



Re: R&D tax credit incentive Discussion Document  
C/- Deputy Commissioner, Policy and Strategy  
Inland Revenue Department  
PO Box 2198  
Wellington 6140

1 June 2018

### ***Fuelling Innovation to Transform Our Economy, Discussion Document***

Dear Madam

We appreciate the opportunity to comment on the Discussion Document “Fuelling Innovation to Transform Our Economy” (Discussion Document).

Our submission consists of views and comments from the Angel Association New Zealand, New Zealand Venture Investment Fund and PwC. In forming those views, we have liaised widely with a number of businesses, especially those that are in the seed and angel investment phase.

We have come together to jointly submit on the Discussion Document 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 (NZ). Our view is consistent with the stated policy intent of the Discussion Document, which is to increase the level of private sector R&D spend in NZ to 2% of GDP within the next 10 years.

More importantly, we see the need for the continued financial support for early stage businesses. New R&D focussed businesses are an integral part of the NZ economy that are building and finding new products/services that NZ can take to market. Therefore, it is critical that any R&D incentive package continues to support new businesses.

#### ***General comments***

We strongly agree with the Government’s acknowledgement of the importance of innovation to the NZ economy and, in particular, R&D active businesses. 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 NZ economy.

We are also positive with respect to the Government’s attitude that “sustained increases in government investment are important” and are required in tandem with growing private investment in NZ’s R&D active businesses.



The proposed tax credit incentive is a welcome addition to the NZ R&D landscape and could be effective as an element of a wider package of support for NZ R&D, the possibility of which is highlighted in the Discussion Document. We also think that the proposed incentive would be of utility to established medium to large enterprises undertaking valuable R&D work in NZ. However, in its current form, the proposed tax credit will be an inadequate tool to support R&D active SMEs or loss making entities (emphasis on start-ups) due to the combined negative impact of the following features of the proposed R&D tax credit:

1. The inherent lack of utility of a non-refundable tax credit for businesses that are typically cash constrained, invest in R&D and growth, and take a number of years to reach an income tax paying position;
2. The removal of Callaghan Innovation Growth Grants (Growth Grants);
3. The potential removal of the R&D tax loss credit at the end of 2019-20 tax year;
4. The potential that continuity provisions may apply to the tax credits;
5. The proposed definition of “research and development” would appear to exclude many activities and associated expenditure that would be within the definitions of R&D for Growth Grant and R&D tax loss credits; and
6. The imposition of additional compliance costs for potentially no benefit.

We recommend that the Government outlines in detail the policy intent for reducing cash support for loss-making start-up type businesses that typically could access Growth Grants and potentially R&D tax loss credits.

In our view, and even for an interim period, providing less support for loss-making start-ups contradicts the broader policy goal of increasing the level of private sector R&D spend in NZ.

We further note that the coverage of Growth Grants and R&D tax loss credits are different. In particular, the R&D tax loss credits was introduced as a supplement to the Growth Grants as there is a minimum spend requirement before a business is eligible to the Growth Grants. Therefore the removal of either one of the two schemes will likely negatively impact a different group of businesses that are accessing the cash support.

Our submissions below aim to assist the Government to bring an increased level of support into effect.

### ***1. Eligibility requirement and ownership of intellectual property***

Page 14 of the Discussion Document outlines various eligibility requirements including that the taxpayer “effectively owns the results of the R&D”.

Often when a NZ company is acquired by a foreign group, all intellectual property is transferred as part of the transaction to a non-NZ entity that is part of the buyer’s group for commercial and intellectual property protection reasons. The NZ company would then continue to undertake R&D activities from NZ, but a foreign entity in the same group as the NZ company would own all resulting R&D.



We request that the Government clarifies what “effectively owns the results of the R&D” means in the context of this example.

## ***2. Rate and non-refundable nature of tax credit***

### ***Winners - medium to large enterprises***

As the proposed incentive is in the form of a non-refundable 12.5% tax credit, it will be of most benefit to businesses in profit or soon to be in profit. This is most likely to be medium to large enterprises with a history of R&D work (which investment will have already created net profits).

Established medium to large enterprises that are already carrying out R&D activities without Growth Grant allowances and are not in a tax loss position will be the biggest winners if the tax credit is enacted in the current proposed form. We agree that this will be a positive change as these larger players with their own funding, plus an additional tax credit, will be encouraged to, and be able to, carry out more sophisticated and high-cost R&D work than they may have done otherwise. This will also assist them to carry out valuable work on a scale that SMEs cannot.

However, for businesses that are using a Growth Grant and receiving an allowance (which effectively provides a net cash benefit of 14.4%), the 12.5% tax credit will be a reduction to the previous benefit. The businesses that currently have a Growth Grant are more likely to be smaller businesses who are unable to fund their own R&D activities in the same way as medium and larger enterprises.

We submit, in line with our general comments above, that any introduced incentive scheme must increase the level of support for R&D active businesses. If the rate of the benefit is reduced, there is less incentive than before – which is opposite to the Government’s stated goals.

We therefore submit that the 12.5% tax rate should be reconsidered and increased for certain businesses, with reference to any previous R&D incentives they have received under the Growth Grant scheme or support from the tax loss cash out mechanism.

### ***Losers - emerging R&D businesses***

As the proposed tax credit is non-refundable, this means that it is not going to be of immediate value, or of value at all to businesses in loss, most likely to be emerging businesses that are in intensive growth phase and new start-ups. While these businesses could carry forward the R&D tax credits to a future tax year, the reality is that they will not receive the economic value of the incentives for several years, if ever, depending on when the business reaches profit at a level which can absorb the credits carried forward. This means that the credit may have no use for small R&D businesses.

We further comment on other aspects of the proposed tax credit that potentially limits its benefit to emerging R&D businesses.

#### ***i. Forfeiture of tax credits on loss of continuity***

The Discussion Document raises the issue of whether shareholder continuity rules should apply to the R&D tax credits in the same manner as other credits. As discussed above, businesses going through R&D intensive phases are frequently in loss position due to the large investment required and consequently the ability for such businesses to utilise carried forward tax credits may not arise for a number of years. If shareholder continuity requirements are introduced these businesses may never be



able to use the credits due to the likelihood that they will undergo many rounds of equity investment (since debt funding is rarely an option).

This is a potential deterrent to not only future investment but for those businesses from engaging in R&D intensive activity in the first place. If NZ is to hold its own on the international stage and grow the knowledge economy (as the Government appears to be committed to doing), it simply cannot afford to disincentivise those emerging R&D businesses. It is important to note that NZ's medium and large R&D performing businesses would have been a start-up once. It is therefore important to ensure these businesses are supported to give them the most chance of success.

We therefore submit that in order for the proposed credit to encourage investment into R&D, the tax continuity provisions should not apply to the proposed incentive.

*ii. Cash is king*

We understand from the Discussion Document that the R&D tax credit will be non-refundable, as stated on page 23 of the document. We further understand from the document “Managing the transition from growth grants to the R&D tax incentive” (the Transition Document) that all Growth Grants will cease on 31 March 2020 with all businesses moving to the R&D tax credit from 1 April 2020.

For loss making businesses the R&D tax credit will be of no assistance from a cash flow perspective. We note on page 5 of the Transition Document the Government is “considering” implementing a temporary grant scheme from 1 April 2019 that mirrors the R&D Tax Incentive with the intention that this will provide support to businesses in a tax loss. However, it is unclear whether this is something the Government definitely intends to implement, whether a similar or better level of support will definitely be available from 1 April 2020, and it is also unclear whether businesses in a tax loss which do not currently have an active Growth Grant (for example because they already reached the end of their five year funding period) will be able to benefit from this temporary grant, if introduced.

In the table below, we have summarised the impact of the proposed R&D credit compared to the current Growth Grant and R&D tax loss credits. This is a simplified scenario but outlines the positions of many R&D focused start-ups that are typically cash poor when the business is focussed on investing in R&D and growth.

	Current Rules	Proposed R&D tax credit	Our observations
<b>Revenue</b>	\$100,000	\$100,000	
<b>Expenses</b>	(\$100,000)	(\$100,000)	
<b>Deductible R&amp;D expenditure</b>	(\$1,000,000)	(\$1,000,000)	
<b>Growth Grant – cashflow benefit</b>	\$200,000	Nil	
<b>R&amp;D tax loss</b>	\$800,000	Nil	
<b>R&amp;D tax loss credit at 28%</b>	\$224,000	Nil	



	Current Rules	Proposed R&D tax credit	Our observations
<b>Total cashflow</b>	\$424,000	Nil	This cash flow helps invest in additional R&D
<b>R&amp;D tax credit at 12.5%</b>		\$125,000	This R&D credit will likely have no marginal impact to invest in additional R&D
<b>Compliance costs</b>	Moderate, but R&D definition based on NZ IAS 38 for Growth Grants and R&D tax loss credits is helpful	Potentially significant due to a new and archaic definition of R&D	Smaller businesses without resources to pay for specialist advice on how to apply the new R&D tax credit rules may choose to not utilise the R&D tax credit as this additional compliance cost will not have a cash return.

We note that the Discussion Document states the following in relation to loss-making businesses:

*“The Government is committed to providing a better policy option to support these businesses. However, the policy issues are complex and will not be resolved in time for the introduction of the Tax Incentive in April 2019.*

*Officials are undertaking further work to consider support for R&D businesses in tax loss and will consult with stakeholders as policy positions are developed. From April 2020, an appropriate policy incorporating additional features supporting businesses in tax loss will be introduced.”*

This approach is unsatisfactory, as the Discussion Document does not provide details of the “complex” policy issues. This will create real uncertainty for businesses and investors. Businesses will genuinely ask, “what if the unknown but complex policy issues are not resolved by April 2020?”

We note that the Government appears to have some understanding of the complex policy issues to outline the removal of the Growth Grant regime, and also signal the removal of the R&D tax loss credit rules. In our view, the removal of the Growth Grants, and potentially the R&D tax loss credit rules must be considering the same “complex” policy issues. Which is, how does the Government best support the cashflow of R&D focussed loss-making businesses.

We recommend that the Government considers deferring the introduction of the R&D tax credit and maintaining the status quo for loss making businesses until the policy issues are articulated and resolved. Another approach would be to allow a refundable R&D tax credit but using a rate and a cap on the refundable amount, so that broadly, for loss making businesses there is no decrease in the amount of cashflow from Growth Grants and R&D tax loss credits.

As acknowledged by the Government on the introduction of the R&D tax loss cash out incentive in 2015, cash flow is vital to small start-ups and SMEs in general. This is especially the case where the new business has significant R&D expenditure in order to establish itself and add value in future years. The recent Australian R&D reforms note the critical nature of cash flow for starting businesses and provide up to \$4m of cash refunds for R&D claimants with aggregated annual turnover less than \$20m.



We further highlight that NZ is generally undercapitalised in relation to early stage investment. This means that actual cash support via grants or rebates is critical to leverage the very thin investment capital available to start-up companies to enable them to carry out R&D work. This point is emphasised in the Startup Genome Global Startup Ecosystem Report 2018<sup>1</sup> which noted that the global median conversion rate from Seed funding to Series A deals was 25% whereas NZ is well behind at circa 10%. This demonstrates how difficult it is for start-ups in NZ to get that first significant round of equity funding through the door.

In addition to the proposed incentive being non-refundable, the uncertainty surrounding the future of the current R&D tax loss cash-out incentive beyond 31 March 2020 is damaging to emerging R&D business and business confidence. This uncertain position means that businesses are unable to effectively forecast, budget and plan operations in advance, causing their own business activity to be uncertain. It also inhibits outside investors from having clear financial insights into the business and means that further (often necessary) equity investment may be called into question.

The problem of a lack of cash flow certainty is compounded by the cessation of Growth Grants, which have provided cash flow support to R&D businesses in the emerging/growth phases. We understand this has been decided by the Government on the basis that the Grants are “funding similar types of activity and have a similar purpose”. However, although they are funding the same types of activity, the Grants and the proposed tax credit will operate in different ways that have different effects on the financial operations and abilities of R&D businesses. Our view is that they should be considered separately.

One other issue for emerging R&D business, in particular, will be the timing of cash flows. Currently, claims under a Growth Grant are processed quarterly which means many businesses are receiving 20% of the cash spend back within five to six months of the expenditure being incurred. If there is a move towards a tax return based claim system, any benefit will not be received by the business until at least three to four months post year end (the minimum time required for most businesses to prepare their financial statements and tax return) or possibly up to one year after year end if there are other matters that need to be resolved before the tax return can be filed (which may be two years or more since the expenditure was incurred).

The closing of applications for new Growth Grants by the end of the 2019 tax year and complete cessation of the Growth Grant scheme by the end of 2020, will cause even further cash flow uncertainty and strain for emerging R&D firms. The blow will be particularly harsh for R&D businesses with Growth Grants which have a date extending past 2020, as their Grant will be cut from 31 March 2020 and moved to the tax credit incentive scheme. As a result, businesses which previously had cash flow and an element of financial security now face uncertainty, causing further difficulty in planning and securing further cash investments. The feeling of “what will we do now” is likely to be shared amongst current Growth Grant recipients.

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<sup>1</sup> <https://startupgenome.com/all-report-thank-you/?file=2018>

The uncertainty around what measures will be introduced from 1 April 2020 is likely to already be creating challenges for business decision makers. Most R&D businesses perform at least three years of budget forecasting and these changes will affect that third year from now. The impact is that the uncertainty may already be forcing R&D spend to slow today.

If the Government is going to provide real, effective support and certainty for emerging R&D active businesses and those otherwise in tax loss, it must introduce a mechanism for cash flow support to replace the Growth Grants immediately. Although there is a transition option for these businesses, the level of support is unclear (eg whether it will mirror the proposed tax credit at 12.5% or as per the rate for Growth Grants) and only for a year.

These challenges could largely be resolved by making the tax credit refundable. This should be introduced or signalled with clarity as soon as possible, so that businesses and investors alike are not “spooked” or discouraged from R&D spending and/or investment between now and 2020 (the proposed cash flow assistance review date and the end of Growth Grants).

### ***Summary of submissions on rate and non-refundable nature of credit***

Our R&D active SMEs in loss are of future value to the NZ economy and to the innovative reputation of NZ, as highlighted in the Discussion Document. This means that these businesses must be provided with support which allows these firms to grow into successful business. Cash support is particularly important as these businesses encounter a higher level of risk and find it harder to secure traditional sources of funding giving cash flow. They also spend longer periods in loss due to R&D intensive periods. We therefore strongly submit that the Government does not reduce cash support for start-up businesses undertaking R&D. In order to achieve this we submit:

- The Government should review the rate of the tax credit to bring it in line with the Growth Grant allowance level and take into consideration any tax loss cash out benefits
- The Government should review the refundable nature of the tax credit or ensure there is a cash flow assistance mechanism if the tax credit remains non-refundable
- The Government should consider the timing of cash flow assistance and whether there is a way to provide businesses with access to funding on a regular basis throughout the year, similar to the quarterly Growth Grant claim process
- The tax continuity provisions should not apply to the proposed incentive in order for the credits to be an incentive for businesses likely to encounter a shareholding change through increased equity funding.

### ***3. Proposed definition of R&D***

#### ***Proposed definition is too narrow***

The Discussion Document notes that the proposed incentive is to have a broad reach across the NZ economy and that a “wider and more diverse range of firms will be able to access the tax incentive which will assist and encourage businesses of all sizes and scales to undertake R&D”.

However, in its present form, our view is that the proposed definition of R&D contained in the Discussion Document does not lend itself to this aspiration, raising several concerns.





Prima facie, the proposed definition of R&D does not appear to be as “robust and practical” as the Government has intended.

Specifically, terms such as “scientific method”, the requirement that the R&D activities are performed with the intention to “advance science or technology through the resolution of scientific or technological uncertainty” and the need to address a “material problem” resulting in a “material advance in science or technology” is, in our view, overly narrow and archaic.

The result of such a narrow definition will mean the proposed tax credit may only apply to a limited set of R&D activities and would greatly undermine the effect of the incentive.

### ***Potential refinements to the definition***

We outline below potential refinements to the proposed definition.

In our view, there is merit in maintaining consistency with the NZ IAS 38 definition of R&D for the proposed R&D tax credit incentive. We note that this NZ IAS 38 definitions of “research” or “development” are currently used for the R&D in the Income Tax Act 2007 (for the R&D tax loss credit, and the R&D deduction deferral rules), and forms the starting point for the definition of eligible R&D for Growth Grant purposes. We discuss this further in the context of additional compliance costs later.

The definition of “scientific method” needs to be used in a broad sense to cover an expansive definition of science, to include “computer science” (including algorithmics and design patterns) and mathematics used in technology creation. However, we recognise that further refinement is required to ensure the term “scientific” is not overly broad, it may be a better approach to define science to include specific other scientific discipline variations which the Government will be able to identify through the submission process.

In addition, we submit that clear and comprehensive guidance as to the scope of the definition will be necessary, ideally with specific industry examples. This is particularly important so that businesses are able to apply the definition easily without incurring significant costs in order to access the incentive.

We further submit that the use of the phrase “resolution of scientific or technological uncertainty” should be altered to reflect that some scientific and technological research could target a specific outcome or product.

The Discussion Document also comments that the tax credit should be available for solving problems that have not already been solved. It is important to note that it is possible businesses are attempting to solve the same issue but through an improved method, or in a different manner which is of benefit to a different demographic or consumer group for example. We also note that the UK R&D tax credit guidelines<sup>2</sup> state, within the discussion on the meaning of “advance in science or technology” that a project which seeks to “.....use science or technology to duplicate the effect of an existing process, material, device, product or service in a new or appreciably improved way (ie a product which has exactly the same characteristics as existing models, but is built in a fundamentally different

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<sup>2</sup> Guidelines on the meaning of Research and Development for Tax Purposes, Department of Business, Innovation and Skills, March 2004.





*manner)*....” will be R&D, demonstrating that this issue has been considered and accepted by other jurisdictions with well established R&D tax incentives.

We submit that the wording of the definition should be changed to reflect this.

#### ***The proposed definition does not suit software development***

The Discussion Document notes the importance of software development businesses to the NZ economy.

As mentioned above, our view is that the proposed definition is too narrow, and it is particularly difficult to apply in the context of software development, app development or other similar technological advancing products. Specifically, such activity generally –

- does not use a traditionally scientific method;
- does not solve an uncertainty (ie is targeted at a specific creation or result);
- does not address a material problem (despite the fact that it may assist people in carrying on their daily lives).

In our view, it would be difficult for such research and development activities to fit within the proposed definition. We therefore support the indication put forward in the Discussion Document for a different definition to apply to software development.

We stress again the importance of getting the definition right for software development, especially as our main R&D emerging businesses are not carrying out strictly scientific work but are in the software area.

#### ***4. Compliance costs***

##### ***Costs associated with establishing eligibility***

Under the current R&D incentives (Growth Grants and the R&D tax loss cash-out), the same definition of R&D is applied across the board and is consistent with the definition of R&D for financial reporting purposes. This results in efficiency savings as businesses need only consider their R&D activities and expenditure once for the purposes of determining how costs should be treated for R&D incentives and financial reporting purposes. We are concerned that the introduction of a different definition for R&D tax credit purposes will significantly increase the amount of internal and external resources required for R&D businesses to establish eligibility and identify qualifying expenditure.

We therefore submit that further consideration should be given to retaining the NZ IAS 38 definition of R&D for the proposed R&D tax credit incentive.

Should the Government decide that it still wishes to implement an alternative definition, we submit that the costs associated with establishing eligibility and identifying qualifying expenditure, whether internal or external, should be specifically included in qualifying expenditure for R&D tax credit purposes.



### ***Application costs***

We understand the need for integrity measures to ensure that funding received by R&D businesses is appropriate and fair, and that valuable resources are not exploited to the detriment of the economy as a whole. We are also pleased that the Government recognises the need for increased certainty for taxpayers as the availability of R&D incentives forms a key part of the decision process around budgeting, cash flow management, business strategy and investment needs.

We are, however, concerned that the correct balance between compliance and claim integrity is achieved. Emerging R&D intensive businesses, in particular, generally have limited internal resources in relation to financial management with a small number of individuals dealing with everything from the annual report to payroll and debtor management. We would be concerned if a high compliance burden, in terms of level of detail and supporting documentation, was levied on such businesses, especially in light of the fact claims made by such businesses are likely to be towards the lower end of the spectrum in terms of dollar amount. Such a burden would likely act as a deterrent to submitting a claim for many resource poor R&D businesses.

These businesses may also have insufficient resources to employ external advisors to assist with the claim process and, as such, it becomes even more important that appropriate guidance on the definitions of R&D and qualifying expenditure is provided to assist these businesses to make an accurate and valid claim from the outset.

Conversely, we accept that it seems appropriate that claims for larger amounts, especially those nearing the maximum funding of \$15m per annum, should be subject to a greater degree of scrutiny and require a greater degree of support (although we note that larger claimants are likely to have more internal resources and/or be in a position to engage external advisors to assist with the claim process so we would expect the information provided to be of a high level of integrity).

We therefore submit that a scaled approach depending on the quantum of the claim is applied to the level of information required to support a claim, together with the level of integrity measures applied post submission of a claim. For example, it may be appropriate to have simplified process for those claims under a certain threshold, say \$2m of R&D expenditure.

We also submit that it may be helpful to taxpayers for a summary of frequently asked questions and common errors to be published on a regular basis, especially during the initial introduction period of the tax credit.

### ***Assessment and dispute process***

It is unclear from the discussion document exactly how the Government will approach the assessment of claims, however, we would stress the importance of Inland Revenue engaging with competent professionals in the relevant fields. While we appreciate that guidance will be provided to taxpayers in relation to qualifying and non-qualifying R&D, in many cases a degree of judgement will be required and Inland Revenue officials may not have sufficient subject matter experience to make an informed decision. If legitimate claims are protracted or rejected due to insufficient industry knowledge on the part of Inland Revenue, this will result in significant frustration amongst taxpayers and would be damaging to the R&D tax credit incentive, especially if businesses incur costs in relation to external advisors to assist with challenges by Inland Revenue.



We therefore submit that careful consideration should be given to how claims will be assessed by Inland Revenue and what expert resources they will have to draw on, as well as providing guidance to taxpayers on how to proceed if they disagree with the view taken (be it through the normal disputes process or a tailored mechanism specific to the R&D tax credit).

### **General**

We thank you again for the opportunity to comment. Please let us know if you would like to discuss our submissions further.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Anand Reddy', enclosed in a light blue rectangular box.

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