



Internet Industry Association

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THE TREASURY CONSULTATION PAPER: THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

Submission by the Internet Industry Association

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About the IIA

The Internet Industry Association (www.iaa.net.au) represents the main net providers, content creators and associated services. It issues policy guidance to government and advocacy on business and regulatory issues, to promote laws and initiatives that enhance access, equity, reliability and growth of the Net within Australia.

The IIA was pleased to see the consultation paper - The new research and development tax incentive September 2009,

www.treasury.gov.au/documents/1599/PDF/Consultation_paper_90916.pdf

In particular, we applaud the following advances on the previous regime:

- Increased rates of benefits
- Removal of the complexities associated with the premium
- Extension of the rebate concept
- More generous provisions relating to overseas R&D
- Allowing foreign ownership of generated IP

However we note it failed to take up the Cutler report's recommendations concerning software in particular -

http://www.innovation.gov.au/innovationreview/Documents/NIS_review-chapter8.pdf

The Cutler report noted that

"... One area in which the Panel considers progress is possible is software development. Providing it is technically risky software development is eligible for the R&D Tax Concession. In addition it must be made available for multiple sale or lease. The Panel accepts that this is not an ideal situation because some such projects would both be worthy of assistance and might not go ahead without it. However we accept that the rule is there to prevent what would be large claims from large firms – for instance in retail and banking – on projects that would proceed without government support."

"On the other hand, there is one area in which it is clear that there will be substantial spillovers from software development. Where firms develop open source software and donate the code from their development back to the open source project, this will generate clear spillovers for the rest of the community which will be able to access their developments. It is hard to think of a more straightforward case for government support. The Panel accordingly recommends that R&D on open source programs should qualify for the multiple sale test. Given the pervasiveness of positive spillovers, it may also be cost beneficial to relax somewhat the degree of technical risk required in relation to open source software."

It recommended (R8.7) in the immediate term:

- R&D on open source programs should qualify for the multiple sale test;

Indeed the IIA notes that many recent advances in the digital economy are directly attributable to the strong support given to open source software developments, in particular.

Instead the Consultation paper has singled out software development and applications as a matter with the view to limiting even more applications for the new incentives.

Of immediate interest is Paragraph 76 dealing with software and websites -

76. It is clear that the eligibility of software R&D requires review. The United Kingdom (UK) system may provide a useful starting point for developing a new general approach to software R&D. Under the UK system, software projects considered unlikely to be eligible for tax incentives include:

- the handling of interactions with users (for example, the development of user interfaces and development of data entry procedures);
- using standard methods of encryption, security verification and data integrity testing;
- the creation of websites or software using tools designed for that purpose; and
- creating software that replicates an established paper procedure. That fact that a previously manual task has been automated does not in itself make it R&D.

Michael Kadoury, a lawyer specializing in the management of commercialising R & D concludes that, the upshot is that the new R & D funding arrangements will diminish funding to ICT industries to benefit traditional industries at a time when the investment is most needed (to support the NBN etc)

Though attractive at first glance, the new incentives will be tightened by redefining eligible R&D activities. Effectively they will be stealing from software, IT and internet industries to fund other industries, even though the Cutler Report also questioned the issue of “whole of mine” claims that appeared to favour mining and engineering interests in the past.

The IIA appreciates that the Government needs to allocate scarce R & D tax incentives with care. However no evidence was provided to sanction such discrimination.

If the proposed changes go through it could contract funding for most innovative software related projects within industry and exacerbate moves for companies to develop their projects off-shore.

Furthermore flaws inherited from the 80s definition of the “multiple sale test” for software and internet business and the difficulty of splitting the R&D cost of designing software from the cost of what is actually sold, the Government will restrict eligibility of the incentive for software development R&D.

The Discussion Paper’s example 3 of the attachments to the discussion paper, indicate a weakness in the current scheme with the multiple sale test without explaining why many internet based applications will be excluded under the new scheme.

A company in the finance industry undertakes to provide customers with an enhanced online experience and more simple use of the company’s products. The business solution will provide customers with access to an extensive range of on-line facilities. The project provides a common platform for delivery of software-based services over the internet. The project involves internal software development and the integration of a number of existing on-line services with single customer sign-in.

All activities are claimed to involve both innovation and technical risk. The existing multiple sale test provision for software is deemed satisfied, because customers are 'licensed' to access a single sign-on integrated on-line environment. The claim is expected to be in the order of \$15 million over the 4 year life of the project.

This claim illustrates the weakness of the current multiple sale test and the high level of taxpayer subsidy available to activities which largely involve customisation and/or integration of existing systems.

The IIA believes that this scenario is expedient. It would in any event fail even the current definitions of innovation and technical risk. Instead if a new definition was required the IIA would have preferred a dropping of the multiple sales test. As the Cutler Report suggests this already discriminates against open source software developments, commonly deployed in many internet platforms and services, in particular.

Inconsistent signals for R & D incentives for the local industry

Only two years ago, software and internet based companies had several options for government support for new R&D projects. There were upfront type grants like the commercial ready program and the R&D tax rebate. Many of these are now gone and send a discouraging signal to internet based software companies.

Two months earlier on 14 July, the Minister for Broadband Communications and Digital Economy issued effectively the Government's strategy on the digital economy: [*Australia's Digital Economy: Future Directions—final report*](#).

This made the strong and clear statement that (at p. 16 of the PDF version) -

It is important that Australia has a strong digital innovation research and commercialisation base.

Research and development, particularly in ICT, drives skills development and attracts investment, which can promote knowledge transfer. It can also increase Australia's innovation capacity. It noted that ...too many Australian inventions and discoveries end up being commercialised overseas, where the value they create is captured by others. This costs Australia jobs and wealth, and denies us the chance to build new industries.

At the same time, governments in the region such as Singapore are aggressively targeting software, internet and multimedia firms and talent with very generous grants for projects in that space. The IIA would welcome further consideration of the unwarranted targeting of software and internet research and development incentives.

Alternative options to revenue neutral outcomes

Indications have been that the government intends to keep the program revenue neutral, and this could be done by either;

- a. specifically excluding certain industries it want to exclude (such as mining or finance);
- b. tightening the definition of R&D; for example to say "innovative & high level of technical risk"; or
- c. Limit the funding for supporting R&D activities

The IIA would recommend that the government be open about its intention by using the first option and limiting only those industries or projects it wishes to specifically exclude.

The risk of limiting these industries through the definitions is that other types of projects or industries could be adversely affected. This could be creating conflicting policies and impact projects such as the National Broadband network.

The IIA also remains clear on the merits of firms' needing to distinguish core and supporting R&D activities.

If the policy intent is to limit all or part of the supporting activities then the IIA would be opposed to the idea. This would open the definition of what is claimable to individual interpretation and would create uncertainty and predictability in the new law. The current model which requires an element of core R&D activities each year which is supported by other activities should remain.

The experience of some IIA members is that where AusIndustry requires taxpayers to split activities into the two categories, these are often a precursor to disallowing some supporting activities in an audit.

Limiting funding for supporting activities could also remove much of the commercial elements of projects and adversely affect ICT based projects.

Theoretical science projects which focus only on core research with no supporting activities, development and therefore no commercial direction are important to Australia. They are already supported by other generous government funding targeting universities and other public institutions such as the Australian Research Council Grants.

Transition period

In the event the Government chooses to proceed with its proposal, it should consider the interests of those companies that have invested resources and other costs into existing project. There should be at least a two year transition period for those companies already working under R&D plan.

The IIA would suggest that firms that have submitted an R&D plan spanning over several years under the old system, should not be disadvantaged. They should be allowed to complete their projects under the old rules.

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