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Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
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CANBERRA ACT 2600

24 August 2007

Attention: Committee Secretary

Tax Laws Amendment (2007 Measures No. 5) Bill 2007 (the Bill)
Schedule 11 – Research and Development

The Government's initiative to increase business expenditure on R&D ("BERD") is to be commended. However, it is our view that the proposed amendments, extending the premium 175% R&D Tax Concession to companies belonging to a multinational group, do not go far enough in encouraging a broader increase in BERD.

That said, we have limited our submission to the scope of the proposed Bill. In summary, the Bill provides for the following:

- A base rate deduction of 100% will apply to expenditure incurred on "Australian centred research and development activities" undertaken on behalf of a foreign company, which resides in a country with which Australia has a double tax treaty, pursuant to a written agreement between the two companies. Under this measure, a premium deduction of 175% will be claimable subject to there being an increment over the prior three year rolling average.

- Broadly Australian-centred R&D activities are those R&D activities undertaken and funded in Australia, or else funded and beneficially owned by a foreign company and directly related to core R&D activities undertaken in Australia.

- The written agreement must be between the foreign company and the eligible company and no other party. The activities can be undertaken by the eligible company or be sub-contracted to another.

- In order to be operative sub-section 73B(9) of the *Income Tax Assessment Act 1936* ("ITAA 1936") can not apply. Also not applying in relation this new program is section 73CA of ITAA 1936, which would otherwise deny deductions, as it applies to funding/reimbursement of costs by the foreign company of any R&D undertaken in Australia.

- The program applies for years of income from 1 July 2007. As per the existing 175% program, the additional deduction applies to the increase over the average of the previous three years. The rolling 3 year average is determined by one of the following transitional rules:

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- If nil expenditure, (therefore able to claim all eligible expenditure at 175%) - in order to qualify, the eligible company, and any other company to which it is grouped for R&D purposes, could not have existed in Australia in the preceding 10 years. Further, the foreign company was not a primary or secondary group member of any R&D group during the preceding 10 years.
- The transitional rules obviate the need for an R&D Plan and therefore apply to expenditure in the prior thee years that would otherwise not have been claimable had the R&D plan requirements applied
- Where a company has had a presence in Australia before 1 July 2007 and the nil expenditure rule does not apply, transitional measures have been introduced whereby the previous 3 years are deemed to be 90%, 80% and 70% of initial year amount.

In respect of the above, we submit the following:

- The policy intent was to increase investment in R&D in Australia by multinationals. However, the provisions contained in the Bill as it stands may only be accessible by a select group of companies in select industries, rather than companies generally. Even then, for those companies that could make use of the 175% concession for activities undertaken on behalf of a grouped foreign company, the process of applying appears to be administratively and compliantly cumbersome and overly complex to understand. Companies would have to consider carefully the cost benefit analysis of accessing these new deductions.

- The use of the terms “Australian-centred research and development activities” and “expenditure on foreign owned R&D” adds unnecessary complexity to what essentially is the same concept. In relation to the method statements the use of “Australian owned R&D” imports notions not existing under the current legislation and, without clarification as to the concept and context of “owned”, could create confusion.

- In order for the expenditure to be claimable a written agreement is required. No details have been provided in relation to this written agreement. For example, when is the agreement required to be in place? The impact of such agreements on transfer pricing considerations is also not clear. Given the proposed amendments to subsection73B(31) of the ITAA 1936 does this mean cost is sufficient in terms of payment or will cost plus be required by the Australian Taxation Office?

- The requirement that the activities be directly related and have the sole or dominant purpose of supporting a core R&D activity conducted in Australia further limits the application of this initiative. Global companies undertake global projects which, as a whole, would qualify as R&D. Some companies will be undertaking activities that would otherwise qualify as foreign-owned R&D but for the unduly restrictive requirement there need be a core activity undertaken in Australia. The necessity and practicality of this requirement needs to be considered against the backdrop of the policy intent.

- With respect to those companies with a pre 1 July 2007 presence, the deeming provisions in relation to incremental spend history and the concept of “notional expenditure on foreign owned R&D” as provided for in the proposed section 73RB could be disadvantageous for some companies. If a company could identify the expenditure in relation to foreign owned R&D, and the amounts are less than what is calculated under the 90-80-70 rule, is it be the case that a company would be defaulted to use the transitional provisions thereby reducing the 175% entitlement?

- Further, do the transitional rules for a company without a nil expenditure entitlement (and therefore a deemed notional three year rolling average) then require that the company amend

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any entitlement to the 175% premium concession that has been claimed in the three years immediately preceding 1 July 2007? If so, this creates an additional compliance headache for claimants because of the deeming rules.

- The application and operation of the "nil expenditure" clauses are unduly restrictive. The "nil expenditure" status can be lost quite easily through changes in the group structure, such as the acquisition of the Australian company which did exist at any time in the 10 years prior to 1 July 2007. Further as the local company has no history, deductions would not be available under the Australian-owned R&D provisions. By implication this appears to go against the intent of encouraging foreign investment.

- The proposed "wholly or primarily on behalf of the foreign company" test is ambiguous. There is no definition of "on behalf of" in this legislation. The term "primarily" is not further defined. Given this is central to the legislation and therefore key to the intent, this should be clarified given that an adverse interpretation can lead to a denial of deductions under proposed section 73QB.

- The extension the Australian Group under section 73L of the ITAA 1936 to include companies not claiming the 125% concession that may be undertaking foreign-owned R&D (there is a positive requirement to include R&D expenditure even if it has not been registered), may adversely impact other Australian group entities ability to claim the 175% premium. This would appear to be at odds with the intent behind the introduction of the 175% premium. Further, the pooling of both Australian-owned and foreign-owned R&D expenditure for the purposes of calculating the 175% premium might adversely impact Australian entities by impacting on the group R&D history and current year R&D expenditure.

- The ability to sub-contract the foreign-owned R&D activities down one level from the eligible company and that eligible company retaining the eligibility to include this sub-contract expenditure as "foreign –owned" is positive. However, this will require sub-contracts to be clear in terms of the on own behalf requirements to ensure that the sub-contractor and the eligible company do not make the same claim as different "on own behalf" requirements apply to the respective contracts.

- The provisions do not consider the actual manner in which global R&D is undertaken. For instance, there is currently no means for "in kind" overseas contributions to be considered as part of any 175% calculation.

In summary, what the above points highlight is the fact that the proposed extension of access to the R&D Tax Concession will only be of benefit to a small number of claimants, and not the R&D claimant community generally. Even for those entities that will qualify, there are a number of operative concerns and administrative complexities that must be measured from a cost/benefit perspective.

We would welcome the opportunity to elaborate on the points raised above in further detail. Please contact me on (02) 9322 3805 should you require clarification or further information.

Yours sincerely

Deloitte Touche Tohmatsu Ltd

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