

Submission by



GROWING PROSPERITY AND POTENTIAL

to the

Finance & Expenditure Committee

on the

Taxation (Research and Development Tax Credits) Bill

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PO Box 1925
Wellington
Ph: 04 496 6562
Mob: 021 375 061

TAXATION (RESEARCH AND DEVELOPMENT TAX CREDITS) BILL SUBMISSION BY BUSINESSNZ¹

1.0 INTRODUCTION

- 1.0 BusinessNZ welcomes the opportunity to make a submission to the Finance & Expenditure Committee on the *Taxation (Research and Development Tax Credits) Bill*, referred to as 'the Bill'.
- 1.1 We have submitted on R&D tax credits on numerous occasions throughout the years. Aside from the discussion document that came out in April 2018, we also submitted on the 2007 legislation introducing R&D tax credits, effective in 2008/2009. Over that time, our fundamental opinion has not changed and we continue to believe there are better mechanisms than an R&D tax credit for assisting the business community to foster greater innovation and investment and improve productivity. Assuming, however, such assistance will be provided, the submission offers 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 that:
 - (a) ***The Government lower the company tax rate and/or reduces the top personal tax rate as the first step to improving New Zealand's level of research, science and innovation (p.4);***
- 2.1 Notwithstanding its primary recommendation, if the Government decides to introduce R&D tax credits, BusinessNZ recommends that:
 - (b) ***Further work is undertaken to ensure software R&D is adequately addressed in legislation as part of the R&D tax credit framework (p.6);***
 - (c) ***The Government introduces a "same or similar" business test in the tax loss carry-forward rules (p.7);***
 - (d) ***An independent evaluation of the R&D tax credit scheme is carried out by the end of the 2023/24 income year (p.8); and***
 - (e) ***Moves towards yearly recording of R&D expenditure take into account definition changes (p.9).***

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 as it affects 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 for the scheme of \$1b over four years. We assume this will be on top of wider government support for New Zealand research, science and innovation, particularly given some existing R&D growth 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

¹¹ Background information on BusinessNZ is attached as Appendix One.

when other options such as cuts in tax rates are also available. Tax incentives can lead to the very “lolly scramble” approach the Government’s Discussion Document states 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 possibility 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 are to 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? In addition, such questions do not take into account the wider issues around where the R&D tax credit scheme sits as part of a wider strategy to raise R&D in New Zealand.
- 2.8 In terms of trying to define what success would look like, the Government has announced a goal of increasing total R&D as a percentage of GDP to 2 percent over 10 years (up from 1.25 percent currently). Table 1 below shows what this would mean in terms of a dollar amount based on current values. To achieve the goal by 2029/30 would mean roughly an average 8.3% annual increase every year for 10 years. It is interesting to note that between 2016 and 2018, R&D expenditure increased 17%, which was more than the required annual increase to meet the target. At the very least, this indicates to us that the existing strategy to boost R&D in New Zealand is already showing positive results.

Table 1: Statistics on Current and Future Goals for New Zealand R&D Spending as a Proportion of GDP

Year	Total R&D Expenditure	As proportion of GDP
2014	\$2,685M	1.17%
2016	\$3,133M	1.25%
Goal (in 2018 dollars)	\$5,728M	2.00%

- 2.9 The other point the Government needs to take into account is the total cost to both the taxpayer and the business community. The Regulatory Impact Assessment (RIA) for the R&D Tax Incentive sought to ascertain the scheme’s expected benefits and costs. While the RIA was not able to quantify benefits, it did provide some information as to cost. The RIA rightly points out that participation in the system is voluntary and the compliance costs should be outweighed by the subsidy. However, when combined, the costs associated with the tax incentive from a macro perspective are sizeable:

- Fiscal Cost to Government (over 4 years) - \$1,020M
- Government administration costs of the R&D tax incentive - \$6M per annum
- Estimated cost per claimant - \$35,000-40,000 for 1500-2000 businesses likely to be eligible. Taking a mid-point of both figures, this equates to an estimated \$66M per annum increase in compliance costs to business.

Also, from a broad R&D taxpayer cost point of view, this is on top of the current allocation for growth grants of \$528M. Therefore, the total economic benefit to the country would need to be significantly higher than the total cost outlaid if R&D tax credits are to be considered successful.

- 2.10 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 lowers the company tax rate and/or reduces the top personal tax rate as the immediate first step to improving New Zealand's level of research, science and innovation.

- 2.11 Notwithstanding our primary view that a tax incentive approach should not be adopted, we would like to provide comment on certain issues we feel would at least minimise any potential negative consequences of what is proposed.
- 2.12 First however, BusinessNZ wants to acknowledge the consultation IRD has undertaken preparatory to the Discussion Document's release. Given the breadth of submissions on various topics to which BusinessNZ responds, it would be fair to say the term "discussion document" does not always live up to its name. However, in this instance IRD was very proactive in listening to the business community, either through formal submissions or a willingness to attend external meetings and so on. That table 2 shows a number of changes from the original thinking on the subject is testament to the ability of IRD to listen to private sector concerns.

Table 2: BusinessNZ recommendations in Discussion Document vs Government decisions via Bill

BusinessNZ recommendation	Government decision
<i>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.</i>	All Callaghan Innovation growth grants end 31 March 2021.
<i>That State Owned Enterprises are included for the R&D tax credit regime.</i>	State Owned Enterprises included for the R&D tax credit regime.
<i>That the definition for R&D tax credits places a greater emphasis on development, with the definition specifically including the word "development".</i>	Despite the definition changing, the word "development" is still not included. However, the reference to 'advance science or technology' was removed.
<i>That the definition of R&D read '(a) "... creating new or improved materials, products, production equipment, devices, processes or services ..."</i>	Not included.
<i>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).</i>	Now basing eligible expenditure on a broad range of actual R&D costs.
<i>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.</i>	Up to 10% of an annual claim can be overseas R&D.
<i>That R&D software activities are adequately addressed and recognised in the further work currently being undertaken by officials.</i>	Expenditure on internal software development is subject to a \$3 million cap. Also, such expenditure will be excluded altogether where it relates to the ordinary internal administrative functions of a business.
<i>That the minimum threshold of research and development spending is aimed at a figure above \$50,000 but below \$100,000.</i>	Minimum threshold set at \$50,000 (reduced from \$100,000).
<i>That the R&D tax credit scheme looks to have a higher tax credit rate combined with a lower cap.</i>	Rate increased from 12.5% to 15%.
<i>That the option to require pre-registration of large claims for R&D spending is implemented.</i>	Businesses that may exceed the level of the cap can apply for an extension above this figure to the IRD Commissioner (and are also required to consult with the Chief Executive of MBIE). The other option of "Ministerial discretion" will not proceed.
<i>That options relating to transparency proceed if generally supported by the majority of current growth grant recipients.</i>	The Commissioner is required to publish the name of each person, and their eligible R&D expenditure amount in dollar bands, two years after the end of the tax year to which an R&D tax credit claim relates.
<i>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.</i>	Bill requires the Minister of Research, Science and Innovation to commission a review of the R&D tax credit regime every five years. Also, current work by MBIE/Statistics to increase the frequency of the R&D survey from every 2 years to annually

	from 2019.
<i>That the process for any tax incentive scheme aims to minimise business compliance and administrative costs.</i>	Based on the Australian experience, the Regulatory Impact Assessment estimates that the cost per claimant will be around \$35,000-\$40,000.

2.13 While we did not have any firm recommendations, we also noted the following:

- *"Appointment rule for dual purpose expenditure: 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".*

In response, the Government has stated that if R&D activity occurs in the course of commercial production, amounts paid to employees engaged in that activity, plus additional costs, will be considered eligible expenditure.

2.14 Given the significant level of consultation and subsequent changes to the scheme since the Discussion Document' was introduced, BusinessNZ's general view is that the scheme is significantly closer to being a working and enduring policy that meets the needs of the business community. However, like most policies in the developmental phase, there are still areas which can be improved, providing for greater clarity and reduced compliance costs for those the scheme will affect. It is these remaining matters we would like to comment on.

R&D Tax Incentive Definition and Software

2.15 As outlined in table 2 above, during the Discussion Document stage BusinessNZ was concerned that the definition of R&D tax credits was very similar to the definition used in 2008. General feedback from members was that many struggled to meet the 2008 tax credit definition when it came to software. Therefore, without 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 was a high likelihood that in many instances software activities would be excluded.

2.16 In terms of the overall definition of R&D, core activity now has the following parameters:

- Is conducted using a systematic approach, and
- Has the purpose of creating something new, and
- Has the purpose of resolving scientific or technological uncertainty

We note the revised definition uses a "systematic approach" to resolving "scientific or technological uncertainty", with this term replacing the former requirement to use "scientific methods". Overall, BusinessNZ believes this is a positive change given many businesses do not undertake R&D activities using "scientific methods". From our perspective, the new definition should provide a wide range of established businesses that engage in legitimate R&D with greater opportunities. We believe officials have made the changes with the best of intentions, yet we remain concerned that the new definition might still preclude a number of software R&D activities, disadvantaging those engaged in software R&D.

2.17 Software R&D is now an important part of New Zealand's R&D. This is supported by the fact that the Discussion Document pointed out that "*software R&D has become increasingly important in our economy – accounting for approximately 40-50 percent of the value of grants in the last three years*". Therefore, we would expect any definition to align with the Government's intent of increasing the amount of business R&D in New Zealand. If not, there is the potential for a significant proportion of software R&D to be excluded, which in turn would also jeopardise the Government's objective of

growing the IT sector to become New Zealand's second largest industry. Page 15 in the commentary of the Bill outlines states that the definition of 'core activity' has, among other elements, drawn upon Callaghan Innovation's experience with its R&D grants regime. Therefore, it is surprising from our perspective why the proposed R&D definition essentially misses the mark for software R&D.

- 2.18 First and foremost, we are unclear as to whether the vast majority of legitimate software R&D will be covered by the proposed definition. For instance, how does "resolving scientific or technological uncertainty" fit into the context of software development? Given the core definition is dependent on this purpose, many businesses undertaking legitimate software R&D may fall at the first hurdle. If we compare this with the Australian R&D tax incentive scheme, BusinessNZ members who have a deep understanding of offshore R&D settings have indicated that we only have to look as far as across the Tasman to see how their core R&D definition and associated guidelines works significantly better for software R&D as a whole.
- 2.19 Second, in our submission on the Discussion Document, we stated that unless there was a meaningful discussion of ensuring the barriers to including software are at an appropriate level (such as opening the definition up to the novelty aspect for software) and the issue satisfactorily resolved, there was a high likelihood software activities would in many cases be excluded. While the overall definition has been modified to encourage more firms to start R&D activities, at the other end the Bill proposes subjecting expenditure on internal software development to a \$3 million cap. Such expenditure will be excluded altogether where it relates to a business's ordinary internal administrative functions.
- 2.20 As outlined in Section YA 1 of the Bill, internal software development expenditure:
- (a) means, for a person, expenditure or loss that is incurred on developing software for the purpose of—
 - (i) the internal administration of the person's business or of an associate's business;
 - (ii) providing services, and the main reason why the recipients of the services use the services is not the use of the person's computer technology or software itself, but rather the services themselves; but
 - (b) does not include expenditure or loss that is incurred for the purpose of developing software, if—
 - (i) the person's main purpose is disposing of the software or a right to use the software to recipients who are not associated with the person;
 - (ii) the software is an integral part of goods that the person disposes of in the ordinary course of business

- 2.21 BusinessNZ understands the rationale for excluding or limiting claims for internal software development due to limited spill-over benefits and fiscal risk. However, we remain concerned the proposed amendments do not move the needle far enough to the level where a broad range of businesses undertaking legitimate software R&D activities will meet the criteria for the R&D tax credit.
- 2.22 Overall, the worst case scenario for the Government would be a combination of (a) businesses engaged in R&D software that received a Callaghan Innovation Growth Grant being now unable to meet the requirements for an R&D tax incentive, and (b) more broadly, the definition of R&D being still too restrictive for businesses, either engaged in or looking to undertake software R&D, to apply. Therefore, BusinessNZ believes further work needs to be done to ensure legitimate software R&D is effectively recognised as part of the R&D tax credit framework.

Recommendation: That further work is undertaken around ensuring legitimate software R&D is adequately addressed as part of the R&D tax credit framework.

Tax Loss Carry-Forward Rules

- 2.23 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 carrying 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.

- 2.24 To that end, IRD officials have already undertaken work on both the substantive proposal and 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.
- 2.25 IRD officials have estimated that both the substantive proposal and possible implementation costs would be between \$30 million and \$60 million per annum. By comparison, the Government intends to spend over \$1 billion over four years on its R&D tax credit package. The proposed same or similar business test for carrying forward tax losses would represent, at a relatively modest cost, an important companion reform to the R&D tax credit package, and would remove an impediment to businesses accessing additional capital in order to grow.

Recommendation: That the Government introduces a "same or similar" business test in the tax loss carry-forward rules

R&D Tax Incentive Guidelines

- 2.26 One feature of the claims' process BusinessNZ considers especially important relates to the range of guidance and education material (including online tools) available to assist claimants. The R&D tax credit guide, on which we commented in 2007/2008, is especially important for the business community.
- 2.27 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, further additions will likely be needed as R&D tax credit issues, perhaps unique to New Zealand, evolve.
- 2.28 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.
- 2.29 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 about 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. 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 we recommended clearly stating upfront the full implications of the record keeping and other requirements, ensuring businesses were aware of their obligations.
- 2.30 Third, examples throughout the guide should lessen the need to seek further outside assistance. An example of this would be the specifics around 'overheads' as part of 'eligible expenditure', which is discussed in schedule 21B part A, clause 2. While the commentary provides examples such as rates, utilities, insurance and lease payments, a more comprehensive list in the guidelines would provide a greater degree of certainty for the businesses in question.
- 2.31 In relation to the point above, 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 straightforward and that applicants should check the guide itself or consult a professional, some more complex examples would help explain the procedure more clearly.

- 2.32 Last, as an overall point, we believe the Government needs to be cognisant of the fact that the guidelines should not be viewed as the answer to everything. Ideally, participants in the scheme should have a high degree of black letter law to turn to that provides clear guidance. We fully appreciate the fact that not every situation will fall neatly into one box providing participants with a clear understanding of the scheme. However, we hope the Government can provide a helpful balance between black letter law and any guidance material it might produce.

Independent Evaluation

- 2.33 In our submission on the Discussion Document, we strongly agreed 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.
- 2.34 We note the Bill proposes carrying out an objective and independent evaluation of the R&D tax credit regime every five years. Given the first application of the regime is the 2019/2020 income year, this would mean the first report would be due after the end of the 2023/24 income year.
- 2.35 Overall, we agree with the main focus of the review, and endorse the fact that the Minister's report must objectively and independently evaluate the R&D tax credit regime. 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 incentive's introduction. Given the total cost to both the taxpayer and the business community outlined in paragraph 2.9 above, the review should involve a comprehensive cost-benefit analysis and recommend whether or not the incentive should continue.

Recommendation: That an independent evaluation of the R&D tax credit scheme is carried out by the end of the 2023/24 income year.

Future Measurement of R&D

- 2.36 In relation to the point above, we note that there are current discussions between MBIE and StatsNZ about increasing the frequency of the R&D survey from every 2 years to annually from 2019. BusinessNZ strongly supports this approach since the survey's increased frequency should produce a rich set of data for the 5-yearly report and also provide the Government with regular updates of New Zealand's business R&D trajectory compared with the rest of the world.
- 2.37 However, like any survey, regular R&D statistical information will only be useful if good survey design principles are followed. To that end, the remaining data/evaluation issue discussed by BusinessNZ in our submission on the Discussion Document centered on how businesses self-select R&D expenditure when completing StatsNZ surveys, particularly when there is 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, the official time series indicating an increase or otherwise will be critical to evaluating any changes that may subsequently need to be made. Incorrect official survey measurements could hamper further policy development.
- 2.38 One area we assume will need to be examined is the likely difference in definition between the StatsNZ survey and the R&D tax incentive. The current StatsNZ R&D questionnaire's definition is:

What is Research and Development (R&D)?

Research and development comprises creative work undertaken on a systematic basis in order to increase the stock of knowledge. Any activity classified as R&D is characterised by originality. Investigation is a primary objective.

Business R&D: *Investigative work that has an actual or potential use for the business in the development of new or enhanced materials, products, devices, processes, or services. R&D ends when work is no longer experimental and pre-production begins.*

Don't include:

- *research after the material, product etc. is substantially developed and the primary objective is to develop markets (for example market research and marketing)*
- *pre-production planning or work to get production or control systems working smoothly*

(Further definitions of R&D are provided on page 17 (this provides a list of what R&D includes and excludes))

Obviously, the two are different and therefore, to get an accurate idea of the degree to which the R&D tax incentive meets the Government's goal of increasing the amount of R&D undertaken in New Zealand, both MBIE and StatsNZ will need to determine two things:

- a) The extent to which the R&D tax credit definition will influence the current definition used in the StatsNZ R&D Survey (especially since one could argue the current definition used by StatsNZ would exclude the great majority of software R&D), and
- b) Given any changes to the R&D definition, how best to ensure the statistics collected for the R&D survey prior to the enactment of the Bill match what is classified as R&D from the 2019/20 tax year onwards.

Recommendation: That moves towards yearly recording of R&D expenditure take into account definition changes.

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](#)).