

A Response to the Research and Development Tax  
Incentive from the Perspective of Small Business and  
Open Source Software  
Greg Baker

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## 1 Abstract

This document is a response on the proposed new research and development tax incentive from a small business owner (Greg Baker, who owns and runs The Institute for Open Systems Technologies Pty Ltd).

It is the author's opinion that if the new initiative were put in place:

- Venture-capital funded firms would be better served than they are now.
- Self-funded start-up firms will continue to be poorly served by research-and-development incentives unless a provision for accruing R&D expenses is added.
- That the rules on software would still be a grey area
- That open source software development should automatically be regarded as research and development for tax purposes.

## 2 Venture capital funded startups

A typical venture-capital funded startup is launched with around \$1m-\$5m and spends 3-4 years without any significant profitability, 1-2 years profitably and is then floated on the share market so that the venture capitalist can get their money back in time.<sup>1</sup>

Australia's rules on continuity of ownership state that if the ownership of a company is changed, then any previous tax losses can not be applied against any future profits unless the continuity of business rule applies. Given that a company doing R&D is almost definitely doing so in order to introduce a new product, there is essentially no chance of passing the continuity of business rule.

In the past this has meant that venture-capital backed startups will generally lose some of their tax loss credits when they go public, because they simply haven't had enough time to generate enough profits to apply the tax credits against.

So I applaud the new model in which companies with turnover less than \$20million can get refunds immediately. This is excellent and will help continue Australia's very high per-capita venture capital investment.

## 3 Self-funded startups

Both the new scheme and the old scheme fail to support self-funded startups very well.

This is a problem. According to the CAUSEE study by QUT, roughly one-quarter of all new business startups consider themselves

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<sup>1</sup>*Enterprise Venture Capital in Australia* by Christopher Golis, who is a venture capitalist with Nanyang.

“hi-tech” startups, and a similar proportion say that “R&D expenditure will be a major focus”. Out of their dataset of roughly 1000 firms, precisely two of them had venture capital funding.

The vast majority of startups are initially funded from personal savings, credit cards, money from other business that the founder owns and personal loans. They then bootstrap themselves up from there<sup>2</sup>.

This is essentially what I am doing. In my case I am using my existing training and consulting business to fund the development of a new kind of intra-oral camera for dentists to use. So far, in the four-and-a-half years (with around \$200,000 spent) in which I have been working on this, only once have I been in a position to claim any R&D tax concession, because my company’s per-annum expenses on R&D are too low.

As for even more tightly cash-strapped startup firms (e.g. those launched from credit cards or personal loans) the idea of having a spare \$50,000 in a financial year to spend on R&D is simply laughable.

It’s rare for a small business to be able to devote more than 5% of its revenue to R&D. In the 2006 financial year I was fortunate enough to be able to devote more than 10%, but that was the most profitable my company has ever been.

In order to make the \$50,000 cut-off required in the previous legislation a company needs to have around \$1million per year in revenues per annum. This excludes the majority of small businesses.

And yet, it is these very same start-up small business which are the powerhouse of innovation, especially in the IT industry. Neither the previous scheme nor the proposed new scheme addresses this problem.

Dropping the minimum cut-off would not be efficient. The cost to the tax office to process small R&D returns would make the scheme too expensive to maintain.

The compromise which I suggest needs to be explored is the idea of allowing small businesses (e.g. with revenues below \$5million) the option of accruing R&D costs. It would not be permissible to lodge an R&D claim below \$50,000, but if \$50,000 were incurred over the space of 2, 3 or even 4 or 5 years then in the final year the total amount could be claimed.

A 5 year window would make it possible for a \$200,000-per-year self-funded company to invest in R&D if there is sufficient dedication. Many farmers – who might be interested in breeding new strains of crops – would benefit from this. Small innovative IT firms could benefit as well.

The documentation requirements and supporting evidence would not change, and the effort for the tax office involved to examine a

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<sup>2</sup>*Anatomy of New Business Activity in Australia: Some Early Observations from the CAUSEE Project* available as a QUT ePrint at <http://eprints.qut.edu.au/13613/>

claim would not change either regardless of the length of the accrual period – there just simply might be older dates on some paperwork.

There are probably other solutions which could be devised to better provide incentives for small business to innovate, but allowing R&D expense accrual is the simplest.

## **4 Comments on software**

The following comments may be premature since the paper admits that rules for what constitutes R&D for software is still a grey area.

I think the broad direction of the UK rules are correct, but I notice that (for example) Google Wave – which was developed in Google's Sydney office taking advantage of Australia's R&D tax concessions – would not meet the criteria to be considered innovative since it is only a "new" user interface for existing applications.

I would like to make an argument to suggest that open source software should be automatically included as qualifying for R&D concessions regardless of whether it meets any other criteria for being innovative.

The R&D tax concession is aiming to support risky ventures which bring about a greater good to the community.

When a company decides to develop software under an open source license instead of a closed-source commercial license they are taking a financial and commercial risk in the hope that co-operative behaviour with other companies will produce a better result than competitive behaviour.

That is, when IFOST, Cybersource, or some other Australian open source software company – releases some software under the Gnu Public License they guarantee that that the program (including source) will be accessible to everyone equally without cost. They do this because they are hoping that other companies will work with them and pool resources to produce a program which is much better than any company could themselves have produced.

They are taking a major risk because free-riders get to benefit from the work done without having to pay. But the benefit to the community from their decision to share rather than hoard is large since everyone can benefit.

The tax concession and/or rebate should only take effect from the moment that software is released under an open source license and never retrospectively because otherwise companies could receive a tax benefit from open-source-dumping a failed product which they never intend to maintain or fix.

The value multiplier to society of open source software is very high. A modern Linux distribution is estimated to have the equivalent of

several billion dollars worth of development donated to it<sup>3</sup> – but that the benefit to society just from the saved licensing costs is well in excess of one hundred times that.

For this reason, the GDP increase from encouraging open source software development more than compensates for the lost taxation revenue.

## **5 About the author**

Greg Baker BSc. (Hons) is the director of an Australian-owned consulting, training and development business (The Institute for Open Systems Technologies Pty Ltd) based at 10 Cassia Grove, Beecroft, NSW, 2119.

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<sup>3</sup>*More than a gigabuck: Estimating GNU/Linux's Size* by David A. Wheeler, available at <http://www.dwheeler.com/sloc/redhat71-v1/redhat71sloc.html>