

Submission by



GROWING PROSPERITY AND POTENTIAL

to the

Ministry for Business, Innovation & Employment (MBIE)

on the

**Fuelling Innovation to Transform our Economy – A
Discussion Paper on a Research and Development Tax
Incentive for New Zealand**

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FUELLING INNOVATION TO TRANSFORM OUR ECONOMY – A DISCUSSION PAPER ON A RESEARCH AND DEVELOPMENT TAX INCENTIVE FOR NEW ZEALAND

SUBMISSION BY BUSINESSNZ¹

1.0 INTRODUCTION

- 1.0 BusinessNZ welcomes the opportunity to make a submission to the Ministry of Business, Innovation and Employment (MBIE) on the Discussion Document '*Fuelling Innovation to Transform our Economy*', referred to as the 'Discussion Document'.
- 1.1 On several occasions, including on the introduction of R&D tax credits in 2008, BusinessNZ has submitted to the Government on the use of tax incentives and our fundamental viewpoint has not changed over time. In BusinessNZ's view, there are better mechanisms for assisting the business community to foster greater innovation and investment and improve productivity than introducing R&D tax credits. But assuming such assistance is to be provided, the submission provides comment on the best way to do this while ensuring as little distortion as possible.

2.0 SUMMARY OF RECOMMENDATIONS

2.0 BusinessNZ's **primary recommendation** is for:

- (a) ***The Government to lower the company tax rate and/or to reduce the top personal tax rate as the first steps to improving New Zealand's level of research, science and innovation (p.3);***

2.1 Notwithstanding its primary recommendation, if the Government decides to introduce R&D tax credits, BusinessNZ recommends:

- (b) ***The transition from growth grants to R&D tax credits involve (a) a rolling over of the growth grants during transition, and (b) an extension of the growth grants out to 31 March 2021 (p.5);***
- (c) ***State Owned Enterprises are included in the R&D tax credit regime (p.6);***
- (d) ***The R&D tax credits' definition places a greater emphasis on development, with an option for the definition to specifically include the word 'development' (p.7);***
- (e) ***The definition of R&D is amended to read '... creating new or improved materials, products, production equipment, devices, processes or services ...' (p.7);***
- (f) ***Determining eligible expenditure on R&D is based on a broader range of direct and indirect costs (including options for determining appropriate overhead expenditure) (p.8);***
- (g) ***The overseas concession for up to 10% of the total cost of the project is increased, if an increase is supported by a majority of other submitters (p.9);***
- (h) ***R&D software activities are adequately addressed and recognised in the further work officials are currently undertaking (p.9);***
- (i) ***The minimum threshold for research and development spending is aimed towards a figure above \$50,000 but below \$100,000 (p.10);***

¹¹ Background information on BusinessNZ is attached as Appendix One.

- (j) ***The R&D tax credit scheme has a tax credit rate higher than currently, combined with a lower cap (p.11);***
- (k) ***The option of pre-registration for large R&D spending claims beyond the cap is implemented (p.11);***
- (l) ***Options relating to transparency proceed if generally supported by the majority of current growth grant recipients (p.11);***
- (m) ***A comprehensive review and cost-benefit analysis is undertaken within four years of the introduction of R&D tax credits to ascertain their success or otherwise in relation to innovation, investment and productivity in New Zealand (p.12); and***
- (n) ***The aim of any tax incentive scheme is recognised as being to minimise business compliance and administrative costs (p.13).***

OVERALL IMPRESSIONS AND OBSERVATIONS OF TAX CREDITS

- 2.2 BusinessNZ's long-held and primary recommendation for any broad review of New Zealand's tax system affecting the business community is for a reduction in tax rates both at a company and personal level. Overall, a tax reduction is the most efficient and broad-based way of enabling all businesses to engage in, and/or experience, increased innovation, investment and productivity.
- 2.3 According to the Discussion Document, the R&D tax credit scheme will not stand alone. The 2018 Budget announced funding of \$1b over four years for the scheme. We assume this will be on top of wider government support for New Zealand research, science and innovation, particularly given some existing R&D grants will continue for the foreseeable future.
- 2.4 As stated in our previous submissions, our overall view of tax incentives is that, as international evidence clearly shows, they create winners and losers, since certain sectors and businesses are more able than others to make use of such initiatives. BusinessNZ has always taken the view that New Zealand's tax system should remain broad-based and as least distortionary as possible, especially when other options such as cuts in tax rates are also available. Tax incentives can lead to the very 'lolly scramble' approach the Government states in the Discussion Document it does not want to occur.
- 2.5 Tax incentives of this kind can see business practices changing significantly merely to obtain the tax credit, not from any real desire to undertake the activity to which the tax credit is directed. While we appreciate the Discussion Document is trying to establish boundaries for use, there is still a significant opportunity for the inefficient allocation of resources.
- 2.6 At the same time, we also recognise any loosening of the definition and eligibility criteria would involve a trade-off between ensuring the eligibility of those who should receive an R&D tax credit and the total fiscal cost to the taxpayer. Despite best intentions, the fiscal cost can be an unknown element and a surprise on the upside if the scheme is at a level where there are few barriers to entry. In addition, there is the opportunity cost for government if the money involved could be used for other purposes.
- 2.7 The key question is: 'what is the optimal way forward for R&D in New Zealand?' Also, what options would the Government look to introduce instead, given the critical importance R&D can play in boosting economic growth for the country? As discussed below, the R&D tax credit scheme will eventually replace an R&D growth grants scheme which, while obviously not perfect, is generally viewed in a positive light by the business community. Will moving from one scheme to another enhance or inhibit R&D in this country?
- 2.8 Our primary view is still that government should examine other initiatives through the tax system to broadly assist the business community with investing in research, science and innovation.

Primary Recommendation: That the Government view a drop in the company tax rate and/or a reduction in the top personal tax rate as the immediate first step to improving New Zealand's level of research, science and innovation.

- 2.9 Notwithstanding our primary view that a tax incentive approach should not be adopted, we wish to provide comment on certain issues we feel would at least minimise any negative consequences of what is proposed.

R&D Grants

- 2.10 As outlined in the Discussion Document, the R&D tax credit will not stand alone. After stopping the R&D tax credit scheme in 2008, the previous Government introduced the R&D grant system, which in its current form is summarised below in table 1.

Table 1: Existing R&D Grants

Type of R&D Grant	Eligible	Restrictions
Getting Started Grants	<ul style="list-style-type: none"> Only receive funding for R&D done in New Zealand Receive a one-off payment on completion of the project. 	<ul style="list-style-type: none"> Receive 40% of eligible R&D project costs, up to \$5,000 (based on a quotation).
Project Grants	<ul style="list-style-type: none"> Typically receive 40% of eligible R&D project costs; reducing for large projects, or when the business has had multiple grants, or when the business has had a Growth Grant. Only receive funding for R&D done in New Zealand (unless pre-approved) Receive payment in arrears (monthly or quarterly). 	<ul style="list-style-type: none"> 40% funding for the first \$800,000 of eligible R&D, then 20% for the remainder, or If previous Growth Grant then flat 20% funding, or If business has had more than \$800,000 of R&D Project funding then flat 20% funding applies.
Growth Grants	<ul style="list-style-type: none"> Have spent at least \$300,000 per annum and 1.5% of revenue on eligible R&D in each of the last two years; OR plan to exceed these levels over the next year (transitional application) Receive a two year extension after three years, subject to having met annual review requirements. 	<ul style="list-style-type: none"> Receive 20% of eligible R&D expenditure, up to \$5m per annum.
R&D Experience Grants	<ul style="list-style-type: none"> Have an active R&D programme i.e. a R&D budget and R&D staff. 	<ul style="list-style-type: none"> Receive funding of \$7,200 (plus GST) for 400 hours of full-time work upon proof of your payment to the student.
R&D Career Grants	<ul style="list-style-type: none"> Receive the first six months of the student's annual salary costs up to: <ul style="list-style-type: none"> \$30,000 (plus GST) for a masters graduate (based on annual salary of \$60,000) \$35,000 (plus GST) for a PhD graduate (based on an annual salary of \$70,000) 	
R&D Fellowship Grants	<ul style="list-style-type: none"> Business and the university supervisor will jointly supervise the student's research project, and the research is undertaken at both sites. Depending on the length of time for the student to complete their qualification, qualifying businesses will receive: <ul style="list-style-type: none"> PhD – maximum payments (36 months duration) <ul style="list-style-type: none"> Stipend \$75,000 (GST exempt) Travel allowance \$2,666 (excluding GST) University host fee \$13,333 (excluding GST) Masters – maximum payments (12 months duration) <ul style="list-style-type: none"> Stipend \$20,000 (GST exempt) Travel allowance \$888 (excluding GST) University host fee \$4,444 (excluding GST) R&D Fellowship Grant students receive a stipend and travel allowance and a fee is paid to the university to support their role in the scheme 	

2.11 Although not perfect, the general view of businesses that have gone through the process and received a growth grant is that the scheme has worked well. It has been fairly simple to use both for applying and complying, while supporting cash flow and facilitating innovation, particularly in the early stages. There has also been a greater level of certainty, particularly as once pre-approval has been given, the focus then can be both on research and development. Last, the grant schemes - particularly the growth grant - have led businesses to undertake projects they would not otherwise have undertaken. Therefore, a number of members have asked *'if it's not broken, why fix it?'*.

Transitioning from Growth Grants to the R&D Tax Incentive

2.12 As well as the R&D Discussion Document, we note the Government has also released a Discussion Document entitled *'Managing the Transition from Growth Grants to the R&D Tax Incentive'*. While BusinessNZ does not intend to submit on that Document, we note that those who currently receive growth grants will be able to do so until 31 March 2020. Current growth grant recipients have the option of transitioning to the R&D tax credit scheme from 1 April 2019, with 31 March 2019 the closing date for any new growth grant applications and extensions to existing growth grant contracts. The rationale behind this phasing out, is that the Government will be funding similar types of activity through the R&D tax credit, which they view as having a similar purpose. To the best of our knowledge, we have not seen any indication from the Government that any other types of R&D grants will be phased out, although this is obviously possible given the shifting nature of policy development.

2.13 While R&D growth grant recipients will eventually transition to the R&D tax credit scheme, our members have noted two critical concerns:

- Overall, companies currently receiving the growth grant will most likely receive less money, making them less likely to innovate, and
- The transition period from the growth grant to the tax credit will create business uncertainty.

2.14 A broadening of the scope for what is classified as R&D expenditure would assist with the first concern (discussed in more detail below) while rolling over the growth grants during transition and extending the growth grants out to 31 March 2021 would assist with reducing uncertainty.

Recommendation: That the transition from growth grants to R&D tax credits involve (a) a rolling over of the growth grants during transition, and (b) an extension of the growth grants out to 31 March 2021.

Rate of the R&D Tax Credit Scheme

2.15 The Discussion Document states the R&D tax credit will be set at 12.5%. This is below the 15% rate previously introduced under the 2008 tax credit scheme and lower than the 20% growth grant (14.4% after tax) over the last four years. A relatively low 12.5% does not seem consistent with the aspirational goals outlined in the Discussion Document.

2.16 While we understand the risk of total fiscal cost has seen the Government err on the side of caution by way of setting a lower tax credit rate than previously, obviously existing growth grant users will receive a lesser amount. Also, the lower the rate the lower the probability of a business applying for a tax credit given both actual costs and opportunity costs need to be taken into account. Much like the corporate tax rate, the rate for the R&D tax credit scheme sends an upfront signal to the global market about how seriously investment into innovation and technology is regarded, especially if a primary aim is to drive multi-nationals to shift R&D activities to New Zealand.

2.17 As we will discuss in response to question 16 below, there is an inverse relationship between the rate of the R&D tax credit and a cap on the amount a business can claim each year.

3.0 SPECIFIC DISCUSSION DOCUMENT QUESTIONS

3.0 The Discussion Document has asked a series of questions relating to the introduction of an R&D tax credit. We would like to take the opportunity to comment on some of these questions.

Question 1: If SOEs, Crown Research Institutes, District Health Boards, Tertiary Institutions, and their subsidiaries are excluded from the tax incentive, what will the likely impact be on business R&D in New Zealand?

- 3.1 BusinessNZ agrees that Crown Research Institutes, District Health Boards, Tertiary Institutions and their subsidiaries should be excluded from the R&D tax incentive which should, however, be available to all businesses regardless of their legal structure. Any attempt to restrict particular entities would lead to restructuring if an R&D tax incentive were to be claimed and would place further unnecessary compliance and administrative costs on the business in question.
- 3.2 But BusinessNZ questions the exclusion of State Owned Enterprises (SOEs) from the tax incentive scheme. SOEs have the principal objective of operating as successful businesses. All SOEs are registered as public companies and are bound by the provisions of the Companies Act. Most SOEs operate in deregulated markets and are on equal terms with the private sector. Given the current list includes a variety of industries, including telecommunications, postal services, banking, railways, electricity and broadcasting, exclusion would effectively result in an uneven playing field compared with fully private sector competitors. At the same time, we would expect the Government to monitor the use of R&D tax credits by SOEs to ensure the pool of funds is not all but drained away from private sector businesses.
- 3.3 Overall, since the objective of R&D tax credits is to achieve an ambitious R&D target that will see a step change in New Zealand's approach to innovation, BusinessNZ believes there is good reason to make the R&D tax credit available to SOEs.

Recommendation: That State Owned Enterprises are included for the R&D tax credit regime.

Question 2: How well does this definition apply to business R&D carried out in New Zealand?

Question 3: Does this definition exclude R&D that you think should be eligible, please illustrate with examples.

Question 4: Does the scientific method requirement exclude valid R&D in some sectors? Please illustrate with examples.

Question 5: What would the impact be on business R&D in New Zealand if a materiality test was applied to both the problem the R&D seeks to resolve and the intended advancement of science or technology?

Question 6: How well does this definition apply to business R&D carried out in New Zealand?

- 3.4 The key to any definition, particularly in relation to R&D, is that it is easily understood by those applying for the credit, has few loopholes and yet is broad enough to capture those at whom the scheme is aimed. In short, a balancing act is required to satisfy both administrators and recipients.
- 3.5 We are pleased to see the Government has taken the opportunity to investigate definitions for tax incentive provisions based on international best practice. There are countries that are similar to New Zealand in various respects and have success stories (including software) around which to draw on for any R&D incentive approach introduced to New Zealand.
- 3.6 The Discussion Document states the current definition of R&D used in the R&D grant system and for income tax deductibility, based on the New Zealand equivalent to International Accounting Standard 38 (NZIAS 38), is not considered suitable. This means any new definition on top of the one used for R&D grants is likely to create significant compliance and administration costs, especially as the existing definition is simpler to use for taxpayers already familiar with it for accounting purposes.
- 3.7 Regarding the definition now proposed for R&D tax credits, we note that the 2007 Act defined R&D as:
 1. *Systematic, investigative and experimental activities (SIE) that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes or services and that:*
 - o *are intended to advance science or technology through the resolution of scientific or technological uncertainty;*

or

- *involve an appreciable element of novelty.*

2. *Other activities that are wholly or mainly for the purpose of, required for, and integral to, the carrying on of the activities in paragraph (a).*

3.8 The new definition of R&D (below) is in many ways very similar to the definition used in 2007:

(a) Core activities: those conducted using scientific methods that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes, or services; and that are intended to advance science or technology through the resolution of scientific or technological uncertainty.

OR

(b) Support activities: those that are wholly or mainly for the purpose of, required for, and integral to, the performing of the activities referred to in paragraph (a).

3.9 Despite the similarities between the 2007 and the new definitions, BusinessNZ members who receive the current R&D grants and/or would look to apply for the R&D tax credit scheme generally agree the tax credit eligibility criteria are too greatly weighted toward 'R', rather than 'D'. Some even see the scheme as an 'R' only scheme. The problem with the imbalance between the scheme's two key aspects is that businesses predominantly spend money on 'D' than 'R'. As one member has pointed out:

'Businesses create economic value by developing innovative solutions to solve customer problems. There is inherent risk in the development and commercialisation and the R&D growth grants has helped business to increase their risk appetite. The R&D tax credit scheme will lead to business taking less risk.'

Therefore, we are concerned that if the current definition is introduced, the ability for many businesses to apply for and succeed in getting the R&D tax credit will be greatly affected.

3.10 Also, this limitation will be even more evident when smaller businesses are considered. While larger businesses will have some capacity to undertake research, in reality this is far less likely for SMEs. The financial costs that represent a larger proportion of their total capital mean SMEs, typically, do not focus on research.

3.11 As a first step to address this imbalance, we believe the definition requires a greater emphasis on 'development'. While we have no strong views as to the exact wording that would largely rectify this problem, a positive start would be to include the word 'development' in the definition.

Recommendation: That the definition for R&D tax credits places a greater emphasis on development, with the definition specifically including the word 'development'.

3.12 One other aspect of the definition we believe needs addressing relates to production equipment. During the Bill stage in 2007, BusinessNZ requested (1) to read '*... creating new or improved materials, products, **production equipment**, devices, processes or services ...*'. This was because the creation of production equipment is fundamental for some in terms of creating new product, and including that term would help clarify the definition for those applying for an R&D credit.

3.13 Therefore, BusinessNZ again recommends that sentence (a) of the definition read '*... creating new or improved materials, products, **production equipment**, devices, processes, or services ...*'.

Recommendation: That the definition of R&D read '(a) ... creating new or improved materials, products, **production equipment**, devices, processes or services ...

Question 7: Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe.

3.14 In addition to discussing the specific issue of dual purpose activities in question 9 below, the only other point we wish to raise is that it needs to be made clearer to the business community that the excluded activities obviously do not reach the threshold for the R&D tax credit scheme (are not core

activities). However, as support activities (part (b) of the definition) there is a higher likelihood they would be included. But many businesses will simply see the excluded list and automatically assume it applies to the entire definition.

Question 8: Please provide any examples where social science research is/has been a core part of business R&D in New Zealand?

- 3.15 On balance, in most instances we believe research on social sciences, arts or humanities should not be included as part of R&D incentives. While we support research into these areas, we believe this will not bring about the level of innovation, investment and productivity the Government is seeking. Research in these fields is often more a by-product of an economy that has already developed a sound infrastructure, and shows strong economic growth.
- 3.16 However, an exception to this could be where social science research activities are aimed at informing other R&D initiatives, such as a better understanding of the social implications for new products that improve peoples lives.

Question 9: What is the likely impact on business R&D in New Zealand if dual purpose activities are ineligible for the R&D Tax Incentive?

- 3.17 While BusinessNZ appreciates the stance taken regarding dual purpose activities – namely an R&D tax credit would be better targeted if it applies to an activity conducted solely for an R&D purpose – we strongly urge caution. In almost all situations, a business will undertake R&D for the purpose of making income as businesses are generally not narrowly defined by research activity. They have, continuously, to be sufficiently nimble to look for opportunities in the market where R&D is undertaken with the end purpose of commercialising the work. Therefore, to apply the tax incentive solely to R&D purposes without recognising the associated purpose of commercialisation would inhibit almost all businesses from applying. For instance, it is common practice in certain industries to de-risk the commercialization aspect of R&D by pre-selling where possible to recoup part of the cost soon after completion.

Question 10: What are the advantages and/or disadvantages of limiting eligible expenditure to R&D labour cost?

- 3.18 Of the two approaches that are outlined for determining eligible expenditure, BusinessNZ strongly prefers the second approach whereby it is based on a broader range of direct and indirect costs (including options for determining appropriate overhead expenditure). While the labour cost method may be simpler, it would not maximise the potential of the regime to raise R&D expenditure and therefore reaching the goal towards 2% of GDP.

Recommendation: That determining eligible expenditure on R&D is based on a broader range of direct and indirect costs (including options for determining appropriate overhead expenditure).

- 3.19 In principle, BusinessNZ agrees R&D costs incurred overseas should be eligible for the concession up to a certain percentage of the total cost of the project if the overseas work is part of an R&D project based in New Zealand and at least half the R&D project expenditure is for activities carried out in New Zealand. We view this as a pragmatic outcome and in 2007 we supported a similar stance particularly as it would be idealistic to think New Zealand can do everything as there will always be areas where New Zealand lacks the skills and/or capability. As the paper notes, New Zealand might not have complete capability to do the work locally, so foreign R&D jurisdiction requirements might have to be observed and the customisation of a product for a particular market take place in that market.
- 3.20 However, a key question is whether the 10% percentage value outlined in the Discussion Document is realistic enough in today's global environment? While we do not want a situation where almost all R&D is done offshore, at the same time we do not want to see missed opportunities because of the restrictive nature of the 10% limit creating some form of silo mentality when it comes to R&D activity in New Zealand. In addition, the Government needs to be mindful of situations where none of the Crown Research Institutes or New Zealand tertiary institutions have sufficient expertise in specific R&D areas, which would mean offshore options become a key focus.

3.21 Therefore, if other submitters provide sufficient practical reasons why the limit should be greater than 10%, we have no significant concerns about an increased percentage.

Recommendation: That the overseas concession for up to 10% of the total cost of the project is accepted, subject to an increase if an increase is supported by a majority of submitters.

3.22 The section on eligible expenditure lists a variety of business expenditure the Government believes should attract the R&D tax credit. While we have no particular comments on the list provided, we want to touch on the broader issue of the administrative and compliance elements involved in ensuring businesses understand exactly what is and is not regarded as eligible expenditure.

3.23 Establishing the boundaries of eligible expenditure for tax incentives has the potential to end up an administrative nightmare for some businesses, taking up a considerable amount of a business's time and resources. If boundaries are not clearly defined, this may well deter many businesses from even considering an application. Businesses already see tax compliance costs as the largest priority for the day-to-day running of their firm. A tax incentive approach causing confusion and administrative headaches will only exacerbate the problem.

3.24 Therefore, the clearer the Government can be about exactly what is or is not considered R&D expenditure, preferably by way of a comprehensive list in any guidance material (discussed in question 21 below), the less time and resource businesses will have to spend on 'grey' expenditure areas.

Question 11: What are the advantages and/or disadvantages of setting overhead costs as a percentage of R&D labour costs? What would the appropriate percentage be?

3.25 Overall, BusinessNZ believes there should not be limits on overhead costs as long as reasonable apportionment is undertaken. However, we would not be adverse to the idea of some form of pre-approved percentage of overhead costs if supported by most other submitters.

3.26 As discussed below, any guidance material around this needs to clearly outline what would be included as overhead costs so as to reduce uncertainty and ensure that the right resources are allocated effectively and efficiently.

Question 12: Are there any reasons why expenditure related to R&D activities for which commercial consideration is received should be eligible for a tax incentive? Please describe.

Question 13: What variations or extensions to the definition of core activities are required to ensure it adequately captures R&D software activities?

3.27 BusinessNZ agrees software R&D has become increasingly important in our economy. The fact that it has accounted for approximately 40-50 percent of the value of grants in the last three years is testament to this. Also, we would presume the level and depth of R&D software activities has grown exponentially since New Zealand last had an R&D tax credit ten years ago.

3.28 We are pleased to note the Discussion Document mentions officials currently undertaking additional work to see how the R&D definition should apply to software. However, we are concerned the definition of R&D tax credits is very similar to the one used in 2008 and general feedback from members was that many struggled to meet the 2008 tax credit definition when it came to software. Therefore, unless there is a meaningful discussion on ensuring the barriers to including software are at an appropriate level (such as opening the definition up to the novelty aspect for software), there is a high likelihood that in many instances software activities will be excluded.

Recommendation: That R&D software activities are adequately addressed and recognised in the further work currently being undertaken by officials.

Question 14: Are there reasons why continuity rules should not apply to tax credits? Please describe.

3.29 BusinessNZ has been formally collaborating with a number of interested business groups on the question of whether continuity should be imposed on R&D tax credits carried forward, advocating for

a change to New Zealand's loss continuity rules. We would like to see an amendment to a law that currently disadvantages many fast growing and innovative companies. Specifically, the proposal is to amend the current rule relating to the carry forward of tax losses by enacting a 'same or similar business' test as an alternative to the existing 49% continuity of ownership requirement. This would bring New Zealand's rules into line with those of many comparable jurisdictions, reduce compliance costs, and further the potential for business growth.

- 3.30 To that end, IRD officials have already undertaken work on both the substantive proposal and on possible implementation costs. A focus on the requirements for the carry-forward of tax credits further recognises the potential unfairness of a continuity of ownership structure.

Question 15: Is the minimum threshold set at the right level? If 'no', please provide further details.

- 3.31 As a background, BusinessNZ notes the 2008 legislation set the minimum threshold for receiving the R&D tax credit at \$20,000. At that time, the then Government indicated the amount was equivalent to a part-time salary and some related overhead costs.
- 3.32 The new threshold is \$100,000, the rationale being to filter out claims unlikely to be for genuine R&D. This is roughly the cost of one full-time employee's salary plus related overhead costs.
- 3.33 First, as mentioned in 2007, BusinessNZ has no firm view on whether the above figure is appropriate, although we are disappointed the paper lacks any summary showing other countries' minimum thresholds, including the threshold that creates a balance between ensuring the exclusion of questionable R&D and attracting genuine R&D work.
- 3.34 Second, in New Zealand's case the minimum threshold is not only influenced by a monetary value applying to general costs but also by the thresholds employed by the R&D growth grants. Table 1 (above) shows the closest generic grant above the R&D tax credit value as the growth grant (minimum \$300,000 spent on eligible expenditure), while the closest grant below the R&D tax credit value is the getting started grant (40% of eligible R&D project costs, up to \$5,000). One could argue that at \$100,000, the R&D tax credit sits somewhat in the middle but whether that figure is a bridge too far for many smaller businesses who undertake legitimate R&D work is a key point.
- 3.35 Given the Discussion Document states the '*proposed R&D Tax Incentive has been designed to provide easily accessible support to a broad range of businesses, and to do so in a fiscally responsible way*', we question whether the increase from \$20,000 in 2008 to \$100,000 in 2018 meets the accessibility target for smaller businesses. After discussions with members, the most practical monetary threshold is considered to be above \$50,000 but certainly below \$100,000.

Recommendation: That the minimum threshold of research and development spending is aimed at a figure above \$50,000 but below \$100,000.

Question 16: How important is a cap or a mechanism to go beyond the cap? Please provide further details.

- 3.36 As we briefly mentioned in our section on the R&D tax credit rate above, there appears to be an inverse relationship between the R&D tax credit rate and the cap on the amount a business can claim each year.
- 3.37 According to the Discussion Document, a business will be able to claim a tax credit of up to \$120 million of R&D expenditure each year, equating to a tax credit of \$15 million each year (based on the 12.5% rate). First, we understand the need for a cap. Given the wider implications for government expenditure, some line in the sand has to be drawn to ensure the total fiscal cost of the R&D tax credit scheme does not balloon out beyond the \$1 billion allocated over the next four years. If that happened, there would have to be trade-offs with other areas of government expenditure. This might not only cause problems with the Government's policy programme but could also cast the business community in a less than satisfactory light given the possibility of forsaking expenditure in other areas deemed important by society in general.
- 3.38 Realistically, BusinessNZ would doubt whether many businesses would get near to \$120 million R&D expenditure per year. Therefore, to ensure the three-pronged desirability of minimising exploitation, setting a rate which encourages legitimate R&D expenditure but provides a cap for larger business

claims, a trade-off between a higher rate/lower cap or a lower rate/higher cap is required. Combined with what we outline in question 17 below, BusinessNZ would be more in favour of a higher rate/lower cap so more businesses are able to apply.

Recommendation: That the R&D tax credit scheme looks to have a higher tax credit rate combined with a lower cap.

Question 17: What features of a Ministerial discretion or pre-registration would make them most effective?

- 3.39 Generally speaking, BusinessNZ is in favour of a cap on how much a business can claim each year, and we agree with the Discussion Document's reasoning that this would protect against the exploitation of loopholes which could create shocks to the cost of the scheme and reduce its sustainability.
- 3.40 However, we acknowledge a cap can reduce genuine large claims and this should be factored in when considering that New Zealand's largest R&D performers should be encouraged to increase their R&D and large, international R&D intensive firms encouraged to come to New Zealand.
- 3.41 Beyond the issue of needing to introduce a cap, the Discussion Document outlines two possible ways to incentivise spending on R&D above the level of the cap, either:
1. By having a Ministerial discretion to waive the cap for genuine claims; or
 2. Requiring pre-registration for large claims.
- 3.42 While we accept both options have advantages and disadvantages, we would favour the pre-registration option. Of the two, this option provides greater certainty for business. Also, we see potential pitfalls with the first option as it operates on a case-by-case basis and, in particular, allows the Minister a direct say on when the cap on claims will be waived. At worst, this could lead to political interference.

Recommendation: That the option to require pre-registration of large claims for R&D spending is implemented.

Question 18: What are your views on the proposed mechanisms to promote transparency and enhance evaluation?

Transparency

- 3.43 While the standard approach to taxpayer-specific information is for secrecy provisions to apply, the Discussion Document proposes that where substantial government funds are allocated through the R&D tax credit, the Government should consider an alternative approach. Transparency would assist in maintaining the integrity of the scheme. This would range from publishing the names of recipients and the amounts of R&D support (expressed in bands with a two-year lag), making taxpayer-specific information relating to R&D tax credit claims available to certain government departments, and integrating the data with Stats NZ's Longitudinal Business Database.
- 3.44 Overall, BusinessNZ does not have significant concerns with the transparency proposal. However, we note that R&D growth grant recipients are not published, so growth grant recipients moving to the R&D tax credit scheme would obviously see a change in process. We would be concerned if because of the change, many growth grant recipients decided not to move to the R&D tax credit scheme.
- 3.45 Broadly, we agree that in order to protect commercially sensitive information, a two-year lag before publishing the names of R&D tax credit recipients is a practical step. However, we would not be averse to an extension of the timeframe if realistically, other submitters find the two-year frame too short.

Recommendation: That options relating to transparency proceed if generally supported by the majority of current growth grant recipients.

Evaluation

- 3.46 BusinessNZ strongly agrees that following the transition from growth grants, the R&D tax credit scheme should be evaluated within four years of commencement. The R&D grant scheme underwent an extensive review, so reviewing the R&D tax credit scheme would be consistent with existing practice.
- 3.47 The review should seek to ascertain whether there has been any meaningful increase in innovation, investment and productivity on a national basis due to the tax incentives' introduction. The review should involve a comprehensive cost-benefit analysis and recommend whether the incentives should continue.
- 3.48 How businesses self-select R&D expenditure when completing StatisticsNZ surveys could also be an issue associated with the proposed change in the definition of R&D. With the success or otherwise of the R&D tax credit scheme largely dependent on seeing a genuine increase in gross R&D expenditure as a percentage of GDP, incorrect official survey measurements could hamper further policy development.

Recommendation: That a comprehensive review and cost-benefit analysis is undertaken within four years of the introduction of R&D tax credits to ascertain their success or otherwise in promoting innovation and investment and increasing New Zealand's productivity.

Question 19: Are there any other risks that need to be managed? Please describe.

- 3.49 As outlined above, the key risk for any R&D tax credit scheme is getting the correct balance between ensuring taxpayer money is correctly targeted towards genuine R&D expenditure, while ensuring any R&D tax credit thresholds are not so constrained as to deter worthwhile businesses from applying for a credit so that the scheme is underutilised.

Question 20: Are there risks with extending penalties to external advisors in this way?

- 3.50 The Discussion Document states that '*The standard penalties provisions in the Tax Administration Act 1994 would apply to R&D Tax Incentive claims*'. There is also consideration around the idea that '*penalties should be extended where a tax advisor has, or would have, received a direct financial benefit from the claim and the R&D Tax Credit application demonstrates a serious offence*'.
- 3.51 BusinessNZ does not have a strong view on this matter but would like to point out that if penalties are too heavy handed, this could have an adverse effect on SME applications given the high perceived risk. As mentioned above, the current growth grants require a pre-approval process easing a number of concerns applicants have about possible penalties. Taxpayer funds should be allocated correctly and standard penalties are likely to be needed to ensure consistency across tax policy implementation. However, there is scope for investigating whether concerns over potential penalties could be allayed via some form of auditing process, perhaps undertaken by Callaghan Innovation. This could be part of the investigative work into the second wave of the R&D tax credit scheme post the winding up of growth grants.
- 3.52 Also, the issue of potential penalties plays out in relation to the accompanying material available to applicants, discussed below.

Question 21: What is the right level of information required to support a claim?

Question 22: What opportunities are there for customers to submit R&D Tax Incentive claims via third party software?

- 3.53 Overall, BusinessNZ supports the initial features of the claims' process under consideration. These range from the use of the MyIR portal, through to the ability of businesses in the future to use third party software to enable records to be kept, ensuring R&D expenditure is correctly characterised.
- 3.54 One feature of the claim's process BusinessNZ considers especially important relates to the range of guidance and education material (including online tools) to assist claimants. The R&D tax credit guide, on which we commented in 2007/2008, is especially important for the business community.
- 3.55 First, a guide should be a guide, not a 'locked-in' definitive publication requiring modification or additions over the short to medium term. While the first publicly released guide should be as accurate

as possible, there will most likely be further additions as R&D tax credit issues, perhaps unique to New Zealand, evolve.

- 3.56 Second, as with the scheme itself, the guide should not be overly prescriptive in its interpretations. IRD generally takes a self-assessment approach to taxation with taxpayers responsible for calculating their own tax obligations, paying the tax to the IRD and filing tax returns. Although the self-assessment regime is buttressed by audit activity, generally the regulatory approach IRD favours facilitates good outcomes compared with prescribing a set way of doing things.
- 3.57 In 2008, we found the guide's first draft bordered on the prescriptive in its approach requiring considerable planning and record-keeping in order to tell the IRD of actual R&D expenditure incurred. While the guide discussed the role of self-assessment in relation to record-keeping responsibilities, the assessment requirements were high. Obviously, we did not want businesses allocating expenses that were not R&D but the considerable record-keeping provisions created significant compliance costs of which businesses needed to be aware upfront. We did not want businesses to find the prescriptive requirements so high that any decision to apply for a grant was put in doubt. Therefore the full implications of the record keeping and other requirements should be made clear at the front of the guide so businesses were aware of their obligations.
- 3.58 Third, while the initial guide provided examples throughout that attempted to explain the guidelines' practical outcomes, we also considered there was scope for a 'next level' of examples, going beyond the often simple examples provided in the draft. While all examples had a disclaimer explaining they were simple and applicants should check the guide itself or consult a professional, some more complex examples would help explain the procedure more clearly.

Question 23: What integrity measures do you think Inland Revenue should use?

- 3.59 BusinessNZ will be taking a keen interest in the success of the R&D tax credits system in improving the country's level of R&D. We hope the scheme will lead to businesses taking a more proactive part, giving strategic consideration to the role played by R&D plays in their further expansion.
- 3.60 We would also expect IRD to accept rather than reject applications which are on the margin for being classified as R&D expenditure. As mentioned above, BusinessNZ would want to ensure R&D tax credits are provided for legitimate purposes. However, there is a point at which the threshold becomes so difficult to reach, no-one applies and R&D tax credits are underutilised (i.e. there is disuse of the credit from fears of misuse). While IRD might be taking an initially conservative stance to ensure allocated funds are not soaked up by doubtful R&D expenditure, a consistent decline in applications could inhibit businesses' future use of the tax credits. With the time and effort required for the application process, businesses could perceive their chances as low and an application most probably a waste of business resources.

Recommendation: That the process for any tax incentive scheme aims to minimise business compliance and administrative costs.

Appendix One - Background information on BusinessNZ



BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups [EMA](#), [Business Central](#), [Canterbury Employers' Chamber of Commerce](#), and [Employers Otago Southland](#)
- [Major Companies Group](#) of New Zealand's largest businesses
- [Gold Group](#) of medium sized businesses
- [Affiliated Industries Group](#) of national industry associations
- [ExportNZ](#) representing New Zealand exporting enterprises
- [ManufacturingNZ](#) representing New Zealand manufacturing enterprises
- [Sustainable Business Council](#) of enterprises leading sustainable business practice
- [BusinessNZ Energy Council](#) of enterprises leading sustainable energy production and use
- [Buy NZ Made](#) representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation ([ILO](#)), the International Organisation of Employers ([IOE](#)) and the Business and Industry Advisory Council ([BIAC](#)) to the Organisation for Economic Cooperation and Development ([OECD](#)).