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Ministry of Business, Innovation &  
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1 June 2018

Dear Sir / Madam

### **Submission in response to the discussion paper on the R&D tax incentive**

We write in response to the recently released discussion paper and provide our comments herein.

#### **Policy overview**

Before addressing the technical questions raised in the discussion paper, we recap below the key policy objectives of R&D incentives for New Zealand:

- Creating high value added jobs with good pay
- Attracting foreign direct investment
- Attracting and retaining skilled, globally mobile talent
- Fostering an innovation ecosystem with a free flow of information between businesses, government and institutions
- Keeping successful local companies in New Zealand

Any reform which does not reinforce these objectives will see the scheme promoting R&D for R&D's sake, raise BERD without translating into meaningful change for average New Zealanders, and ultimately, will be a liability rather than an asset going into future elections which creates uncertainty and instability leading to poor participation in the scheme.

#### **Continuity and stability**

For any reform in this area to have traction, it's critical that there is broad political support to prevent the continual 'ping ponging' between grants and tax credits depending on which Party is in power.

Under the 2009 R&D tax credit, there was initially significant engagement amongst the business community, with a high level of enthusiasm to record and grow their R&D spend. However, when the new National government axed the regime immediately following the 2008 election, businesses lost interest.

Since 2009, there have been multiple reforms leading up to the creation of Callaghan, and then again further reforms in the Callaghan era.

We are now again going through the latest round of reforms.

For these reasons, it's understandable that there's apprehension in the business community about the degree to which it can rely on the sustainability of any new reforms.



This concern is further underscored by the negative public statement made by the National spokesperson for Innovation, Dr Parmjeet Parmar on 19 April 2019 in response to the R&D tax credit discussion paper. Similar scepticism was indicated through questions raised in the House regarding:

- The cost of R&D tax credits v growth grants, and government pushing the risk of doing R&D onto businesses (1 May 2018);
- Concerns regarding sorting the system and reclassification of existing spend as R&D (24 May 2018);
- The projected percentage growth in R&D spend by 2020 (24 May 2018).

KPMG represents a large cross-section of the New Zealand business community and our primary concern is that whatever scheme is in place, whether grants or credits, that there is stability so that businesses can plan and engage with government in a meaningful way for the long term.

For the new reforms to gain traction, it's important that there's broad political support so that the business community can rely on these in the event of a change of government.

To-date, the comments from the Opposition indicate that these reforms do not as yet have a breadth of political support. We therefore urge Officials to take the necessary steps to remedy this, as much as can be done practically, and to share with the business community what steps have been taken.

### Replacing the growth grant

As the credit is replacing the growth grant, it's beneficial to highlight business' experience with the growth grant and its pros and cons:

#### Pros

- Quarterly payment which helps with cashflow.
- Grant income is recognised 'above the line' as additional revenue, increasing business unit performance and providing an incentive for business unit managers and their teams to drive R&D growth and record it appropriately.
- 3 year grant contracts confirmed before undertaking the R&D, providing a degree of certainty to assist with planning, resourcing and budgeting.
- An on-going relationship with experts at Callaghan Innovation which also provides a network to connect with others in the industry.

#### Cons

- **Limited access:** In five years, approximately 300 growth grants were awarded, an average of 60 annually. In the one year of the 2009 R&D tax credit, approximately 1,000 taxpayers filed claims. It's possible that a percentage of these claims were marginal, however, this is offset by the number of quality R&D businesses that did not file in 2009 because it was only in place for one year after being cancelled by the new National government.
- **Initial and annual R&D audit requirement.** For businesses who already have their financial statements audited, this is not a major issue. However, for those businesses who have never been through an audit, having to justify revenue and other non-R&D items for an R&D grant is time consuming, costly and unrelated to the purpose of the incentive.

By way of example, the types of matters businesses must attest to in their R&D audit include accounts receivable, credit notes, bank reconciliations, HR processes, the various

legislation and regulations governing the business, consolidation entries for group companies - amongst many others. There is no one R&D audit process amongst firms for assessing these matters, therefore the evaluation of businesses can vary significantly.

It's hard to see what any of this has to do with R&D, and in that respect the growth grant has failed a large proportion of NZ businesses doing quality R&D and who need to demonstrate the above for the sole purpose of an R&D audit.

This in part explains the poor uptake of growth grants at 6% compared to R&D tax credits described above.

- **Financial due diligence:** Companies have to justify their financial position to officials in order to access the funding. However the risk to government is limited because if the company did not have the cash to fund their part of the R&D then government would not need to pay anything. This is fine for large companies who have financial due diligence information readily available, however it creates significant challenges for small privately owned businesses, which comprises 95% of the New Zealand business community.

In this regard, the growth grant has been criticised for being biased against entrepreneurs who risk their own funds to create genuine innovation. These small, privately owned companies may have raised funds through loans from friends and family, second mortgages on the family home, or funding secured against a previously successful venture.

In such cases, there is often not a stand-alone set of financial statements which clearly demonstrates the entrepreneur's actual position. Furthermore, such entrepreneurs spend their time working on their innovation and not preparing detailed investor ready reports. This can lead to them falling short of the high standards for financial due diligence which they are subjected to, even when this is the genesis of so many of our successful innovative companies. Ultimately, many of these entrepreneur's don't even bother engaging in the process due to these roadblocks.

This again is another explanation for the poor uptake of growth grants at 6% relative to R&D tax credits.

- **Exclusion of costs which would otherwise be capitalised under IAS 38:** It's apparent that the original Ministerial Directive's reference to R&D as defined under IAS 38 was to provide readily identifiable R&D costs in an applicant's financial statements. It is also probable that the reason for excluding capitalised intangible assets per IAS 38 was that some R&D in this area might be considered market development rather than R&D.

Overtime, this inadvertently morphed into heuristics such as 'Research is eligible' but 'Development is ineligible' - a strange outcome for an R&D grant. This became even further warped when the intangibles exclusion for IAS 38 was applied even to cases where there was no intangible asset to capitalise costs to.

In practice, the distinction between expensed R&D costs and R&D costs which would otherwise be capitalised was arbitrary and disconnected from the reality of how organisations do R&D.

Modern business R&D is customer-centric and driven by the needs of the market. Accordingly, the space between "research" and "development" has become reduced so much that the dividing line is practically indistinguishable and archaic. For this reason, significant amounts of quality R&D was unnecessarily excluded from the growth grant regime.

Where relevant, the strengths and weaknesses of the growth grant are reflected in our recommendations in the remainder of this document.

### **Further comments on the Growth Grant**

We note that there are a significant number of weaknesses in the growth grant highlighted above. Nevertheless, terminating growth grant contracts before their maturation creates further instability in the R&D funding ecosystem.

Government has talked about creating partnerships with business, and the growth grant contract itself emphasises the importance of both parties acting in good faith.

Notwithstanding that commitment to act in good faith, government has undertaken by itself to cancel growth grant contracts before their maturation with no 'good faith' reason provided other than the fact that it has the right to do so as long as it provides two months' notice.

This is not acting in good faith and does not contribute toward building meaningful partnerships between government and businesses.

For all the faults highlighted with the growth grant, if government intends to achieve anything meaningful with its R&D reforms, it must close the credibility gap created by this action. If not, it's possible that government will simply not see the results it's forecasting from the R&D tax credit due to the apathy engendered amongst business from failing to keep its word.

One simple action to help close this credibility gap is to honour current R&D growth grant contracts to maturation. This will cost the government nothing since these companies will claim an equivalent amount under the R&D tax credit regime as they would under their growth grants. Furthermore, we understand that the overhead costs at Callaghan for managing growth grant payments and compliance is immaterial.

### **Response to specific 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?**

Generally speaking CRIs, DHBs and Tertiaries receive substantial recurring targeted research funding from central government thus there is no need to provide additional broad-based funding via the tax credit.

However, in some cases, they may setup special purpose companies for commercial purposes which is ring-fenced from their existing operations. In this case, it's arguable that access to the R&D tax credit for the special purpose company will provide a positive incentive as is the case for any other privately-owned company.

Furthermore, most, if not all, funding provided by central government to these agencies is fully allocated to existing programs thus it would be incorrect to assume that core funding can be used to fund such spin off commercial ventures. It's also unrealistic to expect that the agency can simply just ask central government to increase its core funding merely to pay for its commercial R&D venture.

Accordingly, there may be merit in allowing commercial subsidiaries of these agencies to access the R&D tax credit, with a proviso that any R&D funded by other government sources is ineligible.

As regards SOEs, these are businesses setup with a profit motive, and unlike the other government-affiliated organisations listed above, they receive little to no recurring research funding from government. Accordingly, as SOEs are subject to the same limitations and market forces as any other NZ business, there is no reason to exclude them from the R&D tax credit regime.

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

The language used in the Frascati Manual and overseas is antiquated and harks back to an earlier, industrial era which bears very little resemblance to many of the innovative, high growth organisations which the R&D tax incentive is targeted at.

If you were to walk into many leading innovative tech companies and ask an employee at random if they were doing R&D, they wouldn't understand the question, yet these are exactly the kinds of companies which government is keen to support.

It's clear that the era of test tubes and white lab coats setting the standard for what is and isn't R&D should be consigned to our past.

A further concern regarding the Frascati model is that many other countries derive their definition of R&D from this. However, in practice it is highly likely that administrators of the fund/credit just ignore the overly technical language and simply ask 'is this genuine innovation, yes or no'.

Accordingly, a revised definition would be as follows:

~~Core R&D activities: those conducted using scientific methods that~~ are activities 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 **further science technology, technical know-how, or science** through the resolution of technological, technical or scientific uncertainty **by following a methodical process, which a competent professional could not reasonably resolve.**

Note the following changes:

- Removal of 'scientific method' as this is antiquated and irrelevant to most businesses today. By including it, government would simply be asking businesses to define an artificial hypothesis which bears no connection with their actual internal project management processes. It's sufficient that the business has simply followed a 'methodical process', hence this term being inserted toward the end of the paragraph. This addresses the scientific method query raised in question 4.
- Replacing 'advance' with 'further' to make the definition more accessible to the typical business person.
- Reversing the order of 'technology' and 'science' to reinforce the importance of R&D in the field of technology in modern business.
- Insertion of the term 'technical know-how' in the same class as 'technology' and 'science' because there are a vast range of innovative R&D activities which are neither technological nor scientific but which support government's policy objectives e.g. innovation in engineering, agriculture, applied statistics. The boundaries of 'technical know-how' will be constrained by the fact that its meaning is coloured by the words around it (i.e. technology and science).
- Insertion of a threshold of 'competent professional' to provide a standard against which the R&D can be measured to exclude trivial activity. This will negate the need to add a 'materiality test' as proposed by question 5.

Creating two different types of R&D as 'Core' and 'Supporting' activities is redundant and very confusing for businesses. It's sufficient, and common sense, to simply state immediately following the definition above that:

"Activities undertaken directly or indirectly to support the R&D activities can be included within the taxpayer's eligible activities."

For the reasons outlined in the discussion above on replacing the growth grant, we recommend inserting an express provision stating that “activity is included as R&D, and the costs treated as eligible, even if they would have been treated as capitalised intangible costs elsewhere in the Act”.

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

Our response to question 2 addresses the required changes in this regard.

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

Our response to question 2 addresses our concerns regarding the use of the term ‘scientific method’ and the suggested alternative. Refer also to our response to question 13 regarding the R&D method in the context of software companies.

**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?**

Our response to question 2 addresses our views on the materiality test and our suggested alternative.

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

Our response to question 2 addresses our view on this definition.

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

As noted in our response to Question 2, the distinction between core and support activities is antiquated and confusing to businesses. The activities listed amongst the exclusions would not meet the definition of R&D therefore there is no benefit to adding this list to the regime. Rather, it may be more effective to include examples in the guidelines of what is and is not R&D.

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

We would point to the important R&D being done around artificial intelligence, machine learning, human behaviour, impact of environment on genetics and personality, gamification systems or UI/UX environments, etc. These are examples of genuine R&D originating in the social sciences, which are becoming more important in driving economic growth for modern economies.

For example, WSP Opus prioritises the development of human centric infrastructure, and they have undertaken significant R&D which has helped shape the rebuild of Christchurch post-earthquake, informed various rebuild activities for Kaikoura earthquake recovery, leading the way in disaster resilience. In this regard, smart mobility and smart cities concepts are changing the urban landscape and the contribution of social science in these fields is vital in shaping human focused environments.

**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?**

The proposed exclusion for ‘dual purpose R&D’ is unworkable as no business does R&D solely for the sake of doing R&D. Every business has a profit motive and conducts R&D for a commercial end.

It would be an abuse of language to state that something is not R&D simply because it is being done for a commercial purpose.

A more practical and intellectually honest approach would be to accept that this is R&D, and then insert a test to identify whose R&D it is. If it is in fact R&D commissioned by a customer, then we should acknowledge that valuable R&D is being done, and the only question which remains is 'who performed the R&D'.

For that reason, we recommend removing this exclusion and re-inserting the 'on behalf of' test from the 2009 regime.

For example, if an engineering company was engaged by a customer to assist in the construction of a large complex project and the engineering company undertook R&D to arrive at a cutting edge solution which had wide application across other industries and projects, then valuable R&D has been performed. The only question which remains to be answered is 'who's R&D is it?'. If the engineering company controlled the IP, bore the financial risk and controlled the R&D phase of the project, it is the engineering company's R&D.

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

Focusing on direct labour alone would significantly distort the type of R&D incentivised. It would be inconsistent with the intent of the incentive to apply broadly to businesses.

*Advantages:*

- Simple for companies to identify and calculate. Likewise, it would be simple for the government to administer and monitor compliance.
- Incentivise labour-intensive R&D activities in the fields of engineering and high tech software.

*Disadvantages:*

- Creates bias to businesses that are labour-intensive (e.g. software, services based companies) and against those that incur more direct, contractor and capital expenditure (e.g. engineering, agriculture, manufacturing businesses).
- New Zealand still has a relatively large manufacturing base. Limiting eligible expenditure to labour cost would exclude these business from participating in the credit as they move towards modernising production and implementing cutting edge production techniques to maintain and grow manufacturing jobs.
- Excludes many costs that would generally be considered part of undertaking R&D such as: research services, production of prototypes, purchase and use of R&D-specific equipment and facilities, depreciation, etc. As a consequence, only a small part of the total business R&D costs would be included, reducing the effectiveness of the program.
- The program also seeks to attract large international R&D-intensive firms to NZ. Sometimes these firms prefer to utilise local contractors to undertake their R&D activities, which would be excluded.

Furthermore, many businesses rely on indirect R&D labour costs to achieve their R&D goals. NZ is a small growing economy and there are only a handful of companies who have full time R&D teams. In this regard, we are very different from larger economies, where many companies employ large teams of R&D experts. Most of our companies have only a few full time R&D employees, and they rely on indirect support from the rest of the team to achieve their goals. Examples include:

- Project Managers, including Innovation Managers, who shepherd the R&D activity through the company and help pull in resources as needed;
- Senior management, who provide input on how the R&D fits within the broader strategic goals of the company and guide the direction that the R&D program should take;
- Customer facing staff, who are able to source real time feedback and identify user requirements, so that the output of the R&D meets a real world need, avoiding it being 'wasted R&D';
- Production experts, who provide input on prototyping and also whether something can actually be produced at scale. There is no point in the 'Innovation Lab' of a company creating something which cannot actually be produced.

To control the types of non-labour costs which are claimed, we recommend the guidelines include examples of eligible overhead, prototyping and third party costs.

**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?**

For the tax credit to be effective in supporting the cost of doing R&D, it is important that it supports the fully costed value of R&D.

The fully costed value will differ from company to company, therefore it would be overly burdensome for government to intervene in mandating how businesses calculate this.

For management reporting and the preparation of financial statements, organisations already follow sound commercial practice in allocating overheads to their activities. In most cases, this will be "activity labour" divided by "total company labour". For those organisations where this results in a warped allocation, they already turn to alternative methods.

Accordingly, there is no need for government to add any further mandates. It should suffice to state that the method be fair and reasonable, and consistent with generally accepted accounting practices. A standard methodology can also be included in the guidelines with an example.

**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 12 is in some sense another way of asking question 9 (dual purpose R&D). In reality, all businesses undertake R&D for this purpose. By excluding R&D for which a commercial return was received, that would only incentivise failed R&D, and businesses who had successful R&D would be penalised.

Furthermore, current best practice is to work collaboratively with customers to get feedback from users in real time. The best kind of customers to work with are paying customers because that provides a signal that they care about the results of the R&D.

The feedback from non-paying customers is heavily discounted because they have no 'skin in the game'. Accordingly, excluding R&D for which commercial consideration was received bears no relation to modern R&D practices and can also encourage poor R&D methodologies by incentivising businesses not to engage with customers to get early feedback.

In light of this, any reforms in this area should be directed at identifying 'who's R&D' it is, and that can be managed by using the same 'on behalf of' test from the 2009 regime as described in our response to question 9.

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

Broadly speaking our recommendations in question 2 address the necessary changes.

However, we are aware of two broad concerns in some quarters within government that we wish to address.

Firstly, we understand that some officials, especially those that have come up through the ranks in academia and government research agencies, do not consider software development as a class to be genuine R&D. This is a very out-dated view of the world and disconnected from the primary engine driving business growth. Furthermore, software development is a form of computer science, which is a science in and of itself. In this regard, software development incorporates some of today's most important cutting edge science, such as artificial intelligence, machine learning and data analytics. Therefore, there is no need to create special subclasses of R&D in the legislation just for software activity.

We appreciate that R&D in software happens at such a rapid pace that traditional R&D experts may struggle to fully comprehend the rigour in the methodology. This is especially so with cloud based technologies, where new features can be pushed out rapidly and testing done in real time.

By way of example, MYOB has a cloud-based platform in which it rapidly pushes out new features that its R&D team have been working on. Often, the R&D team can deploy 5-10 times in a given day. This allows for rapid feedback on performance, customer usability, stability and platform integration. Even though the company follows an agile development process with rapid deployment, agile does not mean ad hoc. MYOB's R&D team, numbering over 100 software engineers have a highly methodical and focussed approach in the technologies they are researching and their development cycle, coupled with rapid evaluation via input from real customers.

In the modern era, best practice for R&D means real time, fail fast, lean and customer centric. It just happens to be that software currently leads in this approach, but many traditional and industrial businesses are quickly adopting this as well because it generates superior results.

For this reason, government should applaud software companies for leading in this space through their early adoption of 'agile' and 'lean' development, rather than holding it against them because it does not conform to the norms established when the Frascati model was originally written 50 years ago.

Secondly, we understand that officials are also concerned about their experience in 2009 and examples from Australia of large financial institutions and other big corporates upgrading legacy systems and simply claiming the whole cost as R&D. On this point, we are in agreement with officials that care must be exercised in this area. The modified definition of R&D we've provided above will exclude these cases as they do not exhibit eligible activities.

In saying that, to the extent that they do exhibit genuine R&D this should be embraced.

For example, if a financial institution replaces a current manual paper-based process with an interactive artificial intelligence agent that uses data analytics to adapt to customers' specific needs and uses the latest encryption tools to protect their privacy, then this should be assessed on its merits and not excluded simply because it's a case of a financial institution replacing a legacy system. Not only should it be evaluated on its merits, but there would no logical reason to have a cap on the amount of R&D that can be claimed.

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

A significant number of loss-making companies will rely on the R&D loss cash-up regime in the first year of the R&D tax credit, therefore, we recommend continuity issues be revisited in year two once it's clarified what will replace that regime and the support for loss making companies more broadly.

For profitable taxpayers, most of these will receive their refund shortly after the R&D activity is undertaken, therefore the risk that a different economic owner receives the benefit from the

incentive is limited. In addition, some businesses may choose to reduce their provisional tax payments by the amount of their expected R&D tax credit. As the credit will count as 'tax paid' the existing imputation continuity rules should suffice.

Furthermore, we understand that in subsequent years with regular R&D reporting government may in turn pay the incentive on a regular basis (e.g. quarterly or monthly). This will significantly reduce the time lag between R&D activities and receipt of the credit which will further eliminate the risk of a different economic owner receiving the benefit.

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

We agree that this minimum threshold is reasonable. Organisations need to have a critical mass of R&D for their activity to have a long term impact in building their internal R&D capability. The figure of \$100,000 is approximately 1 full time equivalent skilled employee fully costed for overheads. By setting the minimum threshold at one FTE, it signals the need for businesses to take R&D seriously and dedicate sufficient resources to this to achieve sustainable innovation.

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

A cap is beneficial as it will provide an avenue for businesses to engage with government early before undertaking large R&D projects.

This will provide an opportunity to engage in more wide reaching conversations about the spill over benefits to NZ from such a project and the other tools government has to support projects at these large scales. This is an especially important signal for large foreign companies looking to move their R&D facilities to NZ as that can then be undertaken in a planned, methodical manner in partnership with government.

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

It may be more sustainable to move the decision to the executive branch rather than cabinet as decisions are less likely to be impacted by election cycles. As regards criteria, two critical features would be:

- That the R&D is for the benefit of NZ
- That the activity is sustainable in the long term

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

We broadly agree with these proposed mechanisms.

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

We have no further comments in this regard.

**Question 20: What are the risks with making external advisors liable in this way?**

We agree that there are merits to curbing contingent fees and have no further concerns regarding this proposal.

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

It's critical that the company records its R&D activity in real time (or as close to real time as possible). This avoids the risk of leaving it until the end of the tax year, plus the additional one year proposed, to attempt to recall all the R&D undertaken.

We understand that some jurisdictions have a 'contemporaneous' requirement i.e. that unless the activity was recorded at the time of being performed, it will be ineligible for the R&D tax credit. We agree that there are merits to this approach.

Government can achieve a greater buy-in for real time record keeping by committing to pay the credit in regular instalments, rather than after the end of the tax year.

In this manner, businesses will be incentivised to record and submit their R&D information on a regular basis throughout the course of the year.

As regards the specific form of the documentation, it would be most efficient if taxpayers can utilise commercial documentation which they already possess internally, to the best extent possible. Requiring R&D specific documentation is incredibly onerous and our experience with the 2009 R&D tax credit was that IRD would simply request the taxpayer's internal project files, largely bypassing the word-limited descriptions provided in IRD's online portal.

Nevertheless, if R&D specific documents are required, this should be clearly stipulated in either the legislation or guidelines, and the format explicitly provided so that companies can prepare the necessary documentation on that basis as the activities are performed.

We note that some of the negative experience which officials had with the 2009 R&D tax credit is unfairly laid at the feet of that regime writ large. IRD's experience at the time was that businesses waited until the end of the year to document their R&D claims.

However, we point out that after the then-Labour government announced the scheme in 2007, there was significant interest in the business community around proper recording of R&D and implementing systems and processes to capture data in real time.

Half way through the tax year the government changed and the regime was cancelled for subsequent years. This created a disincentive for businesses to implement real time record keeping, leaving them to only reflect on their R&D activity when they filed their 2009 tax return several months after the end of the tax year.

For this reason, it's critical to gain trust from the business community in the stability of the R&D funding ecosystem so that they are willing to make the investment in real time record keeping processes and systems for the long term. We have already provided our thoughts on the stability of the ecosystem at the outset of this document.

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

Businesses are open to submitting claims via third party software especially if the collection of data in real time will mean that they can receive the credit in regular instalments e.g. quarterly/monthly.

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

The most robust form of integrity measures will be that which is driven by the taxpayer. For that reason, ensuring that they have robust systems and processes to collect their R&D data in real time is critical, as outlined in our responses to questions 21 and 22.

Real time data collection and sharing by taxpayers should allow officials to review R&D claims throughout the course of the year rather than post year-end. This should mean that safeguards that currently exist for GST can also be adopted for R&D e.g. holding back the refund and contacting the company where there is abnormal activity for a particular month.

We understand that it's currently planned for IRD to be the first port of call for all R&D tax credit claims, and that Callaghan Innovation will be used on an ad hoc basis for 'complex' projects. Furthermore, it's our understanding that IRD may recruit technical experts to review the merits of R&D claims.

We have the following concerns regarding this plan:

- There is currently widespread negative speculation about the future of Callaghan Innovation. Having lost \$100 to \$150 million (39% to 58% of Callaghan's total revenue) by shifting funding to R&D tax credits, this only adds to confusion and uncertainty in the business community about what role Callaghan will play in administering these reforms. Accordingly, it is critical that government provide a definite role for Callaghan as soon as possible to reduce uncertainty and get buy-in from the business community.
- Hiring R&D specialists for IRD goes against the Business Transformation which that organisation has embarked on for the past several years. This reduces the scope for broad political support, increasing the likelihood of a future National-led government reforming the scheme. This again creates risk and uncertainty which needs to be negated to get buy-in from the business community.
- There is an inherent conflict of purposes by having R&D specialists inside of IRD. The culture of IRD is to preserve the tax base by limiting the amount of funds being disbursed. The R&D experts should work collaboratively with businesses to foster, surface, and promote innovation in business. These two purposes are incompatible. Accordingly, we recommend that Callaghan experts are the sole source of technical expertise used in evaluating R&D claims. IRD's role should be clearly defined by government as the facilitator of payments, and policy administration in equal contribution with Callaghan and MBIE.

## **Other matters**

### **Effective start date**

We understand that there is some uncertainty amongst officials as to how a start date of 1 April 2019 will actually be implemented, given that many applicants have non-standard balance dates.

Practically speaking, there are two options in this regards:

- Option A: The legislation can refer to application from 'the 2020 income year onwards'. This removes any confusion and ensures that there is equitable treatment across early (e.g. December year-end), standard and late (e.g. June year year-end) balance dates. Furthermore, this is internally consistent with the rest of the income tax rules which, with few exceptions, operate on an income year basis.
- Option B: The legislation instead has a 'hard' start date of 1 April 2019, and refers to 'expenditure incurred after 1 April 2019'. In this case, companies with financial years beginning 1 January 2019 will include costs for the last nine months of the financial year. For companies with June balance dates, they would claim R&D costs from the last 3 months in the period 1 April 2019 to 30 June 2019, and then the full twelve months from 1 July 2019 onwards. There is precedent in the Act for new regimes having a hard start date (e.g. removal of depreciation loading and taxation of gains on investment properties) so this would have a degree of internal consistency.

We recommend adopting Option A for its ease of administration and natural fit within the existing income tax framework. Furthermore, the major non-standard balance dates are December (3 months early) and June (3 months late) and there are a large number of taxpayers in both pools. Accordingly, by treating these as equal to standard balance date taxpayers, the impact of non-standard periods is netted off (i.e. plus 3 month and minus 3 months). Not only is there equity amongst taxpayers, but there is also no adverse impact on the tax base.

We understand that in some quarters of government there is an inclination to refer to 'income years beginning on or after 1 April 2019'. This is unacceptable as early balance dates (which form a large part of the business community) would be denied access to the regime for

approximately a year before the announced start date. This inequitable treatment of taxpayers based solely on their financial years is inconsistent with the purpose of the income tax regime and the government's policy objective in reforming R&D funding. Furthermore, it would deepen the level of apathy in the business community regarding these reforms, resulting in poor engagement with officials, a lack of uptake and ultimately an ineffective regime.

#### **Dual system filers**

We understand that it's yet to be determined how to manage companies who have a growth grant and who wish to file an R&D tax credit claim for costs not claimed in their growth grant (or vice versa). Furthermore, we understand that one of the options being looked at by officials is to simply make companies choose one method and deny access to the other.

The growth grant is a government grant like any other, and presumably the provision from the 2009 regime will be reintroduced which requires businesses to exclude R&D funded by some other government grant. We suggest that this method is relied on to mitigate the risk of 'double dipping' as:

- It is relatively easy to monitor since IRD has access to both growth grant and tax credit data;
- It empowers companies to take ownership and control their own transition off the growth grant and into the tax credit on terms which are most suitable for their business;
- It covers off companies that have project grants as well.

#### **Revenue above the line**

For many companies, one of the biggest benefits of the growth grant was that the payment from government was recognised 'above the line' as revenue. This helped with budgeting, management reporting, stakeholder engagement, and driving positive behaviours throughout the organisation.

It should be remembered that R&D incentives may be a payment from government to the company, but the company then also has to incentivise the desired behaviour in its organisation and the form that that incentive takes can either help or hinder in this regard.

In various quarters within organisations, there is often a sense of apathy with tax credits as team members feel, whether rightly or wrongly, that 'head office' will simply just bank the credit and decide how to spend it and that the department and team members who actually did the underlying R&D will have no say. This is one of the issues which an 'above the line' payment helps remedy as the receipt can be recognised in business unit P&Ls within the organisation and business unit managers can drive the right behaviours within their teams with a degree of independence from 'head office'.

We appreciate that it's not government's responsibility to help companies manage their people. However, as mentioned above, the form that the incentive takes can either help or hinder companies within the broader purpose of achieving the goals of the regime.

In that regard, we recommend government officials consider publishing guidelines for financial reporting purposes and potentially endorsing the treatment of the payment as an investment tax credit under IAS 20 so that companies who wish to can include the credit 'above line' in their management reports and financial statements. Upon filing their tax returns, these companies can reverse the item as a tax adjustment so that they are not taxed on the receipt.

#### **Control, ownership of intellectual property (IP) and financial risk**

There is some confusion in the business community about government's view on R&D performed by New Zealand companies who are part of multinational groups, where the R&D is

undertaken in NZ but the ultimate control, IP ownership and/or financial risk rests within the global group.

Below, we've recapped again the policy objectives of the R&D incentive for reference:

- Creating high value added jobs with good pay
- Attracting foreign direct investment
- Attracting and retaining skilled, globally mobile talent
- Fostering an innovation ecosystem with a free flow of information between businesses, government and institutions
- Keeping successful local companies in New Zealand

Based on the above goals, it's irrelevant whether R&D performed in NZ is ultimately under the control, ownership and/or risk of the NZ legal entity or an overseas legal entity within the same global group.

Consistent with recent trends in income tax policy (e.g. debt remission reforms) and the pragmatic approach adopted throughout the Callaghan era, it should be sufficient that the R&D is being performed under the auspices of the same ultimate economic owner.

#### **Loss-making companies**

We understand that this issue is being parked while government works through the key items for the R&D tax credit. In preparing to engage with government at that later point, we make the following observations about the shape of future support for loss making companies:

- A transitional package for loss making companies which has the hallmarks of an R&D growth grant is an inadequate solution due to the limited access that most businesses have to the growth grant i.e. the 6% relative uptake due to the issues highlighted above.
- We understand that one of the primary drivers for government in excluding loss making companies in the first year is to hedge against the cost of opening access too broadly. This is a false economy since loss making companies already (and justifiably so) have access to growth grants, project grants and the R&D tax loss cash-up.
- Many high growth, R&D intensive companies will have an initial period of loss making, and as government looks to rationalise the R&D funding regime, it would be sensible to open up access to the R&D tax credit to them as well. From a risk management perspective, the companies actually have to spend \$100,000 at least to get back a minimum of \$12,500 so the reservation of throwing good money after bad is unfounded as these companies must still have the financial wherewithal to overcome that constraint.

Based on the above, we see no reason why the regime can't be opened up to loss making companies from 1 April 2019.

In the event that government decides not to take this up for the first year, the regime should be opened up to loss-making companies in the second year in full (i.e. a refundable credit).

#### **Regular feedback and reporting to the House**

As mentioned at the outset, our number one priority is stability of the R&D funding system, regardless of what form it takes. To achieve this, it's critical that there is broad political support.

To assist government in achieving this, we recommend that there is a steering group established with officials (IRD, MBIE, Callaghan) and professional advisors to regularly report on what's working with the regime and where it's falling short. This would be a two way

conversation and also provide a regular and 'on the record' opportunity for officials to raise their observations and concerns directly.

We recommend that the group meets quarterly and, in furtherance of shared goals of transparency and achieving broad political support, the key issues discussed should be published on MBIE's website and tabled in the House.

#### **Overseas expenditure**

Many businesses are unable to obtain local expertise to support the R&D activities being undertaken in NZ and need to rely heavily on overseas resources. In that regard, the 10% upper limit may be too restrictive to support genuine R&D which benefits NZ through the transfer of knowledge, and creation of innovative goods and services for New Zealanders.

For example, Fletcher Building's Laminex division has been investigating the use of 3rd Gen photovoltaics in the construction industry. However, there was no local expertise for the cutting edge technologies they were investigating. They also checked with local universities with little success. After engaging with NZTE, they were able to find the necessary expertise overseas. As the company is focussed on solving global problems, it's critical that they can work with global R&D experts where appropriate.

Accordingly, we recommend a waiver of the 10% upper limit for projects with a substantial overseas footprint. We suggest that the threshold for applying for the waiver is where the 10% figure exceeds \$1million and the applicant can demonstrate the benefits to NZ from undertaking the project.

#### **Next steps**

We would be happy to meet with officials to discuss the above in further detail.

Should you have any questions in the interim, please feel free to contact us.

Yours sincerely



Gwen Riley  
Partner