Private and confidential
Deputy Commissioner
Policy and Strategy
Inland Revenue
P O Box 2198
Wellington

Ref: R&D tax losses submission

18 September 2013

Dear Sir

Submission on R&D tax losses - Angel Association of New Zealand

The Angel Association of New Zealand ("the Association") welcomes the opportunity to make a submission on the R&D tax losses issues paper and appreciates the additional time for this submission.

About angel investment and the Angel Association New Zealand

An "angel investor" is a person who invests directly, either as an individual or as part of a syndicate, in a privately-owned business with which they have no connection. Angel investment is typically used to bridge the gap between the initial capital provided by a business founder, their family and friends, and structured capital provided by venture capitalists and private equity investors. Angel investment can be distinguished from venture capital and private equity investment, which are pooled investments (i.e. may attract investment capital from a combination of institutional investors, such as pension funds, high net worth individuals, and other persons exempt from public offer legislations). In addition, private equity is typically focussed on mature businesses, while angel investment (and venture capital funds) tends to focus on investments that are at a much earlier stage in their life cycle (the "seeding" and "start-up" phases of a business).

The Angel Association of New Zealand was established in 2008 to bring together business angel networks and early stage funds to work towards an agreed national vision and to deliver the activities required to achieve that vision.

The Association includes members of angel investor groups who are typically senior business leaders and entrepreneurs (angels are typically required to be certified as wealthy investors for the purposes of the Securities Act). The Association aims to increase the quantity, quality and success of angel investments in New Zealand and in so doing create a greater pool of capital for innovative start-up companies.

The primary objectives of the Association are to:

- promote the growth of angel investment in New Zealand, including encouraging and educating entrepreneurs, new angel investors and angel groups; and
- ensure the ongoing success of the industry through developing industry strategy, encouraging collaboration between members and providing education for those involved.

Objective of our submission

The objective of our submission is two-fold. To provide Inland Revenue with a broader understanding of the innovation process, which we believe should be the focus of the proposal. Secondly, we provide some comments on the detailed features of the cashing up of tax losses mechanism being proposed, including other possible options to encourage R&D.

Role of angel investors: R&D vs innovation

Encouraging innovation is one of the Government's key initiatives. The issues paper states that R&D is a key element in the innovation process.

Although R&D expenditure is an important component of successful innovation, it is nonetheless only one part of what innovation entails. Instead, it is the culture of innovation and turning R&D into developed, tangible, products or services (i.e. through "commercialisation") that powers innovation among businesses. A 2010 report on innovation by the OECD has this in mind; [1] in acknowledging that R&D is important, the report notes that innovation rarely occurs in isolation. The OECD report defines innovation as the "introduction of a new or significantly improved product, process or method". The OECD notes that this will increasingly be needed to drive growth and employment and to increase living standards. This is particularly relevant for New Zealand.

The technology life cycle

The technology lifecycle of a technology product typically involves the following phases:

- The "bleeding edge" phase when the idea is first generated, developed further, and tested resulting in a "technology product". The resulting technology product may show high potential but hasn't demonstrated its value.
- The "leading edge" phase when costs relating to the technology product are starting to be recovered to break even. This phase potentially signals the start of business operations relating to the technology product. That is, the technology may have a

[1] http://www.oecd.org/sti/theoecdinnovationstrategygettingaheadstartontomorrow.htm

proven use, but is still new enough that it may be difficult to find knowledgeable personnel to implement or support it.

- The "maturity" phase when the product is being fully exploited commercially (i.e. is "in production") and returns are high and stable.
- The "decay" phase of reducing returns and utility of the technology product.

A linear view of the technology lifecycle considers these stages discretely and in order. However, in practice there tends to be considerable overlap between the bleeding edge stage in which new ideas are generated, developed and tested and the commercialisation of a technology product (which will typically be during the leading edge stage). This can and does happen contemporaneously in many industries (for example, software development) in order for businesses to remain relevant and competitive in today's ever changing market.

Innovation is not confined to the R&D (or what the issues paper considers to be the bleeding edge) phase. Nor can innovation be construed as being developed wholly internally. Whether R&D spending is successful – i.e. whether it creates valuable intellectual property, or products or services based on that intellectual property, which can be sold for a profit – depends not just on the initial R&D spend but, rather, on what the company and investors (particularly angel investors) do to take the idea and product to market. It is these interactions, both within the company and with other businesses and market participants, which give rise to successful and sustainable innovation.

The Association provides opportunities for its members to develop networks to facilitate the dissemination of business skills and expertise, commercial opportunities, and the provision of some limited support infrastructure for New Zealand's fledgling innovative businesses. It is all of these components, in conjunction with pure (or "blue sky") R&D, which lead to innovation, that will drive the New Zealand economy, jobs and higher living standards for New Zealanders. Simply encouraging investment in R&D expenditure in isolation, will not support the other activities required to commercialise the R&D. It is certainly not how angel investors make their investment decisions.

The Association believes that the narrow focus on R&D, in the proposal, misses the wider opportunity to encourage innovation.

Our submissions on the proposal

We support the Government's intention to encourage innovation by improving cash-flows and removing tax distortions facing innovative start-up companies. If targeted properly, it may help to increase the success rate of these start-ups.

However, we are concerned that the R&D tax loss refund proposal, in the issues paper, does not meet the Government's stated objective. We believe the proposal will have a minimum impact in encouraging innovation, and removing cash-flow constraints, for the reasons noted below. In addition, we challenge whether incentivising the company is

the right approach to successful innovation or whether alternative incentives to investors could provide a better overall outcome for New Zealand.

Cash-flow constraints will still arise for early stage businesses

This is because R&D expenditure must first be incurred before tax losses can be cashed out. It is no surprise that "cash is king" for fledgling innovative businesses. However, the tax proposal still requires start-up companies to fund the R&D expenditure (however this is defined) before being able to cash out tax losses arising from that expenditure. For example, to receive the maximum cash refund of $140,000 a company must first spend $500,000 on eligible R&D and also show a tax loss of at least $500,000. Finding the $500,000 to fund a new idea, product or process, will be difficult if companies have limited access to finance in the first place. The proposals will therefore do nothing to help those innovative businesses which are unable to raise funds to finance this initial R&D outlay, such as those having difficulty obtaining a bank loan or additional equity injections.

Cash-flow constraints will be further exacerbated if refunds are delayed because of IRD processing

The Association understand that there may be significant delays in receiving tax loss refunds after the expenditure has been incurred, due to the time available for most companies to file their tax returns (this can be up to 17 months following balance date) and, more importantly, IRD's proposed screening process for claims. While the former will to some extent be within a business's control, the latter will not. (Our submission discusses this latter concern in greater detail later on.) This will mean that any cash-flow relief will take longer than two years, from the start of the year to which the claim relates – i.e. for every R&D dollar spent in Y1, up to $0.28 (to a maximum of $140,000) will only be received around Y3. This will do little to alleviate the cash-flow constraint faced by innovative start-up companies in Y1 and Y2 and it impossible to budget for within the "start-up" years. If the business cannot guarantee when it will get the funding and how much that will be it cannot develop its R&D plan to include the funding.

The tax loss refunds will not be easily accessible by R&D start-ups

We believe that the complexity engrained in the tax proposal does not recognise the commercial reality of how innovative businesses operate and will prohibit genuine start-ups from accessing the refunds. We provide some examples to illustrate the point.

Definition of R&D

The proposal aligns the proposed R&D definition with the current tax definition, which in turn refers to accounting standards (in this case NZIAS 38). As noted earlier, innovative businesses that the Association's members invest in will not be limited to an accounting standard definition of R&D or innovation. We also understand that many very small start-up businesses (for which angels may provide "seed" funding) will not be conversant with NZIAS 38 given their size and the costs involved in getting expert

advice. Also, we understand that once the new financial reporting requirements are enacted this will remove the requirement for small and medium businesses to publish audited financial accounts, and compliance with NZIAS 38 will not be required in any event. This also goes to our earlier point, that R&D is a subset of innovation, not an end in its own right, which we discuss below.

Deficiencies of the R&D wage intensity test

The issues paper appears to assume that R&D relates to hiring as many people in white lab coats as possible – we refer to the 20% "R&D wage intensity test" in the issues paper –whereas encouraging innovation (which the Association believes is the Government's end goal) is a more holistic process.

Commercialisation of the R&D product needs to occur side-by-side with the R&D itself for innovation to be successful. That is, it is essential for businesses to consider commercialisation at the earliest stages of the technology lifecycle (i.e. while pure R&D is taking place). This helps to ensure that R&D takes place with an eventual commercialisation object in mind. R&D expenditure is of little value if it cannot be successfully turned into a product and brought to market (as this is when the accompanying spill over benefits to New Zealand will arise). This is where angel investors typically become involved, using their business expertise to help guide innovative businesses.

In that context, we have the following concerns with the R&D wage intensity test:

(1) It will disadvantage businesses where much of the commercialisation occurs at the same time as the R&D for the reasons outlined above.

(2) It will give R&D related salary and wages priority over other expenditure. It will therefore introduce a new tax distortion by creating a disincentive for start-ups to invest (a) in business/commercial development activities or (b) in capital-intensive R&D:

   (a) *Business development*: R&D expenditure incurred in isolation without the ability to commercialise the resulting technology cannot be construed as successful innovation, in our view. Business development is, therefore, a fundamental aspect of successful innovation, and is necessary for business sustainability. This is critical to modern lean "start-up" businesses today. A tax distortion away from such expenditure, because investing in a further scientist/engineer versus a business analyst could be the difference between getting a tax loss refund or not, sends inappropriate signals. (This could have an impact, for example, on very small start-ups for which an additional $140,000 cash injection may be the difference between survival or not.) We reiterate that the creation of new ideas is not an end unto itself. As already explained, innovation requires the union of a great idea and how it can be utilised commercially.

(b) *Capital-intensive R&D*: The R&D wage intensity test may not be met for innovative businesses where materials and hardware costs comprise a large part of the R&D process, as R&D related salary and wages may not be a significant factor in such businesses. Such a test may not be an accurate reflection of R&D intensity for these businesses, where total R&D expenditure may be a better indicator.

(3) Excluding shareholder salaries in the form of equity from counting towards the R&D wage intensity test will limit the ability for many start-up companies to qualify under the proposal. Again, we believe this omits commercial reality. The reason that key employees become shareholders (or will receive options to acquire shares) is due precisely to the cash-flow constraints that the Government is trying to address as part of this proposal. Start-ups will not have the cash to pay salaries in the same way as a more mature business. Employee compensation in the form of equity also allows shareholder and employee motivations for successes to be aligned, which the Association believes to be particularly crucial in the early stages of a business venture.

IRD's administration of the new rules

IRD's proposed screening process for claimants under the new regime seems overly complex and over-engineered given the cash savings at stake. It is disappointing that IRD appears to be keen to repeat the approach for assessing claims under the 15% R&D tax credit, which was repealed in 2010. This will result in considerable costs (i.e. getting help from external advisers to comply with the detailed requirements to minimise the risk of claims being rejected, and management/employee time dealing with IRD queries) in complying with the new rules. This will be a turn-off for many businesses.

The cost to business from complying with IRD's requirements needs to be kept in perspective, as the maximum cash-in-hand benefit will be limited to $140,000 per annum, per business. This is not a huge sum of money (and even at $500,000, if the cap is raised) and would not justify significant compliance costs. Particularly, as this will be businesses' own funds that are being advanced to them, interest-free, by the Government, and are repayable at a future date. The funding itself is merely a loan, not a grant from which the compliance costs can be funded

Are integrity rules really needed?

The Association is concerned with the proposed "integrity" measures to claw back the value of tax loss refunds paid to an innovative business, on sale of the shares in the business or the sale of the underlying intellectual property.

We do not believe that the sale of shares in the company should be a trigger for IRD to reclaim the cash refunds. Early-stage companies could have numerous shareholding changes before the R&D is actually commercialised. The claw-back of tax loss refunds

on such events will significantly reduce the value of the proposal and introduce new costs from having to track even minor shareholding changes.

Also, in paragraph 7.4, IRD mistakenly takes the view that if the shares in the company are sold for a profit it is highly likely the R&D company will also no longer face the same cash flow constraints (presumably on the assumption that the higher share price will reflect the underlying cash position of the company). This seems a bit of a leap of logic, as not all transfers in shareholding will occur when the company is profitable and has surplus funds. In fact, share gains on start-ups (particularly in the technology sector) will typically reflect expectations about future profitability rather than current profitability and cash-flow.

The claw back should be when/if the company starts making profits. At a minimum, the trigger point should not be a sale of 5% or more of the shares, but rather a controlling (i.e. 51% or greater) shareholding change. We note 51% is when shareholding continuity for tax loss carry-forward purposes would be lost.

Our other concern is that recovery of the cash refunds would be from shareholders, including angel investors, on exit from the company (e.g. typically this will be pre-IPO for angel investors when the company is mature). We do not believe this is fair as the company, and not the shareholder, will have benefited from the cash-up of any tax losses. It will also be difficult to explain to incoming investors, and this tax cost will be factored into the pricing of investment, to the potential detriment of the company. We are also concerned with the comment in the issue paper that offshore investors may not be subject to any reclaim, because of collection costs. This will unfairly disadvantage Kiwi investors, including Angels, in early stage R&D companies.

The proposed integrity rules will simply add a further layer of complexity to an already complex regime as we understand the proposal is to make the reclaim out of shareholders' share sale proceeds (by triggering taxable income equal to the shareholders' share of the company's cashed-up losses, with this potentially taxed at 33% when the company has received the benefit at only 28%) but then reinstate the losses to the company. We question the rationale for this. In effect, the company not only gets to keep the benefit of losses previously cashed-up but also has these losses "refreshed", which seems a strange outcome.

Our recommendations

Based on the detail of the proposal, in the issues paper, it seems to us that cash-strapped innovative businesses are being asked to jump through a series of "hoops" to qualify for some limited cash-flow assistance through the tax system, when access to this assistance could be:

- significantly simplified; or
- provided directly through non-tax channels.

To achieve simplicity, we believe that IRD/Government needs to be prepared to accept certain compromises. That is, for example, rather than having a prescriptive definition of R&D (and the various exclusions from this definition), specify the eligible companies by reference to a list restricted activities (i.e. based on activities officials and Government are uncomfortable providing additional assistance to through the tax system). If this basic "entry" test is met, instead of requiring businesses to calculate their qualifying R&D, and the loss refund amount by reference to multiple thresholds, each year, make this up to 50% of the business's salary and wage expenditure in the first year (capped at $140,000). This percentage could be abated in later years (e.g. 40% in year 2, 30% in year 3, 20% in year 4, to 0% by year 6) to limit the amount of the benefit. This also recognises that assistance will not be ongoing.

While we acknowledge that this will not be a precise tool, the difficulty with the current proposal is we struggle to see any businesses that will see value in applying for it, given the compliance costs and associated constraints discussed earlier. For example, existing Government grants (such as Callaghan funding) would provide, certainty on the amount of funding, a timing advantage and would not be required to be refunded at a later date. Other innovative businesses may well choose not to allocate time to applying for the incentive given the temporary nature of the funding. The proposal therefore has real scope to be a "white elephant". It is also imperative that the tax proposal not be viewed an alternative to actual grant funding, to reduce the level of such funding, as the two are clearly not substitutable.

Alternatively, the complexity associated with the R&D tax loss rules could be circumvented by using existing (non-tax) delivery mechanisms, such as Government grant funding for innovation. These processes could also be used to target assistance in the way of interest-free loans, which are repayable on the successful commercialisation or sale of the resulting R&D/technology product. This would also have the benefit of targeting the relief to when start-ups actually need the help, i.e. at the time of planning their future R&D spend. A concern we have with current grant funding is that this is set up for larger innovative companies. Therefore, there would need to be some relaxation of those entry criteria and rules to accommodate smaller R&D start ups. We believe this would have much wider ranging benefits.

Tax incentive schemes to encourage investment in high-risk companies

It is a fact that other countries have significantly more generous and supportive tax regimes than New Zealand, for innovative businesses. The tax proposal, while useful if able to be accessed at reasonable cost, does not help New Zealand make up this ground.

In a competitive global economy, New Zealand's lack of explicit tax support for innovation, particularly to encourage private investment in those innovative companies, sticks out.

While potentially outside of the scope of the issues paper, we note that the United Kingdom offers an incentive scheme (the "Enterprise Investment Scheme" or EIS) that is designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies. The tax reliefs[2] include a tax credit equal to 30 percent of the value of shares acquired (up to a maximum of £1,000,000 invested) against an individual's income tax liability. This means a maximum tax credit of £300,000 can be claimed against one's tax liability. There is also relief from UK capital gains taxes if the shares are held for more than 3 years. The full array of tax relief is limited to those new shareholders previously unconnected with the business (e.g. does not apply to controlling shareholdings or connection by way of employment)[3]. The focus is, therefore, on attracting genuine new angel investment.

Qualification for the EIS, for a company and a particular share issue, is managed by the Small Company Enterprise Centre ("SCEC") of the UK HMRC. The SCEC decides if a company and a share issue qualifies. If they do, the SCEC then takes responsibility for checking the accounts etc of the company to ensure that it continues to meet the requirements. The SCEC also operates an advance assurance scheme, whereby companies can submit their plans to raise money, details of their structure and trade etc. before the shares are issued, and the SCEC will advise on whether or not the proposed issue is likely to qualify[4]. This, we understand, significantly reduces the cost to participating businesses and investors.

There is no definition of a high-risk business, although there are a number of excluded trading activities[5]. Generally, the exclusions are for low-risk, passive investing, and traditional production and service activities (e.g. legal and accountancy services, financial services, property development, leasing businesses, electricity/coal/steel production, etc).

Consideration could be given to a similar scheme (with appropriate modifications to mitigate revenue risk) to help R&D start-ups obtain additional external funding. That is, instead of Government providing finance for start-ups, by cashing-up tax losses, the encouragement could be for greater angel investment instead, through the tax system. We believe this has wider spill over benefits, due to the unique role angel investors play.

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[2] http://www.hmrc.gov.uk/eis/part1/1-2.htm
[3] http://www.hmrc.gov.uk/eis/part1/1-3.htm
[4] http://www.hmrc.gov.uk/eis/part2/2-5.htm
[5] http://www.hmrc.gov.uk/eis/part2/2-4.htm

Contact details

We would be happy to discuss the issues raised in this submission further. To engage further with the Association, please contact our advisor, Gwenan Riley of KPMG on (04) 816 4755.

Yours sincerely

Gwenan Riley

on behalf of the Angel Association of New Zealand