Principles for an innovative software development tax incentive

Third Issues Paper: Senate Select Committee on Australia as a Technology and Financial Centre

KPMG Australia

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Overview

As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We strive to contribute to the debate that is shaping the Australian economy and welcome the opportunity to provide a response to the Senate Select Committee on Australia as a Technology and Financial Centre's (the Committee) Third Issues Paper.

KPMG provided a response to the Committee's First Issues Paper in December 2019 and Second Issues Paper in November 2020 and welcomed the Committee's First and Second Interim Reports. Particularly we strongly welcomed the recommendation that noted the need for further clarification around eligibility for tax incentives to ensure genuine software and technology creation by Australian start-ups and the recommendation that the Australian Government consider the establishment of a separate software-specific tax incentive scheme.

KPMG supports the concept of the Digital Games Tax Offset announced in the 2021-22 Federal Budget and this paper seeks to leverage this measure to look at developing a framework that may support a Software Development Tax Incentive (SDTI) for innovation in software that doesn't currently meet the eligibility criteria set out in the Research and Development Tax Incentive (RDTI) program.

The need for new measures that encourage investment in innovation is vital as we look to recovery post COVID-19. While Australia has weathered the health crisis well, border closures mean limited access to overseas talent, increasing the cost of labour and limiting the ability for some businesses to pursue innovation agendas and invest in growth. Further, as the world opens at a faster trajectory than Australia, we will be competing with our international peers to secure footloose investment. Incentivising software-related innovation plays to Australia's strength as a service focussed economy and could offset some of the loss of income the university sector has faced through increased private investment in innovation.

The Board of Industry Innovation and Science Australia (the Board) now has the power to make binding determinations on interpretation in respect of the RDTI, which it is hoped will be used to provide greater clarity to both industry and regulators alike. However as this power was only granted from 1 January 2021, it is still untested. In addition, any determination needs to be in line with the law and this still doesn't capture innovation that falls outside the RDTI.

A recent report for Industry Innovation and Science Australia (IISA) noted that whilst the RDTI supports R&D based innovation, there are other types of innovation which do not require R&D but have the same potential, and in some cases more, to benefit both the business developing the innovation and the broader economy.[1] In fact, the 2020 IISA report on Australian Business Investment in Innovation highlighted that close to 50 percent of innovation in Australia is non-R&D based and many of these examples are from digital innovation. Examples of this include novel hardware and software solutions which use existing technologies to develop previously untapped markets, combine and integrate platforms and technologies for innovative applications, or the creation and use

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[1] *AlphaBeta (2020) Australian Business Investment in Innovation: levels, trends and drivers, a report for the Office of Innovation and Science Australia, January 2020.*

of datasets that are required to test and unlock new product offerings. This problem was also highlighted in the recently published Kalifa Review of UK FinTech with a recommendation that the UK R&D tax credit program should be expanded to accommodate the cost of financial data sets.

In the context of FinTech and RegTech, there are many innovative solutions being developed that do not currently qualify for the RDTI due to the interpretation of software-based R&D activities. There are also more common examples of innovative software solutions that AusIndustry has assessed as having no levels of R&D but the product later went on to be shown to be highly innovative and led to significant ongoing investment in Australia. Having access to incentives at the early stages of software development for start-ups could accelerate investment and provide much needed capital to grow the business.

To further incentivise innovative software development that positions Australia as a technology and financial centre, the Federal Government could consider a specialised SDTI to provide support for innovative software solutions which do not qualify for existing tax incentives or grants. In addition, a collaboration premium which would reward companies for collaborating with each other and with research institutions could be developed to further incentivise innovation.[2]

This paper sets out the key principles that would form the framework of such a tax incentive.

Yours sincerely,

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[2] *As recommended by several reports; 3F report and the ISA Prosperity 2020 report.*

Background

KPMG is a global network of professional firms providing a full range of services to organisations across a wide range of industries, government and not-for-profit sectors. We operate in 147 countries and territories and have more than 219,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digitally driven world.

Accelerating Business Growth team

KPMG's Accelerating Business Growth (ABG) team is dedicated to developing integrated advice aimed at supporting the growth ambitions of our clients. We work with our clients to understand their business needs and assist in delivering holistic advice that enables them to help reach their growth potential.

Our R&D team within ABG assists some of Australia's most innovative companies gain access to government grants and incentives for R&D activities undertaken in Australia. We also assist companies in developing governance frameworks, policies and procedures to streamline their R&D processes and substantiate their R&D activities, and look to provide opportunities for further government support through our local and global network and our connections within the federal and state government agencies and industry bodies. Through these initiatives, we work with our clients create long term value, and assist in providing a competitive advantage for Australian companies.

Section 1: High-level principles for a Software Development Tax Incentive

KPMG Australia supports:

1 Exploring the merits of SDTI to support activity in Australia that doesn't qualify for support under the R&D Tax Incentive program.

2 Eligibility for the SDTI should be based on the outcome or the intended outcome of the development activity, rather than the process. That is, the primary test is the product and whether it is innovative and a driver of future jobs and economic growth. Evidence to support eligibility could include the developer's detailed business case for undertaking the development activity.

3 The establishment of an industry consultation program to better understand key features of 'innovative software development' to identify criteria that could be used to define an appropriate tax incentive. Eligible expenditure should also be reviewed and supported by an expert panel of software industry professionals where required.

4 An initial 'pilot program' that is limited in scope so that issues can be tested before full implementation. The pilot program could have the following features:
- include a registration process that incorporates pre-approval to ensure claimants have confidence in applications and that only legitimate activities are eligible;
- be limited in terms of eligibility by the turnover of the business;
- be limited to those that provide new or significantly improved software products to market and for whom software is their primary product.
- only allow eligible expenditure that has been incurred on development undertaken in Australia;
- include a refundable tax offset above the corporate tax rate; and
- include both a minimum threshold amount and a maximum amount that can qualify under the program in a given year.

5 Following the pilot program, clear guidance should be issued from the regulator including specific real-life case studies to provide greater certainty and confidence to businesses assessing eligible activities and eligible expenditure.

6 The Digital Games Tax Offset should be used as a point of learning when developing the SDTI so key elements are aligned, subject to final consultation with industry. For example, the determination of eligible expenditure should be in line the new Gaming Tax Offset, where industry is supportive of the final definition.

7 Consider incorporating program features in regulation rather than legislation to ensure the program is flexible and responsive.

Section 2: Illustrative example

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SoftCo's engineers have presented a high-level idea to management about developing a new and innovative software product that could be licensed to customers. SoftCo's CFO obtains external advice and concludes that the activities involved in developing the new product would not qualify for the RDTI.

The development of the new product would require considerable resources and financing. It also has significant revenue potential, both from domestic and overseas markets as the product offers an innovative solution to a need in the market. The engineers and management team draw up a detailed business plan for the development and commercialisation of the product for consideration by SoftCo's board.

This plan includes the potential impact of the Software Development Tax Incentive (SDTI) on the return on investment for the proposed new product. The Broad grants in-principle approval to commence the development, subject to confirmation that the SDTI will be available. SoftCo submits the development and commercialisation plan to the ATO for pre-approval, in addition to any other information required under the SDTI regulations.

The ATO considers SoftCo's application and grants provisional approval for the SDTI to be available, subject to annual reports from SoftCo that confirm the development activity is being undertaken as stated in the application. SoftCo must disclose in these reports any material variation from the original development plan for further consideration by the ATO.

Provided that SoftCo meets its annual reporting obligations on a timely and accurate basis, it can claim the SDTI for eligible costs actually incurred in any given financial year within the limits set by parliament. ATO "after the fact" review is limited to confirmation that the actual costs claimed are sufficiently related to the approved development project.

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