

Submission in regards to: **The New Research and Development Tax Incentive**
(Consultation Paper – September 2009)

Organisation: Submission by SAP Research a division of SAP Australia Pty Ltd

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Type of Organisation: Information Technology and Software

About SAP Research Australia

SAP Research Brisbane is one out of currently 13 global research centres. The location was founded in 2001 and has successfully grown from one to more than 50 staff. The Research Centre has been a strong contributor to SAP R&D and the research community for many years. With direct impact on products (e.g. SAP's new Business ByDesign) and a world-class reputation to drive innovation and deliver professionally, the Centre has visibility on senior executive level inside SAP.

Delivering impact on a global scale, SAP Research Brisbane is also leveraging the local market and research community. Over the last 7 years SAP Research has been investing more than AUD 6m cash in the Australian research community.

The Centre is closely linked to Australian Universities with sponsoring projects, offering internships, and providing partners a global platform to disseminate their research, e.g. at SAP Research's International Research Forum or global customer events.

26th October 2009

General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Re: The New Research and Development Tax Incentive

SAP Australia views the new Research and Development (R&D) tax incentive as a welcome change to the current legislation. SAP Australia is very pleased with the government's action in regards to proposing a more simplified and streamlined R&D tax incentive program. We support a large majority of the proposals as noted within the consultation paper and have only a few areas of concern or possible improvement. Our division (SAP Research) as noted earlier is heavily focused on research and as such any change to the R&D tax incentives will heavily influence our business practices, spending techniques and strategic decision-making.

SAP Australia would like to focus on four areas for further investigation and discussion:

- Refundable Tax Credits versus Non-Refundable Tax Credits
- Tax Incentives for Software and the Multiple Sales Test
- Calculation of Supporting Activities
- Long-Term Research and Development Spending Protection

Refundable Tax Credits versus Non-Refundable Tax Credits

SAP Australia seeks the government to consider transforming all tax credits to an *above-the-line* tax credit. This would benefit SAP Research by helping the tax incentives be traced directly back to the cost centre, thus providing decision makers with more clarity with regards to the total cost of R&D activities in Australia.

SAP Australia understands that, under the current proposal, the refundable R&D tax credit is only applicable to companies with a turnover of less than \$20 million. SAP Australia's turnover is over \$20 million and as such the firm would only eligible for the standard, non-refundable 40% tax credit.

Quoting from the Australian Government consultation paper, dated September 2009, *The Case for Reform*:

“an effective R&D tax incentive needs to result in firms conducting R&D that they would otherwise not perform because they cannot capture sufficient benefits from the activity to justify an investment”.

The non-refundable tax credit being a *below-the-line* refund benefits the company by reducing its overall tax, but the benefit is not directly reflected in the R&D cost centre, nor easily linked to it by strategic business managers or decision makers. SAP Research would prefer an *above-the-line* system such that the tax incentives could be traced back to the cost centre and has effect of reducing the total cost of the R&D cost centre. In the long-run this will influence strategic business decisions in regards to research expenditure in Australia.

If the tax credit was *above-the-line*, the R&D cost centre could see a return of credit which could go towards research expenditure such as salaries, travel, equipment, etc. Executive decision makers would have further reasons to invest in Australian research as the traceable benefits of the tax incentive would improve the cost-centre balance.

We understand that the government is seeking to create a favourable environment for more international companies to set up research in Australia. Many of these companies similarly employ a cost centre approach to accounting and as such would have more incentive to invest under an *above-the-line* system.

There are R&D tax incentive or grant funding schemes in place in many of the competing markets. SAP Research believes that Australia could consider the EU model which provides 50% of fully-loaded costs in an *above-the-line* manner in some scenarios. Such a system provides the necessary benefits to cost centres, prevalent in many larger businesses.

Overall, we recommend an *above-the-line* tax incentive which would reinforce the need for SAP Australia to think strategically about R&D as a critical part for their business, while also reducing the cost of the R&D centre, and encouraging the growth of research opportunities in Australia.

Tax Incentives for **Software** and the **Multiple Sales Test**

SAP Australia believes that the Multiple Sales Test should be remodelled as it is limiting R&D in regards to software and furthermore providing a disincentive to engage in highly technical R&D. It is also proposed that software innovation not be singled out and limited as the changes to the core R&D test will provide the necessary limitations to this form of innovation. We believe that software innovation is one of the most important and influential areas of research and has great potential to bring spill over benefits to the whole Australian economy. We also believe the current system needs change to encourage innovation in software.

SAP Research Australia focuses heavily on software innovation and as such the current multiple sales test provision under s 73B(2A) of the *Income Tax Assessment Act 1936* (Cth) is influential on our ability to claim tax credits. The requirement for rent, license or hire to two or more associates, limits the ability for software innovation to receive tax incentives.

The multiple sales test was conceived before the advent of mass-adoption of internet services, which now dominates much of the workflow in Australian business. As such, it has little conception of the new forms of software distribution such as hosted software not shipped on physical media and licensing. Furthermore, the prevalence of microprocessors and software integration into physical innovations means that software is often the backbone of the research and development that the government is trying to foster. For this reason much of the most beneficial and potentially profitable innovation is excluded and limited from the current tax incentive scheme.

SAP Research's innovation into business technology solutions has provided significant benefits to numerous clients in Australia. As such, the benefits of this innovation have spilled over into productivity and efficiency improvements to numerous stakeholders in the Australian community and also to the Australian economy itself.

The multiple sales test restriction on software innovation limits the availability of the R&D tax incentive as it often takes many years to commercialise an innovation and meet the multiple sales test requirements. In larger projects it is very difficult to trace a particular piece of innovation from inception to commercialisation and as such attaching any sales test is extremely difficult.

SAP Research believes that the government can eliminate the type of claims that the current limitations target, through the changes in the definition of core R&D activities. The requirements for activities to involve high levels of technical risk and the production of new knowledge and improvements should ensure that supporting activities and proprietary software not appropriate for the incentive are excluded. We are of the belief that the importance of software innovation should be recognised, encouraged and fostered rather than be specifically limited.

SAP Australia supports a majority of the regulations in regards to R&D under the UK legislature, however the differentiation of software innovation will create yet another aspect of complexity to the taxation system that should not be necessary and that the Australian Government is seeking to remove. SAP Australia believes that there should be no differentiation in regards to software investment to any other form of core R&D activities and that the tests for core R&D activities should exist universally.

R&D into software activities is without a doubt an area of huge potential not only to individual companies but to the whole Australian economy. For Australia to remain competitive and to create an appropriate environment of software innovation, Australia must embrace these activities and duly provide incentives for their innovation. As such, SAP Australia proposes that software activities should not be differentiated from other activities and that the core R&D requirements be universally applicable to all forms of R&D. This would require the removal of the multiple sales test which SAP Research believes creates unnecessary complexity and is out-dated.

Calculation of Supporting Activities

In regards to question 4 of the consultation paper, SAP Australia proposes option (b) is the optimum solution – *only eligible where they are for the sole purpose of supporting core R&D*. However, as under paragraph 63 the test should be amended to 'predominantly for the purpose.'

SAP Australia understands the government's concern that the supporting R&D activities can be non-proportional to core R&D expenditure and hence be used to gain taxation benefits in situations not of true R&D. For this reason the requirement that these activities be for the sole purpose of the core R&D activity will ensure that only appropriate expenditure is considered.

We agree that this sole purpose test will create a positive test and would limit the taxation incentives. However in today's business environment, activities almost always have the dual purpose of supporting core activities and improving business relations or other aspects of productivity.

For this reason SAP Australia proposes a – ‘predominantly for the purpose’ – test to be implemented in regards to the calculation of supporting R&D expenditure. To ensure that supporting activities are not unnecessarily limited and that true innovation expenditure can be calculated.

Long-Term Research and Development Spending Protection

SAP Australia wishes to ensure that under the new proposal the tax incentives for long-term, prospective R&D are protected.

SAP Research Australia undertakes numerous long-term, prospective R&D projects that have the ability to create the greatest impact but similarly have very large risks attached to them. As such we wish to ensure that under any new conception of core R&D activities, that these forms of expenditure will be protected and that tax incentives will be available. Any impact on these forms of expenditure would no doubt affect strategic decision-making in regards to investment in Australia.

Concluding Statements

SAP Australia is extremely pleased with the proposals as outlined within the September 2009 Consultation Paper ‘*The New Research and Development Tax Incentive.*’ However we wish the government to consider the aforementioned areas that we believe require further investigation.

To create an environment of optimal incentives, SAP Australia believes that the government should consider making all tax credits *above-the-line* due to the cost centre character in larger firms. Furthermore SAP Australia believes that the multiple sales test should be removed and that a universal application of the core R&D rules would provide best incentive for software innovation. We also believe that supporting activities should be tested under a ‘predominantly for the purpose of’ test and finally that the government ensure that long-term R&D incentives are protected.

There is no doubt that the Australian Government is moving in the right direction and that these proposals will create a positive environment in Australia that will better foster R&D innovation. SAP Australia believes that the above changes will improve the R&D tax incentives and solidify Australia as one of the best nations for international firms to engage in R&D activities.

Yours Sincerely,