

# ***TA 2017/5 - Claiming the Research and Development Tax Incentive for software development activities***

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! This Alert has been jointly developed by the Australian Taxation Office (ATO) and Department of Industry, Innovation and Science.

The Research and Development (R&D) Tax Incentive is jointly administered by Innovation and Science Australia (supported by AusIndustry within the Department of Industry, Innovation and Science) and the ATO.

! This document has changed over time. This version was published on *19 January 2024*


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# Taxpayer Alert

**TA 2017/5**

## Claiming the Research and Development Tax Incentive for software development activities

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*Alerts provide a summary of our concerns about new or emerging higher risk tax or superannuation arrangements or issues that we have under risk assessment.*

*While an Alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an Alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.*

Refer to [PS LA 2008/15](#) for more about Alerts. See [Alerts](#) issued to date.

### Description

The ATO and AusIndustry are reviewing the arrangements of companies that are claiming the R&D Tax Incentive on software development projects where some (or all) of the expenditure incurred is on activities which are not eligible R&D activities.

These types of arrangements exhibit some or all of the following features:

- A company undertakes a software development project that involves one or more of the following:
  - developing new software
  - modifying, customising or upgrading existing software, and
  - acquiring and modifying off-the-shelf software.
- The software development project includes one or more of the following:
  - undertaking activities that use existing software development knowledge and expertise to achieve the required technical outcomes

- undertaking activities that involve business risk rather than technical uncertainty
  - undertaking activities to replace manual work processes using software technologies that are available in the market and adapted to the requirements of the company, and
  - using existing software technologies as they were intended to be used.
- Some or all of the registered R&D activities are broadly described and non-specific. For example, they may describe project objectives or business and system requirements that the company is seeking to design and implement.
  - All of the project, or a substantial part of it, is registered as R&D activities.
  - The company includes the whole, or a large proportion, of their expenditure on the software development project in the calculation of their R&D Tax Incentive claim.

## Background

The Australian Government supports companies that undertake eligible R&D activities through the R&D Tax Incentive.

Eligibility under the R&D Tax Incentive is based on specific R&D activities rather than on entire projects.

In order to be eligible, there must be an experiment or experiments being carried out for the purpose of generating new knowledge. The outcome of the experiments cannot be able to be known or determined in advance by a competent professional in the field. The experiments being carried out must be based on principles of established science and must seek to prove whether specific technical hypotheses are right or wrong to resolve specific technical issues or risks.

Supporting activities may also be eligible if they are directly related to eligible experimental activities. It is not sufficient that these activities are related to the project more generally. Additionally, in some circumstances supporting activities must also be conducted for the dominant purpose of supporting the experimental activities.

Companies undertaking software development projects sometimes assume or assert that software development activities are by their nature eligible R&D activities. However, it is extremely unlikely that all of the work involved in a software development project will meet the legislative criteria for eligible R&D activities. While a project may involve some experimental activities, that does not qualify the entire project as an eligible R&D activity.

The processes of developing, modifying or customising software can appear superficially similar to the process of performing eligible R&D activities. They are by definition systematic and can be iterative and cyclical and almost always involve testing. However, the application of a software development lifecycle does not automatically mean that eligible experimental activities are taking place, nor that the outcome of any technical issues being solved are not using existing knowledge, information or expertise.

There are routine testing steps in software development projects that are frequently incorrectly claimed as core R&D activities. Activities such as bug, beta and user acceptance testing are often claimed as core R&D regardless of the stage of development of a software project. Activities such as these can only be claimed as core R&D activities when they are being done as experiments that are resolving hypotheses about specific technical issues. Examples of activities that are not eligible unless there is evidence they are being done as experiments to test a hypothesis are:

- Bug testing
- Beta testing
- System testing
- Requirements testing
- User Acceptance Testing
- Data mapping and data migration testing
- Testing the efficiency of different algorithms that are already known to work, and
- Testing websites in operation by measuring the number of hits.

The activities listed above, however, may be eligible as supporting R&D activities if they are directly related to core R&D activities.

Under the R&D Tax Incentive, companies self-assess the eligibility of their activities and register through AusIndustry. Companies then claim a tax offset (the R&D Tax Incentive) for their 'notional deductions' relating to eligible expenditure through the annual company tax return. The registration of activities does not, by itself, render the activities described in a registration as eligible R&D activities for the purposes of the R&D Tax Incentive. The ATO and AusIndustry may review the eligibility of activities or expenditure after registration.

The R&D Tax Incentive claimed in a company's tax return must relate only to expenditure on eligible R&D activities. Further, software development projects that are for the sole or dominant purpose of internal use by the company (or related entities) for their administration or the administration of their business functions are not eligible for the R&D Tax Incentive.<sup>1</sup>

### **What are our concerns?**

The operators of some affected companies may believe (or have been advised) that their activities are innovative or constitute eligible R&D activities. However, we are concerned that:

- Activities may not fit within the stringent requirements of the laws that govern the R&D Tax Incentive.
- Expenditure claimed may not relate to eligible R&D activities.
- Taxpayers may not be applying adequate levels of governance and review to the registered activities and the claims made for the R&D Tax Incentive.

### **Activities**

We have observed a number of cases where companies have registered software development activities with AusIndustry which are ineligible for the R&D Tax Incentive.

The reasons these types of activities have been found to be ineligible include:

- The software development project has been registered on a whole of project basis, without distinguishing eligible R&D activities from ineligible activities. For example, developing and rolling out a new online customer platform may be incorrectly identified as a single eligible R&D activity.

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<sup>1</sup> See paragraph 355-25(2)(h) of the *Income Tax Assessment Act 1997*.

- The activities do not have the purpose of generating new knowledge. The purpose of generating new knowledge must be substantial enough to characterise the activity as being conducted for that purpose.
- The activities are not undertaken to prove or disprove a hypothesis or hypotheses through experiments.
- There is no clearly identified technical uncertainty being addressed by the activity. The software development lifecycle can be complex and highly technical. While this complexity poses risks, it does not mean that all activities involve a specific technical knowledge gap that requires the formulation of a hypothesis and the undertaking of experimental activities to test that hypothesis.
- Project management, commercial or economic risks are mistaken for technical risks. For example, a bank develops a mobile banking application and the delivery of the application is quite certain on the basis of current knowledge, information and experience. There is, however, a risk that existing or future customers may not embrace the application. This risk is commercial in nature only and hence the relevant activities do not constitute eligible R&D activities.
- The activities involve the purchase of 'off-the-shelf' software and subsequent modification to integrate it into the existing environment. Most or all of the activities involve the application of existing knowledge and expertise rather than the generation of new knowledge through experiments.
- The activities are not directly related to experimental activities or do not have a dominant purpose of supporting such activities.

## Expenditure

We have also observed that often some or all of the expenses included in the calculation of the R&D Tax Incentive claim are not correct because:

- Expenditure incurred in acquiring, or in acquiring the right to use, technology cannot be claimed as a notional deduction.<sup>2</sup>
- The expenditure included in the calculation is not for amounts that are incurred on one or more eligible R&D activities; for example production costs of software sold to the market in the ordinary course of business.<sup>3</sup>
- Expenditure is being apportioned between R&D activities and ineligible business activities in an unreasonable manner. For example:
  - expenditure is included as part of overall overhead expenses which does not relate to R&D activities, for example advertising and sales expenses, or
  - overhead expenses are apportioned using a method that allocates an unreasonably large amount to R&D.
- Expenditure is incurred on R&D activities that have, to a significant extent, been 'conducted for' another entity.<sup>4</sup> Where the company undertaking the

<sup>2</sup> See subsection 355-225(2) of the *Income Tax Assessment Act 1997*.

<sup>3</sup> Note, specific legislation applies to feedstock; see section 355-465 of the *Income Tax Assessment Act 1997* or refer to the ATO Factsheet on Feedstock.

<sup>4</sup> See subsection 355-210(1) of the *Income Tax Assessment Act 1997*.

activity is recompensed by another entity under a contract, the expenditure may also not be at risk as required by legislation.<sup>5</sup>

- Expenditure is claimed twice, that is, it is claimed as a notional deduction under the R&D tax incentive and also as an actual deduction in the calculation of taxable income.

## Corporate Governance

Companies are expected to distinguish eligible R&D activities from ineligible ordinary business activities at the time of registration and throughout the conduct of the activities. Proper, detailed and contemporaneous records must be kept to support the registration application and the claim for the R&D Tax Incentive.

We are also concerned that some companies are not applying adequate levels of governance and review to the R&D activities that have been registered and to the claims that are subsequently made for the R&D Tax Incentive on their behalf. For example, we have observed:

- Suitably qualified company officers or employees who understand the relevant activities failing to undertake reviews and approvals of the company's R&D registration applications.
- Company management deferring responsibility for distinguishing ordinary business activities from R&D activities to external advisors, without checking whether the external advisors' understanding of the eligible activities aligns with that of the company's officers or employees.
- Accounting systems or records being kept which do not contemporaneously or adequately segregate R&D expenses from other expenses.

We have observed that these practices can result in activities being registered as R&D activities and expenditures being claimed under the R&D Tax Incentive that should not be.

## What are we doing?

The ATO and AusIndustry are working together to alert taxpayers and their advisors to practices that may result in increased risk of registering ineligible activities and incorrectly claiming the R&D Tax Incentive.

We will be contacting companies directly to advise them of our concerns with their registered activities and/or their R&D Tax Incentive claims if:

- Advisors who may apply high risk practices are involved in the preparation of the registration application and/or claim.
- The registration of R&D activities continues with the use of broad descriptions that fail to distinguish them from ordinary business activities.
- The level of expenditure claimed for the R&D Tax Incentive is high for the industry or stage of business.

Innovation and Science Australia will continue to issue Findings to companies confirming whether activities qualify for the R&D Tax Incentive.

We have developed a Specific Issue Guidance product to assist companies engaged in software development, and their accountants and advisors, to correctly identify and

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<sup>5</sup> See section 355-405 of the *Income Tax Assessment Act 1997*.

document eligible R&D activities in that industry. This product is available on [www.business.gov.au](http://www.business.gov.au)

### **What should you do?**

You should consider whether our concerns apply to you. The onus is on you to ensure that your registration and claim for the R&D Tax Incentive are correct. We would encourage you to:

- Review your registration to ensure you are registering only eligible R&D activities.
- Ensure your claim for the R&D Tax Incentive is correct and that you are not claiming expenditure related to ineligible ordinary business activities.
- Have the records to demonstrate the R&D activities being undertaken and support the associated R&D Tax Incentive claim.

If you consider that our concerns apply, you may want to:

- Phone us at the contact details provided below.
- Seek independent professional advice.
- Ask the ATO for our view through a private ruling or apply for a Finding from Innovation and Science Australia.
- Apply to AusIndustry to amend or withdraw your registration or make a voluntary disclosure to the ATO or amend your tax return.

Penalties may apply if you have incorrectly claimed the R&D Tax Incentive but will be significantly reduced if you make a voluntary disclosure. Generally, the reduction is greater if you make the disclosure before we notify you of an examination of your tax affairs.

Sanctions under criminal law may apply to fraudulent claims.

Registered tax agents, including R&D Consultants, advising companies to incorrectly claim ordinary business activities may be referred to the Tax Practitioners Board to consider whether there has been a breach of the *Tax Agent Services Act 2009*. Promoter penalty laws may also apply under Division 290 of Schedule 1 to the *Taxation Administration Act 1953* for promoters of schemes to access the R&D Tax Incentive for ineligible activities.

For more information about eligible R&D activities, what can be claimed under the R&D Tax Incentive and recordkeeping, refer to [Research and development tax incentive](#).

### **Do you have information?**

To provide information about this or another arrangement, or a promoter of this or another arrangement:

- phone us on 1800 060 062 or
- complete the [ATO Tip-Off Form](#)

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### Amendment history

Date	Comment
19 January 2024	Updated ATO tip-off hotline number

### References

#### Legislative References:

*Income Tax Assessment Act 1997*

- 355-25(2)(h)
- 355-210(1)
- 355-225(2)
- 355-405
- 355-465

*Tax Agent Services Act 2009*

*Taxation Administration Act 1953*

- Div 290 Sch 1

#### Related Taxpayer Alerts:

- TA 2017/2
- TA 2017/3
- TA 2017/4

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