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R&D Tax Incentive - AusIndustry's Expectations

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1 Overview

The R&D Tax Incentive is a self-assessment programme designed to encourage industry to conduct research and development. The programme provides a tax incentive for industry to conduct experimental activities, in a scientific way, for the purpose of generating new knowledge.

AusIndustry (on behalf of Innovation Australia) and the Australian Taxation Office (ATO) share responsibility for the administration of the R&D Tax Incentive, and conduct compliance on claims to ensure the integrity of the programme.

The programme is governed by legislation which includes definitions of what eligible 'R&D activities' are for the purposes of registering with the programme and claiming tax offsets for expenditure.

Companies that wish to claim the incentive must self-assess whether their activities meet the programme's definitions of 'R&D activities'.

Software development (with the exception of internal administration software) is subject to exactly the same programme requirements as any other industry or area of technology - specific activities must be self-assessed against the eligibility requirements, and records must be kept that substantiate the self-assessment, just like any other tax claim.

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2 What are the requirements for eligible R&D activities?

A company's research and development activities must meet legislative definitions to be eligible for the R&D tax incentive. They must be classified as either 'core R&D' activities or 'supporting R&D' activities. Broadly, core R&D activities are experimental activities that both:

- are based on principles of established science
- proceed from hypothesis to experiment, observation and evaluation, and lead to logical conclusions.

Importantly, core R&D activities must be conducted for the purpose of generating new knowledge (including the creation of improved materials, products, devices, processes or services).

A supporting R&D activity is one that is directly related to core R&D activities, and, for certain activities, has been undertaken for the dominant purpose of supporting core R&D activities.

An important guidance resource for companies and their advisers is AusIndustry's *Guide to Interpretation*, available on Business.gov.au. It explains in some detail the interpretation of the definitions of eligible R&D activities. The following sections 2.1 and 2.2 just reproduce the legislative definitions for core and supporting, and you should refer to the *Guide to Interpretation* for detailed explanations of how to generally apply the definitions. Following sections of this paper address particular issues of interpretation and application of the law to software development activities.

2.1 Core activities

ITAA SECT 355.25

Core R&D activities

- (1) Core R&D activities are experimental activities:
 - (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).

2.2 Supporting activities

ITAA SECT 355.30

Supporting R&D activities

- (1) Supporting R&D activities are activities directly related to * core R&D activities.
- (2) However, if an activity:
 - (a) is an activity referred to in subsection 355- 25(2); or
 - (b) produces goods or services; or
 - (c) is directly related to producing goods or services;

the activity is a supporting R&D activity only if it is undertaken for the dominant purpose of supporting * core R&D activities.

2.3 Internal Administration

ITAA 355-25(2)... none of the following activities are core R&D activities:

...

- (h) developing, modifying or customising computer software for the dominant purpose of use by any of the following entities for their internal administration (including the internal administration of their business functions):
 - (i) the entity (the developer) for which the software is developed, modified or customised;
 - (ii) an entity *connected with the developer;
 - (iii) an *affiliate of the developer, or an entity of which the developer is an affiliate.

355-30 ...if an activity:

- (a) is an activity referred to in subsection 355 25(2);

...

the activity is a supporting R&D activity only if it is undertaken for the dominant purpose of supporting *core R&D activities.

Projects involving software development are subject to the same definition of R&D activities as other forms of R&D. However, software activities related to the development, modification or customisation of software where the software is for the dominant purpose of 'internal administration' by the entity (or connected entities or affiliates) for which it was developed, modified or customised, are excluded from being core R&D activities .

Software for 'internal administration' includes management information systems, and enterprise resource planning software that is for use in the day-to-day administration of a business. The

software exclusion does not apply to software developed in-house that is of an applied nature, forming an integral part of an electrical or mechanical device (such as home appliances or industrial equipment).

Companies need objective evidence of their purpose for conducting the claimed activities. Contemporaneous evidence is necessary.

Evidence of purpose can come from the company's own records, and also from:

- a. The nature of the software. What type of software is it?
 - Is it clearly a design intended purely for commercial sale? If yes, then the activities in its development are unlikely to be excluded;
 - Is it customised to the company's requirements so as to make it unlikely that others could buy it? If yes, then some or all parts of the activities might be excluded if they meet the other parts of the test;
 - Is the relevant part of the software itself providing customers with a service? If yes, then the activities in developing this part of the software may be less likely to be excluded;
 - Does the relevant part of the software serve both the service provision and internal administration e.g. a database accessed by both functionalities? Assessors will need to consider the nature of the activities, software and context to determine the dominant purpose of undertaking the activities to develop this part of the software;
- b. What is the software actually used for in practice by the company; and
- c. When was the software first used in this way, and what circumstances led to that use. For example, if the software was developed initially for the purpose of its own internal administration, and was only later used for sale, that may be evidence that the exclusion applies. Conversely, if the software was originally designed predominantly for sale, but for various reasons no-one bought it and that is why the company is the primary user then the exclusion might not apply.
- d. Any records of claimed alternate purposes must be supported by the nature of the activities and the software developed.

Make sure to consider whether particular software development activities have been defined that meet the primary definition of core R&D activities. A focus on whether a software product is to be used for internal administration can distract from proper consideration of whether specific activities have been defined, and whether they would meet the primary definition.

Any software activities that fall into this exclusion will not only be excluded from being core R&D activities, they will also be ineligible as supporting R&D activities. This is due to the impossibility of satisfying two competing dominant purpose tests.

3 Tips for getting it right

3.1 Whole of Project Claims

We are concerned with characterisation of the activities and not with that of the project of which they form a part.
(RACV Sales and Marketing Pty Ltd and Innovation Australia [2012] AATA 386)

The self-assessment process of identifying and registering R&D activities must be careful to recognise that eligibility under the R&D Tax Incentive is based on specific experimental activities and not on whole software development projects.

Companies naturally think in terms of commercial projects and not individual R&D activities. However, it is unlikely that all of the activities being conducted in a software development project would be eligible R&D activities. While companies might need to do some experimental activities as part of a project, that doesn't make the entire project an eligible R&D 'activity', or all the activities within the project eligible.

The legislative requirements for the eligibility of activities must be satisfied by specific activities, and can't be assessed or substantiated for a whole project at once. In the first instance, self-assessment should focus on identifying experiments and separating these from the non-experimental activities.

Each experiment will be trying to prove a specific hypothesis about a specific technical issue that can't be resolved by using existing expertise or knowledge.

Frequently, the hypothesis identified by companies in their registered core R&D activities is in fact an overarching project objective, rather than a targeted hypothesis developed to guide an experiment and bridge a specific technical challenge. Often, these whole of project objectives by their nature, cannot be falsified by undertaking an experiment or set of related experiments. An hypothesis defines the focus of the experiment and must be formulated in such a way that it is falsifiable, that is, it can be shown to be correct or incorrect.

Some software development projects will not succeed to achieve their intended objectives for a range of reasons. However, the failure of software development projects is not always due to technical risk and may be caused by a number of business factors including failure to deliver a solution that addresses a market need or an organisation's needs over time and can also be closely related to available skills, capability and the management processes as opposed to specific technical uncertainties. Likewise, success of achieving project objectives will involve the successful completion of many activities not related to experimental resolution of specific technical issues.

3.2 Identify a specific technical knowledge gap

There are many categories of software. Each type of software interacts with other software – application software requiring the facilities provided by operating systems, network and data management software - to achieve an outcome. Development of operating systems, data systems, network systems, firmware, microcode, middleware, applications and mobile applications software can be highly technical in nature and complex.

While this complexity poses risks, this does not always constitute a specific technical knowledge gap or challenge that requires the formulation of a hypothesised solution and experimental activities to test that solution. In many cases, a solution can be seen to be possible from the outset with the appropriate technical skills and expertise in place, and applying existing technical knowledge.

For the purpose of the R&D Tax Incentive, one or more specific technical knowledge gaps must be identified that cannot be bridged through the application of the knowledge, information and experience of a competent professional in the relevant field. The degree of uncertainty involved in bridging that knowledge gap must only be able to be resolved by undertaking one or more experiments.

Defining and delivering on one or more project objectives or systems requirements as part of a software development lifecycle is not necessarily the same as bridging a specific technical knowledge gap by undertaking an experiment. In many instances, a significant proportion of the requirements for a particular software project can be delivered with a high degree of certainty on the basis of current knowledge, information and experience.

3.3 Assuming eligibility because following a SDLC methodology

Software development activities can pose a challenge to the self-assessment of eligible activities under the R&D Tax Incentive because the process of developing software is superficially similar to the process of performing experimental research and development. That is, it is by definition systematic and it can be iterative and cyclical, and almost always involves testing. However, it is not necessarily experimental as defined under the Programme's legislation. The application of a software development lifecycle does not mean that an eligible experiment is taking place, nor that the outcome of any testing that may be being conducted is not knowable in advance.

For example, software development that uses focussed stages of problem solving such a 'sprints' in agile development cannot be assumed to be R&D. As with any development, activities during a 'sprint' must be able to be substantiated to satisfy the requirements of the definitions of eligible activities.

Testing in software development is not generally for the purpose of developing new techniques outside the knowledge of competent developers. It is generally about finding problems, and the solutions are generally determined using existing knowledge and expertise. Certainly stages such as beta testing and user acceptance testing are quite clearly not for the purposes of generating new knowledge, and not an experimental stage of development.

Many software development activities will also fail to satisfy the requirements for supporting R&D activities. The requirement that supporting R&D activities are directly related to experimental activities

does not draw in a wide range of project activities. Activities to explore options before the need for experimentation is identified are unlikely to be directly related to the experimental activities unless it can be substantiated how they directly contributed to formulating the hypothesised solution or designing the experiments. Developing other parts of the system or product will generally not be directly related to the experimental activity. Development using the solution once it is known to work will not be directly related to the experimental activity

3.4 Documentation and Record Keeping

An applicant cannot succeed in establishing those requirements in the absence of detailed documentation recording the process of each activity as it develops. (*Docklands Science Park Pty Ltd v Innovation Australia* [2015] AATA 973)

Registrants under the R&D Tax Incentive are required to keep and maintain documentation and records to evidence their claimed R&D activities and the claimed expenditure on those activities should AusIndustry and/or the ATO undertake an examination of compliance on the registered activities. It is necessary for registrants to keep documentation and records that will evidence eligibility against key aspects of the R&D Tax Incentive legislation.

Documentation and records must:

- substantiate the company's self-assessment that each part of the eligibility requirements was met for each part of the registered activities.

Substantiate that the activities were actually carried out, and in the way described.

Projects using methodologies which don't fully document steps need to maintain adequate records to evidence that experiments were undertaken, not just a record of the final source code. Using an 'agile' methodology is not an excuse for not keeping tax records.

- be sufficient to verify the:
 - amount of the expenditure incurred on the registered activities, and
 - relationship of the expenditure to the activities.
- show how expenditure was apportioned between eligible R&D activities and non-R&D activities.

It is the company's responsibility to demonstrate that it has used reasonable methods to differentiate between expenditure on R&D activities and expenditure on non-R&D activities.

Tax agents need to conduct due diligence that there are records to substantiate tax claims.

3.5 Examples of common ICT activities that are unlikely to be eligible core R&D activities

Examples of common ICT activities that are unlikely to be eligible core R&D activities include:

- Collecting user requirements
- Solving technical problems where similar problems have been overcome previously, such as on the same operating system or computer architecture
- Post R&D activities such as further development using the proven solution, preparation of user documentation and maintenance of existing systems
- Minor adaptation of existing software, materials or products
- Adding minor user functionality to existing applications
- De-bugging, beta testing, user acceptance testing
- Using the capabilities of existing software as they are intended to be used and within their limitations
- System integration where uncertainty that it could be done is low.