

## **Research and Development Tax Incentive Amendments – Consultations**

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### **Input to Exposure Draft Exploratory Materials**

Chapter 3 - Improving the administration and transparency of the Research and Development Tax Incentive

#### **Determinations about the performance of the Board of ISA's functions**

Sections 3.26 through to 3.35

#### **Amending or revoking a determination**

Sections 3.35 through to 3.41

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### **Commentary**

(1) This input is intended to provide insights on improving the administration and transparency of the Research and Development Tax Incentive (R&D TI) in the cited draft exploratory materials for R&D entities conducting R&D activities in the areas of IT and software development.

(2) The current definition of R&D activities as per ITAA 1997 cites the definition of Core R&D activities (Section 355.25 of the ITAA 1997) and Supporting R&D activities (Section 355.30 of the ITAA 1997).

(3) The citation in Section 355.25(1) of the ITAA 1997 defines Core R&D activities as experimental activities:

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“(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:

(i) is based on principles of established science; and

(ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and

(b) that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).”

(4) The Australia 2030: Prosperity through Innovation primary document<sup>5</sup> has highlighted the limitations of the definition of the above definition of Core R&D activities in the perspective of software-related activities within the R&D TI.

(5) Advancement of technology and effective deployment of technology-based business solutions is a major driver of economic growth and sustenance of national competitiveness. The R&D TI is a major source of indirect funding for conducting R&D in Australia. The philosophy behind the existence of the R&D TI is to enable Australian businesses to conduct R&D which wouldn't have occurred otherwise. Australian businesses have always historically leveraged upon the R&D Tax Offset to successfully commercialize their developed intellectual property (IP), conducting R&D activities along the pathway to commercialization.

(6) As R&D TI is a self-assessment scheme, R&D entities are required to diligently maintain records for their registered R&D activities that substantiate their notional R&D deductions. This principle has been discussed generally in the Frascati Manual 2015 – Guidelines for Collecting and Reporting Data on Research and Experimental Development<sup>6</sup>. Specific guidance with respect to R&D activities conducted in the areas of IT and software development needs further development in the light of this guidance manual and contemporaneous literature available in the public domain.

(7) The ATO has identified a set of Australian and global software development trends, highlighting in a 2016 publication<sup>7</sup> the impact of such trends on the ATO. This publication identifies some key areas of software development in the areas of DevOps, enterprise applications, software tools, apps, APIs and social media. However, other areas of software development such as operating systems, electronic data storage and platforms enabling application development have been omitted. As

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<sup>5</sup> <https://www.industry.gov.au/sites/g/files/net3906/f/May%202018/document/pdf/australia-2030-prosperity-through-innovation-full-report.pdf>

<sup>6</sup> [https://read.oecd-ilibrary.org/science-and-technology/frascati-manual-2015\\_9789264239012-en#page1](https://read.oecd-ilibrary.org/science-and-technology/frascati-manual-2015_9789264239012-en#page1)

<sup>7</sup> [https://softwaredevelopers.ato.gov.au/sites/default/files/resource-attachments/Australian\\_and\\_global\\_software\\_development\\_trends.pdf](https://softwaredevelopers.ato.gov.au/sites/default/files/resource-attachments/Australian_and_global_software_development_trends.pdf)

the area of IT and software development is vast, broad and diverse, we think that a more detailed compilation of software development trends in Australia and the world needs to be done in order to effectively provide specific guidance on R&D activities in these areas. This also applies to multidisciplinary R&D projects where IT and software development is a key enabler to obtaining specific experimental outcomes.

(8) The IT and software development industry has been evolving to become more efficient in terms of documentation and record keeping. Several global standards have been proposed for this purpose<sup>8</sup> <sup>9</sup>. Specific guidance material could reference some of these standards as a basis of substantiation of notional R&D deductions.

(9) One of the issues with registering R&D activities in the areas of IT and software development is that a lot of registrations has already been allowed by ISA since the inception of the R&D TI. Inconsistency in correctly identifying R&D activities by R&D entities and limited finds made by ISA in this context has allowed several registrations with limited R&D matter stand. This calls into perspective the treatment of all taxpayers fairly. Going forward specific guidance that is effective, relevant and comprehensive needs to be made available to the general public so that administration of the R&D TI scheme improves on the intent of its service delivery.

(10) We propose some ideas that could be considered in this context:

(a) Effectively engaging relevant experts in relevant R&D subject matter areas on behalf of ISA to create specific guidance material;

(b) Creating a public database for specific guidance material that is built on information and feedback provided on a continuous basis by all stakeholders in the R&D TI scheme. This database could be moderated by the ISA and developed by R&D entities, relevant government departments, universities, research experts, R&D TI service delivery managers and any interested member of the general public. R&D entities could access this database, enter in a brief summary of their proposed R&D activities and directly understand whether their conducted activities are eligible for registration. This would be for indicative purposes only as a basis of guidance;

(c) Providing a platform whereby R&D entities can submit a brief description of their proposed/conducted R&D activities and the substantiation basis of notional R&D deductions to a panel jointly administered by the ISA and ATO and obtain notification about their eligibility and substantiation correctness. The Advance Finding process scopes the legally binding nature of the eligibility of R&D activities only. It says nothing about the substantiation of notional R&D deductions, which is a crucial component for R&D entities to correctly manage from a risk management and tax integrity perspective. Obtaining a notification about substantiation correctness at the time of conducting the R&D activities would be very helpful to

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<sup>8</sup> <https://ieeexplore.ieee.org/document/5762403/>

<sup>9</sup> <https://ieeexplore.ieee.org/document/7814181/>

R&D entities in the areas of IT and software development, especially when they're conducting normal operations and doing record keeping in accordance with global standards. This would enable the R&D entity correctly substantiate R&D labour hours on specific tasks, determine appropriate apportionment ratios for R&D overheads, apply correct ratios for incidental expenditures related to R&D projects and generally link notional R&D deductions better with registered R&D activities;

(11) One of the issues that we would want to highlight while preparing the specific guidance material for R&D entities in the areas of IT and software development is the consideration that needs to be given to the R&D model specific to this space. The early stages of R&D in this space are based on discussions and exchange of concepts and ideas relating to a particular issue and can potentially involve a process that takes place over several months. The ideas may be tested against a prevailing technology platform and by drawing from a series of failures and partial successes, a particular idea may either be dropped or further refined to an articulated outcome. If this process is applied across a wide range of commonly-used platforms in IT infrastructure, the ongoing R&D requirement is a complex and broad scale fundamental component for any type of systems software to remain relevant and constantly report new knowledge. This R&D model needs greater understanding in the pathway to preparing guidance material.