

The New Research and Development Tax Incentive - Exposure Draft Legislation and Explanatory Materials

Comment on the exposure draft legislation and associated explanatory material

by

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Broadway NSW 2007

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This submission addresses two matters:

1. one limb of the definition of core R&D activities: the need for Core R&D activities to involve considerable novelty and high levels of technical risk; and
2. the exclusions applying to software.

1. Considerable Novelty and High Levels of Technical Risk

The Explanatory Materials (EM) states that “the rationale behind the new R&D tax incentive lies in the combination of the potential for technical uncertainty to discourage R&D activities and the potential for the knowledge gained from the conducting of R&D activities involving novelty to ‘spill over’ to the benefit of the wider Australian economy”. This concept is accepted and endorsed.

The EM further states “accordingly, the definition of R&D that is eligible for the tax incentive centres around the activities that are most likely to produce spillover benefits that, in the absence of the incentive, might not go ahead because of technical uncertainty. The R&D tax incentive is not intended as a subsidy for innovation in general. The degree of novelty needs to be considerable, rather than a mere logical progression from existing knowledge”. This concept is accepted and endorsed.

The EM further states “The threshold ‘high levels’ of technical risk is set down in terms of uncertainty that can only be removed through application of the scientific method based on scientific. This contrasts R&D from less rigorous ‘trial and error’ or ‘fitting’ that is part and parcel of simply making things work.” This concept will, in my extensive and ongoing experience of R&D projects, significantly limit support for genuine R&D that provides spillover benefits and from which the company cannot capture the full benefit.

The desire for both a novelty and a risk requirement for eligible R&D activities to be included in the legislation is understood. Companies will undertake activities that involve innovation in order to differentiate themselves in the market, but once this innovation is recognised competitors seek to adopt that innovation either directly if possible or with sufficient differentiation to avoid IP infringement. This provides benefit to the community but equally reduces the benefit to the original innovator, a

classic spillover effect. Consequently there is a powerful argument for the legislation to require novelty OR risk. To state this in another way, a company undertaking innovation is making a judgement that (1) the outcome will be acceptable to the market and also (2) it inherently attracts commercial risk in that if the outcome is a success then it frequently may not be able to receive full commercial returns. For these two reasons it is in the interest of the community, through a tax credit, to share the commercial risk associated with novelty.

In my experience activities that contain novelty also have technical risk. To require both conditions is certainly a stronger test, but to require “high levels of technical risk” in addition to novelty would, in my experience with hundreds of companies who have claimed the present tax concession, make many vital and important technical advances ineligible for the tax credit.

This distinction is particularly vital in regard to software development, but I only use software as an example as that is my primary area of expertise although my case against “high levels” of technical risk applies equally to other fields of scientific endeavour. In this regard I note that my written opinion on the eligibility of software activities was used extensively by AusIndustry in administering the Tax Concession and also was part of the case when the decision of the Tax Concession Committee to disallow certain software activities was upheld in the first test of the legislation before the AAT.

Software is recognised as a primary factor in increasing national productivity. When a new software product or service is envisaged – and by this I mean innovative and novel software– it is generally known that it can eventually be produced using current technology and development environments. It may be challenging, the interactions between the new software and the platforms on which it is to operate may be unknown and in particular the response of users to the new services cannot be foretold. When these users first experience a new function or service they very frequently have a long list of changes that they say they need before they will purchase it. As a consequence even with excellent software project management, meticulous planning and careful execution these factors combine so that nearly all novel software projects are late and over-budget and contain bugs.

The relevance of this is that technical risk is often not a significant factor. A company will recognise that the novel concept is commercially sensible; it may recognise that technical risk is finite but not high, but the process of producing that novel product or service is a major undertaking that, without some shared risk through a subsidy, will frequently not be undertaken. Should it be successfully completed there will be spillover benefits as its value is demonstrated and the principles adopted by others.

Recommendation:

To equitably apply the new tax credit the definition of R&D activities should not involve considerable novelty and high levels of technical risk but rather involve **considerable novelty and technical risk**

2. Multisale Test for Software

The EM states “the multisale test can only be satisfied where the purpose of the supply is to make a commercial return directly from the supply. This has the effect that the test is not satisfied where software is licensed for zero or a nominal charge — such as where principally made available to enable customers to access other products (for example, software supplied to customers so that they can conduct their online shopping or banking with the supplier of the software).”

This test is at odds with commercial reality. Software is viewed by the community as a commodity that they need not pay for because multiple copies can be produced at fundamentally zero cost or because there is an expectation that companies should provide that software service as part of their client interface. Both views ignore the real initial cost and ongoing maintenance cost of any operational software, but this attitude frequently prevents software from being sold like a physical commodity. The exception is enterprise applications, such large software packages intended for corporate use are paid for by the clients when they are supplied. Even for companies there are exceptions as open source operating systems, language compilers and applications demonstrate.

The attitude of users towards software has forced many suppliers to ‘hide’ the cost of supply in general client charges. The classic means is for banks or retailers to charge enough to cover their software costs, or for the inventors of small applications to receive payment only if the user upgrades to a version with greater functionality or to an enterprise version. These mechanisms are intended to be excluded by the multisale test yet such software can be innovative, novel, have entailed technical risk to produce, it may increase national productivity and generate an additional benefit for the economy. These are powerful arguments to permit such software to benefit from a tax credit.

As software is one of the foremost tools to increase national productivity, to not recognise the commercial reality of how suppliers receive a return on their investment could be seen as an attempt to limit the legitimate scope of the tax credit.

Recommendation:

The software test should reflect the concept that multisale occurs if the software is offered to two or more unrelated users and the supplier receives a financial benefit from those users, either directly or indirectly.

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