposes only.

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The purpose of this section appears to be to ensure that only those members of a group of companies who increased their R&D Spend above the prior 3 year average would be entitled to a portion of the group's 175% Premium Amount (as calculated under sections 73Q to 73W).

However, shortly after the introduction of the new provisions, it became apparent that the section 73X had following serious flaws:

1. In the case of the single company who had increased its R&D Spend above its 3 year average but not above Y_{-1} – it was not clear whether or not that company would be entitled to a premium deduction.
2. In the case of group companies, there are severe adverse effects when the largest company (as measured by R&D Spend) in a company group had increased its R&D Spend above its 3 year average but not above Y_{-1} .

Policy Intent

As explained above, following its introduction, the legislation as worded and introduced was not giving effect to the associated policy intent. The amendments contained within the Bill are, in our view, designed to rectify the problems with the legislation. Our view is based upon statements contained with the Explanatory Memorandum ("EM") to the Bill which sets out the reasons that the changes are being made and provides that the changes are being made:

"... [to] improve the operation of the R&D provisions by amending taxation legislation to clarify the law, remove unintended consequences and ensure that the law reflects the original policy intent in relation to the tax offset and the premium incremental concession."

Timing of the Proposed Changes

It is the purpose of this letter to highlight a discrepancy in the timing of the proposed amendments, which, in our view, unfairly disadvantages groups of companies who have previously been unable to claim the Incremental Tax Concession due to acknowledged and unintended flaws in 73X which are to be remedied via the Bill. In particular, Item 20 provides that the change made by Item 19 will only apply going forward to those income years commencing the year after the Bill receives Royal Assent. It is our view that when a provision is acknowledged as being flawed, amendments to that provision should apply retrospectively to ensure that the original intent of the legislature is given effect from the original time that the provision was introduced.

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Request

In our view Item 19 should operate retrospectively. The Bill is designed to address acknowledged flaws in the original legislation. As set out above, the original legislation did not give effect to the stated policy intent and as a result groups of companies have been denied Incremental Concession deductions that were intended by the legislature. Item 19 of the Bill should apply retrospectively such that all Incremental Concession claimants, both individual companies and groups of companies, have been treated equally since the introduction of the Incremental Concession and have been allowed to claim deductions as intended originally by the legislature.

We recommend that Item 20 be changed to read:

“The amendment made by item 19 applies to assessments for years of income starting after 30 June 2001.”

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Should you have any queries, please do not hesitate to contact me on (02) 8266 0470

Yours faithfully



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