FEBRUARY 2018

TECHNICAL UPDATE

INNOVATION REPORT RECOMMENDS R&D TAX CHANGES

ON 30 JANUARY 2018 THE GOVERNMENT WELCOMED THE RELEASE OF 'AUSTRALIA 2030: PROSPERITY THROUGH INNOVATION', A REPORT PREPARED BY INNOVATION AND SCIENCE AUSTRALIA (ISA) WHICH CONTAINS 30 RECOMMENDATIONS ACROSS FIVE AREAS - EDUCATION, INDUSTRY, RESEARCH & DEVELOPMENT (R&D), CULTURE & AMBITION, AND GOVERNMENT - TO SUPPORT AUSTRALIA'S INNOVATION SYSTEM.

THE GLOBAL INNOVATION RACE

According to ISA, the top priority of Australia's innovation policy should be to increase business expenditure on R&D to push us to the forefront of the global innovation race. This is because according to the Global Innovation Index, Australia consistently lags behind international competitors. In 2017, the index ranked Australia 23rd of 127 countries in terms of its research performance. But on innovation efficiency, which is a measure of how well we translate research into commercial outcomes, we rank a lowly 76th.

It is the view of the ISA board that the recommendations of the 2016 *Review of the R&D Tax Incentive* by the Government's review panel should be implemented to improve the effectiveness, integrity and collaboration impact of the programme as well as generating additionality and spill overs. Among other things, the 'Australia 2030: Prosperity Through Innovation' report says business R&D investment can be increased by better targeting the R&D Tax Incentive programme, and increasing support for direct grant programmes that target national priorities. The report also says industry-research sector collaboration could be increased by introducing a collaboration premium in the R&D Tax Incentive programme i.e. a collaborative premium tax offset. The Minister for Jobs and Innovation, Michaela Cash has said the Government will carefully consider the recommendations made.

BACKGROUND

The Review of the R&D Tax Incentive concluded in April 2016 and the Review Panel's R&D Tax Incentive Review report was released for public consultation on 28 September 2016. Interested parties were invited to comment on the report by 28 October 2016 and provide feedback on the findings and the proposed recommendations. BDO contributed comments which are available here.

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The original six recommendations by the Ferris, Finkel and Fraser Review Panel in 2016 are as follows:

- **Recommendation 1 – Programme Clarity**
  Retain the current definition of eligible activities and expenses, but develop new guidance to give greater clarity to the scope of eligible activities and expenses
- **Recommendation 2 – Premium Offset**
  Introduce a collaboration premium of up to 20% for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations
- **Recommendation 3 – Refundable Offset Cap**
  Introduce a cap in the order of $2 million on the annual cash refund payable under the R&D Tax Incentive, with remaining offsets to be treated as non-refundable tax offset carried forward for use against future taxable income
- **Recommendation 4 – Intensity Threshold**
  Introduce an intensity threshold in the order of 1 to 2 percent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit
- **Recommendation 5 – Increase Expenditure Threshold**
  Increase the expenditure threshold to $200 million so that large R&D-intensive companies retain an incentive to increase R&D in Australia
- **Recommendation 6 – Improving Administrative Function**
  Improve the administration of the R&D Tax Incentive.

2018 'AUSTRALIA 2030: PROSPERITY THROUGH INNOVATION' REPORT

The report recommends implementing various recommendations of the 2016 Review of the R&D Tax Incentive to improve the effectiveness, integrity and collaboration impact of the programme. It also introduces new recommendations to strengthen the Australian innovation system, including start-ups, basic research, and the education system. The table below highlights some of the recommendations from the report specifically in relation to indirect support programmes for R&D and Export Market development and captures BDO's response.

RECOMMENDATION	BDO COMMENT
Recommendation 3 – Refundable Offset Cap ISA proposes that the refundable offset cap of $2 million as recommended in the *Review of the R&D Tax Incentive* be increased to $4 million per year, with a maximum cumulative refund of $40 million per company.	Whilst BDO welcomes the ISA's recommended increases to the proposed refund cap, concerns remain for how a cap to the annual and cumulative refundable offset would impact entities already heavily invested in large R&D projects. Whilst only a small number of applicants will be impacted by the proposed cap to the refundable offset, these are companies that generally achieve the high levels of R&D intensity that are the target of promotion elsewhere in the recommendations. In addition, these are the companies that the report suggests are the most responsive to fiscal incentives in regards to generating additionality and spill overs. To alleviate any funding issues and maintain industry confidence BDO recommends and expects transitioning rules to be put in place for such a cap, to allow the affected companies to adapt to any resulting changes in anticipated cash flows.
Recommendation 4 – Intensity Threshold ISA proposes to instate a trigger threshold of 1% of total annual expenditure relating to R&D expenditure, and more importantly allows the claimant to claim the entire R&D expenditure once the 1% threshold has been triggered (rather than amounts in excess of the threshold).	While the 1% trigger could be viewed as tempering the previous 2% threshold, it still retains the key issues associated with the original recommendations. In particular: ▶ The trigger will reduce certainty around eligibility as the threshold trigger has to be calculated on a retrospective basis at year end and cannot be determined in advance of conducting R&D activity ▶ It unfairly targets industries with low profit margins and high operational expenses, and in many cases will prevent them from accessing the programme entirely ▶ A tiered system adds additional administrative burden to all stakeholders, and the design of the mechanism could be open to manipulation such as the method used for calculating the total annual expenditure. In light of the above, the introduction of a trigger should be avoided, as it would unfairly target some of Australia's most globally competitive industries, substantially increase administrative burden, and further reduce certainty around the R&D Tax Incentive programme.

RECOMMENDATION	BDO COMMENT
Recommendation 2 - Collaboration premium Whilst ISA has not made additional amendments to the other recommendations in the *Review of the R&D Tax Incentive,* it has strongly supported **Recommendation 2**, which is to introduce a collaboration premium of up to 20 percent on the non-refundable tax offset. The ISA believes that introducing a collaboration premium will incentivise business to increase collaboration with publicly-funded research organisation to enhance the ability to translate knowledge creation into application.	BDO welcomes the recommendation for a collaboration premium of up to 20% however believes this should have been extended to all claimants, not only those entitled to the non-refundable offset.
R&D claims in the digital transformation and software space The ISA board also states that it 'is aware that digital transformation projects have resulted in an increasing number of companies making claims for software-related activities under the R&DTI' and that in many cases, only a small part of overall projects form eligible research and development activities.	BDO notes that this commentary on software development under the R&D Tax Incentive aligns with recent warnings issued in publications by the ATO and AusIndustry on 'routine software development' activities or taking a 'whole of project' approach. However this seems to countermand the ISA Board's emphasis on the importance of digital, technology and mathematic skills, artificial intelligence, machine learning, automation and data sharing during the current climate of "digital disruption". The underlying message here is that claimants should be comfortable that the activities they are seeking to claim are consistent with the eligibility criteria as set out in the ITAA 1997. That is, they involve uncertainty of outcome that can only be overcome through experimentation, and that they are undertaken for the purpose of generating new knowledge, including in the form of new or improved products, processes or services.

RECOMMENDATION	BDO COMMENT
Increased funding for Export Market Development Grants (EMDG) The report also included a recommendation to prioritise new and redirected investment in stimulating business R&D programmes that directly support activity in areas of competitive strength and strategic priority. The importance of export, not only to Australia's economy but also to its innovation culture, was stressed by ISA. The ISA Board proposes increasing EMDG funding and expanding international trade agreements in order to stimulate improved growth in international export.	BDO strongly agrees with this recommendation and recognises that both the federal and state governments are already seeing early success in this area, with directed programmes such as the Advanced Manufacturing grant and the QLD Ignite Ideas fund. The EMDG scheme also provides much needed support to early stage Australian exporters. Successful export is critical to economic activity, strong job growth, and innovation and BDO agrees with ISA's assertion that increased funding to the EMDG scheme will not only stimulate export growth but create stronger and longer lasting business innovation.

BDO COMMENT

The 'Australia 2030: Prosperity Through Innovation' report provides a strategic plan that promises to rejuvenate the nation's lagging innovation performance. However, we note that this roadmap for Australia's future is littered with detours, dead ends, and red lights which should be green. Whilst the report correctly identifies that Australia's science and innovation system is fragmented and uncoordinated and identifies a need for establishment of improved policy and regulation settings, it is not clear how the new recommendations will be implemented. There is also a distinctly clear lack of targets and goals along with systemic approaches to achieve them. Contact BDO for assistance with:

- Developing an innovation strategy for your organisation
- Understanding your organisation's utilisation of current incentives and how you can improve this
- Reporting on and improving the return on investment from your innovation activities
- Leveraging new ideas by collaborating with start-ups, research facilities and other organisations to pilot new ideas.