Committee Secretariat
Finance and Expenditure Committee
Parliament Buildings
Wellington 6011

14 December 2018

Taxation (Research and Development Tax Credits) Bill

Dear Sir / Madam

We appreciate the opportunity to comment on the *Taxation (Research and Development Tax Credits) Bill* (the Bill).

Our submission consists of views and comments from the Angel Association New Zealand, New Zealand Venture Investment Fund, and PwC. In forming these views, we have liaised widely with a number of businesses that are in the technology sector and at an early stage.

We have come together to jointly submit on the Bill as we are in agreement that there is a need for the Government to, at a minimum, maintain or otherwise increase its support to encourage further research and development (R&D) activities in New Zealand. We support the Government's stated objectives to increase the level of private sector R&D spend in New Zealand to 2% of GDP within the next 10 years. The increased activity will help build New Zealand's R&D capability, and the continued growth in capability is critical in the wider context of R&D in New Zealand.

More importantly, we see the need for continued financial support for early stage businesses undertaking R&D activities. New R&D-focused businesses are an integral part of the New Zealand economy. These businesses are building and finding new products/services that New Zealand can take to market, and are thereby creating jobs and wealth and increasing New Zealand's standard of living. It is critical that any R&D incentive package continues to support new businesses. Such businesses should not be "worse off" under any new tax credit regime.

Finally, for R&D to really have an economic impact for New Zealand, there needs to be support for businesses to commercialise the scientific or technological findings both in terms of capability and private sector investment. We see the R&D tax credit as a vital link in the overall support of the R&D ecosystem.

We wish to appear before the Select Committee.

Please contact us if you have any questions regarding our submission.

Yours sincerely

Sandy Lau
Director
sandy.m.lau@pwc.com
T: +64 4 462 7523

General comments

We strongly agree with the Government's acknowledgement of the importance of innovation to the New Zealand economy and, in particular, businesses undertaking R&D activities. We further agree that it is important to provide real support to these R&D firms in order for them to grow and "move further up the value chain" in the New Zealand and global economy.

We also positively support the Government's attitude that "sustained increases in government investment are important" and are required in tandem with growing private investment in New Zealand's R&D-active businesses. The proposed tax credit incentive is a welcome addition to the New Zealand R&D landscape, and it could be effective as an element of a wider package of support for New Zealand R&D.

However, we have real concerns about the effectiveness of the proposed tax credit in its current form. It is questionable as to whether it delivers upon the Government's stated policy intent of increasing private sector R&D activities in New Zealand. In particular, we question whether the tax credit, as currently drafted, will have the ability to reach 2,000 businesses as estimated by the Government.

Specifically, we consider the current proposed definition of eligible R&D activity remains too narrow, especially in the context of software development. The Angel Association New Zealand is particularly concerned about software development's eligibility for R&D tax credits as software is such a key component of so much 'research' and almost all 'development'. The list of exclusions (both eligible activities and expenditure) is wide, and the ultimate compliance costs will result in many innovative businesses being unable to access the benefits that are promised under the proposed R&D tax credit. It is therefore critical that businesses can include software development as R&D.

We are also particularly concerned with the real prospect that many of the current Growth Grant recipients will lose any form of funding once the Growth Grants are completely phased out – either as a result of a lack of refundability of the tax credits or as a result of the overly narrow scope of the tax credit regime.

We strongly believe that a successful R&D tax credit can help encourage and support New Zealand businesses to be more innovative and undertake more the R&D activities in New Zealand.

Our submissions therefore aim to assist in bringing an increased level of support into effect.

Eligible person

Proposal

The Bill proposes that businesses must satisfy certain general criteria to be eligible for R&D tax credits. Certain persons are excluded from the R&D tax credit regime.

Clause 10 (proposed new section LY 3)

General eligibility criteria

Comment and submission

We generally support the proposed criteria, in particular that all types of businesses can be an eligible person. However, we note that further refinement is required to the definition to ensure that it can be applied in a commercial and practical manner by a wide range of businesses.

R&D controlling rights and ownership of R&D results

We understand the policy rationale behind the requirements of the business having the controlling rights and ownership of the results. However, a common scenario is where businesses will work collaboratively with another business, either through a formal or informal joint venture arrangement. In those cases, it is unclear whether either one of the businesses that are working together will be an eligible person.

Specifically, proposed section LY 3(1)(c) requires that the person or a company in the same group of companies as the person has the "sole right" to start, stop, change the direction of the activity and the ability to choose whether the results are followed up or not.

Similarly, proposed section LY 3(1)(d) requires the person or a company in the same group of companies as the person has the ownership of the results or the person is able to use the results for no further consideration.

In the context of collaboration and joint ventures, neither one of the businesses can be said to have the "sole right" in controlling the R&D activity. Further, it is possible that there may be some restrictions on how the results may be used in the future by either of the businesses (e.g. one party may only have rights to commercialise the results in a particular location). However, provided the activities are undertaken in New Zealand, there is no good policy reason to exclude such businesses from the R&D tax credit regime. Under the current drafting, neither party would be able to access the credit, even though a joint venture R&D activity may provide significant economic benefits to New Zealand.

Another example where the current proposals may impede collaboration is the requirement that the business must be able to use the results of the R&D activity for no consideration. We are aware of the situation where businesses are furthering the R&D activity that was initially started by another party (e.g. the commercialisation arm of a tertiary education provider) and the results of that further R&D activity will initially be licenced back to the business for a period of time for consideration. Economically, the licence arrangement allows the initial R&D party to recuperate their costs but the final R&D results will very much be for the business to commercialise.

In our view, these types of "commercialisation" arrangements differ from the R&D contractor situation. Businesses that undertake the next phase of R&D activities should be eligible for the proposed tax credit, despite not meeting the requirements of proposed LY 3(1)(d). The "commercialisation" model should be supported by the proposed tax credit as it ultimately results in more R&D activities being undertaken in New Zealand – therefore, it is entirely consistent with the stated policy intent of the proposed R&D tax credit.

We submit that further consideration is given to the eligible person criteria to ensure that it does not exclude businesses that undertake collaborative R&D activities, in particular "commercialisation" arrangements where a business further develops an R&D project.

R&D activities

Proposal

The Bill proposes that R&D activity is defined to mean core activities and supporting activities.

Clauses 10 (proposed new section LY 2), 21(6), 21(14) and 21(16)

Core activity

Proposal

Proposed new section LY 2(1) defines a core activity as an activity that is:

(a) conducted using a systematic approach;

(b) has a material purpose of creating new knowledge, or new or improved, processes, services, or goods;

(c) has a material purpose of resolving scientific or technological uncertainty; and

(d) has its day-to-day management conducted in New Zealand.

An activity is excluded if the knowledge required to resolve the uncertainty in (c) is:

- publicly available;
- deducible by a competent professional in the relevant scientific or technological field.

Activities performed outside New Zealand cannot be core activities. There is also a schedule of activities that cannot be core activities.

Comment and submission

We consider the proposed definition of core activity is too narrow and reflects the "Research" aspect of R&D rather than "Development". Typical R&D activities in the digital economy are likely to be excluded from the proposed tax credit by this definition, particularly software development. In addition, having a tax credit specific definition, different from R&D definitions for financial reporting and other tax regimes, will lead to significant compliance costs for businesses.

We recognise that the current draft definition is an improvement from the initial draft put forward in the Discussion Document, *Fuelling Innovation to Transform Our Economy,* by requiring the activity to be conducted "using a systematic approach" as opposed to a "scientific approach". However, the requirement of "resolving scientific or technological uncertainty" is difficult to apply in the context of development activities, including software development.

We stress that R&D activities in the context of software development was highlighted as an issue requiring specific consideration in the Discussion Document, as it was recognised that it is important any resulting R&D tax credit adequately supports software development.

In our view, the current proposed definition falls short of ensuring R&D activities in software development are supported. In particular, there is a concern as to whether software development will meet the requirement of “resolving scientific or technological uncertainty”.

We have talked to our clients that are in the business of software development, and they have explained to us that a lot of software products involve using known technologies to solve a customer problem and provide a better user experience than other available technologies can.

As an example, many of New Zealand’s cloud B2B software developers build integrations using Application Programme Interfaces (APIs) to access data from another software programme. It is unclear whether, for example the use of APIs would meet the requirement of “resolving scientific or technological uncertainty”, particularly where these APIs have already been built by other software developers. As a practical scenario, would a software business that builds an integration into cloud-based accounting software be resolving technological uncertainty when many other software developers have already done this?

We have had meetings with the Inland Revenue officials who prepared the Discussion Documents and the tax bill in which comments have been made that take a narrow view of what is considered R&D in the software context. These same views were given by Inland Revenue officials at the Chartered Accountants of Australia and New Zealand 2018 Tax Conference. We understand Inland Revenue will be issuing detailed guidance on what is an “R&D core activity” in the software context. At this stage, we have concerns that a narrow view will be taken. This would run counter to the Government’s stated policy goal of incentivising and increasing private sector R&D, as many of these software developers’ R&D activities are currently eligible for Callaghan Growth Grants. This type of narrow interpretation would result in software developers receiving less funding through the R&D tax credit compared to the current position under the Growth Grant. This is an issue of real concern for software developers. The Discussion Document states software R&D accounted for approximately 40-50 percent of the value of grants in the last three years.

We also have concerns as to the compliance costs the proposed definition will impose on businesses. We note that the Income Tax Act 2007 and Callaghan Growth Grants currently use the NZ IAS 38 definition of R&D. Therefore, businesses that currently operate in the R&D area are already familiar with that definition. Requiring these businesses to use a completely new and different definition of R&D solely for the purpose of the proposed R&D tax credit will impose additional compliance costs which, in our view, run counter to the rationale of providing more support to these businesses so that they can increase their R&D activity.

Another compliance concern is the level of work and documentation required to determine if the knowledge required to resolve the scientific or technological uncertainty is either publicly available or is deducible by a competent professional in the relevant or technological field. While we understand the rationale behind this requirement, guidance will be needed to ensure businesses are clear about the level of work/costs involved to meet this requirement and how to meet this test across multi-year projects, some of which will have commenced prior to the introduction of the tax credit. These considerations are particularly relevant to early stage ventures receiving angel funding.

Excluded activities

Proposal

The Bill proposes that certain activities are expressly excluded from the R&D core and supporting activity definitions.

Clause 22 (proposed new schedule 21, part A and part B)

Comment and submission

We understand that certain activities will be excluded from the proposed R&D tax credit regime, and that some of these exclusions are common amongst R&D tax incentives.

However, we are concerned that the list of excluded activities results in significant restrictions on R&D software development. As an example, "testing" is an activity that is integral to the agile software development methodology. Many businesses aim to release a minimal viable product to market, receiving customer feedback, iterating and testing. In our view, "testing" in this context is a critical R&D activity for software development, and the policy intent behind excluding testing is unclear. The Angel Association New Zealand is particularly concerned about this issue as excluding "testing" will negatively impact a significant number of the businesses that angel investors back.

Furthermore, we note that a number of the Growth Grant recipients are active in the software development industry.

Under the current proposed definition of R&D and the excluded activities, there is a real possibility that those businesses will no longer be able to access the support they have been currently receiving from Callaghan. For these businesses, the cash support is often critical to their continued development and eventual success given they are often in the start-up or intensive growth phase. We strongly believe the New Zealand economy benefits from having these businesses and therefore support should continue to be provided.

We therefore submit that the list of excluded activities are reconsidered from a perspective of the commercial impact on businesses (in particular, those in software development), including whether the proposed R&D tax credit will result in a reduction/elimination of the cash support such businesses are currently receiving from Growth Grants.

It would be contrary to policy intent to have a new regime that would reduce the level of support that start-ups or growth-intensive businesses are receiving in relation to their R&D activities.

Internal software development

Proposal

The Bill proposes that expenditure on internal software development is subject to a $3 million cap. It also proposes that such expenditure is excluded altogether where it relates to the ordinary internal administrative function of a business.

Clauses 21(10) and 21 (proposed new schedules 21and 21B)

Comment and submission

Again, we understand that certain activities will be excluded in order to manage fiscal risk and where activities are deemed to have limited spill-over benefits for the wider New Zealand economy.

However, the draft definition of "internal software development expenditure" is wide. In our view, that definition can exclude or restrict businesses that undertake valuable software development R&D leading to greater digitisation of the New Zealand economy.

Specifically, "internal software development expenditure" is defined as expenditure that is incurred on developing software for the purpose of:

- the internal administration of a person's, or the person's associate's, business; or
- providing services to customers, unless the main reason the customers use the services is to use the software or technology developed by the person.

"Internal software development expenditure" does not include expenditure incurred for the purpose of developing software if:

- the person's main purpose is to sell the software, or a right to use the software to third parties; or
- the software is an integral part of the goods that the person sells.

We understand that the rationale behind wanting to exclude software developed solely for the business's internal administration is based on the limited spill-over benefits. However, the second limb of the proposed definition can exclude businesses that have developed software which forms an integral part of the services they provide to their customers but yet what the customers receive is not strictly speaking the "use" of the software or the technology developed by the business. A typical example would be R&D to build a new or improved digital interface for customers to access information, goods, and services.

The internally developed software may enable a business to create a particular experience or product (eg the realistic depiction of particular features in animation or more efficient screening for a particular cancer) but, arguably, the customer will not be using the software or the technology directly and therefore the R&D cap will apply.

Consideration needs to be given to the commercial realities for businesses that operate in this sector, including how these businesses commercialise the results of their R&D activities. In our view, such businesses should not be restricted in the level of support they can access under the proposed tax credit regime.

As a first step, software that is an integral part of the goods and services that the business provides should not be restricted by the "internal software development expenditure" restrictions.

As an alternative, the rules could instead specify the types of internal software development that are of concern as opposed to the current wider approach.

Eligible expenditure

Proposal

The Bill proposes that certain expenditure on R&D be eligible for R&D tax credits.

Clauses 10 (proposed new section LY 5), 21(7) and 22

Comment and submission

The proposal is to allow eligible expenditure that is incurred to "the extent" of undertaking the R&D activities, unless the R&D is undertaken in commercial production. For R&D that is undertaken in commercial production, expenditure that would have been incurred "in the absence" of the R&D activity is excluded. Apportionment is allowed for employee costs where the employee undertakes both business as usual and R&D functions.

The "in the absence" test may be too high a threshold for businesses and, in our view, will overly narrow the scope of the R&D tax credit for the more established businesses where they still undertake the R&D but it makes more commercial sense to perform those activities as part of their ordinary business.

While we appreciate the concerns officials have raised with regard to the businesses looking to claim all of their commercial production (business-as-usual) costs as their eligible R&D spend, we consider the proposed apportionment rule is too restrictive. For example, all overhead costs that are incurred by a business are excluded from being eligible expenditure unless the R&D activity is undertaken on a day where no other commercial activity is undertaken by the business. This could result in distortionary behaviours where a business may choose to undertake R&D activities on specific days as opposed to when it makes most sense (e.g. when there is commercial production occurring).

We submit that further consideration is given to this issue to ensure that established businesses are not too limited in their ability to access the proposed R&D tax credit when balanced against the fiscal risk concerns raised by officials.

An alternative could be to introduce a specific anti-avoidance rule to ensure the type of behaviours that concern officials do not occur.

Contracted expenditure

Proposal

The Bill proposes a formula for calculating eligible expenditure where a person pays an R&D contractor to perform R&D activities on their behalf ("contracted expenditure") resulting in only 80% of the contracted expenditure as being eligible.

Clause 10 (proposed new section LY 6) and 21(15)

Comment and submission

We consider 100% of the "contracted expenditure" should be eligible as R&D expenditure.

We note that the policy rationale put forward by officials for the reduction is to take into account the profit margin that would be charged by the R&D contractor. We do not agree with this rationale as the same does not apply to other eligible expenditure e.g. consumables purchased for use, or other overhead costs associated with the R&D activity, all have a profit margin that would be included in the price paid by the business.

As such, we submit that 100% of contracted expenditure is treated as eligible expenditure.

Foreign expenditure

Proposal

The Bill proposes foreign expenditure that would otherwise be eligible expenditure comprise no more than ten percent of a person's overall R&D tax credit claim.

Clause 10 (proposed new section LY 7)

Comment and submission

We consider the limit of ten percent of a person's overall R&D tax credit claim is too low. As recognised in the Discussion Document, the level of R&D activity is currently too low in New Zealand. One direct effect of this is that New Zealand may not currently have the expertise required by businesses to further their R&D. This is very much the case for disruptive startups. As a result, there is a real possibility that New Zealand businesses are required to go offshore to obtain the expertise required in order to progress their R&D projects.

Specifically, we are aware of businesses that have had to use a foreign R&D contractor to undertake all of their R&D on the basis that the required expertise is simply not available in New Zealand. The results of the R&D activity will still be used by that business in New Zealand which will still contribute positively to the New Zealand economy. Such businesses should not be penalised and be any less competitive when compared to businesses that can undertake R&D activities in New Zealand and therefore receive the proposed tax credit.

As such, we submit that the limit of eligible foreign expenditure is increased to 20 percent. Further, where a business is using an overseas R&D contractor, and the technical expertise required is not available in New Zealand, that business should still be able to access the proposed tax credit. This may be on a case-by-case basis (e.g. requiring an application to the Commissioner for approval) with particular latitude given to startups.

Refundabilty and carry forward of surplus tax credits

Proposal

The Bill proposes that R&D tax credits be refundable for companies in loss or with insufficient income tax liability to use all of their R&D tax credits in an income year, provided certain criteria are met. A company may receive a maximum of $255,000 refundable R&D tax credits. Any credits that are not refunded may be carried forward by the company to the next income year, provided shareholder continuity requirements are met.

Clauses 9, 10 (proposed new section LY 8) and 21

Comment and submission

We appreciate the efforts that the Government and officials have made in ensuring the proposed tax credit will have some meaningful impact for start-ups and growth-intensive businesses that are in tax loss. We further understand from officials that a more fulsome refundability of surplus tax credits policy is currently being progressed, and the expectation is that further proposals will apply from the 2020/21 income year.

We stress again the importance of cash for start-ups and growth-intensive businesses. Therefore, we consider a more fulsome refundability policy is critical for their continued growth. Further, these businesses will often undertake capital raising that will often result in a shareholder continuity breach, which again will impact the effectiveness of the proposed tax credit.

We therefore submit that the issue around refundability is progressed as a priority and depending where that work leads to, consideration should also be given to the shareholder continuity requirements for the carry forward of surplus tax credits. The Angel Association New Zealand is very focused on this aspect of the R&D tax credits regime and its impact.

We also submit that the “part-year” provisions that apply for tax losses should be included in the proposed R&D tax credit regime, so that unused R&D tax credits can be carried forward if the R&D has taken place during an income year but the shareholder continuity breach occurred prior to the R&D activity/expenditure.

Administrative requirements

Proposal

The Bill proposes that taxpayers must keep sufficient records to support their claims. It is also proposed that a person who wishes to claim an R&D tax credit must file an R&D supplementary return within 30 days of filing their tax return for the relevant income year.

Clauses 26 to 29

Comment and submission

We are concerned with the level of compliance costs that the proposed tax credit would impose on businesses who wish to make a claim. We note that, if compliance is too onerous, the larger R&D claimants will benefit from the credit but smaller businesses may be deterred. If private sector R&D expenditure is to grow, the involvement of the SME sector will be critical.

Specifically, we are concerned about the level of documentation a business must obtain and keep in order to satisfy their record-keeping requirements.

Further, we are also concerned that businesses may be required to provide significant information in the R&D supplementary returns.

In our view, it is important that any information that is required should already be available as part of the normal commercial and business activities. Any additional information that is required outside of their general business operations should be kept to a minimum.

We note that, given the differences in the definition of R&D activity and what is considered to be eligible expenditure, our anticipation is that businesses will be required to perform significant additional work to classify and work out what expenditure will be eligible for the proposed tax credit. Currently, many businesses will be relying on their accounting treatment (under IAS 38) for both their accounting and tax requirements. This will no longer be the case under the proposed tax credit if the current proposed definition of R&D activity and eligible expenditure is maintained.

As such, the proposed tax credit will already impose significant compliance costs for businesses. We submit that this should be taken into account when officials are determining the level of information required in the supplementary returns and maintained as part of the record-keeping requirements. The amount of additional work required to comply should not be underestimated, especially for SMEs.

We therefore submit that a simplified compliance regime should be introduced for businesses with smaller R&D claims and for those businesses using external R&D contractors to encourage the SME sector to utilise the regime.

We also submit that a less stringent set of requirements are imposed in the 2019/20 income year (first operational year of the proposed tax credit). This is because for early balance date businesses (year starting 1 October 2018), the 2019/20 income year has already begun. It would be unreasonable to require those businesses to revisit any information requirements that may cause significant compliance costs at a later date due to a lack of clarity of the requirements at the time the expenditure is incurred or the activity is undertaken.

Penalties

Proposal

It is proposed that the promoter penalty regime is extended to include people offering schemes involving R&D tax credits.

Clauses 36 and 37

Comment and submission

We are concerned the promoter penalty rules are extended to advisers who have operated on a contingent fee basis.

Many R&D businesses, especially emerging high-growth businesses with limited internal resources, will be dependent on external advisers to assist with the application process. We note that the proposed tax credit has a different definition of R&D than the definitions used for financial reporting and Growth Grant purposes. We expect that many businesses will need external advisers to help them comply with the proposed R&D tax credit rules.

At the same time, given the new definition and especially if the business has not previously received grant funding, there will be a degree of uncertainty about whether an application will be accepted (as they may be unclear whether the R&D work carried out will qualify). As such, many emerging R&D

businesses will be reluctant to commit to a fixed fee for preparing and submitting an application and only be prepared to proceed if a fee is contingent on success. As outlined in our submission already, many R&D focused businesses are cash-constrained and would see contingent fee arrangements as a sensible way to create an alignment of interests with their external advisers.

When assisting with a R&D tax credit application, either fixed fee or contingent, advisers will be heavily dependent on the client to use their judgement to determine the correct amount of expenditure to include as R&D. While the adviser will be able to provide advice in relation to which activities may meet the definition of R&D for tax credit purposes, and may be able to provide guidance in relation to the types of expenditure which may be claimed, it rests almost exclusively with the client to determine exactly which costs and what proportion of employee salaries can be included.

The taxpayer will have a far greater incentive to inflate the claim than the adviser (as the adviser fee will only be a small percentage of the value of the claim) and, if a claim is inflated by the client, it is entirely possible the adviser will be unaware of this.

In our view, the level of incremental fees an adviser would benefit from as a result of an inflated claim are very unlikely to make it worth risking their professional reputation and relationship with Inland Revenue. Imposing promoter penalties will increase the likelihood that advisers become reluctant to offer a contingent fee basis, which may mean certain R&D businesses are discouraged from claiming the tax credit as they cannot afford to commit to a fixed fee when they are uncertain an application will be successful.

We therefore submit that promoter penalties should not be extended to advisers who have operated on a contingent fee basis.

Approval: significant performer regime (year two)

Proposal

The Bill proposes that persons with more than $2 million of eligible expenditure in an income year have the ability to opt out of the general approval process and into the significant performer regime.

Clauses 38, 39, 42, 43 and 44

Comment and submission

We generally understand the policy rationale of requiring in-year approval in relation to the proposed tax credit. The approval process will provide a level of certainty for businesses so that they can be sure the activity being undertaken will be eligible as R&D activity.

For those that undertake significant R&D activities, we support the ability for those businesses to opt into the significant performer regime whereby those businesses will be required to obtain certification from an R&D certifier. We see this requirement similar to the audit requirement that currently applies for Growth Grant recipients.

However, we note the criteria that a person must meet to become a R&D certifier is minimal. We consider further requirements may be useful to ensure that those providing the certification have the appropriate expertise, processes, and procedures in place to ensure they can provide the level of scrutiny the Commissioner is seeking. As a minimum, we submit that the regime should require a certifier to be an accredited member of a professional body that requires both technical competencies and ethical standards.