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# Incentivising innovation – the broader equation

Australia needs a healthy innovation ecosystem if it is to thrive in competitive, knowledge-based, technology driven and increasingly global markets. KPMG Partner David Gelb and Director R&D Incentive Georgia King-Siem explain why the R&D Tax Incentive program is a vital part of the equation.

As Australia transitions from a resource-based economy to a knowledge-based economy, fostering a culture of innovation is vital for it to remain globally competitive. The Turnbull Government's National Innovation and Science Agenda (NISA), launched in December 2015, made this imperative clear. It also highlighted that innovation and science are critical for Australia to deliver new sources of growth, maintain employment levels and to boost economic prosperity.

The NISA contends a culture that "learns from taking risks and making mistakes" is fundamental to our future success and must occur across every sector. It outlines four key areas of focus; culture and capital; collaboration; talent and skills; and government as an exemplar.

Supporting this vision is the Research and Development (R&D) Tax Incentive, which is designed to encourage and boost innovation in business and other organisations, regardless of industry. Notably, investment in R&D is considered to be a key factor to enhance skills, jobs and economic growth.

The R&D Tax Incentive was introduced in its current form in 2011, but has roots back to its inception in 1986. Aware that cash strapped companies often need it most, the Incentive offers a refundable tax offset that has made the difference between success and failure on many occasions. While the benefit has been reduced recently, the Incentive is one of the more powerful drivers of innovation activity in the private sector. In fact, there is a correlation between R&D and Australia's GDP.

Here we look into the relationship between the NISA, the R&D Tax Incentive, Australia's innovation ecosystem, and how business can best participant successfully.

## An Agenda to boost output

Australia has a poor innovation efficiency index. That refers to the ability to translate inputs – such as smart people and quality education – into innovation outputs – such as commercial successes. So while Australia has great innovation inputs, it performs surprisingly poorly on innovation outputs and hence a low innovation efficiency index.

This issue is not new. Australia has a history of inventiveness (e.g. Wi-Fi, Black Box recorders, refrigerator, etc.), but it is less effective at commercialising its innovations.

The NISA is largely about harnessing inputs, and creating more and better innovation outputs, with the R&D Tax Incentive a key support mechanism for that goal.

Other aspects in the NISA include increasing the number of people in STEM (science, technology, engineering and mathematics) employment, along with tax breaks for angel investors and venture capitalists (VCs).

An effective 'innovation ecosystem' requires inventive people, employment opportunities for those people, and of course funding to support invention. The R&D Tax Incentive program feeds this system, as it enables companies to claim innovation tax offsets, and puts the money back into employing more people.

The Incentive offers immediate assistance to innovators, but also provides a longer term benefit through the spillover of knowledge gained from R&D and the flow on effect that has on the broader economy.

## Support for a complete ecosystem

An effective 'innovation ecosystem' requires inventive people (such as people with STEM skills), employment opportunities for those people (i.e. to curb them leaving the country to invent elsewhere), and of course funding to support invention.

The Incentive feeds this system, as it enables companies to claim innovation tax offsets, and put the money back into employing more people.

Collaboration is also vital to the ecosystem – in particular, connecting the public and private sectors with research institutions. One of the NISA initiatives looks at changing how academics are assessed in relation to commercial outcomes, rather than purely academic output. This is more akin to the US approach, where professors are often aligned and with, and have interests in, business.

Companies also need to innovate with each other – not just compete. Collaborating with competition is dubbed 'co-peting' and there is a strong trend for companies to work with startups and competitors to innovate and provide more meaningful products and services to customers.

## The R&D Tax Incentive factor

The R&D Tax Incentive is a key part of fueling the NISA and innovation ecosystem; both in the short and long term. The Incentive offers immediate assistance to innovators, but also provides a longer term benefit through the spillover of knowledge gained from R&D and the flow on effect that has on the broader economy. It is estimated that for every $1 of tax foregone under the Incentive, at least the same amount or more is returned in taxes later on.

Importantly, the Incentive is industry agnostic as Government cannot predict where innovation may come from. As a result businesses, regardless of industry, can access the Incentive; so long as it is an eligible R&D entity, undertakes and registers its R&D activities and then claims the eligible R&D expenditure on those activities. The Incentive can be claimed indefinitely and provides a tax offset on up to $100 million of R&D expenditure per year.

If undertaken correctly, the Incentive can provide a solid boost to innovation activities for businesses, enabling further research and hiring or retaining employees.

## A shift in industry focus

Traditional sectors such as manufacturing, agriculture or mining are still vital to Australia's economy, but as we shift from a resource-based economy to a knowledge-based economy, the nature and focus of R&D Tax Incentive claims is changing.

The fastest growing and largest sector for R&D in Australia is information technology (IT) by smaller companies. IT-based claims now make up more than 40 percent of R&D Tax Incentive claims in Australia. This reflects our increasingly digital economy and we are seeing globally competitive innovation in a number of areas. For instance, the burgeoning 'fintech' startup scene has a variety of startups developing world-leading solutions for mobile banking, faster payments, bitcoin, crowd funding, fractional lending, and more.

However, despite enthusiasm for the Incentive in certain areas, many pockets of business are still unaware of its potential – particularly start-ups and parts of the private sector that are not well versed in tax matters. Given the significant financial assistance the Incentive can offer, it's important that start-ups are aware of the Incentive. At a more macro-economic view, research shows young, dynamic companies contribute a great deal to job creation, and the creation of innovative products and services will increase the welfare of society over time.

## Proof of innovation design

If companies are undertaking R&D activities, there is no point in trying to claim the Incentive without supporting documentation that evidences what was done and what was spent. A R&D claim without such evidence will fail upon review, regardless of how world class the R&D may be. Documenting all R&D activities via technology solutions such as KPMG's R&D Edge is one way to help substantiate a claim.

This approach is particularly useful for the increasing number of IT-based claims, which are made up of code and complex novel solution architectures. Explaining discrete hypotheses around changing lines of code or design to authorities reviewing a claim can be challenging. This is even trickier if the developer or solution architect who undertook the activities at the time has moved on to a different company. This could leave the business with a successful solution, but a complete inability to explain or demonstrate the R&D that was required to create it.

This challenge extends across many new, complex areas of innovation, such as artificial intelligence, scientific modeling, genetics and abstract medical concepts. These concepts and the R&D behind them are difficult for others, including authorities, to understand, especially when compared with more tangible R&D claims such as manufacturing or engineering.

The ability to substantiate a claim properly is critical – the cost of failing to do so can include not only the repayment of the benefit received, but also interest and penalties – this demonstrates why real-time documentation of R&D activities is so vital.

## A sum of many parts

With the base of our economy shifting towards knowledge and technology, it is clear that programs like the R&D Tax Incentive have a key supportive role to play in ensuring Australia remains competitive. For businesses to make use of the Incentive, not only must they seek to innovate through undertaking R&D activities, but they must also document their efforts in a way that supports a successful claim. Only then can they use those funds to reinvest in their future.

# Contact us

KPMG's R&D Advisory team can assist you to identify and access R&D tax credits and a range of relevant government grants and incentives, as well as evaluating projects for tax efficient outcomes. KPMG R&D Edge, our end-to-end online solution for R&D Tax Incentive claims helps streamline the process.


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