

IT Industry Innovation Council

Submission to the Treasury

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**Submission regarding: The New Research and Development Tax Incentive
Exposure Draft Legislation and Explanatory Materials**

BACKGROUND

The Information Technology (IT) Industry Innovation Council (the Council) was announced on 5 May 2009 in recognition of the leading role that IT plays across all sectors of our economy and its potential to enable innovation which can transform existing industries, create new ones, enhance Australia's competitiveness, assist with solutions to environmental problems and enhance social inclusion.

The Council acts as an advisory body to the Minister for Innovation, Industry, Science and Research, Senator the Hon Kim Carr both in regard to innovation within the sector and IT's potential to foster innovation across the economy. Members of the Council have been drawn from across the IT spectrum and include representatives of industry, suppliers, users, education, research, government and unions.

The Council also plays an advocacy role promoting the sector in its own right and as an enabler of innovation, productivity and sustainable development for the economy as a whole.

The Council thanks the Government for the opportunity to comment on the exposure draft of the *Tax Laws Amendment (Research and Development) Bill 2010*.

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PREAMBLE

All too often in the workings of government and industry we approach issues and initiatives on a point basis rather than as part of a continuum - on a short term rather than mid to long term basis. Such is the case with this draft legislation. When considered on its own, one can argue the case for the approach taken in the legislation as an appropriate way to deal with the here and now. However when considered as part of a continuum, a strong case can be put that aspects of the proposed legislation will frustrate and damage outcomes we seek as a nation in the mid to long term. Research and development by its very nature is not an end in itself but is part of a continuum and must be dealt with as such.

The Council's view of this continuum ends with the belief that our nation's primary mid to long term objective should be to continually improve our global economic standing and performance. By doing so our citizens will enjoy sustained levels of personal and national wealth into the future and our nation will attract skills and investment that will in turn further fuel our global economic standing and performance. If we do not generate ever increasing wealth, our ability to provide services to and ensure a positive future for our citizens is limited.

The key attributes we must develop as a nation in order to achieve this objective are to be **global leaders** in national and individual **productivity** and to be global leaders in the **competitiveness** of our industries and the ways in which we deliver services to our citizens. Fueling productivity and competitiveness is **innovation** – innovation in the production and application of new technologies, services and processes and innovation in the application of existing global best practice technologies, services and processes. Underpinning the production and application of new technologies, services and processes is **research and development**.

The continuum starts with an environment for meaningful and effective research and development underpinned by the very best **skills, infrastructure and incentives**.

Limiting or deterring our national investment in research and development will ultimately reduce our productivity and competitiveness and frustrate the achievement of our national objective.

The Council therefore concludes that in broad terms, the objectives of any legislation relating to research and development should strengthen this continuum.

A strong ICT industry in which participants actively reinvest is fundamental to producing and applying innovative new and existing technologies, services and processes. The Council concludes in specific terms therefore that the objectives of any legislation relating to research and development should contribute to strengthening our ICT industry.

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SUBMISSION

The Council supports the **intentions** of the reform in its aim to streamline the R&D tax incentive to reduce complexity and better target support for business R&D which will result in a net benefit for the Australian community. The Council also welcomes the higher level of support available to SMEs under the proposed 45% refundable credit, equivalent to a tax deduction of 150%. Along with the increased level of incentive, another positive change is the location of intellectual property (IP) no longer being relevant for multinationals.

However, the Council wishes to express its key concerns about a number of the proposed changes and their potential to impact negatively on research and development within the ICT sector and hence weaken its ability to contribute to achievement of our national objective. It is incontestable that there is a direct linkage between innovative ICT and high levels of productivity and competitiveness.

In R&D terms approximately 22% (or \$2.5 billion) of the \$11.59 billion spent on R&D by companies registered for the R&D tax concession in 2006-07 was on research in Information, Computing and Communication Sciences. The Council believes it to be imperative and in the national interest to ensure this level of expenditure on R&D by ICT companies is increased under the new scheme.

CONCERNS

The most serious concerns of the Council are:

1. The definition of eligible R&D (both core and supporting) has been greatly narrowed by introducing the dual requirement of innovation *and* high technical risk. This can only reduce rather than further R&D in Australia, contrary to the stated aim of the proposed legislation. The ITIIC specifically objects to the proposed changes because:
 - a. The definition differs from widely accepted working definition of what constitutes R&D found in the OECD Frascati Manual
 - b. The ITIIC is not aware of any evidence that the existing definition has caused inappropriate claims
 - c. The increased compliance burden goes against the intended simplification and is of particular concern for SME's

[COMMENT: By its very nature, software development is not 'experimental' in the usual sense where the occurrence of previously unknown or unexpected physical phenomena represents much of the technical risk. In the case of software development, the eligibility restriction to "activities of high technical risk" (defined by "the probability of obtaining a given technical or scientific outcome from the activities cannot be known or determined in advance on the basis of current knowledge, information or experience") is unfairly limiting. Even the most risky and complex software projects will ultimately find a technical solution by sheer persistence and innovation. Therefore this enhanced restriction is particularly discriminatory against the software industry, compared with other industries where the R&D risk criteria are more directly applicable].

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2. The exclusion of software innovation in the business context by the adoption of tests restricting the concession to new operating systems or languages, new search engines and discovery level research is sector-specific and potentially damaging to the ICT industry.

[COMMENT: The size of the Australian market has historically precluded investment in fundamental research of that nature, but without this exclusion multinational software companies might be encouraged to consider outsourcing to, or joint-venturing with, local ICT companies to perform important software research and development in these excluded areas]

3. The application of new limitations to the types of *supporting* R&D that can be claimed and/or a lower rate of assistance under the new scheme is likely to have an unintended impact on the activities of ICT companies.

[COMMENT: Strong emphasis should be placed on developing clear definitions, guidelines and related materials as a way of ensuring greater understanding and compliance].

4. The introduction of the "Multiple Sale" condition. This requirement (that eligible software developments requires sales to at least two arms-length customers) can severely, and presumably unintentionally, impact companies that are licensing their software to large OEM's (Original Equipment Manufacturers). This would particularly impact SME's.

[COMMENT: A single, exclusive software license sale will normally result in the software being marketed to a very large number of end users, for example as software pre-installed on computers manufactured and sold by the OEM, or in embedded form (chipsets) that are built into cars and any type of mass-manufactured electronic goods (mobile phones, computers, TV's, digital cameras etc.).]

5. The extension of the list of excluded activities to include certain activities currently considered as supporting.

The Council believes that these elements of the draft legislation have the potential to unduly limit and effectively deter, innovation in ICT at a time when innovation in and through ICT is paramount to the government achieving short to mid-term returns on policy objectives associated with sustainability, the NBN and productivity gains, and mid to long term national outcomes through strengthening the continuum for a prosperous future.

The Council is further concerned that the timing of the legislation on the back of the recent economic downturn and when other government investments risk not being realised without significant ICT input will cause us to fall further behind in terms of international innovation investment benchmarks by damaging the sector that many other countries have singled out as having the most potential to drive productivity, competitiveness and export improvements.

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RECOMMENDATIONS

1. As a minimum, the ITIIC urges a review of the concerns listed above particularly in terms of the continuum we have described. We are aware that more detailed submissions have been made by the AIIA and groups like KPMG. The Council is broadly supportive of those wider concerns without necessarily placing the same emphasis on particular matters.
2. For the purpose of supporting broader national economic priorities such as the NBN, the Council recommends that special regulations could be invoked to allow, under limited circumstances, a broader definition of R&D in relation to software development. Particularly, the definition could be applied to support software application development that goes to the heart of driving the value and use of the National Broadband Network structure, for example in relation to distance education, remote healthcare, teleconferencing etc. The changes as they stand could potentially discourage the development of smart applications using the NBN, which would appear to be at odds with national priorities.

It is the sincere hope of Council that the Government will recognise the significance of research and development in the continuum in which we are global leaders in economic standing and performance and that the above points of concern and Council's recommendations will be taken into consideration in finalising this important legislation.

We will be pleased to elaborate on the views presented in this submission and to interact constructively with the Government in your endeavours to produce an optimal outcome in the interest of our nation.



John Grant
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Information Technology Industry Innovation Council