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By email - digitalgames@treasury.gov.au

Digital Games Tax Offset –Treasury Laws Amendment (Measures for Consultation) Bill 2022 & Exposure Draft Explanatory Materials

EY Submission

Dear Director of the Industry Tax Policy Unit

Ernst & Young (EY) is pleased to respond to Treasury's Digital Games Tax Offset (DGTO) Exposure Draft Legislation and Explanatory Statement released on 21 March 2022 and provide feedback in respect of the draft provisions and draft explanatory materials .

EY supports the introduction of a DGTO as the offset would attract digital game development to Australia and make Australia an attractive destination for foreign investment, strengthen the digital games tax offset in Australia, expand employment opportunities for digital and creative talent, enhance the industry's international competitiveness.

We have included our comments in respect of the various provisions and highlight where further guidance will be required in the guidance materials.

1. Certificate issued on completion of the game

Section 378-20 of the *Treasury Laws Amendment (Measures for Consultation) Bill 2022* states that the Minister must issue a certificate (a completion certificate) to a company for an income year in relation to a digital game if the game is completed in the income year. Under section 378-20 (2) a digital game is completed on the earlier of:

(a) when the game is first released to the general public (other than for testing purposes); or
(b) if the game is developed by a company under a contract entered into at arm's length with another entity – when the company first provided a version of the game to the entity in a state where it could reasonably be regarded as ready to be released to the general public.

Based on our experience with gaming development companies, many gaming developers offer alpha/beta pre-releases of their games and the games can remain in this stage for many years before the game is progressed to an official version 1.0 release. Based on the draft legislation and explanatory statement it is not clear whether an alpha/beta release would be considered to be sufficient for a completion certificate and whether further development work on a beta stage game would be allowed post completion or whether the official release would be recognised as the stage the game is 'completed'. Alpha/beta releases could be argued as being for testing purposes which would render such games being in a development phase and not eligible for a completion certificate even when they are often available to the general public as part of the beta phase.

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Our recommendation is that the definition of a 'completed game' needs to either be clearer in the legislation or more detailed provisions need to be drafted about the treatment of alpha/beta versions of the game and whether they would be 'completed games'. We also detailed guidance in relation to the DGTO needs to be developed and released to provide certainty in respect of the scenarios in which a game would be deemed to be completed.

2. Abandoned/Discontinued Game Development

The Digital Game Tax Offset is only available to games that are released to the general public. There are a number of games that are developed but are never released to the market as they may be abandoned for a number of reasons including technical development issues. Gaming developers at the commencement of the development of a game in Australia would want certainty that they are able to claim the DGTO in respect of their gaming development activities. For whatever reasons, if the game is not completed and abandoned, this would result in the company not be eligible to claim the DGTO. The purpose of the DGTO is to encourage gaming development in Australia, but if the gaming developers are not provided with the certainty that their investment in gaming development will be eligible for the DGTO where a game is never released publicly, this could discourage gaming development in Australia.

Our recommendation would be that the DGTO is sufficiently broad to include game development in respect of games that are abandoned as this would provide certainty of investment to gaming developers and could potentially solve a number of issues as outlined in respect of the alpha/beta versions of the game.

3. Amount of the digital games tax offset

Under section 378-15(1)(b) of the draft legislation, the amount of the digital games tax offset is capped at $20 million per income year which required $66.7million of qualifying Australian development expenditure in an income year. For many of the larger gaming developers located in Australia, the annual expenditure cap of $66.7million will easily be exceeded and we recommend that this cap be increased to reflect the expenditure that is currently being spent on gaming development in Australia.

4. Qualifying Australian Development Expenditure

Section 378-30 defines ***Development Expenditure*** and lists a number of specific inclusions and exclusions of expenditure. Our feedback is respect of the development expenditure is summarised below:

- **Specific Inclusions: Remuneration**: We note in the draft exposure legislation under section 378-30 (2) (a) that remuneration is included as development expenditure, however remuneration is not defined in the draft exposure legislation. For clarity and certainty, we recommend that remuneration be defined in the legislation or if not in the legislation in the draft guidance that is to be issued for the DGTO. For example, does remuneration only include salary and superannuation or does it also include bonuses, share based payments, payroll tax, workers compensation. In addition, for a number of smaller start-up gaming developers, the actual gaming developer may be a director of the company and undertaking the gaming development activities and there is uncertainty as to whether directors fees could be claimed as remuneration for the purposes of determining development expenditure.

- **Specific Exclusions: Other expenses:** We note there are several specific exclusions as to the types of expenses that can be claimed. The intent of the legislation seems to exclude any form of overhead expenditure that has a nexus to the development activities as the draft Explanatory Statement states that general business overheads are excluded. The draft Explanatory Statement states that ongoing or operating business expenses are not reasonably attributable to activities

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developing a particular game as the offset is not intended to support fixed or corporate costs a company may incur whilst carrying on its development activities. Australian companies must incur overhead expenditure to undertake the development activities and therefore these types of costs should be allowed to be claimed or a deemed overhead rate could be applied to remuneration expenses to include overhead expenses such as 25-30%. Expenditure in respect of hardware/servers that are directly related to development is also excluded. Our view is that development servers, licence fees for development software should be considered to be development expenditure as these are necessary costs incurred by the business to undertake game development and can be easily differentiated from production servers.

5. Porting Certificates

Under section 378-20 (3) of the draft legislation, a porting certificate is available to a company for an income year in relation to a digital game if the game is ported in the income year and where the total of the company's qualifying Australian development expenditure incurred in porting the game is at least $500,000. Based on feedback from the gaming development industry, there is a consensus that the development expenditure threshold requirement for porting is too high and that there should be a minimum threshold of $20,000 for Australian development expenditure for porting.

6. Minimum amount of qualifying Australian development expenditure is at least $500,000

We note under section 378-20 (1) (c) the total of the company's qualifying Australian development expenditure incurred in completing the digital game is at least $500,000. We note that the $500,000 limit may be high for a number of independent developments and smaller studios and therefore means that a number of smaller development companies will not be able to access the DGTO. We recommend that the minimum amount of qualifying Australian development expenditure be reduced to $100,000.

7. Requirements in relation to IP ownership of the games developed

The draft legislation does not require that the IP resulting from the development of digital games be legally or commercially owned by the Australian gaming developer nor does the draft Explanatory Statement make comment in relation to any requirement for IP ownership, however there is uncertainty as to whether this is implied in the draft legislation or will be further clarified in the draft guidance material.

Our recommendation is that the guidance material should state that the eligibility for the DGTO should not be impacted if the resulting IP in respect of the game development is owned offshore by a related entity. Many gaming developers undertaking digital games development in Australian undertake the development activities for offshore related entities and the IP is owned offshore.

8. Expenditure not at risk requirements

The draft legislation does not require that the development expenditure incurred in respect of development of digital games be at the risk of the digital games' developer, however there is uncertainty as to whether there is an expenditure not at risk requirement that is implied in the draft legislation or will be further required in the draft guidance material.

Our recommendation is that the guidance material should state that the eligibility for the DGTO should not be impacted if the Australian game developer is engaged to undertake the development activities for an offshore related entity.

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9. Consolidated groups and the DGTO cap

Where a company is a member of a consolidated group or MEC group, under section 378-50 (1) (b) the head company of the tax consolidated group or MEC group is to apply for the certificate for the DGTO. The explanatory statement also states that the actions of all subsidiaries are taken to be the actions of the head company and that the game development activities undertaken by a subsidiary company in a group will be taken to be undertaken by the head company when working out the head company's tax liability. The explanatory statement also states that integrity rules exist to ensure the cap remains effective across closely affiliated companies and consolidated groups and that the cap applies to the offset for a single company and applies to any amount of cumulative offset to which a group of related companies would be entitled to. The $20million DGTO cap is therefore applied to each tax consolidated group which poses a number of issues where there may be larger tax consolidated groups that have a number of subsidiaries that are undertaking gaming development in Australia.

Our recommendation is that the cap of the DGTO be increased for tax consolidated groups to ensure that where there are multiple gaming development entities within the one tax consolidated group, that they can then claim the DGTO and all benefit from the DGTO.

10. Interaction with other government grant programs

Section 378-30 (3)(l) and (m) states that any expenditure claimed for the purposes of another tax offset, including for the purposes of section 355-100 (tax offsets for R&D) and expenditure that gives rise to notional deductions for the purposes of section 355-205 (deductions for R&D Expenditure) is excluded as development expenditure in relation to a digital game. Therefore it is clear that any gaming development expenditure that is claimed under the R&D Tax Incentive cannot be claimed under the DGTO.
The draft legislation and explanatory statement do not state whether there is a clawback mechanism under the DGTO which applies to digital game development activities for which government grants have been received. We note section 378-30(3)(n) states that "expenditure incurred in relation to applying for the digital games tax offset, or any assistance programs administered by the Commonwealth or the States" is excluded from development expenditure. The explanatory statement states "Expenditure incurred in relation to applying for the digital games tax offset, or any assistance programs administered by the Commonwealth or the States is excluded. If a company is receiving assistance in developing a game from an Australian Government agency, such assistance does not preclude eligibility for the offset." There is some uncertainty as to whether this provision which specifically excludes expenses incurred in relation to applying for government grants such as writing applications also excludes expenditure for which a government grant was received.
The R&D Tax Incentive has clawback provisions in respect of clawing back expenditure for which a government grant was received and therefore clarity and certainty is required as to how section 378-30(3)(n) would be applied to digital games development expenditure for which a government grant was received.

Our recommendation is that clarification is required as to whether it was the intention of the Government to allow digital game development activities to receive both the DGTO and State/Federal Governments grants and if this provision does exclude development expenditure for which a grant was received.

11. Digital game to be made available to the National Film and Sound Archive of Australia

Once a company has been issued with a certificate under section 378-20, the company must make a copy of the digital game named in the certificate available to the National Film and Sound Archive of Australia. We are concerned that this requirement may discourage some Australian companies from applying for the offset due to this requirement and potential issues around infringement of intellectual property. Further clarity is required in relation to the form of the game that is to be provided and that no source code is required to be provided.

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Should you have any queries in relation to the above or to discuss these matters in further detail please contact Jamie Munday on (02 9276 9087, jamie.munday@au.ey.com) or Amanda Primmer on (02 9248 5588, amanda.primmer@au.ey.com) in our R&D and Government Incentives tax practice.

Yours sincerely

Ernst & Young