SUBMISSION TO MBIE ON THE DRAFT R&D TAX INCENTIVE PROPOSAL - DESIGN PROCESS

Dear Sir / Madam

SUBMISSION: DRAFT R&D TAX INCENTIVE PROPOSAL - DESIGN PROCESS.

This submission is from:

HMI Technologies Limited (HMI) and **Ohmio** Automotion Limited (Ohmio).

53 Ben Lomond Crescent, Pakuranga

Manukau

Auckland 2010

The contact person in respect of this submission is:

s 9(2)(a) [redacted]

Thank you for the opportunity for HMI Technologies and Ohmio Automotion to provide comment on the "Draft R&D tax incentive proposal - design process".

Yours sincerely

s 9(2)(a) [redacted]

INTRODUCTION

HMI Technologies was founded in 2002 and is a world leader in the development, design, manufacturer and service and support of Intelligent Transport Systems. HMI specialises in variable message and speed activated signs, speed indication devices, motorway signalling, modem/network based systems and accompanying sensors and data collection and manipulation. It is headquartered in Auckland with offices in Wellington, Christchurch, Melbourne, Sydney and Brisbane.

Ohmio is newly formed company spun out of HMI Technologies (they are now sister companies) to develop, design, manufacture and sell self-drive vehicles and related infrastructure and services.

Ohmio employs a dedicated research and development team of over 20 systems engineers, physicists, mechatronics engineers, algorithm developers, software developers, electronics engineers and designers. This team is a leader in indoor navigation and utilising Artificial Intelligence to enable the self -drive shuttles to make the safest and the best decisions.

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?

No comment on this question

QUESTION 2: HOW WELL DOES THIS DEFINITION APPLY TO BUSINESS R&D CARRIED OUT IN NEW ZEALAND?

The proposed definition (core and support) whilst recognising a range of R & D activities, part of which is the creation of new or improved products and services that "resolve technological uncertainty", doesn't necessarily capture software R & D. This our primary interest.

We submit that a broader definition of R&D is required that focuses less on technological uncertainty. As a result, we submit that the definition of core activities should be changed to the following:

(a) Core activities: those conducted using scientific or engineering methods that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes, or services.

Further detail is provided in the answer to Question 13 which seeks direct feedback if software is captured in the definition.

We support the development and publishing of extensive guidelines that clarifies work which is "innovative and challenging" but not necessarily R& D as it not resolving technological uncertainty. However uncertainly is defined.

QUESTION 3: DOES THIS DEFINITION EXCLUDE R&D THAT YOU THINK SHOULD BE ELIGIBLE, PLEASE ILLUSTRATE WITH EXAMPLES.

Clarity is needed if the definition includes software engineering R & D, that we believe should be eligible. Covered by question 13.

QUESTION 4: DOES THE SCIENTIFIC METHOD REQUIREMENT EXCLUDE VALID R&D IN SOME SECTORS, PLEASE ILLUSTRATE WITH EXAMPLES?

As noted above and in question 13, we submit that a broader definition is required to cover valid R& D unless the "scientific method" here is intended in a broader sense i.e. "science and technology", which includes (software) engineering.

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?

Applying a materiality test is dependent on agreement, widespread understanding and then easy and consistent application of any definition. This will be hard to define and enforce. We submit that a materiality test should not be applied.

QUESTION 6: HOW WELL DOES THIS DEFINITION APPLY TO BUSINESS R&D CARRIED OUT IN NEW ZEALAND?

Definiton is adequate for support activities.

QUESTION 7: ARE THERE ANY REASONS WHY THE EXCLUSIONS SHOULD NOT APPLY TO SUPPORT AS WELL AS CORE ACTIVITIES? PLEASE DESCRIBE.

If the purpose of detailing excluded activities is to 'remove uncertainty and clarify boundaries' then exclusions should be detailed for both core and support activities. Furthermore guidelines should be provided of those activities excluded from core that are then deemed as support and those that are excluded from both categories.

QUESTION 8: PLEASE PROVIDE ANY EXAMPLES WHERE SOCIAL SCIENCE RESEARCH IS/HAS BEEN A CORE PART OF BUSINESS R&D IN NEW ZEALAND?

No comment on this question

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?

Likely to have little or no impact as businesses will organise their activities carried out for R & D and non -R & D i.e. a clear boundary between the two.

QUESTION 10: WHAT ARE THE ADVANTAGES AND/OR DISADVANTAGES OF LIMITING ELIGIBLE EXPENDITURE TO R&D LABOUR COST?

Advantage is that it is simply determined and accounted for. Disadvantage being that other eligible costs are excluded.

QUESTION 11: WHAT ARE THE ADVANTAGES AND/OR DISADVANTAGES OF SETTING OVERHEAD COSTS AS A PERCENTAGE OF R&D LABOUR COSTS?

Advantage is that it is simply determined and accounted for however bias against capital intensive R & D projects needs to be accommodated in some manner.

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.

No reasons.

QUESTION 13: WHAT VARIATIONS OR EXTENSIONS TO THE DEFINITION OF CORE ACTIVITIES ARE REQUIRED TO ENSURE IT ADEQUATELY CAPTURES R&D SOFTWARE ACTIVITIES?

As noted in our answer to question 2 we would change the definition of core activities to the following:

(b) Core activities: those conducted using scientific or engineering methods that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes, or services.

We submit that a broader definition of core activities is required that focuses less on technological uncertainty. Sometimes R&D is needed not only to resolve scientific or technological uncertainty, but to piece together certain parts of science or technology (i.e. innovate) into new products or functions.

R & D relies less on the scientific method (which HMI sees as quite rigid) and opens up to engineering methodologies, of which there are quite a few. Software engineering is a branch of engineering which gives us new programs and products while computer science is the branch of science which gives software engineers new tools in which to make those programs and products.

Alternately if the "scientific method" here is intended in a broader sense i.e. "science and technology", then it includes engineering.

HMI and Ohmio look forward to seeing the results of the additional work on software development and would welcome the opportunity to comment further. We submit that core activities should capture development of computer algorithms, data analysis, and mathematical modelling which would cover software related R&D.

QUESTION 14: ARE THERE REASONS WHY CONTINUITY RULES SHOULD NOT APPLY TO TAX CREDITS? PLEASE DESCRIBE.

No reason continuity rules should not apply i.e. carried forward.

QUESTION 15: IS THE MINIMUM THRESHOLD SET AT THE RIGHT LEVEL? IF 'NO', PLEASE PROVIDE FURTHER DETAILS.

We submit that the threshold should be set at a level which incentivises those businesses that need the most encouragement to invest in R & D but also provides ongoing incentive to those to continue investing. That threshold is not necessarily determined by the cost of an employee (including overheads) as stated.

A detailed understanding/analysis of businesses currently receiving grants should provide better guidance.

QUESTION 16: HOW IMPORTANT IS A CAP OR A MECHANISM TO GO BEYOND THE CAP? PLEASE PROVIDE FURTHER DETAILS.

A cap will assist in building confidence, amongst recipients, that the programme is sustainable and likely to be long lived.

A mechanism to 'go beyond the cap' is highly important in that it encourages large initial and ongoing investment in R&D.

QUESTION 17: WHAT FEATURES OF A MINISTERIAL DISCRETION OR PRE-REGISTRATION WOULD MAKE THEM MOST EFFECTIVE?

Discretion or pre-registration should be given on proposed investment/expenditure beyond the current financial year in that business planning and thus likely R & D spend is committed to well in advance of it occurring.

QUESTION 18: WHAT ARE YOUR VIEWS ON THE PROPOSED MECHANISMS TO PROMOTE TRANSPARENCY AND ENHANCE EVALUATION?

Support the measures listed.

QUESTION 19: ARE THERE ANY OTHER RISKS THAT NEED TO BE MANAGED? PLEASE DESCRIBE

There should be no publication of the nature of the R & D, not that it is suggested. Although an internet search will generally disclose what is it but that is controllable by the business undertaking the research.

QUESTION 20: WHAT ARE THE RISKS WITH MAKING EXTERNAL ADVISORS LIABLE IN THIS WAY?

No comment

QUESTION 21: WHAT IS THE RIGHT LEVEL OF INFORMATION REQUIRED TO SUPPORT A CLAIM?

Extensive education/guidance is required "on the hypotheses the business is seeking to address" –and the correct application of the scientific method as such.

QUESTION 22: WHAT OPPORTUNITIES ARE THERE FOR CUSTOMERS TO SUBMIT R&D TAX INCENTIVE CLAIMS VIA THIRD PARTY SOFTWARE?

No comment.

QUESTION 23: WHAT INTEGRITY MEASURES DO YOU THINK INLAND REVENUE SHOULD USE?

No comment on what integrity measures the IRD could use to ensure claims are correct but as noted whatever is used needs to provide, amongst other things, greater certainty to claims prior to submission.

MANAGING THE TRANSITION FROM GROWTH GRANTS TO THE R&D TAX INCENTIVE

Q1 WHAT IMPACT WILL THE PROPOSED TRANSITION ARRANGEMENTS HAVE ON YOUR BUSINESS? FOR EXAMPLE, YOUR CASH-FLOW OR INTERNAL REPORTING MECHANISMS? PLEASE DESCRIBE.

Cashflow will be impacted, which is 'king' in a period where there is heavy expenditure on R &D.

With Growth Grants being paid quarterly in arrears versus the benefit from the R& D tax incentive only be "received" once an annual tax return is completed/filed/assessed and if the business is making a profit further external funding or capital may need to be sought or R& D expenditure plans revised.

No further reporting/information capture will be required.

Q2 WHAT DO YOU BELIEVE TO BE A NECESSARY TRANSITIONAL PERIOD? PLEASE EXPLAIN THE REASONS WHY THIS IS NECESSARY FOR YOUR BUSINESS?

The transition arrangements should have greater individual business flexibility i.e. discretion granted to those organisations that currently are experiencing or have planned heavy investment in R &D beyond 31 March 2020, that will not necessarily be covered by cashflow from the commercialisation of this R& D and/or other revenue sources.

Q3 WHAT IMPACT WILL THE PROPOSED TRANSITION ARRANGEMENTS HAVE ON YOUR R&D PROGRAMME OVER THE NEXT FEW YEARS?

Whilst business planning is well advanced for R & D programme for the short- medium term the change in cashflow may necessitate a change in these plans and/or, as noted, if left unchanged extra debt/more capital.

Q4 PLEASE PROVIDE ANY OTHER COMMENTS ABOUT THE PROPOSED TRANSITION ARRANGEMENTS?

No further comments to those noted above.

Q5 FOR BUSINESSES IN TAX LOSS, WHAT IMPACT WILL THE PROPOSED TEMPORARY GRANT HAVE ON YOUR BUSINESS DURING THE TRANSITION PROCESS? PLEASE DESCRIBE

No impact as the temporary grant reverts to the current Grant programme but note that the transitional arrangements are, at this stage, for a 1 year until 1 April 2020.

1 June 2018

R&D Tax Incentive Team
Ministry of Business, Innovation & Employment
PO Box 1473
WELLINGTON 6140

RDincentive@MBIE.govt.nz

Dear Sir / Madam

FUELLING INNOVATION TO TRANSFORM OUR ECONOMY: A DISCUSSION PAPER ON A RESEARCH & DEVELOPMENT TAX INCENTIVE FOR NEW ZEALAND

Methanex New Zealand Limited ("Methanex") is writing to provide comment on the discussion paper *Fuelling Innovation to Transform our Economy: A discussion paper on a Research & Development Tax Incentive for New Zealand* ("the discussion paper").

Methanex welcomes the opportunity to submit on the proposed R&D tax incentive, and in particular to comment on aspects of the proposals that we believe require clarification and refinement to ensure the regime meets its intended purpose of growing R&D investment in New Zealand.

ABOUT METHANEX

Methanex is ultimately owned by Methanex Corporation, a Canadian corporation listed on the Toronto Stock Exchange and the NASDAQ Global Market. Methanex Corporation, together with its global subsidiaries (the Group), produces and sells methanol globally.

Methanol is an essential ingredient used to produce hundreds of everyday industrial and consumer products such as building materials, foams, resins, plastics, paints, polyester and a variety of health and pharmaceutical products. It is also a clean-burning, cost-competitive alternative fuel.

Methanex owns two methanol production sites in Taranaki. The Motunui site produces methanol via two production facilities, whereas the Waitara Valley holds a third. Our plants produce methanol from natural gas provided from New Zealand gas fields.

It is estimated that our methanol production adds $834million to New Zealand's GDP each year, and sustains 3,117 jobs directly and indirectly.

Methanex New Zealand Limited
409 Main North Road, SH3
Motunui
Private Bag 2011
New Plymouth 4342
New Zealand

Tel: +64 6 754 9700

www.methanex.com

Methanex is consistently looking to improve its scientific and technological processes, and resolve uncertainties that can arise through the production process. Research and development is therefore an important part of our business, allowing the safe and sustainable production of methanol and the economic contribution to, and employment in, regional New Zealand that is associated with our facilities.

OVERALL COMMENTS

Methanex welcomes the introduction of an R&D tax incentive for New Zealand. Methanex Corporation subsidiaries operate in multiple jurisdictions globally and therefore it has considerable experience in operating within many legal and tax systems.

We believe that an R&D tax incentive will be an important part of New Zealand reaching the Government's goal of raising R&D expenditure to 2% of GDP.

In our view R&D expenditure by large industrial businesses such as Methanex will be crucial to achieving the 2% goal. It is therefore important that the R&D tax incentive is sufficiently broad to capture legitimate R&D expenditure undertaken by businesses such as Methanex. However, we are concerned that elements of the regime as currently proposed in the discussion document are overly restrictive, and will prevent the regime from achieving its intended purpose.

In particular, a shift in focus is required away from limiting eligible R&D expenditure to incentivising R&D expenditure through a more broadly applicable regime. For example, the eligibility tests as currently proposed may restrict many New Zealand subsidiaries of multinational corporations from accessing the regime (as elaborated on below), and should be reconsidered.

SUBMISSIONS

Eligibility criteria

The discussion document lists a number of eligibility criteria, including that the businesses making the claim:

- Have control over the R&D activities
- Bear the financial risk of the R&D activities
- Effectively own the results of the R&D

As explained above, Methanex is ultimately owned by Methanex Corporation. Certain R&D undertaken by Methanex in New Zealand is ultimately reimbursed by Methanex Corporation.

The basis for this is the global nature of the Methanex business structure and operations. Methanex Corporation, the ultimate parent of the Methanex group, ultimately absorbs certain R&D expenditure in its budget and then reallocates these costs to subsidiaries via global cost sharing arrangements. Since R&D affects the global operations of Methanex, the costs are therefore ultimately borne by the business globally.

Our concern is that under the regime proposed in the discussion document, Inland Revenue would not view Methanex as bearing the "financial risk" of the R&D activities – due to our global arrangements (which are not unusual). If this were the case, then a material proportion of R&D undertaken by Methanex would be excluded from the regime.

We note that commentary to the previous regime was clear that a party receiving payment for carrying out R&D regardless of the outcome of the activity is unlikely to be bearing financial risk.[1]

This would not just limit the availability of the credit to Methanex, but more broadly would restrict the regime in many situations where multinational organisations operate in New Zealand.

Our concern is that unless the eligibility criteria are sufficiently broad, the R&D tax incentive will not encourage R&D activity to be undertaken in New Zealand. Further, without large industrial businesses stepping up their R&D investment, including those owned by non-residents, it will limit the national increase in R&D investment that the Government is targeting.

We also note that while Methanex does receive support from Methanex Corporation to undertake R&D, there is a broader financial risk to that R&D not being successful (or not being undertaken) for which we are not compensated. That risk is that we are not able to continue to innovate, our facilities do not operate at their optimum level, and ultimately this has broader economic repercussions.

Dual purpose activities

The discussion document proposes to exclude "dual purpose" activities. It states "*if an activity was carried out for a R&D purpose and a non-R&D purpose, the entire activity would not qualify as a R&D activity*."

We are concerned with the application of this restriction to Methanex, as arguably in a commercial context all R&D that we undertake is with a non-R&D purpose. Ultimately, we are seeking to produce methanol for sale, in order to derive revenue and grow our business. Thus, R&D is not purely undertaken for an R&D purpose, it is also undertaken with commercial benefits in mind such as improving efficiency, increasing profits, increasing asset life, etc.

In our view, this proposed test, when combined with the other restrictions, will materially reduce the application of the regime – and it will not fulfil its intended purpose. To the extent that we can demonstrate that a particular activity has an R&D purpose, we believe it should qualify.

If the purpose of this limitation is to prevent "business as usual" expenses from being reclassified as R&D, then it should be clear that this is the intention and the extent of the limitation should be subject to commentary from Inland Revenue to ensure that the boundaries are sufficiently understood. In this context, we submit that in many instances there will be a mix of R&D and non-R&D in a particularly cost centre. For example, if we have a staff member activity involved in an R&D project for 50% of the time, and helping to manage a back-office activity 50% of the time, it would seem reasonable for 50% of those labour costs to be eligible R&D expenditure.

Commercial consideration

The discussion document proposes to exclude expenditure that relates to R&D activities for which the entity conducting the activity has received or could reasonably be expected to receive consideration.

We understand that the intent of this limitation is to ensure that the entity claiming the credit bears the financial risk of the R&D, and that there is no 'double dipping'. However, if this is the concern, we expect it can be appropriately addressed through a more targeted measure.

[1] Tax Information Bulletin: Vol 20, No 3 (April 2008)

As explained earlier, Methanex is reimbursed for certain R&D activities by Methanex Corporation. This is a commercial structure employed globally by many multinationals. It appears that the current proposals would exclude any R&D undertaken by Methanex that is subject to reimbursement, as this would be viewed as commercial consideration.

We submit that this approach would remove the incentive for multinational groups to undertake R&D activity in New Zealand. It also appears to be in conflict with the purpose of the regime to encourage all R&D activity. There are numerous economic spill over benefits to multinational corporations choosing to undertake R&D activities in New Zealand, which we believe should be weighed up against proposed "financial risk" requirements.

Again, intention of the regime is to increase R&D activities to 2% of GDP. Certainly where such projects would be undertaken by multinational operating in New Zealand – as will almost certainly be required to some extent – the current 'commercial consideration' restriction will severely limit that.

Software R&D

Methanex is not a "tech company", but nevertheless software is an important part of our business operations and is incorporated into many facets of R&D. It is very important to the success of the regime that software is included, and that the regime is workable and provides certainty to taxpayers.

Timing of expenditure

The discussion document states that tax incentives will be available in the year in which the R&D expenditure is recognised as a deduction for income tax purposes.

In our view it would be appropriate that capitalised R&D expenditure is eligible for the tax credit. Methanex will regularly capitalise project costs, including R&D, to the cost of the particular project/asset for financial reporting purposes. Such projects are often Work in Progress (or WIP) during the initial stages. Except to the extent that such expenditure meets the definition of "feasibility expenditure", it is not tax deductible until such time as there is a depreciable asset (and this would not qualify for the tax credit).

It seems to us arbitrary to provide a tax credit that is directed at incentivising R&D, but to restrict the ability to access that credit based on accounting treatment (noting that R&D that is expensed for financial reporting purposes is deductible for tax).

If a key goal of the regime is to increase R&D investment in New Zealand, then capitalised R&D expenditure should also be eligible for the credit.

Concluding statement

Methanex is supportive of the introduction of an R&D tax incentive, and we believe it will be an important part of New Zealand reaching the Government's goal of raising R&D expenditure to 2% of GDP.

However, it will be important to the ultimate success of the regime that it is broadly applicable and not unnecessarily restricted for multinational organisations. In particular, we believe that the eligibility tests and proposed restriction around commercial consideration will restrict many New Zealand subsidiaries of multinational corporations from accessing the regime, and this will have a flow on impact to its overall success.

Thank for you the opportunity to comment on the proposals. We hope our submission will assist in shaping the final details of the regime.

Yours sincerely

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s 9(2)(a)
Methanex New Zealand Limited

Tel: +64 4 472 5850
Fax: +64 4 473 3582
wellingtondirectors@bdo.co.nz
www.bdo.nz

BDO WELLINGTON LIMITED
Level 1, Chartered Accountants House
50 Customhouse Quay
PO Box 10 340
Wellington 6143, New Zealand

1 June 2018

'R&D Tax Incentive Team'
Ministry of Business, Innovation & Employment
Wellington

By email: RDincentive@MBIE.govt.nz

Dear R&D tax incentive team

Fuelling Innovation to Transform our Economy

Introduction

This submission on the research and development ("R&D") tax credit proposals set out in the *Fuelling Innovation to Transform our Economy* discussion document is made on behalf of BDO New Zealand.

By way of brief introduction, BDO is an international network of member firms. It has 1,500 offices in 62 countries and territories and 74,000 employees. The BDO New Zealand firms have 91 partners and 800+ highly skilled staff providing audit, tax, accounting and advisory services

Submission

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?

We agree with this approach for the intended purpose of the program i.e. to drive business R&D activity and provide an incentive for entrepreneurial R&D. However as was recommended in the recent Innovation and Science Australia review of the Australian R&D Tax Incentive, measures should ensure there is an incentive for collaboration between industry and research organisations.

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

We agree with a definition of business R&D that aligns with the five criteria of identifying R&D as defined in the OECD's Frascati Manual. The proposed activity definitions appear broad enough to capture business R&D in NZ, and although we note that the guidance material suggests that the definitions are to recognise a spectrum of R&D activity it is unclear whether they capture all three types of R&D as defined in the Frascati manual (basic research, applied research and experimental development). Specific guidance will also be required around the definition used in the core activity, particularly 'intended to advance science or technology'.

In addition, the definition of support activities which incorporates an 'and' test could significantly restrict the eligibility of business R&D activity as many businesses do not have dedicated resources or facilities available to conduct R&D activity, such that experimentation is often needed to be performed in a commercial environment where there is more than one purpose attributed to the experiment. Refer to further comments in question 9 on a 'dual purpose' exclusion.

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

We note that the core activity definition does not preclude social sciences, which are often precluded from R&D tax incentives in some jurisdictions, although these would be excluded by the proposed activity exclusion list.

It is unclear how the application of the 'intended to advance science or technology' test could be applied to certain industries such as engineering or software development. For example would the development of new functionality through resolving technical unknowns qualify as an advance in technology? As noted in the discussion paper software R&D is important to the economy.

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

The scientific method requirement is one of the key criteria identified in the Frascati manual and should help identify R&D activities from routine 'trial and error' type activities that are not planned or experimental.

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?

A materiality test could be overly complex, subjective and difficult to implement given the wide array of sectors with which business R&D could reside in. For example, how does one distinguish between the materiality of a software project from that of an agribusiness project, or for a project that would benefit the general population versus one for a minority?

A materiality test would likely favour certain industries over others and may prevent an innovator embarking upon a project that could result in multiple benefits for multiple industries. Many of our greatest inventions today such as penicillin and teflon arose as a consequence of research into other substances.

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

We have taken that this question refers to the definition of supporting activities. Most R&D projects would involve supporting activities that are either wholly or mainly for the purpose of, required for, or integral to the performing of core R&D activities. However the definition currently reads as an 'and' test which requires satisfying all three elements which would substantially limit any supporting activities that have more than one purpose. Please refer to the questions 2 and 9 responses for more detail.

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

Many of the exclusions listed could be part of the experimental process whether core or supporting. For instance, 'routine collection of information', 'complying with statutory requirements and standards' and 'quality control of products' would be pretty standard in a lot of experimental development activities, for example in clinical trial activity. Applying these exclusions to both core and support activity would severely limit the scope of eligible activity.

We strongly recommend the removal of dual purpose activities from the exclusion list. Application of this exclusion to either core or support activities would severely restrict the scope of eligible R&D activity. Please refer to the question 9 response for more detail.

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

Social sciences can often provide insights into the behaviours of populations that can lead to the development of improved processes or technologies such as in veterinary science. It should therefore not be excluded as a support activity.

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 application of a 'solely for a R&D purpose' test as noted in the discussion document is concerning. Most if not all business R&D activity is undertaken for more than one purpose, namely for the commercial reasons of making a profit. There is no point for a business to create a new product or process if there is no commercial benefit. Recent Australian case law on the meaning of 'the purpose' of conducting R&D accepted that there can be more than one purpose for conducting R&D activity.

A dual purpose activity exclusion to prevent 'business as usual' expenditure inclusion could severely limit the extent of activity that could access the program. This is easily demonstrated through an analysis of several examples of business R&D used as guidance by the Department of Industry, Innovation and Science with the Australian Tax Incentive. A prime business R&D example is 'baking stuff' in which the company used production line equipment to test whether the microencapsulated fish oil ingredient impacted on mechanical mixing of the dough since this could not be accurately tested on a bench scale. It then used the production ovens and vehicles to test the baking and transportation of the experimental bread along with non-experimental batches. A dual purpose activity exclusion would essentially exclude most of this project from a claim and would not likely meet the proposed $100K expenditure threshold for eligibility.

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

Limiting expenditure to only R&D labour would favour certain industries over others. For instance, software industries tend to have a high labour component, whereas manufacturers and agribusiness have a low labour component and high operational costs including the costs attributed to producing tangible products (as opposed to intangible products in software).

Some of New Zealand's greatest innovators (Britten motorcycles, Martin Jetpack, Hamilton engine) would have started their business with considerable prototype expenses and little salary. A labour cost only incentive would not provide an incentive for these businesses in the early years of development. We recommend an industry agnostic approach.

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?

Similar to our answer to question 10, such an approach would favour certain industries over others (i.e. software). We note that the Canadian R&D credit offers the capability of claimants to opt in to use a proxy amount. Proving an option to opt in could save on some administrative burden.

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.

We agree with the approach taken with the Australian R&D Tax Incentive regarding expenditure not at risk. This exclusion would apply to R&D conducted under a contract where there is certainty around reimbursement of expenditure on the activities irrespective of outcomes. But we caveat that the unreimbursed amount should be eligible for the tax incentive if it is clear that there will be partial reimbursement only.

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

We believe that the current definition would broadly be inclusive of R&D Software development, and it would be difficult to create a specific definition for this ever-evolving industry. We would recommend specific software eligibility questions to be included at the R&D Application stage as specific legislative definitions could rapidly become outdated.

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

It is arguable that continuity rules are not needed. The value of the unallocated credits should be factored into the share price and so the original investors, not the later shareholders, should effectively receive the benefit of the unallocated credits.

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

A $100k would limit access to the Incentive for start-ups and those that started their R&D program late in the financial year. Whilst it could be argued that it could incentivise a strategic approach to timing of the investment in R&D it could also limit it. The nature of an everchanging landscape in R&D means that a delay in undertaking a R&D project could significantly impact on the commercial reality of the project. We would recommend a $50K limit, particularly for smaller businesses.

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

We agree with the suggested approach of either pre-registration or ministerial discretion.

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

Early engagement and positive encouragement by the IRD with businesses likely or targeted to have higher R&D expenditure. Published guide-lines as to the sorts of factors most likely to be taken into account by the minister. An efficient process to minimise costs and provide timely decisions.

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

We strongly disagree with publishing of the names of recipients and the amount of support available, even after a 2-year period. This may lead to unnecessary competition and artificial inflation of claims to try and match a competitor. However specific projects (high level 'success story' descriptions) could be published if agreed to by the taxpayer to act as guidance. We note the jurisdictions where such an approach has been taken (Scandinavia) have a high proportion of government agencies undertaking R&D.

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

We note the current definition of eligible expenditure includes materials incorporated into plant. This could provide an unintentional benefit for large scale capital projects. We also note that ineligible expenditure refers to the cost of feedstock other than the net cost. Whilst we understand the rationale behind the approach the legislation should be carefully drafted in respect of materials consumed or processed in R&D activities.

The exclusion of the cost of acquiring intangible assets would prevent the purchase of software from a claim.

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

We agree that penalties should be made to advisors that are found to **deliberately** inflate claims to increase fees. However it is often difficult for an advisor to accurately quantify the amount of eligible expenditure in a R&D claim and for smaller claims may not recover their costs. In such cases a contingency basis may be the only way that an advisor can recover some of their costs. Accordingly this should be considered in the context of any integrity approach.

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

The 'right level' should be considered on a case by case basis. A large company with the facilities and resources and a large claim should be expected to maintain greater documentation that a small company making a small claim. Likewise some industries would be expected to have more supporting documentation than others. Agribusiness and manufacturers for example may have less supporting documents generated during experimental development than a software or biotech company.

As the taxpayer bears the burden of proof, it would be helpful for Inland Revenue to provide guidelines on what it considers necessary under various scenarios.

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

Such an approach is viable and would provide opportunities for software development in this space.

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

It is important to note that the government's intention of introducing the incentive is to build a better New Zealand where science, innovation and research can play an important role. Accordingly, Inland Revenue should implement standard integrity measures befitting of an incentive program, not of fraud. That is, they should embrace guidance materials and be willing to assist taxpayers new to the program.

The standard integrity measures should be sufficient. If experience subsequently suggests that R&D-specific measures are needed, the position can always be re-visited.

Thank you for the opportunity to submit on the proposals.

Yours sincerely
BDO WELLINGTON LIMITED

s 9(2)(a)

Corner Ruakura
& Morrinsville Roads
Private Bag 3221
Hamilton 3240
New Zealand

Ph +64 7 858 3750
Fax +64 7 858 3751
www.dairynz.co.nz

30 May 2018

By Email: RDincentive@mbie.govt.nz

SUBMISSION ON THE R & D TAX INCENTIVE

To: R & D tax incentive team

Name of Submitter: DairyNZ

s 9(2)(a) [redacted]

Address for service: DairyNZ
Private Bag 3221
Hamilton 3240

About DairyNZ

Thank you for the opportunity to submit on the R & D tax incentive discussion document. DairyNZ is the industry good organisation representing New Zealand's dairy farmers. Our purpose is to secure and enhance the profitability, sustainability and competitiveness of New Zealand dairy farmers and their local communities.

Comments

DairyNZ supports the re-introduction of the R & D tax incentive, the goal of increasing R & D spend per percentage of GDP and to continue a system of wider government support for New Zealand research, science and innovation.

DairyNZ is heartened that the R & D tax incentive is part of a wider package to encourage R &D and that the Government will continue to fund R & D through grants like the successful Primary Growth.

Having the R & D tax incentive available to industry research cooperatives (including levy bodies) that receive contributions or levy payments is supported by DairyNZ. A key proponent of the scheme must be the ability of non-tax paying entities to partake in the scheme, be they charities, or have exemption through the income tax act for scientific purposes or as a herd improvement body.

DairyNZ has answered only the questions from the discussion document that is relevant to DairyNZ or where we have the required understanding to give an informed answer.

DairyNZ is happy to meet with the R & D tax incentive team to discuss our submission.

Responses to the discussion documents 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?

DairyNZ response: DairyNZ encourages the government to extend the incentive to Crown Research Institutes. DairyNZ partners CRI's in several research initiatives and believes that opening the incentive to CRI's will simplify funding agreements and encourage R & D. DairyNZ have various JV's, partnerships and associate entities with CRI's and do not want legislation to be a disincentive for R & D investment in these vehicles.

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

DairyNZ response: DairyNZ supports a clear, practical and consistent definition within the tax system. Support activities for the core activities must be included for those entities that invest in infrastructure to be able to complete the core R & D.

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

DairyNZ response: DairyNZ strongly encourages the the ability of non-tax paying entities to partake in the scheme, be they charities, or have exemption through the income tax act for scientific purposes or as a herd improvement body.

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?

DairyNZ response: DairyNZ believes the materiality test should be removed from the legislation. DairyNZ invests in several projects that intend to improve Dairying in NZ in incremental steps. If the materiality provision was considered over DairyNZ as a whole rather than its individual projects then we consider the materiality provision acceptable.

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

DairyNZ response: DairyNZ believes Social Sciences should be included in the incentive scheme. Farmers and farm employees are under pressure from disruptive technology,

biosecurity risks and environmental factors, science that aids those pressures should receive an incentive.

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

DairyNZ response: Support and core activities eligibility should be consistent.

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?

DairyNZ response: DairyNZ opposes the introduction of ineligibility of dual purposes activity. This will exclude a significant amount of R & D expenditure. DairyNZ encourages a dispensation model for overseas expenditure where an entity wishing to invest offshore a % greater than 10% they can apply for dispensation. Biosecurity or GM activities may be prudent to conduct offshore.

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

DairyNZ response: DairyNZ believes a full cost funding model allows for maintenance and investment for science capability and infrastructure.

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?

DairyNZ response: The incentive should cover full overhead costs calculated by the business. Monitoring agencies should be able to assess if claims are reasonable.

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.

DairyNZ response: DairyNZ reiterates that CRI's and their subsidiaries should be included in the scheme to ensure R & D expenditure conducted in partnership is eligible and that a relationship with a CRI does not affect the eligibility of the other party.

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

DairyNZ response: DairyNZ believes the value should be set at $50,000 to encourage the small entities in rural New Zealand to conduct R & D specific to their environmental or biosecurity conditions.

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

DairyNZ response: A mechanism to go beyond the cap is recommended to allow the government to control the required investment in the scheme and to also incentivise investment above the cap amount.

Question 20: Are there risks with extending penalties to external advisers (who gain from a contingency fee in inflating a claim)?

DairyNZ response: DairyNZ supports the extension of penalties to external advisers.

R&D TAX INCENTIVE CONSULTATION

KIWINET RESPONSE – MAY 2018

SUMMARY OF RECOMMENDATIONS

1. Remove uncertainty around the R&D tax incentive and grant system as swiftly as possible
2. The R&D Tax Incentive needs to be refundable for start-up/early stage companies
3. Continue the Callaghan R&D Growth Grants Alongside the Tax Incentive
4. Promote in-licensing of commercially-derisked technologies from public research organisations as a starting point for R&D activity (Questions 2 & 3)
5. Ensure companies seeking to use the Tax Incentive are fully supported to encourage uptake and commercialisation (Question 17)
6. Fully support early-stage companies that risk falling through the gaps during the transition period (Question 19)
7. Reward R&D-Intensive Firms to incentivise increased R&D activity (Question 16)
8. Provide clear guidance materials and streamline application processes to minimise compliance costs (Question 21)
9. Lower the Minimum threshold to $20,000 (Question 15)
10. The definition of R&D (and eligibility) should be expanded to include development activities (the 'D' of R&D) (questions 3 and 7)
11. Include Dual Purpose R&D Activities in eligibility (Question 9)
12. Include non-labour costs in eligible R&D expenses (Questions 10, 11 & 12)

The tax incentive, as presented, is of limited use to small and early-stage companies – we urge the Government to continue and expand the Callaghan grant programmes alongside the tax incentive, and to ensure that these interventions support:

1. Development of innovative products and processes (R&D)
2. IP protection
3. All developments to at least Minimum Viable Product (MVP) level
4. Commercialisation support
5. In-licensing of technology

ABOUT KIWINET

Since its inception, the Kiwi Innovation Network (KiwiNet) and the wider Commercialisation Partner Network have demonstrated the power of bringing together diverse players across the science and innovation ecosystem to work towards a collective vision for New Zealand: a globally-competitive technology sector that delivers significant economic growth and prosperity. KiwiNet partners are dedicated to creating growth for our country through a collaborative approach to research commercialisation.

By leveraging the combined capability of NZ's research organisations and increasing the scale and impact of scientific and technology based innovation, KiwiNet is achieving greater commercial outcomes. KiwiNet invests PreSeed Accelerator Funding (PreSeed) from MBIE into transforming scientific discoveries from public research organisations into new products and services. Our investments have, to date, delivered a greater than five-fold return on investment to New Zealand. Our ambition is to maximise benefit from publicly-funded research by delivering innovative technologies that can diversify our economy and drive prosperity for all New Zealanders.

KiwiNet partners are Plant & Food Research, Callaghan Innovation, AgResearch, Otago Innovation, Landcare Research, Lincoln University, University of Canterbury, Viclink, WaikatoLink, AUT Enterprises Ltd, Cawthron Institute, Environmental Science & Research, NIWA, Scion, GNS Science and Malaghan Institute. Principal support is also provided by the Ministry of Business, Innovation & Employment (MBIE). www.kiwinet.org.nz

DISCUSSION DOCUMENT FEEDBACK

1. REMOVE UNCERTAINTY AROUND THE R&D TAX INCENTIVE AND GRANT SYSTEM AS SWIFTLY AS POSSIBLE

Having a solid and stable R&D tax incentive scheme is critical to start-up and growth entities. It provides confidence to entrepreneurs that financial support will be available throughout the lifecycle of the research and development process. Without a strong degree of legislative certainty, we envisage there will be fewer entrepreneurs willing to embark on research and development activities.

A stable research and development incentive scheme is also important platform for entities to raise capital; giving investors' confidence that the business have sufficient capital to be supported through its growth phase. Uncertainty in the system decreases business value, and in some situations this is potentially worth millions of dollars.

2. THE R&D TAX INCENTIVE NEEDS TO BE REFUNDABLE FOR START-UP/EARLY STAGE COMPANIES

The R&D Tax Incentive which is to be introduced from 1 April 2019 is proposed to be "non-refundable" and therefore the support it will provide to start-up and early stage businesses which are usually in a tax loss position is negligible. These businesses will only be able to carry forward their tax credit to a future tax year. This proposal is inconsistent which many global R&D tax credits (e.g. Australia, UK and Canada) which are refundable to early stage companies in a tax loss position.

As the Government undertakes further assessment of this issue we strongly urge it to consider a "refundability" mechanism and that these refunds are paid on a quarterly basis. Start-up companies need cash in order to fund their ongoing R&D Activities and to accelerate the growth of the business. While there is uncertainty around the refundability of the R&D Tax Incentive it will be more difficult for early stage businesses to raise capital from investors.

We acknowledge that a 'refundability' model could increase the potential risk to Government from fraudulent claims or companies exploiting loopholes. Improved transparency and accountability could be achieved by:

1. building in a pre-registration process through Callaghan Innovation; AND
2. establishing a lower R&D tax credit cap for smaller companies – those below a defined turnover threshold.

The Australian Government recently adopted this approach following a review of their R&D tax incentive policy – a $4M annual cap has been introduced for companies with a turnover below $20M (with an exemption for highly R&D-intensive biotechs conducting clinical trials).

3. CONTINUE THE CALLAGHAN R&D GROWTH GRANTS ALONGSIDE THE TAX INCENTIVE

We note that the Government is proposing that the Growth Grant Scheme will end 12 months after the start of the R&D Tax Incentive. While we support the introduction of the R&D Tax Incentive, our view is that the Growth Grants should continue as well, or that all grants that have been written and executed should be allowed to run until completion. Growth Grant funding has already been built into the business' cash flow and valuation models therefore the premature cancellation of the Growth Grant directly impacts both of these items. While there is

uncertainty around the Callaghan Grant programme it will be more difficult for early stage businesses to raise capital.

We strongly urge the NZ Government to consider offering a combination of both Growth Grants and the R&D Tax Incentive, so that start-up companies can access both programmes (but not for the same activities/expenses). By offering both programmes the Government provides businesses with options rather than a one-size-fits-all model, encouraging them to be innovative.

It will be important that both grant and tax incentive programmes are directed in a way to encourage commercialisation. The managed grant system by nature encourages companies to think more strategically about their R&D activities and consider a commercialisation pathway upfront, when compared to the more passive tax incentive model.

4. PROMOTE IN-LICENSING OF COMMERCIALLY-DERISKED TECHNOLOGIES FROM PUBLIC RESEARCH ORGANISATIONS AS A STARTING POINT FOR R&D ACTIVITY (QUESTIONS 2 & 3)

Licensing of a partially-commercialised technology opportunity from a public research organisation represents a much easier route to innovation for many NZ firms, particularly those with a minimal existing R&D footprint that are seeking to grow their innovative activity.

KiwiNet and our Commercialisation Partner Network (CPN) partners hold a robust pool of licensable technologies that have been progressed to point of private-sector-readiness through PreSeed Accelerator Funding (PreSeed) from MBIE. These technologies originate from publicly-funded research and have been commercially de-risked. These licensing opportunities represent a much more 'market-ready' option for may NZ firms, when compared with embarking on a new R&D programme from scratch. In many cases, the licensee needs to undertake minimal additional R&D activity to achieve a market-ready proposition, thereby providing a route to focus the tax incentive intervention towards commercialisation outcomes. Acquisition of technology from research organisations is an effective means for companies to integrate new technology into their new products & services, while also helping to avoid redundancy and duplication of efforts across New Zealand. Offsetting R&D to take a licensed technology from a research organisation to market would be an excellent use of the R&D tax incentive and would align the policy with the existing CPN and PreSeed commercialisation interventions – we strongly urge Government to promote in-licensing of PreSeed technologies as an opportunity for NZ businesses to maximise benefit from the R&D tax incentive.

R&D managers will need to demonstrate early wins if they are to hold any budget increases within their firm and in-licensing of technologies is the fastest way to achieve early wins. R&D Managers will have only a limited time window to demonstrate that an increase in R&D activity delivers commercial results for the firm. For many New Zealand businesses with limited existing R&D capability, in-licensing of a technology from the PreSeed pipeline for further in-house development would be a much easier means of increasing their R&D footprint than embarking on a new R&D programme from scratch. This provides opportunities for low R&D-intensive firms to build capability, to join up interventions across the research, science & innovation ecosystem, and thus driving R&D deeper into the New Zealand economy.

5. ENSURE COMPANIES SEEKING TO USE THE TAX INCENTIVE ARE FULLY SUPPORTED TO ENCOURAGE UPTAKE AND COMMERCIALISATION (QUESTION 17)

The managed grant system by nature encourages companies to think more strategically about their R&D activities and consider a commercialisation pathway upfront, whereas the Tax Incentive model is a more passive approach that may not generate genuinely new R&D activity leading to innovation gains.

Support for companies seeking to increase their R&D footprint through the tax incentive could also be provided through Callaghan Innovation. Companies wishing to take advantage of the R&D tax credit could be

mandated to first register with Callaghan Innovation (companies in Australia are similarly required to register with the Department of Industry, Innovation & Science). Even with a tax credit as financial incentive, companies typically require an effective internal R&D champion whom can make the case to for a more strategic approach to in-house R&D. Support for these champions could be provided by Callaghan Innovation to maximise outcomes from an R&D tax credit intervention. Guidance and support from Callaghan, prior to the R&D activity being undertaken, could have the benefits of:

1. Encouraging and supporting commercialisation of R&D outputs to realise benefits from business R&D to the economy and prosperity
2. providing business with greater comfort around appropriate R&D activity for compliance
3. providing an opportunity to advise and support companies with commercialisation strategies, to drive R&D outputs deeper into the economy
4. enabling Government to minimise ineligible (and in extreme cases, fraudulent) activity through a pre-approval or registration process
5. enabling Callaghan to connect businesses with technology in-licensing opportunities and capability from public research organisations, for instance the Commercialisation Partner Network (CPN).
6. Providing support to internal R&D/innovation 'champions' within New Zealand businesses.

6. FULLY SUPPORT EARLY-STAGE COMPANIES THAT RISK FALLING THROUGH THE GAPS DURING THE TRANSITION PERIOD (QUESTION 19)

Should the Government proceed with discontinuing the R&D Growth Grants, care will be needed to ensure that companies don't fall through the gap between the discontinuation of the R&D Growth Grants from April 2019 and suite of supporting interventions for start-ups and early-stage businesses that Government has indicated will be ready from April 2020.

The temporary grant that will 'mirror' the tax incentive for companies on existing R&D growth grants will be delivered at the lower rate of 12.5% - this may have a detrimental and destabilising impact on the cashflows of recipient start-up/early-stage companies. Further, it is not clear how start-up/early-stage companies that are not on an existing R&D Growth Grant (and for which the Growth Grant is the most appropriate intervention) will be supported during the transition period. We acknowledge that for many early-stage companies, the other existing Callaghan mechanisms such as Getting Started Grants, Project Grants and Student Grants will still be available during the transition.

7. REWARD R&D-INTENSIVE FIRMS TO INCENTIVISE INCREASED R&D ACTIVITY (QUESTION 16)

The R&D Tax Incentive should appropriately reward higher, more intensive R&D investment within larger companies and encourage firms to increase their R&D footprint. The tax incentive (at 12.5%) is lower than the existing R&D Growth Grant rate of 20%. R&D is a high-risk activity for firms that entails significant investment and uncertain outcomes. For companies with an existing R&D footprint that are already utilising the growth grant model, a transition to the lower tax incentive rate will in effect increase their R&D costs, thereby acting as a disincentivise which may in-turn lead to a *reduction* in their total R&D activity. Even with a tax credit as financial incentive, companies typically require an effective internal R&D champion whom can make the case to for a more strategic approach to in-house R&D. The job of these champions becomes more difficult as the real-terms cost of R&D becomes more expensive.

The Australian Government has responded to this challenge (in recently-announced changes) by linking the tax offset to the intensity of R&D expenditure. For companies with turnover less than $20M, the refundable R&D offset will be a premium of 13.5 percentage points above the company's tax rate with the offset capped at $4 million per annum. For companies with turnover of more than $20M, the rate of the offset is tied to the company's tax rate plus:

- 4 percentage points for R&D expenditure between 0 and 2 per cent R&D intensity;
- 6.5 percentage points for R&D expenditure between 2 and 5 per cent intensity;
- 9 percentage points for R&D expenditure between 5 and 10 per cent intensity; and
- 12 percentage points for R&D expenditure above 10 per cent intensity

Although the Australian R&D tax incentive provides a much larger investment and offset across the board, compared to the proposed NZ model, the Government may like to consider how to mitigate the reduction in funding that existing R&D-intensive companies may experience while transitioning from the 20% growth grants to the 12.5% tax incentive.

8. PROVIDE CLEAR GUIDANCE MATERIALS AND STREAMLINE APPLICATION PROCESSES TO MINIMISE COMPLIANCE COSTS (QUESTION 21)

The purpose of a broad-based R&D Tax Incentive is to encourage business to undertake R&D in a manner which is streamlined and supportive to their stage of growth. However, there is a concern that the compliance burden will be very high for SMEs. The reporting, capturing and compliance costs for SMEs is likely to be high and, in some instances, may be prohibitive to access the R&D Tax incentive.

To enable a streamlined compliance process, we ask that good clear guidance materials are published, and that application processes are designed to be streamlined. If not, time poor early stage companies will need to engage a consultant, which is just another cost to cash poor businesses.

9. LOWER THE MINIMUM THRESHOLD TO $20,000 (QUESTION 15)

The minimum eligible expenditure threshold is proposed to be set at $100,000 in order for a company to qualify for the R&D Tax Incentive. While this minimum threshold does not apply to R&D activities outsourced to an Approved Research Provider, we think this threshold is too high for start-up companies. Many start-up businesses run very light for the first year or so, and often they don't pay the founders. As such, the true "cost" to the business and shareholders to reach $100,000 of overheads and other direct costs would be much higher.

We recommend the minimum expenditure threshold is reduced to [$20,000] in order to allow early stage companies to access the R&D Tax Incentive at a time when it is material to their ongoing activities.

10. THE DEFINITION OF R&D AND ELIGIBILITY SHOULD BE EXPANDED TO INCLUDE DEVELOPMENT ACTIVITIES (THE 'D' OF R&D) (QUESTIONS 3 AND 7)

The proposed definition of R&D appears more oriented towards research than development. Companies are more focused on using scientific knowledge and applying it to secure competitive advantage or new products and processes. These applications are not a material advance in scientific knowledge but they are development.

Pre-production activities have been excluded but are an important part of developing the minimum viable product – this would normally be considered R&D by companies.

11. INCLUDE DUAL PURPOSE R&D ACTIVITIES IN ELIGIBILITY (QUESTION 9)

Many SME activities by necessity are dual purpose. Good R&D is based on market insight and frequently working with a potential customer.

The sole purpose test should be replaced with another requirement which indicates the main purpose of the activity needs to be R&D, but not always the sole purpose. Start-up and early stage companies are usually focused on developing new products based on customer-focused innovation. This enables them to create products which have real-world appeal. To achieve this, the R&D needs to occur in a commercial environment

and is often undertaken in collaboration with potential customers. As a result, most of these R&D activities have multiple purposes, even if R&D is the main purpose.

12. INCLUDE NON-LABOUR COSTS IN ELIGIBLE R&D EXPENSES (QUESTIONS 10, 11 & 12)

Labour cost can be a minor part of total R&D costs especially when the activity is developmental.

The Discussion Document proposes to limit the expenses a company can claim to only labour costs or to apply a standard overhead rate. While this might streamline the compliance process, it would have some direct disadvantages for start-up companies. Small companies that are very early stage, in order to keep costs low, often don't pay the founders. Therefore, limiting the R&D expense to labour expenses would be unfairly detrimental to early stage companies. Furthermore, in this circumstance, applying a standard overhead rate based on labour costs would also reduce the company's ability to include the actual costs it spends on the R&D project. The best solution would be to just let companies claim the costs they actually spend on the R&D.

Acquisition of technology is an effective and frequent means for developing new activities. Most companies adapt new technology into their new products and processes. By making this cost ineligible then either the company will be encouraged to reproduce that which has already been done or the benefit from the credit so small as to be unattractive. It will certainly impede the flow of technology from research institutions (see also Recommendation 3, above).

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HIKINA WHAKATUTUKI

R & D Tax Incentive

Your contact details

Name of organisation: Health Research Council of New Zealand

Contact person name: s 9(2)(a)

Position: s 9(2)(a)

Business demographics
N/A

(v) What industry sector does your business operate in?
Government Sector - Research Funding

(vi) Has your organisation ever received a R&D project or R&D growth grant? **N/A**

(vii) Has your organisation ever received any other R&D government support?
If yes, please specify names of grant(s)/support.
The HRC is a Crown Agent, which receives funding to meeting the objectives specified in its legislation and the scope of the relevant appropriations from Vote Business, Science, and Innovation ($92.996 million) and Vote Health ($0.29 million).

R & D Tax Incentive

Questions asked in the discussion document

Eligibility

Q1 If SOEs, Crown Research Institutes, District Health Boards, Tertiary Institutions, and their subsidiaries are excluded from the R&D tax incentive, what will the likely impact be on business R&D in New Zealand?

Currently, health research in NZ is funded primarily by the government, and conducted primarily by researchers within tertiary institutions, but the private sector is funding a significant and increasing share.

Private investment into R&D could increase if the rule enables businesses to claim incentives for health research which is subcontracted to research institutes in NZ (e.g. a Crown Research Institute like ESR which currently attracts investment not only from the private sector in New Zealand, but also from across the Asia-Pacific region). The proposed R&D Tax Incentive would support efforts by these types of entities to generate income by offering health research services to businesses within NZ and offshore.

Another example of private-sector health research which would be eligible for the tax incentive, and which could therefore be likely to increase as a result, would be clinical trials by large multinational companies. In the field of health there are important reasons for these companies to conduct research here, including New Zealand's diverse ethnic population mix, high standard of healthcare and trained professionals, and rich health datasets. These companies might gather data here to supplement their global datasets, or they might need evidence specific to the health of Māori and Pacific Islanders, or information on the determinants of disease in a New Zealand context. The health system in NZ also has important differences to those in other countries which may be particularly useful in a clinical trial context, in terms of the specific standard of care offered here (e.g. treatments or health services).

We don't have good estimates of the amount of health research being done in health-sector agencies such as District Health Boards (DHBs or Primary Healthcare Organisations (PHOs), but much of it is likely to be in partnership with either academics or with business. The 2017 NZ Health Research Strategy recommends that DHBs and PHOs participate more in research and development to improve health and reduce inequity. Where businesses fund this research directly, via contracts with health-sector agencies, it's appropriate for them to claim incentives. However, it will be important to clarify how the Incentive applies to more complex private-public partnerships. The 2017 NZ Health Research Strategy encourages researchers to collaborate to maximise the impact of their work; this explicitly includes a focus on partnerships between industry, iwi, universities, not-for-profit organisations, and health-sector agencies.

The Incentive should attempt to clarify eligibility rules, so that new partnership contracts can be drawn up with clear understanding of how tax incentives might apply (for example to a business which makes a donation to a philanthropic organisation for the purpose of supporting health research from which it might indirectly benefit, or an iwi which is involved in investment, co-design, participation, and/or implementation of health research to improve Māori health outcomes).

R&D Definition

Q2 How well does this definition apply to business R&D carried out in New Zealand?

The HRC considers that most health research should fit the first part of the definition; i.e. it is "*conducted using scientific methods that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes, or services.*"

However, it may be worth including the idea of knowledge translation, i.e. "*for the purposes of acquiring new knowledge or translating knowledge into new or improved materials, products…*". For example, the original definition would not encompass a business which conducts regular literature searches and meta-analyses of the global body of knowledge to enable healthcare professionals in New Zealand to practise evidence-based medicine.

Please also consider whether the incentive should apply to research *"for the purpose of […] testing or improving […] materials, products…".* For example, a clinical trial of a new medical treatment might be designed to test whether the product is safe and effective in Māori and Pacific patients, and in the context of standard of care in the New Zealand health system. Alternatively it could test the repurposing of a known product, device, or service in a new context.

Q3 Does this definition exclude R&D that you think should be eligible, please illustrate with examples?

The second part of the definition doesn't fit as well with health research such as analysis of large datasets to better understand the burden of particular diseases, the cost of health services, or the complex determinants of health at a national level. This kind of research might be done by health technology or pharmaceutical companies in order to develop products, services, or technologies related to health. Another type of research might be done by businesses which deliver healthcare in NZ (e.g. community services for mental health or for older people), to inform development of better healthcare services.

We would suggest consideration of the following changes: "*and that are intended to advance science, knowledge, services, or technology through the resolution of scientific or technological uncertainty".*

Q4 Does the scientific method requirement exclude valid R&D in some sectors, please illustrate with examples?

No; all health-related research and development by businesses is likely to be conducted using scientific methods, if these are construed broadly to include analysis of data, behaviour, etc.

Q5 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?

In general, health research in NZ does attempt both to address significant material problems (e.g. health issues) and to make significant advances in knowledge. However, there are some cases in which research is needed in order to translate existing knowledge to solve complex problems. Although the advancement of science is secondary in such case, the problems are still sufficiently complex that the problems cannot be solved with a straightforward application of existing knowledge. Alternatively there are cases in which basic research, intended to advance knowledge about a disease or population group, does not link directly with a material problem.

The HRC is currently involved in setting national priorities for health research, as directed under the 2017 NZ Health Research Strategy. The aim is to target the government's investment to health research that will have the greatest impact in achieving agreed goals. It may therefore be appropriate to introduce a multiplier. For example, if the R&D is not only eligible, but also is designed to address a material problem which has been identified as a priority area for New Zealand then it would be eligible for an incentive of more than 12.5%. The priorities could be appended to the policy and include for example the priorities identified under the National Science Challenges.

Another opportunity to introduce a multiplier could be evidence of collaboration between entities to increase the impact of the research. Where a business could demonstrate that as part of its research it was partnering with other organisations (such as iwi or not-for-profit agencies) to maximise the benefit to New Zealanders, it would be eligible for a greater incentive.

Eligible R&D activities

Q7 Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe.

Many of the support activities which are listed do have an important role in health research, when linked to core R&D activities (e.g. research by businesses which aims to assess the management or efficiency of healthcare services, or routine collection of health information). However, on their own these activities shouldn't necessarily be eligible for the R&D Tax Incentives.

One possible exception which might be considered for inclusion in the eligibility criteria is literature searches. Regular literature searchers and meta-analyses enable researchers to keep track of the global body of knowledge to inform evidence-based policy and practice. The NZ Health Research Strategy emphasises that this type of research is best done by the clinicians and policymakers who will directly use the research findings, but the sheer volume of new knowledge means there may also be a role for businesses in filtering this information for healthcare professionals in NZ (e.g. an independent medical publishing company like Research Review). For this reason, please consider revising the definition to remove the need for the knowledge to be new, i.e. "*conducted using scientific methods that are performed for the purposes of acquiring or translating knowledge or creating new or improved materials, products, devices, processes, or services.*"

Q8 Please provide any examples where social science research is/has been a core part of business R&D in New Zealand?

Social-science research to elucidate upstream determinants of health is becoming increasingly important in order to achieve the Government's goal of equity of health outcomes. In future, businesses may have an important part to play in gathering, linking, and analysing these complex datasets.

Q9 What is the likely impact on business R&D in New Zealand if dual purpose activities are ineligible for the R&D Tax Incentive? Please describe.

We agree that only R&D projects which are based in New Zealand should be eligible for the incentive (although up to 10% of the core R&D expenditure can be overseas), and that any 'business as usual' activities should be excluded.

Eligible R&D expenditure

Q10 What are the advantages and/or disadvantages of limiting eligible expenditure to R&D labour costs? Please describe.

We agree that the simplest option would be to limit eligible expenditure to direct labour required for R&D activities. However, this solution would lower the value of the incentive and therefore risk failing to achieve the intended boost to private-sector investment. Also, given that research providers are accustomed to charging overheads to government funding agencies, there would be an advantage to maintaining the same system whether the research activities were being funded by government or by the private sector. [Note however that NZ is unusual in this regard, and that in other countries funding agencies do not pay for overheads at research institutions.]

Q11 What are the advantages and/or disadvantages of setting overhead costs as a percentage of R&D labour costs? Please describe.

All government funding for R&D via Vote Research Science & Technology pays for the full costs of research, including overheads, which are calculated on a negotiated audited rate as a percentage of contract salaries. Given that researchers are accustomed to calculating research costs in this way, there would be an advantage to maintaining the same system whether the research activities were being funded by government or by the private sector.

Q12 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.

-

Q13 What variations or extensions to the definition of core activities are required to ensure it adequately captures R&D software activities?

-

Q14 Are there reasons why continuity rules should not apply to tax credits? Please describe.

-

Minimum R&D expenditure threshold

Q15 Is the minimum threshold set at the right level?

◉ Yes

The minimum threshold will exclude small start-up companies which are conducting health research in order to develop and refine new technologies, treatments or services. However, we understand that the administration costs associated with R&D investments lower than $100,000 are likely to outweigh the benefits, and that these companies tend not to be profitable until they have developed a viable product. Therefore, we think that separate policy options (such as a refinement to the existing growth grants or the R&D tax loss 'cash-out' scheme) should be developed to support these businesses.

Businesses in tax loss

Q16 How important is a cap or a mechanism to go beyond the cap? Please provide further details.

Although there are several advantages for large firms wishing to do health-related research and development in NZ, there are also a number of disadvantages which mean that NZ research institutes may not be competitive internationally. In Implementing the NZ Health Research Strategy government agencies will address these problems (e.g. by introducing a national clinical trial network, improving processes for ethical review, and fostering collaboration between government, institutions, and industry to enable a culture of innovation). These activities are designed to attract greater investment in R&D from multinational businesses, and therefore might result in companies investing in large clinical trials which might legitimately exceed the cap. Therefore, a mechanism to go beyond the cap will be important.

Q17 What features of a Ministerial discretion or pre-registration would make them most effective? Please describe.

Pre-registration would allow strategic forecasting and certainty for large businesses with significant long-term R&D programmes. However, since plans often need to flex in response to research findings or the commercial environment, Ministerial discretion would be the preferable mechanism to go beyond the cap, if this could be done in a timely way to enable timelines for patient recruitment.

Transparency & evaluation

Q18 What are your views on the proposed mechanisms to promote transparency and enhance evaluation? Please describe.

We support the proposed mechanisms to promote transparency and enhance evaluation by publishing the amounts of support provided to specific businesses, allowing government agencies to review and analyse the information, and integrating the data with related datasets.

Q19 Are there any other risks that need to be managed? Please describe.

-

Penalties

Q20 Are there risks with extending penalties to external advisors in this way?

-

Administration

Q21 What is the right level of information required to support a claim?

-

Q22 What opportunities are there for customers to submit R&D Tax Incentive claims via third party software?

-

Q23 What integrity measures do you think Inland Revenue should use?

-

Q24 Would you be willing to be contacted in future on the R&D tax incentive and/or implementation process?

- (•) Yes

Other feedback

Q25 Please provide any other feedback you may have on the proposed R&D tax incentive here.

viclink

PO Box 1762, Wellington, New Zealand
tel: +64 4 463 5135 **fax:** +64 4 463 5199

1 June 2018

R & D Tax Incentive team
MBIE

Dear Team,

Submission on R & D tax incentives

Viclink commercialises new technology projects from Victoria University and is contracted to do the same for the Health Innovation Hub, which comprises 3 DHBs.

Collectively we have a growing portfolio of start-up companies. Securing adequate funding for progressing these enterprises is a constant challenge

The scheme appears to be written with large organisations in mind. As proposed, it is not attractive to SME's and technology start-ups for multiple reasons:

1. (Q3) The definition of R & D appears narrow and more oriented to research than development. Companies are more focused on using scientific knowledge and applying it to secure competitive advantage or new products and processes. These applications are not a material advance in scientific knowledge but they are development.
2. (Q4) The definition is particularly difficult for IT developments which tend to be around new algorithms or code. These are always developments and not material advances in scientific knowledge.
3. (Q7) Pre-production activities have been excluded but are an important part of developing the minimum viable product. This would normally be considered by companies as R & D.
4. (Q9) Many SME activities by necessity are dual purpose. Good R & D is based on market insight and frequently working with a potential customer.
5. (Q10) Labour cost can be a minor part of total R & D costs especially when the activity is developmental.
6. (Q12) Acquisition of technology is an effective and frequent means for developing new activities. Most companies adapt new technology into their new products and processes. By making this cost ineligible then either the company will be encouraged to reproduce that which has already been done or the benefit from the credit so small as to be unattractive. It will certainly impede the flow of technology from research institutions.
7. (Q14) Small companies growing fast frequently secure new investment so continuity rules don't work. This means a tax credit is of no benefit.
8. (Q15) The minimum threshold is too high for most SME's.

The consequences of the above are to reduce the available activity suitable for a tax credit to be very small, to raise great doubt as to what constitutes R & D (D seems to have been removed as eligible) and to have apparently high compliance costs. Overall this looks less attractive than the granting

schemes already in place. It is certainly not as straightforward as the earlier R & D tax credit scheme put in place by the previous labour government.

As the scheme is of limited merit to SME's (and perhaps intentionally so) we urge MBIE to continue and expand the Callaghan project grant schemes with a focus on SMEs and start ups and to ensure that these address:

1. Development of innovative products and processes (R & D);
2. IP protection;
3. All developments to at least MVP level;
4. Commercialisation support;
5. Licensing in of technology.

Yours faithfully

s 9(2)(a)
[redacted]

VENSA'S SUBMISSION: PROPOSED NEW R&D TAX INCENTIVE

Name of Organisation: Vensa Health Ltd
Contact: s 9(2)(a)
Operating in NZ: 10 Years or more
FTE: 15
Sector: Health IT
Received a Growth Grant in 2015, 2016 and 2017

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?

ANSWER: Please consider how private R&D can be further incentivised to address key issues and problems identified at a government level (and by extension, by SOE etc). This would stimulate private R&D to solve real government problems, leading to a direct return on the government's R&D investment (as well as the indirect returns detailed at the beginning of your discussion paper) and the potential for creating global companies tackling these all around the world to generate an economic return for New Zealand in the form of new jobs and taxes.

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

ANSWER: See Q13 below which asks specifically about software R&D.

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

ANSWER: The reason that any organisation does any R&D is to solve real problems, R&D should include user research component which involves gathering data from your users or potential customers and iterate over time to offer a product or service which meets their needs.

User feedback and research should be considered as an R&D component, otherwise we're creating technology in the dark hoping that the solution can be applied to the problem.

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

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?

ANSWER: Should be either / or. A material scientific advance in something that is today considered a 'novelty' (ie not solving a material problem) could lead to solving the problems of tomorrow. Also, how do you decide what is a 'material problem that needs to be solved' and and what is a 'novelty'? Look, for instance, at the development of video games (by some considered 'novelty'), and how that technology has led to the further understanding and contributed to the resolution of many of today's problems.

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

ANSWER: We believe those activities should be apply to business R&D;

1. Market research, market testing, market development - this influences where the company needs to make R&D
2. The making of cosmetic and style changes to materials, product and devices, process, service - this influences the ability for end customers to commercially buy and use the product

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

ANSWER: The exclusions should not apply to support activities. For instance,

- In some cases, you need to conduct market research to define the problem that needs to be solved. If you don't conduct research, you will likely waste $. For this reason Market Research can be a very valid part of R&D activities, and hence should be included in the scheme.
- R&D needs data to define the problem, test, and resolve. Data collection is also a valid R&D activity which should be included in the scheme
- Why exclude social sciences? Arguably this is where we need the most R&D

Arguments can be made for all of the other exclusions as to why in some cases they are valid R&D Support Activities that deserve to be funded under the scheme.

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

ANSWER: Social science is defined as 'scientific study of human society and social relations'. There are numerous examples of core social science R&D, but some really relevant examples which are very pertinent to NZ today include:

- Why do people not go to the doctor when the need to?
- Why do people not take prescriptions when they are sick?
- What can we do to make primary health jobs more satisfying?

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?

ANSWER: In your example you talk of the 'Bright line test'. This is based on a threshold, for instance 'if you live in a house for more than 50% during a time period then this is your main home'. Would similar % rules apply here? It is difficult to see how this 'dual purpose' exclusion would work in practice without such clear cut rules.

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

ANSWER: The advantage is that it is simpler, and hence less of an administrative burden (although it would need to be a higher %); the disadvantage is that you run the risk of excluding valid R&D ie software and hardware costs where spend is not in the same proportions as R&D Labour.

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?

ANSWER: The advantage is that this is simpler, and hence less of an administrative burden (especially for small businesses). 33% would be an appropriate percentage

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.

ANSWER: This could prevent a firm seeking partial compensation when this was appropriate. It would be better to reduce the tax credit eligibility to the extent to which compensation is received (rather than excluding all of the expenditure if any compensation is received).

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

ANSWER: Software development is based on the scientific method (i.e., it starts with a question and background research about a real life problem in a specific industry; a hypothesis is formulated by proposing a design; the software is implemented and tested to verify the hypothesis; then the results are communicated by marketing the products to customers).

Usually, the reason to perform R&D software activities is to develop a software tool that would solve a particular problem. In the process of creating software, often times new advances in science or technology are produced (e.g., new algorithm developed to speed up processing of data in one industry can advance other industries). However, the intent may not necessarily to advance science or technology. The definition should be extended to capture the intent of R&D software activities.

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

ANSWER: Continuity rules should not apply to tax credits - this is disincentivizing to small startups which frequently seek capital. It would be better if the tax credit scheme was paid as a refund in the year it was received, therefore the shareholder continuity rules would not be an issue. This would also more accurately reflect the cash needs of small start up businesses (businesses in tax loss, which you are addressing separately).

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

ANSWER: The minimum threshold of $100k is too high for startups, which at the moment are the foundation of R&D activity. Surely the other R&D tests will rule out ineligible R&D. Why not reduce it to $20k?

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

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

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

ANSWER: We are concerned about the commercial sensitivity of publishing names of recipients and the $ amount. Even with a two year lag the delay of some R&D projects may make this info commercially sensitive. Need a process that company's can apply to not be published.

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

ANSWER: We are a SME startup company, which is similar to 80% of companies undertaking R&D in NZ today. From our perspective this scheme is going to reduce the amount of R&D undertaken by companies such as ours for the following reasons:

1. R&D by its very nature is a long term game. By making this a tax credit only payable once profit is made will make company's focus on short term profit instead of long term R&D.
2. Small companies who are making a loss are desperate for cash, which is why the current grant scheme works so well that it provides cash effectively when it is spent. However under this scheme it could be 5 years before a company reaches profitability and gets any cash back. It is hard to see how this will incentivise small companies to invest in R&D at all.
3. Current R&D tax incentives: Its not clear on what will happen to the current R&D tax loss credit, which has has worked well for small loss making R&D companies as it pays out companies 30% of Loss/R&D in the year of loss (no waiting until a profit has made).
4. The current CI grants have been a fairly smooth system and there's an opportunity to make the process at CI easier for companies to apply by breaking it into categories

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

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

ANSWER: Qualitative as well as quantitative information.

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

ANSWER: We can see how this can work via cloud accounting software (ie Xero) if the methodology is very clear.

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

1 June 2018

R&D Tax Incentive Team
Ministry of Business, Innovation & Employment
PO Box 1473
WELLINGTON 6140

RDincentive@MBIE.govt.nz

Dear Sir / Madam

ENTITLEMENT OF STATE OWNED ENTERPRISES TO R&D TAX CREDIT:
DISCUSSION PAPER *"FUELLING INNOVATION TO TRANSFORM OUR ECONOMY: A DISCUSSION PAPER ON A RESEARCH & DEVELOPMENT TAX INCENTIVE FOR NEW ZEALAND"*

THE PROPOSED TAX CREDIT

This is a joint submission responding to the above discussion paper, prepared on behalf of the following State-Owned Enterprises[1] ("SOEs"):

- Airways Corporation of New Zealand Limited
- AsureQuality Limited
- Kordia Group Limited
- Meteorological Service of New Zealand Limited
- Transpower New Zealand Limited

This submission has been discussed with other SOEs, who also agree with the submission and are separately lodging submissions under their own names.

We would appreciate the opportunity to meet with Officials to discuss our submission and will contact Officials separately to arrange this.

EXECUTIVE SUMMARY

We submit that SOEs (and their subsidiaries) should be included in the proposed R&D tax incentive regime. If SOEs are included in the regime this will:

- Increase the level of high quality R&D currently being undertaken across the SOE portfolio. New Zealand will realise the benefits from the "untapped potential" of SOEs to invest further in R&D activity, allowing for SOEs to maximise their innovation and contribution to New Zealand, leading to an increase in human, social and physical capital.

[1] As defined by the State-Owned Enterprises Act 1986.

- Help raise the SOE R&D investment from the current, average rate of 0.76%[2] of revenue (of the SOEs with an average R&D spend of less than 2% of operating revenue) to the 2% target set out in the proposal, a potential increase in R&D expenditure (and activity) to $12.9million[3] per annum (an increase of circa 160% in R&D activity).

- Create the potential for 91 new jobs through increased future R&D investment, including the flow on benefits of more skilled, highly paid jobs; as well as supporting the continued employment of 109 staff that are currently engaged in R&D.[4]

- Provide additional economic benefits to New Zealand through this increased employment as well as the spill over benefits from the underlying R&D activity.

- See a potential increase in returns to the shareholder of $3.9million per annum.[5]

- Avoid a potential incentive to outsource the existing R&D that is currently undertaken by the SOEs, amounting to over $8.6million of activity per annum[6], to private or foreign-owned entities;

- Ensure the IP developed through these R&D projects remains in state ownership;

- Increase the ability of SOEs to address the challenges that the Government highlights in its discussion paper.

- Ensure SOEs are able to operate consistently with the State-Owned Enterprises Act 1986, which requires SOEs to be "as profitable and efficient as comparable businesses that are not owned by the Crown".

- Ensure that SOEs have the ability to compete on a level playing field. This is vitally important; exclusion will mean SOEs will be placed at a competitive disadvantage and deny them neutrality with their competitors, who are eligible to claim R&D incentives for qualifying expenditure.

We use a number of statistics throughout the submission to illustrate the additional benefits that the New Zealand economy will receive from inclusion of SOEs in the R&D regime. These figures have been calculated based on our current expenditure on R&D, our weighted average cost of capital, current and expected operational revenue and staff populations. We have taken a conservative approach to calculating these figures based on a number of assumptions and would be happy to talk through these numbers further with Officials as necessary.

[2] Calculated as Airways, AsureQuality and Kordia's R&D expenditure as a percentage of their operating expenditure.
[3] Based on Airways, AsureQuality and Kordia raising their average R&D expenditure from 0.76% to 2% of operating revenue, calculated as a percentage of expected operating revenues.
[4] This is based on the R&D FTEs at our 5 organisations, extrapolated out based on the reinvestment of a 12.5% tax credit.
[5] This is based on SOEs reinvesting the 12.5% tax credit, assuming that the investment will only be made if the SOE gets a capital return. This calculation assumes all R&D for financial reporting purposes will qualify for an R&D tax credit (not expected to be the case).
[6] Based on the FY17 R&D spend of our 5 organisations.

OUR SUBMISSION

The main focus of this submission is on the eligibility of SOEs to access the R&D tax incentive regime. As such, we have not made submissions on other aspects of the proposals that are raised in the discussion paper. Once our primary submission has been satisfactorily addressed then we would look to engage on other design aspects of the regime, as necessary. We do wish to state upfront that the current definition of core R&D is too restrictive to allow genuine innovative activities to qualify; we also have concerns about the ability of the regime to adequately incentivise software innovation.

We have set out in the Appendix a brief description of each of the submitters, including the R&D activities that we undertake and details of investment we make (or have the potential to bring) to the New Zealand economy.

1. State-Owned Enterprises should be eligible for R&D tax credits

1.1 We submit that SOEs must be included in the R&D tax incentive regime.

1.2 The R&D tax incentive regime's principal goal, is to increase R&D expenditure in New Zealand to 2% of GDP (over 10 years). Further, as noted in the discussion paper:

> "*The R&D tax incentive will have a broad reach across our economy. 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.*" [Page 4]

To achieve the Government's goal of increasing R&D expenditure, and to ensure that the R&D tax incentive does have the broad reach that is intended, <u>all businesses</u> that are carrying out true R&D activity should have their R&D expenditure captured in the regime.

1.3 SOEs are significant undertakers of R&D and contribute materially to the R&D environment in New Zealand, as commercial businesses. Our R&D activity drives our success, both domestically and internationally, increasing our productivity, creating new jobs and new ways of doing business. Our innovations contribute to New Zealand's wealth of knowledge, skills and capabilities.

1.4 We also have room to grow. There is currently untapped potential that will allow SOEs to undertake greater R&D activity and that will allow SOEs to invest further in R&D activity. SOEs undertake business based on operating revenue, with a focus on cash flows, as opposed to raising capital (which is a difficult option). If we have access to a tax credit for the R&D activity we undertake, then this will increase our operating cashflow and allow us to reinvest in further R&D activity (see our illustrative figures below). This will unlock tangible benefits for the New Zealand economy and New Zealanders, both in revenue and in jobs, capitalising on the potential of SOEs.

What can SOEs offer to the economy?

1.5 For the year ended 30 June 2017, SOEs had $15.5 billion in revenue, while GDP for the same period was $268.1 billion.[7] As a percentage of revenue over GDP, SOEs made up 6% of the productive economy. From our perspective, if the Government's goal is to increase R&D expenditure to 2% of GDP, then inclusion of SOEs will go a long way to reaching this goal.

[7] See page 35 of the Financial Statements of the government of New Zealand for the Year Ended 30 June 2017

1.6 Amongst the SOEs that this submission represents, with an R&D spend of less than 2% of operating revenue, there is an average R&D spend rate of 0.76%[8] of operating revenue. With the benefit of a tax incentive, if this is raised to 2% in line with the Government's goal, this will see a potential increase in R&D expenditure to $12.9 million per annum.[9] This in itself represents a significant increase in R&D activity in New Zealand.

1.7 Due to their individual circumstances, we have separated MetService and Transpower from the above calculation (as MetService's average R&D spend rate is already above 2% of operating revenue and Transpower's revenue is regulated). On this basis we have taken the position that both of these entities will reinvest the return received from the 12.5% tax credit (based on FY17 R&D spend) directly into future R&D activity. Based on this, we expect that we will see an approximate increase in R&D expenditure to $7.5 million the year after.[10]

1.8 This increase in R&D activity will translate to the creation of new, highly paid, highly skilled jobs (as well as the continued employment of 109 staff that are currently engaged in R&D across our organisations). Based on our calculation, an additional 91 R&D staff could potentially be employed by our organisations if an R&D tax credit is made available to us and reinvested.[11] There are also spill over benefits, as with any increase in business, there will be increases across the organisation, and we expect there will be jobs created in other areas of the business.[12]

1.9 The crux of all of this is that, based on the additional R&D expenditure, we will see a potential increase in returns to the shareholder of $3.9 million per annum.[13] This extra benefit is calculated based on the reinvestment of the additional R&D spend of our organisations noted above (assuming that the investment will only be made if we get the capital return).

1.10 In addition, inherent in the creation of extra jobs, is the further spill over economic benefits from increased R&D activity and additional employment. The greatest spill over benefit of R&D activity in New Zealand is the utilisation of New Zealanders in R&D activities, improving and developing their skills and expertise.

2. Other benefits from including SOEs in the R&D tax incentive regime

We can add further value to the economy through our IP and collaboration

2.1 The inclusion of SOEs in the tax incentive regime will increase the amount of intellectual property (IP) that is created, and also retained, in state ownership. SOEs have the capabilities to grow New Zealand's productive economy, for both our shareholder and New Zealand and there it is unclear why the Government would incentivise only the private sector to create IP. If SOEs can access this tax credit then that would enhance our ability to add value to the economy through the creation of our own IP, instead of side-lining SOEs to acquiring IP developed by private sector organisations.

[8] Calculated as Airways, AsureQuality and Kordia's R&D expenditure as a percentage of their operating expenditure.
[9] Based on Airways, AsureQuality and Kordia raising their average R&D expenditure from 0.76% to 2% of operating revenue, calculated as a percentage of expected operating revenues.
[10] Based on the FY17 R&D spend of MetService and Transpower, plus the additional R&D expenditure from the reinvested 12.5% tax credit calculated on this expenditure.
[11] This is based on the current R&D FTEs at our 5 organisations, extrapolated out based on the reinvestment of a 12.5% tax credit.
[12] We recognise that not all R&D is successful and that there is a risk element involved. However, for SOEs this risk is minimised as marginal R&D will not be undertaken, given the mandates under which SOEs operate.
[13] This is based on SOEs reinvesting the 12.5% tax credit, assuming that the investment will only be made if the SOE gets a capital return.

2.2 Further to this, including SOEs in the regime will allow for more collaboration with other businesses in undertaking R&D activity, including Crown Research Institutes. These partnerships, with those who have skills that SOEs do not have (and vice versa), will increase the overall knowledge and ability of each entity, building New Zealand's human and physical capital to transform the economy. As with much R&D activity, with collaboration comes a greater scope to innovate, and to learn.

We address the challenges facing New Zealand in our daily business

2.3 The discussion paper also sets out a number of challenges that New Zealand faces and how to address these issues[14]. We each address these issues as part of our core business. Access to a tax credit will enable us to boost our R&D activity, helping us to provide solutions to data and security and climate change, to changing demographics and the low value economy, and to illness and disease. For example:

- Airways are continually investing in the development of more efficient air traffic management and flightpaths, significantly reducing aviation carbon emissions.

- AsureQuality is leading the way in providing the diverse assurances that the food produced for people worldwide meets the regulatory and industry standards for safety, quality and market access. We do this through our testing, inspection, auditing and certification activities, and the protection of the food supply through our biosecurity activities. The science, technology and digital backbone of these activities provides clear benefits to New Zealand's food industry through any improvements to our efficiency, capacity, time for delivery and new capabilities.

- Kordia's focus is on data and security, in order to make the digital world more secure, reliable and resilient.

- MetService tackle the high carbon economy and climate change with our forward-thinking innovations, applying scientific rigour, valuable data and insights, and leading-edge technology to create ground-breaking new products and services that redefine the weather industry.

- Transpower is focussed on delivering the electricity transmission services required for New Zealand's energy future. To do this, it needs to utilise R&D and innovation to create sustainable and efficient solutions to help it respond to climate change factors and grid reinvestment challenges.

    - New Zealand uses the greatest amount of electricity during winter. As solar will be significantly less effective in winter, but electrification will grow, the size of the winter supply shortage is expected to increase with the penetration of solar. New Zealand will continue to be exposed to winter and dry-year supply shortage risks because of continued reliance on existing hydro assets and the variability of solar and wind.

    - These unique circumstances require a customised solution to meet New Zealand's future demand for electricity. New Zealand cannot wait for solutions to be developed and deployed overseas before importing them, and will need to be at the leading edge of energy innovation to supply winter demand, especially in dry years. New Zealand must invest resources in innovation and adopt new technologies, as related to energy development.[15]

[14] See page 5 of the discussion paper.
[15] Extracts are from Transpower White Paper Te Mauri Hiko – Energy Futures

2.4 We lead the industry in our respective areas and for many of us we are the only local players in these fields. Our exclusion will only act to slow development in these specific areas (with a flow on impact to the wider sectors / industries in which we operate), while our inclusion will enhance the wellbeing of New Zealand.

2.5 To fully maximise the benefits R&D activity provides, we consider the R&D regime should capture as much R&D activity as possible.

3. The principal objective of every SOE is to operate as a successful business – to be as profitable and efficient as comparable businesses

3.1 Section 4 of the State-Owned Enterprises Act 1986 ("the SOE Act"), states the following:

> *4 Principal objective to be successful business*
>
> *(1) The principal objective of every State enterprise shall be to operate as a successful business and, to this end, to be—*
>
> *(a) as profitable and efficient as comparable businesses that are not owned by the Crown; and*
> *(b) a good employer; and*
> *(c) an organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so.*
>
> *(2) For the purposes of this section, a good employer is an employer who operates a personnel policy containing provisions generally accepted as necessary for the fair and proper treatment of employees in all aspects of their employment, including provisions requiring—*
>
> *(a) good and safe working conditions; and*
> *(b) an equal opportunities employment programme; and*
> *(c) the impartial selection of suitably qualified persons for appointment; and*
> *(d) opportunities for the enhancement of the abilities of individual employees.*
>
> [Emphasis added]

3.2 SOEs were created as commercial operations with a goal of being successful businesses, as profitable and efficient as those not owned by the Crown. It is therefore inconsistent for SOEs to be specifically excluded from the proposed regime. SOEs succeed on their own merits and are accountable for the operations we undertake. This means that we strive to be better businesses and innovate for our customers, unrestricted by the Crown and in line with comparable businesses.

3.3 If SOEs are to operate as successful businesses, as profitable and efficient as comparable businesses, then we should be treated as successful businesses and included in the R&D tax credit regime.

4. Why have SOEs been excluded?

4.1 The previous R&D regime was deliberately designed to include SOEs. The following explanation in support of including SOEs was included at paragraph 3.32 of the policy document *R&D tax credits - Definition, eligibility criteria, eligible expenditure - An officials' issues paper on matters arising from the Business Tax Review:*

> "*3.32 Crown-owned businesses that are not funded to do R&D, such as state-owned enterprises, should be eligible for the credit. In principle, crown-owned businesses that are funded to undertake R&D should not be eligible for the credit if receiving it would constitute double funding of R&D. There are options for avoiding double funding, and officials will do further work on this in consultation with crown agencies*."

4.2 Even though SOEs were not eligible for the later Callaghan Innovation Growth Grants, there is a clear difference between these incentives. Specifically, the grants are a targeted regime for providing funding to innovative businesses that met certain criteria. That system was never intended to be a universal source of funding for all innovation, and had a smaller, more limited budget. We understand that the existing Callaghan Growth Grants apply to only 300 taxpayers whereas the R&D tax credit regime is expected to apply to 2000-3000 taxpayers.[16]

4.3 The position is different with a R&D tax incentive; the budget is bigger and the intention is to increase all R&D activity in New Zealand. A greater population of businesses can be eligible for a R&D tax incentive without requiring specific approval and the R&D tax incentive is designed to put similar businesses on an equal footing to increase R&D activity (not pick winners and losers such as through a grant process). If SOEs are to be excluded from this regime, there must be principled, not fiscal, reasons for doing so.

5. To not include SOEs will create distortions in the tax system

5.1 Exclusion of SOEs from the R&D tax incentive regime will hinder the ability of each of our organisations to compete equally with the other businesses (both here and overseas, that operate in our sector). This will create unnecessary and detrimental distortions to the tax system (and to New Zealand's economy).

6. The discussion paper **queries "If SOEs, Crown Research Institutes, District Health Boards, Tertiary Education Organisations, and their subsidiaries are excluded from the tax incentive, what will the likely impact be on business R&D in New Zealand?"**

6.1 Addressing this question directly, we consider that if SOEs are excluded from the regime, this will:

- This will create an unnecessary imbalance in the commercial environment, with SOEs no longer on a level playing field with our competitors. SOEs are intended to compete and be as profitable as comparable businesses, but exclusion from the regime will mean that SOEs start at a disadvantage. SOEs risk getting left behind in their industries as other businesses utilise the R&D tax credit regime.

[16] Dr Megan Woods interview with National Business Review: https://www.nbr.co.nz/article/rd-tax-break-rate-other-details-air-ck-p-215838

- It will provide less incentive for SOEs to proceed with capital investment, the sort of investment that will benefit New Zealand and create / maintain highly skilled jobs. If SOEs are starting with a disadvantage, this will affect decisions to undertake large capital projects, the very projects where there are greater opportunities for broader learning and development.

- Any SOEs that are commercialising R&D in conjunction with the private sector will need to consider whether contractual arrangements should be structured in a manner to allow those other parties to be eligible for R&D tax credits (for example, transferring ownership of intellectual property), which may not always be the best outcome for the New Zealand economy; commercially this is what private sector firms would do (with an expectation of some level of sharing of the benefit) and as such should be the expectation on SOEs under the SOE Act.

- It will be harder to retain talent and attract R&D specialists (both within New Zealand and internationally) to continue our innovative work, when other firms have access to the R&D tax credit and will be able to offer greater opportunities because of a tax advantage. The abovementioned structuring incentives, including IP transfer will also impact on staff engagement in R&D.

- The SOE Act also states that SOEs must be good employers, providing opportunities for the enhancement of the abilities of individual employees. To do this, we need to be able to maximise our output, much of which relates to R&D. The leading scientists, engineers and forward-thinkers are attracted to the best organisations where R&D activity is being undertaken. Access to the R&D tax credit regime would allow SOEs to further the R&D activities we already undertake, continue to enable us to attract the best employees, and enhance the learning and training environment we provide for our employees. Our employees gain invaluable skills and knowledge working with us and the R&D tax credit regime will strengthen the opportunities available for our employees.

- SOEs meet all the other proposed criteria. Our R&D will bring all the benefits outlined in the discussion paper and yet our R&D won't be encouraged, while the R&D activity of comparable businesses will be.

6.2 Taking the above into account, the inclusion of SOEs in the R&D regime will have nothing but a positive effect on the New Zealand economy, bringing in significant benefits. While our exclusion would create distortions, our inclusion will work the other way and take New Zealand forward.

Concluding statement

6.3 We are of the firm belief that SOEs should be included in the R&D tax incentive regime.

6.4 New Zealand is a country of innovation and a world leader in the development of new technologies and novel ideas, with SOEs at the forefront of this.

6.5 We see the tax incentive regime as an opportunity for the Government and New Zealand to give SOEs and other organisations the chance to increase their contribution to the development of New Zealand − and we believe that significant tangible benefits will be realised from this.

Thank you for taking the time to consider our submission. As noted above, we would like to have a meeting to discuss our submission and will shortly be in touch to arrange this.

Yours faithfully

s 9(2)(a)
Airways Corporation of New Zealand

s 9(2)(a)
AsureQuality Limited

s 9(2)(a)
Kordia Group Limited

s 9(2)(a)
Meteorological Service of New Zealand Limited (MetService)

s 9(2)(a)
Transpower New Zealand Limited

Contact

s 9(2)(a)

s 9(2)(b)(ii), s 9(2)(ba)(i)

aranzmedical

June 1, 2018

To whom it may concern,

Please accept this submission related to ARANZ Medical's view of the upcoming proposed changes to the Research & Development Tax Incentive (R&D tax incentive).

Outlined below is some background to our company:

- We, ARANZ Medical Limited, have been operating in New Zealand for over 10 years.
- We have about 25 FTEs in New Zealand, mostly highly skilled engineering and software resources.
- We are all about innovation in terms of product and services offering to global healthcare markets – our products are used in more than 35 countries.
- Our products involve a mixture of custom designed and manufactured scanner hardware, firmware, health information management systems and analytics systems.
- We are winners of multiple innovation awards over the years including: winner of NZ Hi Tech awards, the supreme winner of the NZ Innovation council award in 2016, and the 2016 winner of the World Information Technology and Services Alliance excellence in private sector award.

Through our parent company, ARANZ Healthcare we are the recipient of a Callaghan Innovation R&D Growth Grant. This grant has been enormously helpful in enabled us to increase invest in our research & development resources in New Zealand to drive business growth.

Although full details of the proposed R&D tax incentive are not yet available we believe it will negatively impact our business for the following reasons:

1. **No significant impact - typical early tech companies are not profitable**

   As a typical technology company, our business strategy is to prioritize growth over profitability. In fact over the last few years the company has been in a loss making position as we have continued to invest heavily in innovation. Consequently the proposed tax incentive scheme would be of limited benefit to our organization.

2. **Less Budgeting certainty**

   In a similar vein, the current grant system is cash based and provides certainty allowing us to effectively budget and fund our research & development investments. This has enabled us to make the required resource changes, add new employee, etc., in the knowledge of these quarterly cash inflows.

3. **Definition**

   We have concerns over our current understanding of the definition of eligible R&D under the new proposal, especially on the side of development. Our understanding is

that classic software development processes may be more difficult to include in the proposed definition.

4. Reduction in rate from 20% to 12.5%

The lowering of the percentage rate in the funding will impact on our ability to invest in development The pace of change in our market is accelerating, as it is in many markets globally. To stay competitive in the market we need to continue investing strongly in innovation to ensure our products stay ahead of the competition. Any reduction in support will negatively impact this ability.

Thank you for your consideration of this submission.

Kind regards

s 9(2)(a)

ARANZ Medical Limited

CANTERBURY REGIONAL BUSINESS PARTNERS LTD SUBMISSION ON THE DISCUSSION PAPER ON A RESEARCH AND DEVELOPMENT TAX INCENTIVE FOR NEW ZEALAND

1 June 2018

INTRODUCTION

1. Canterbury Regional Business Partners Ltd (CRBPL) is a joint venture company owned and operated by the Canterbury Employers' Chamber of Commerce (CECC) and ChristchurchNZ. CRBPL was established to deliver the Regional Business Partner Programme in the Canterbury Region.

2. CRBPL is supported by a group of Contract Partners involving the regions' Economic Development Agencies (EDAs) and Chambers of Commerce (Chambers) covering North Canterbury, Christchurch, Selwyn, Ashburton, and South Canterbury.

3. CECC has two FTE funded Callaghan Innovation regional business partners (RBP) whose role is to engage with local businesses already conducting R&D or interested in developing an R&D programme. The RBPs are responsible for connecting eligible businesses to the right support and funding mechanisms to break down barriers to innovation and ensure businesses have access to the best opportunities and expertise.

4. Callaghan Innovation RBPs work closely with businesses to help them understand the innovation landscape, develop their own R&D propositions, and navigate the requirements and processes to access funding and support. Some businesses know with full confidence that they are undertaking highly innovative R&D, some have no idea whether what they are doing constitutes R&D or not. Regardless, the access to tailored guidance from advisors who know the innovation landscape and understand R&D well adds significant value to the businesses in becoming better R&D performers.

5. As a region, we believe the maximum benefit of R&D support mechanisms, including the RBP programme, will be gained by delivering the programme according to a model of collaboration that leverages regional expertise and connectivity.

SUMMARY

6. CRBPL supports the use of tax incentives to increase R&D investment by business in New Zealand. The Tax Credit scheme will generate support for R&D more widely across the New Zealand business sector as it will aid in de-risking the high cost of R&D, particularly by larger businesses with growing R&D programmes.

7. A Tax Credit scheme will be of benefit only to businesses who are already committed to relatively high and recurring R&D spend. Tax credits do little to support R&D in small and medium sized businesses and do very little for high growth-potential technology start-ups.

8. For this reason, our chief concern is ensuring a consistent and cohesive suite of R&D support mechanisms, from low-level targeted grants, to project grants, through to tax credits, as well as associated programmes, networks, and advisory services.

9. CRBPL is a business support agency and it will be our role to explain the full suite of support and grants including the tax credit system. It is critical for business confidence that all R&D support programmes are consistent, compatible, and effective at all stages of engagement and delivery.

10. We continue to support the Regional Business Partner programme as an effective business support tool, particularly in providing guidance and assurance for businesses seeking to increase their R&D investment.

11. Callaghan Innovation, including through the Regional Business Partners, connects businesses with the innovation and research community and emerging technology opportunities. Callaghan works to ensure that NZ business R&D is top quality and truly innovative, driving productivity and driving New Zealand up the value chain particularly in the export sector. It is essential that Callaghan retains this role to connect businesses to the appropriate stage of support in the pipeline.

12. Many of the questions in the discussion document are more appropriate to be addresses by businesses engaged in R&D, rather than support agencies. We do have the benefit of a deep and broad view, working with businesses in the nuts and bolts of R&D support, so for this reason we have grouped questions together according to key areas we believe we can add insight.

13. Current Growth Grants entail minimal administrative complexity for businesses once they have met eligibility criteria. There is evidence that some current growth grant recipients are of the view that if the system 'isn't broken, it doesn't need fixing'. However, we recognise that while the growth grant works for those who reach the current threshold, the tax credit system is an attempt to encourage more businesses to work towards a higher level of R&D investment.

14. For this reason, we recommend that the same definition for R&D be applied consistently to R&D tax credits and R&D grant programmes. In our view it is important that the definition emphasises and maintains scientific and technical rigour, balanced by a pragmatic interpretation of eligible supporting activities that are not technically R&D, including some instances of research in social sciences.

15. We support the lowering of the eligibility threshold to $100,000 of R&D spend in one year, on the proviso that related eligibility parameters and restrictions are clarified.

16. CRBPL supports the proposal that up to 10 per cent of the eligible expenditure on an R&D project can be for offshore R&D costs if the work is part of a New Zealand based project. It will encourage and create opportunities for additional foreign investment into New Zealand R&D and will enable greater transfer of technical knowledge into New Zealand R&D businesses. In our view the 10% limit is a good starting level but could be increased if a review demonstrated positive results.

17. To ensure a smooth transition from active growth grants to tax credits, we recommend that growth grants approved before 31 March 2019 be allowed to run the full 3-year span. This will help maintain business engagement in the meantime until the tax credit system is fully implemented.

COMMENTARY ON DISCUSSION DOCUMENT QUESTIONS

The definition of R&D, supporting activity, exclusions, and dual-purpose activities

18. The definition and interpretation of legitimate R&D has been a point of significant confusion for businesses. A clear and consistent definition for R&D is critical. CRBPL recommends that the same definition of R&D be consistently applied to the proposed tax credits and the current grant programmes.

19. The current growth grant definition is a rules-based assessment with external accounting certification. The standard NZ IAS 38 categorises the R&D from an accounting perspective.

20. We support the Government's proposal to adopt a definition that emphasises the resolution of scientific or technological uncertainty in the research and development of new or improved opportunities with good commercial potential.

21. Our core view is that it is essential to use a definition that encourages rather than deters businesses from pursuing R&D activity and support for that activity. However the purpose of R&D incentives must be to encourage businesses to be more *innovative* in the development of new products and processes by overcoming scientific and technical uncertainty – not simply to develop new products and processes alone. We want to see increased innovation by enabling businesses to do better innovation, not by lowering the threshold of what we consider innovation to be.

22. We acknowledge ExportNZ's comment in their submission endorsing a change in thinking towards defining core R&D activity as 'conducted using a *systematic* approach' instead of 'those conducted using *scientific methods'*. We support this endorsement as in our view this will capture a wider range of research and development activity without jeopardising the necessary focus on solving scientific or technical uncertainty. It better enables the inclusion of social science research in R&D projects when it is still systematic, iterative, uncertain, even if not strictly science or technology.

23. We also acknowledge BusinessNZs concern in their submission that the proposed definition over-emphasises 'research' and underemphasises 'development'. We are not opposed to further emphasising and clarifying the inclusion of 'development' in the definition.

24. However, it is important that the term 'development' is not misunderstood as 'design and build'. That is, the development must be iterative, uncertain, experimental – it cannot simply be pre-commercial production.

25. Our concern is that businesses often see the innovation as being in the use or application of the product, but 'new' products of this nature don't necessarily require technical R&D to produce. R&D instead focuses on the innovation in the ways the new product is created – by creating or manipulating scientific or technical knowledge in order to generate a new or improved outcome. **This highlights the need not just for robust definitions, but for suitable advisory services and processes to help businesses identify the R&D they are already doing or could be doing.**

26. Such an understanding might also alleviate concerns that 'production equipment' be included in the definition for the reason that the creation of production equipment if fundamental to the creation of new products. On a fuller understanding of 'development' it is clear that developing

new methods or tools or production can be legitimate R&D, covered in paragraph b of the Government's proposed definition if not paragraph a. Furthermore, the danger of including 'production equipment' per se is that it generates confusion around the fundability of capital.

27. Regarding excluded activities, our view is that the proposed definition does duly recognise the importance of supporting activities that are not strictly R&D. **Our recommendation is that a high level of discretion and pragmatism is applied in the application and reporting process to capture activities from the list of exclusions under paragraph (b) of the definition.**

28. It is important that businesses clearly understand that the list of exclusions can apply so long as the activity relates back to substantive R&D activities, and that a pragmatic approach will be taken. There is a danger that businesses will simply see the list of exclusions and be deterred from seeking support all together.

29. A pragmatic view of businesses' need to develop new products that are fit-for-purpose and commercially viable supports including gresearch in social sciences. As raised in the discussion document, this is increasingly valid as social science research outcomes are embedded in software solutions. **We therefore recommend that social science research be included in eligible costs where it is clear that it is an essential supporting activity of a broader R&D proposition or solution**. The usability of the solution is essential to successful product development. This is further heightened when the solution has a core educational purpose, for example Banqer, Dexibit, any VR/AR training solutions, etc.

30. The inclusion or exclusion of dual purpose activities in the tax credit scheme would benefit from a great deal of clarification or examples. In our view the project or activity should, from the business perspective, have the dual purpose of legitimate R&D and successful commercialisation/revenue generation. There cannot be an expectation that businesses are required to do R&D purely for its own sake. It's hard to see how a business could be carrying out legitimate R&D in the commercial production of their solution to scientific or technical uncertainty, but it might be the case that after commercial production has begun a business would undertake further development or research to appreciably improve the product.

31. **We recommend greater clarity of dual purpose activities and the recognition that a business can continue to, or begin to undertake legitimate R&D on a product or process that is already being commercially leveraged.**

ELIGIBLE OFFSHORE R&D COSTS

32. The inclusion of offshore research costs will be beneficial and cost effective. It will support New Zealand businesses to access leading-edge technologies and expertise, encouraging the transfer of technical knowledge back into New Zealand businesses.

33. Currently R&D project grants can co-fund the costs of bringing offshore experts to New Zealand to work as an external R&D partner with a business. However, some R&D conducted by New Zealand businesses necessarily and rightly targets offshore markets. Ensuring product development is fit for market will sometimes require research and development to be conducted in situ. This can be particularly seen in advanced manufacturing, Agritech, and Biotech sectors.

34. Callaghan Innovation initiated the International Connections Scheme (ICS) in 2017. The program co-funds international travel and associated costs (up to 50%) capped at $3,500 to assist SMEs to attend technical conferences or events. This program has had strong positive feedback from successful applicants.

35. We already recognise the importance of enabling early-stage R&D businesses to establish international R&D partnerships to lift R&D capability and to improve channels to market. It follows that enabling businesses to leverage these offshore partnerships once they are established R&D performers is a practical and consistent move.

36. Besides R&D partnerships, many businesses have relationships with offshore entities via Joint Ventures, foreign ownership or as subsidiaries. The ability to claim a portion of appropriate research costs would be a useful advantage and will encourage foreign investment in New Zealand based R&D entities.

37. The proposed inclusion of 10% (with conditions) of offshore research is therefore considered a positive step. **We recommend a careful evaluation in order to assess the potential for lifting the percentage once it has been in operation. However, it must also be carefully designed to ensure it expands and enhances New Zealand research capability and does not simply reduce the cost of outsourcing R&D to offshore markets.**

ELIGIBLE EXPENDITURE, OVERHEADS, AND COMMERCIAL CONSIDERATION

38. The CRPBL experience with overhead calculations for grant applications spans several iterations of R&D grant application protocols. The overhead costs calculated by the business created confusion and conflict. A range of 5%-25% was initially set which has been replaced with a 20% flat rate applied to hourly wage value.

39. It is far easier for all to manage and understand a flat rate. It is recommended to use the 20% overhead rate currently used in R&D project and growth grant costing calculations. Most businesses are aware and have accepted this method in our experience.

40. It is appropriate to strengthen the "At Risk" rule of the 2008 tax credit and adopting the Australian rule for commercial considerations. This also aligns the tax credit to international research programs.

ADEQUATELY CAPTURING SOFTWARE R&D ACTIVITIES

41. Software is a growth sector for New Zealand and more activities are expected. The Percentage of project grants for software focused development in products and services supported by CRPBL network for the last three years has been 41%. The current year rate shows software projects has lifted to 46%.

42. CRBPL RBPs have regularly encountered difficulty with software companies in identifying or articulating the 'technical stretch' in their projects. If the R&D incentive is in the form of a tax credit and not a targeted project grant (which follows a thorough and technical assessment process), it becomes even more important for the businesses and the administrators to understand how and when software development is legitimate R&D.

43. The growth in software products and SAAS services in Canterbury will benefit from the proposed definition of Research. In our view the Frascati definition did this adequately in the last implementation of the 2008 Tax Credit scheme. The proposed definition supports a wider range of activities in software product and service research, including:

a. Testing
b. Big Data integration and analysis
c. IOT projects and integrations
d. Firmware integrations
e. Industry 4.0 tracking

THE MINIMUM THRESHOLD, MAXIMUM CAP, AND MECHANISM TO EXCEED A CAP

44. Since 2011 CRBPL has been assisting regional businesses with project grants, and throughout this time we have seen the average grant value increase from $50,895 to $65,330, remembering that this contribution accounts for 40% of the total R&D project costs to the business. This indicates a growth in the investment being made by SMEs into R&D projects in the region. While this growth it positive, and many of the grant recipients have 'graduated' to growth grants, it is not uncommon that these businesses in the mid-range of R&D spend are not yet in a position to invest at this level annually.

45. Project funding through the Callaghan Innovation R&D project grant is targeted at de-risking an investigation into or development of a particular product /service. These grants will increase SME spend on a case by case basis offering 40% co-funding support. For a discreet piece of work that will build capability and ongoing spend but does not reflect a high ($100,000) annual spend, a 40% return has more impact than at 12.5% tax credit.

46. The Tax Credit seeks to encourage and increase a consistent lift in annual research expenditure. It is important to maintain the current grants program (with the exception of growth grants) to help small to medium sized R&D performers reach a level of annual spend where the tax credit system is more efficient and beneficial than targeted funding, or to offer robust, wrap-around advice to a large company undertaking their first formal R&D project, or launching their R&D programme.

47. The proposed minimum threshold is $100,000 R&D spend within one year. The current growth grant eligibility required $300,000 annual R&D spend over the previous two years, or transitional eligibility where the business demonstrates they will exceed this threshold over the following 3 years. Importantly, if the business is eligible for a growth grant, they are not eligible for targeted project funding.

48. **We recommend clarification and assurance that a business is still eligible for a project grant (40% co-funding for a discreet piece of work) even if the total costs of that project exceed $100,000 in one year, especially to de-risk a particularly technical or uncertain R&D project. In our view, targeted co-funding at a 40% rate is more effective in supporting a business to undertake R&D at that level, instead of a tax credit, when they are not yet in a position to spend that amount year on year.**

49. Tax Credits come into their stride when applied to businesses who would do the R&D anyway, but with an incentive will do it 'bigger, better, faster' or more intentionally make it part of their core business. Project funding works at its best when it enables a business who might not yet

have a stable, regular R&D programme to undertake a project they might not otherwise have the confidence to undertake. It is essential that eligibility is flexible and appropriate to allow businesses to utilise the support that will have the greatest impact on them.

50. **We therefore recommend that the eligibility regarding the cross-over from project funding to tax credits be clarified. We further support the proposal to reduce the minimum threshold to $100,000 annual spend as a starting point, with a review to be conducted to gain a full understanding of the best tool for those businesses that straddle the threshold (to then determine if the minimum threshold be further lowered).**

OTHER RISKS TO MANAGE, TRANSITIONING FROM GROWTH GRANTS TO TAX CREDITS

51. Ministerial Directive has been the bench mark for government business support program direction. The objective of this tool is to increase New Zealand businesses' investment in research and development to support long-term economic growth.

52. It will be useful for all government agencies MBIE, Callaghan Innovation, IRD to provide clear guidance of the self-assessment to ensure those applying and those agencies supporting business understand the requirements of the program.

53. The encouragement of R&D needs to be made for New Zealand businesses without risking any reduction of the role of Callaghan Innovation. Callaghan Innovation's connectivity to business is very important in expanding research collaboration between businesses and the wider research community/research innovation ecosystem. The capability of the Callaghan Innovation is important in assisting business directly and providing key introductions to NZ and international research links.

54. The chart in the discussion document (page 29) indicates referral to Callaghan Innovation for expert advice on tax credit applications made to IRD. Currently for Project Grants that exceed a certain value, Callaghan decision committees seek external expert recommendations and reviews. We recommend that a similar process be applied for the tax credits. That is, that Callaghan expertise is sought on tricky eligibility questions, but that there is also an allowance to seek more specific expert and objective advice from external parties were required.

55. Many businesses benefiting from growth grants have also significantly benefited from the cash-flow they generate as R&D activity occurs rather than waiting to the end of the financial year. We are therefore concerned about the challenge associated with lack of cash flow from a tax credit scheme.

56. It has been noted that a tax incentive can be of no help for businesses in tax loss position, which is a situation typical of R&D intensive firms in their early years of development. We believe therefore that this justifies the need to maintain a separate targeted project grant system through the Callaghan project grant model to address these issues.

57. The Transition from Growth grants will require further work based on the outcomes from the submission process.

58. However, CRBPL believes Growth Grants that are approved before 31 March 2019 should have the full 3-year operational life. There is a risk that if these Grants do not have a full life cycle, some businesses will disengage from the R&D ecosystem and wait to see what the Tax Credits

system might provide. While this approach may result in un-budgeted additional costs, this is outweighed by the risk of losing business confidence and engagement.

59. There should be no more Growth Grants approved after 31 March 2019.

60. ExportNZ raises a good point in their submission that many companies currently receiving grants will be reliant on them to ensure cash-flow for their current R&D projects. The careful management of the transition to tax credits doesn't just apply to those companies already on growth grants, but also those businesses transitioning from targeted funding to tax credits. We would welcome a process to carefully manage the transition for businesses who will become eligible with a lowered minimum spend threshold.

61. Page 29 of the discussion document notes that *"Callaghan Innovation brings existing knowledge, networks, and knowledge on R&D activities and expenditure. They will use that capability to support Inland Revenue administer the tax credit and provide certainty to businesses."* Then on page 31 in the discussion of the transition from growth grants, it is noted that the work will be guided by a commitment to "*Maintain business confidence in government support for R&D"* and *"provide certainty and predictability of funding for businesses carrying out R&D."*

62. If Callaghan Innovation provides certainty and guidance, care should be taken not to diminish Callaghan's role in continuing to provide that knowledge, connectedness, and certainty throughout the transition from growth grants, or from project grants, to the tax credits.

63. Furthermore, it is important to maintain efforts to facilitate connections between businesses and the wider research community especially when they are under the tax credit system. This promotes best practice, increases opportunities for collaboration and developments that benefit a group of businesses, sector, or New Zealand society. With more businesses being captured under the accounting exercise' approach of tax credits, it's important not to leave those R&D performers in silos.

64. In our view, Callaghan Innovation and the Regional Business Partner Programme will be essential in ensuring and developing this connectivity and collaboration.

CONCLUSION

65. The use of tax incentives to increase R&D investment by business in New Zealand is a welcome development. However, the scheme is only likely to be of benefit to businesses who have an existing, constant high level of R&D spending.

66. It is important therefore that there is continued support for R&D via other mechanisms as well, such as targeted and project grants, and that the needs of small businesses and start-ups are catered for.

67. We continue to support the Regional Business Partner programme as an effective business support tool, particularly in providing guidance and assurance for businesses seeking to increase their R&D investment.

68. Callaghan Innovation's important role in the R&D eco-system also needs to remain – they play a vital role in connecting businesses with the innovation and research community and emerging technology opportunities. They also ensure that R&D in New Zealand is innovative and of high-quality and is delivering results that improve productivity and move New Zealand products up the value-chain.

New Zealand Institute of Patent Attorneys Inc
www.nzipa.org.nz PO Box 5116, Wellington 6145

1 June 2018

By email to RDincentive@MBIE.govt.nz

'R&D tax incentive team'
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

INTRODUCTION

These submissions have been prepared by The New Zealand Institute of Patent Attorneys, Inc (NZIPA).

NZIPA is an incorporated body representing most Trans-Tasman patent attorneys registered and practising in New Zealand.

The current membership of NZIPA comprises 162 Fellows, 1 Honorary, 36 Students, 18 Non-resident, 15 Associates and 6 Retired.

Patent attorneys operate in the global arena across all sectors of industry to assist businesses in their key markets and to use intellectual property (IP) systems for strategic advantage. Patent Attorneys are qualified to, and regularly advise on, all intellectual property rights including patents, trade marks, designs, and copyright.

COMMENTS

The proposed research and development (R&D) tax incentive is intended to fuel innovation, and support the government's broader goals for an inclusive, sustainable, and productive economy. The aim is to incentivise business R&D, so the economy can benefit from the broader social returns to business R&D.

The Research and Development Tax Incentive Discussion document identifies one factor limiting private sector investment in R&D as uncertainty that business will secure the benefits of that R&D, even if it proves to be successful. Assisting businesses to identify, capture, secure and commercially exploit the results of their R&D is at the heart of the work patent attorneys do.

Callaghan Innovation is the Crown entity charged with assisting New Zealand business to become more innovative. But, for example, Callaghan Innovation's 2017 Annual Report makes a single reference (page 16) to the term 'patent', in Professor Shaun Hendy's piece concerning 'New Zealand's low rates of patenting ideas with commercial potential (14 per million people versus OECD average of 40)'. Callaghan Innovation's 2017 Annual Report also highlights that New Zealand's rate of journal publication is significantly greater than in similar sized economies, and that the quality of those publications is world-class (see page 17).

Despite its comparatively poor private sector investment in R&D, New Zealand continues to create world class innovation, but then favours freely publishing the outputs of that R&D rather than actively managing and controlling the intellectual property.

Increasing private sector R&D is only part of the solution to achieving the government's goals. For New Zealand to fully benefit from the increased investment in R&D, the results of that R&D must be identified, captured, secured and, preferably, commercially exploited.

Accordingly, while many of the questions that are posed in the Discussion document fall outside of the NZIPA's purview, four are particularly relevant:

> **Question 3**: Does this definition exclude R&D that you think should be eligible, please illustrate with examples.
>
> **Question 7**: Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe.
>
> **Question 10**: What are the advantages and/or disadvantages of limiting eligible expenditure to R&D labour cost?
>
> **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?

Page 17 of the Discussion document identifies certain activities as being routinely excluded from R&D tax incentives, but notes such activities could qualify as support activities within paragraph (b) of the scheme's definition of R&D. These activities include 'commercial, legal and administrative aspects of patenting, licensing or other activities'.

Page 6 of the Discussion document states that introducing an R&D tax incentive will, among other things, lead to greater innovative business activity, thus increasing employment, industry diversity, international engagement, profitability and overall sustainability.

The NZIPA considers that achieving these goals requires businesses to be incentivised to not only increase their investment in R&D but also to identify, capture, secure and commercially exploit the results of their R&D activities. To fully realise the benefits of the scheme, eligible expenditure should also include business expenditure on, for example, identifying, capturing, securing and commercially exploiting the results of their R&D activities.

The NZIPA considers that the definition of eligible expenditure should, therefore, include business expenditure on, for example, identifying, capturing, securing and commercially exploiting the results of their R&D activities. Such expenditure should not fall within the excluded activities but should, instead, at least qualify as eligible

New Zealand Institute of Patent Attorneys Inc
www.nzipa.org.nz PO Box 5116, Wellington 6145

expenditure under the support activities within paragraph (b) of the scheme's definition of R&D.

Furthermore, businesses may invest in R&D that for many reasons is not ultimately successfully secured or commercialised. Eligible expenditure should therefore include R&D activities that might not be successfully secured or commercialised. It is important to encourage businesses to invest not only in 'traditional' R&D but also in 'blue sky' R&D, in which the desired outcomes may not be as certain.

Limiting eligible expenditure to R&D labour cost or setting overhead costs as a percentage of R&D labour costs provides no additional incentive for businesses to identify, capture, secure and commercially exploit the results of their R&D activities. This would be wholly inconsistent with the broader aims of the R&D tax incentive. Worse still, failing to at least identify, capture and secure the relevant intellectual property rights potentially allows overseas businesses to benefit from taxpayer-subsidised New Zealand R&D without any benefit to New Zealand.

Yours faithfully

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s 9(2)(a) [redacted]

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listings.everywhere.

Submission: Transition approach from Growth Grants to the R&D Tax Incentive

1 June 2018

The Minister Ministry of Business Innovation and Employment

Thank you for the opportunity to make a submission.

As a software-based company operating in local and international markets, in the first 5-year phase, we are dependent upon investors, and government support through the Callaghan Innovation R&D Growth Grant, to provide positive cash flow while we develop product, infrastructure, and marketing strategy to enable us to launch successfully into international markets.

As a software-based business, products and infrastructure absorb considerable up-front time and financial resources in an environment where there are known skill shortages. If we do not have sufficient cash support, we cannot effectively compete when recruiting the skills required to develop the product and infrastructure and be successful.

During start up and launch phases, cash enables activity to be actioned, and the business to be built.

Unfortunately, tax credits are retrospective and don't pay the bills in the early stages of a company's life cycle. While we support an environment where there is tax support for investors to invest in R&D long term, to remain internationally competitive and provide employment and tax revenue in New Zealand, it is cash that is required early on. It is for that reason that we don't believe the proposed changes are for the betterment of innovative start up business' in New Zealand, and in fact will restrict investment and growth. Tax support for R&D is more appropriate for established developed business' who have their own positive cashflow and can carry the cash cost until the tax return is filed.

New Zealand is an innovative and creative environment, to enable us to be internationally competitive and provide the best opportunities for its citizens, there needs to be an environment where innovators, investors, and government partner in the most effective manner, for the benefit of all. The reality is that it requires cash to do this.

Thank you for the opportunity to make this submission.

s 9(2)(a) [redacted]

BuddyBid Ltd 2.1A/30 St Benedicts Street, Eden Terrace, Auckland 1010 P 0800 110061

Lumley House
3-11 Hunter Street
PO Box 1925
Wellington 6140
New Zealand

DDI: s 9(2)(a)
Tel: 04 496-6555
Fax: 04 496-6550
Mob: s 9(2)(a)
s 9(2)(a)
www.exportnz.org.nz

1 June 2018

R&D Tax Incentive Team
Ministry of Business, Innovation & Employment
Wellington
Email: RDincentive@mbie.govt.nz

RESEARCH AND DEVELOPMENT TAX INCENTIVE

About ExportNZ and ManufacturingNZ

ExportNZ and ManufacturingNZ are national industry associations representing a diverse range of exporters and manufacturers throughout New Zealand. ExportNZ and ManufacturingNZ are both divisions of BusinessNZ, New Zealand's peak business advocacy body.

We are a membership organisation and across our two brands have approximately 2,000 export members. We also have four regional partners: Employers Manufacturers Association (Upper North Island), Business Central (Lower North Island), Canterbury Employers Chamber of Commerce (Upper South Island) and Otago Southland Employers Association (Lower South Island) which between them represents the bulk of manufacturers in New Zealand.

Our value proposition for members is a mixture of policy and advocacy, education and training, networking, trade missions and inspiration through awards events and conferences. Notably, we run a BusinessNZ Chief Technology Officers Group, incorporating the largest innovation-driven companies in New Zealand, many of which export.

Submission

ExportNZ and ManufacturingNZ welcome the opportunity to submit on the R&D Tax Incentive Discussion Document.

This submission doesn't seek to necessarily comment specifically on each question asked in the discussion document. However we do wish to raise issues we know business is particularly concerned with.

Overview

There are pros and cons from moving away from Growth Grants to an R & D tax credit. Feedback we have had from the Chief Technology Officers Group (CTO) which is made up of companies that are largely eligible for growth grants, is that they were very happy with the existing Growth Grants scheme and it was contributing significantly to their ability to increase investment in R & D and make more investment in the pipeline of talent employed in their R & D endeavours. It is worth noting the things that they collectively liked about the existing scheme in case some of the elements can be replicated in the new R & D tax credit scheme.

- Low transaction cost to participate in the Growth Grant scheme. Once you met the criteria there was little ongoing administrative complexity to contend with.
- Essentially pre-approval of what you would be reimbursed for – along with regular payments which is good for cash-flow. So, good predictability and good cash-flow.

It could also be argued that the larger companies that were eligible for growth grants had the greater commercialisation potential. That said, MBIE statistics indicate that we have less R & D occurring in some of our larger firms than is the case internationally and that our small to medium size firms are quite R & D intensive as a proportion of their turn-over. If that is the case – how do we get these larger firms to intensify their R & D – and if they were not currently accessing Growth Grants, will the new tax credit be the incentive they need? It could be, in that some of them were not eligible for Growth Grants – due to the 1.5% of revenue they needed to invest in R & D. For a large revenue firm this could be a high hurdle.

On the con side of Growth Grants, there were a lot of firms doing good R&D or with good R & D potential that were not eligible for support, due to the criteria in place. They were either not meeting the R & D investment hurdle and/or the definition of R&D was too narrow. A tax credit scheme moves away from "picking winners" and spreads the incentive more widely – albeit more thinly.

On the latter point the question needs to be asked as to whether at 12.5% this tax incentive will be enough to shift the dial and be transformational for the New Zealand economy. Australian tax credits are significantly higher (43.5% for under $20m turnover companies and 38% for over $20m companies) – but we also appreciate that if we want simplicity then having a two track approach to large and small firms could increase complexity.

On balance – we think this new approach (R & D tax credits, plus the retention of Project Grants) should be pursued, but aim for a higher rate than 12.5%. We would recommend getting closer to the Australian level of incentive in order to avoid R & D leakage to Australia and in order to keep our firms competitive. The key will be to measure and monitor investment in R & D to ensure that the policy is meeting the objective of encouraging a step change in BERD in NZ firms. If there is a step change, leading to higher paying jobs and better productivity the investment will have been worth it, if not then we should be open to tweaking the policy to get the desired results. We are in a global "race to the top" when it comes to innovation and competition and many other countries around the world are grappling with the best way to achieve greater R & D intensity in their economies.

While we should be open to improving the policy approach if necessary – we should be cautious about significant changes, as investment in R & D can take a while to play out, and major policy flip flops are not conducive to longer term investment horizons. With that in mind we would encourage bi-partisan political support in the R & D policy space as much as is possible. Good R & D results will help with this, but we must be prepared to stay the course.

We do wonder with this proposed change whether Callaghan Innovation will be able to stay well connected to industry. They will still have a relationship with firms using the other services, but the connection to the companies formerly getting Growth Grants could wane. We think Callaghan still has an important role to play – as a

connector between business and the innovation ecosystem (Universities, CRI's, Independent Research organisations etc.) and as a capability builder for SME's. They may need to refocus and connect more proactively with the industry associations that are in regular contact with business. We would be happy to increase our efforts in this regard.

Discussion document specific comments

Definition of R & D

From discussions with officials, we understand that current thinking around the definition of R&D core activities has changed.

The discussion document outlines the following definition of R&D core activities:

1. Those conducted using scientific methods;
2. Those that are performed for the purpose of acquiring new knowledge or creating new or improved materials, products, devices, processes or services; and
3. Those that are intended to advance science or technology through the resolution of scientific or technological uncertainty.

We understand that officials' thinking has now moved toward the following definition of R&D core activities:

a) Conducted using a systematic approach;
For the purpose of creating new knowledge or creating new or improved materials, products, devices, processes or services; and
Resolving scientific or technological uncertainty.

Or b) Support activities: those that are wholly or mainly for the purpose of, required for and integral to, the performing of the activities referred to in paragraph a).

While some clarity will still be needed on some of the definition's grey areas, we endorse this change in thinking and believe the alternative definition to be far more suitable than the original proposal. Feedback from the large companies in the Chief Technology Officer group indicated the original definition in the discussion document had too much emphasis on scientific method which could have precluded support for the majority of investment in innovation, which in New Zealand tends to be development heavy for the purposes of commercialisation of new innovations (small r and big D). In our view, if the bigger and more sophisticated firms investing in R & D felt they would have struggled to meet the definition, then the small to medium size firms would have struggled even more.

The new definition is supported, as is the development of examples and guidance.

Activities excluded from the tax incentive

We feel two specific points within the current exclusions eliminate a large proportion of development currently undertaken by NZ companies.

We do not feel that excluding 'activities involved in complying with statutory requirements or standards' would support development, as development regarding

standards was necessary to ensure quality control but can be substantive in the R&D sense.

Additionally, a substantial amount of development goes into 'pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs' – exclusion would cut out qualification for an area that companies can invest a lot into developing.

Dual purpose activities

While we appreciate the stance taken regarding dual purpose activities – namely an R&D tax credit would be better targeted if it applies to an activity conducted solely for an R&D purpose – we endorse BusinessNZ's point and strongly urge caution here. In almost all situations, a business will undertake R&D for the purpose of making income as businesses are generally not narrowly defined within just the research space. They have to continuously be nimble enough to look for opportunities in the market whereby R&D is undertaken with the end purpose of commercializing their work. Therefore, to solely apply it to pure R&D purposes only without the other purpose of commercialisation would greatly inhibit almost all businesses from applying.

R&D carried out overseas

As with BusinessNZ, we agree that R&D costs incurred overseas should be eligible for the concession. What we are not sure about is whether there should be a limit on the amount spent on overseas R & D that is eligible for the tax credit. For some firms the niche expertise they need for R & D may not be available in New Zealand. In some regards we should not care where the R & D is carried out if the benefits of the R&D flow back to New Zealand. Our R&D community should be prepared to back themselves against international competition to be the best at what they do and at the best price. Our innovating firms have to be globally competitive and so should our research community. New Zealand will have some areas of global comparative advantage with our R&D expertise and in some cases we should be accessing the wider global pool.

In case policy makers are concerned that no R&D would then be done in New Zealand, there are other reasons why research would naturally be done here. There is a lot written in academic literature about keeping R&D close to manufacturing for efficiency and speed purposes (R&D tends to be a very iterative process in manufacturing with lots of prototyping). Also for firms that outsource their manufacturing to lower cost countries, the concern to protect their intellectual property often means they want to keep R&D in New Zealand.

The R&D should be carried out where it is best to be carried out for the New Zealand based business and as long as that leads to increasing investment, higher paid jobs and executives that are exposed to 'World's Best Practice' when it comes to R&D. What we don't want to end up with is an R&D incentive scheme that delivers less than the best result because it all has to be done in New Zealand.

Other issues to consider

Certainty around what qualifies

The discussion document, while providing some guidance on the overall intention of the tax incentive scheme, does leave some vast grey areas in which businesses are concerned around what is to be eligible and what isn't. We believe it would be useful for the government agencies working on this project to provide some guidance on self-assessment in order to ensure those applying for the scheme will be compliant with regulation.

Cash flow for businesses currently receiving grants

Given the current grants are drip fed throughout the year, many of the companies currently receiving grants will be reliant on them to ensure cash-flow for their current R&D projects. We believe this needs to be considered in terms of assisting businesses with the transition to the tax credit system.

We support further work being done on how to treat start-ups and early stage firms that are not in profit. Cash flow will be important for them, so cash rebates should be considered.

Intent vs outcomes

In principle, we agree with the intent of the overall move to tax incentives, in that it will reach more companies and has the potential to encourage investment in more R&D if the rate is sufficient. However, the risk is in the implementation of the system, the compliance costs, time put into applications and risk of claim rejection/penalties would be unconducive to the intent of the change. We see it as essential that clearer guidelines and pre-approvals for qualifying R&D activities are in place as soon as possible.

We also feel that the incentive needs to be administered separately from IRD's normal approach, especially because IRD is seen as exclusive not inclusive (in that they will find reasons to not grant credits).

Finally, there is a risk that in reducing the role of Callaghan Innovation, there will be less connection to business than currently is in place thereby absolving Callaghan's original policy objectives. As mentioned above, we believe they need to increase efforts and focus on facilitating connections between business and the wider research community. They could possibly take on a Pre-approval role for tax credits as well; so that accountants don't end up capturing a significant amount of the value of the tax credit (as we hear happens in Australia).

Yours Sincerely,

s 9(2)(a) [redacted]

s 9(2)(a) [redacted]

ExportNZ and ManufacturingNZ

surestart consulting
26 Hoani Glade
St Johns Park
Auckland 1072
s 9(2)(a)
w: surestartnz.weebly.com
s 9(2)(a)

R&D Tax Incentive Team,
Ministry of Business, Innovation & Employment,
PO Box 1473,
Wellington 6140

1 June 2018

To the Submission Review Team

Submission on the R&D Tax Incentive Scheme Proposal

I have spent the last 20 years working in the High-Tech start-up space, working with companies that have invested intensely in R&D. For 12 years I was CFO at Auckland UniServices Limited and helped commercialise intellectual property arising out of the Research from the University of Auckland. While at the University I launched 28 start-up businesses. These companies are typified by their common drive to go to market, and are all high percentage spenders on R&D. Working alongside MBIE (and its predecessors – FRST and MSI) and Callaghan Innovation over the last 20 years, I have been involved in and constant evolution of the R&D eco-system in New Zealand, watching changes implemented that have either improved or deteriorated the R&D eco-system.

For the last two years I have been consulting as a Strategic CFO to multiple start-up businesses in New Zealand, and are interacting with Callaghan Innovation with Project Grants and Growth grants, and the IRD R&D losses credits schemes on a daily basis. See appendix 1 for summary of these activities. Of the nine current start-up clients that I work for as CFO, eight one of them is either receiving or has participated, or is applying for a Project Grant, Growth Grant or R&D Tax Loss refund, the ninth one has a Callaghan Innovation $450,000 Incubator loan. All of them without exception have been supported in a way by these grants that has allowed them to accelerate their pathway to commercial success, which would never have happened without this support. Most of the proposal in the R&D Tax Incentive scheme as written ignores the significant withdrawal of support that these changes will make to these start-up companies, and is heavily biased towards large profitable companies that are less dependent on these government incentives for success, and as a result these profitable companies will use the Government funding they receive to maximise returns to shareholders as higher dividends.

I have addressed the questions in this submission from the point of view of the start-up business, in particular those business that are spending money to get to market through intensive R&D expenditure (i.e. often >90% expenditure), and who are reliant on the Growth Grants and IRD R&D Tax loss refunds to fill the gap between Equity funding and losses.

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?

No, they should be eligible, especially where they are engaged in a taxable activity such as an operating subsidiary of these Crown Entity's. As a while the entities listed in the current exclusions, make up a significant portion of the New Zealand economic activity and will need to be included if the

target of 2% spend on R&D is to be reached. They are all highly engaged in the New Zealand economy and most of these entities have significant institutions to run. As such the activity of investing in Research and Development in these Crown entities is only able to be included in the operating expenditure budget to the degree that it does not materially divert funding from the main objectives and daily operations of the Crown Entity. However if they are required to carry the entire risk of the R&D expenditure then just like a Private entity their Management will be less likely to invest. A tax incentive will however give these Crown entities a bigger budget that they can invest in R&D without diverting funding from other activities.

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

This works because those involved in Business R&D and the accountants tasked with measuring R&D have developed a common understanding with those government agencies monitoring the R&D claims, in particular Callaghan Innovation and IRD, over the last decade or so. However, the introduction of a Universal claim will significant test the understanding of those businesses not currently part of the R&D grants and refunds system, and will expose the monitoring agencies to high levels of expense classification manipulation again as occurred in the previous 2008 R&D tax credit scheme. It would be difficult for the monitoring agencies to resource up to apply the current practice that has been established in the MBIE and IRD portals for tax payers to apply for Grant claims and R&D loss refunds to the Tax Incentive scheme, and without appropriate monitoring it can be expected that many tax payers will test the boundaries of the definitions without impunity. The government has learnt from previous experience that this will happen, and has since adopted successful monitoring practices to minimize these opportunities, and unless a draconian monitoring and review scheme is introduced to counter the new incentive from the universal Tax Incentive companies will be likely to use the incentive to the maximum that their classification of expenditure as R&D will allow.

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

The definition of R&D has introduced the term "scientific method" as a qualification of what is eligible. After working as the CFO of Auckland UniServices Limited, the commercial research arm of the University of Auckland for 12 years, and observing $100's of millions of research activity I can observe that to define a process as being undertaken "scientific method" is completely ambiguous and open to interpretation. It is poorly understood even in world leading academic institutions where "discovery" is not always as a result of a common "method", and researchers have adopted their own disciplines around applying research methods to undertake their research. The process of Research is creative, innovative and often results are serendipitous or incidental, to the primary activities, and therefore to make a tax ruling over the individual Business's interpretation of the "scientific method" suggests there is a level of objectivity in this definition that in reality is highly subjective. To translate the ambiguous skill of scientific method out of an academic institution into the business world will further cloud the interpretation and therefore create uncertainty in the tax payers application for Tax credit. This uncertainty has a detrimental impact on one of the fundamental goals of the scheme to offer greater certainty.

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

Yes, if one industry can be sighted for being a particularly less "qualified" as research industry it would be software. This is regularly as a result of other experts having a snobbery about their R&D being better and R&D in software not counting. All too often though the challenge and uncertainty that software development is required to overcome is absolutely R&D. Where a Business has set out to develop new and innovative technological solution, or to enhance our lives with a better solution than what is currently on the market, there is no known solution. Software Engineers have to use their skills and creativity to propose solutions, design the architecture to deliver that solution, develop algorithms in software that can respond to these design requirements and do all this in an economically viable and sustainable output. Compared to other research the outcome is just as uncertain, requires a

deep level of developer intelligence in field to arrive at a successful result. Many times the result is unsuccessful and the whole research and development has to go back to the protocols of the development to approach it from another angle.

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?

If the scheme is designed to remove uncertainty to business in undertaking R&D that will be eligible, then it is only important to agree that the R&D solves a problem and advances science or technology. The first use of a technology may be the tip of the iceberg, and therefore to exclude it as ineligible based on a reviewers opinion of materiality has the risk of stifling innovation before it even gets started. One research project that I am working with is a Business developing new technology in Membranes for cleaning water. If the first adopter is a Dairy market that makes up less than 5% of the world membrane market, you could wrongly assume that the product solution was not material. However if every company in the world that uses this membrane took up the new technology, it represents annual turnover of $100's millions. Further, if this product is then sold into Lithium Battery market the value of the market is multiples of the Dairy market, but it will only be available to the business if they can get early runs on the board. This example is similar in piloting a product in a small New Zealand economy with a view to going global later. So there is no merit of looking for a materiality test to approve eligibility, as it is subjective in the eyes of the review depending on the point in time that they assess the potential revenue of the technology.

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

The supporting activities are allowed under this definition if you have successfully overcome the threshold in paragraph a) of the R&D Definition. Therefore if you have achieved this threshold, then this definition is adequate. The conflict is that it relies on your ability in a business R&D program to achieve the benchmark of scientific method, which is a narrow interpretation of Research and Development, and therefore excludes both part a) and part b) expenditure on business R&D if you are excluded by the definition of meeting a criteria of scientific method.

Question 7: Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe.
No

Question 8: Please provide any examples where social science research is/has been a core part of business R&D in New Zealand? No response

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? No response

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

The only advantage that could be construed from limiting eligible expenditure to R&D Labour is if the scheme is targeted at increasing the National % spend on R&D solely as a Labour force lever. This is not the stated purpose of the scheme which is to lift the National R&D spend to 2% of GDP. It is obviously a disadvantage to any company that has a high intensity R&D spend that they can only claim the credit on R&D Labour. While the analysis of NZ company expenditure on R&D in $ terms puts a significant share of the $ value of this total economic expenditure in the biggest companies, they are spending a much lower % of their budget on R&D compared to early stage start-up companies that achieve R&D Intensity expenditure > 90%. To exclude the non-direct labour components and overheads in the eligible expenditure of companies that are extremely R&D Intensive is a disadvantage as it creates a gap of non-claimable expenditure where it is not labour, and will contribute to an even wider disparity with New Zealand and Australia, therefore further encouraging

companies to take their R&D offshore. While this may not be such a large impact on large companies, the large volume of smaller companies that spend the biggest % of their expenditure on R&D could disappear from the economy and be pushed offshore where they can access early stage benefits that have been removed from the New Zealand system.

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?

The advantages of an overhead cost as a percentage of R&D Labour, is it is easy to understand, simple to calculate and review. With a very broad level of experience in submitting claims for Callaghan Grants, an overhead rate in a band between 20-25% is a good bench mark. It can be fair to most business that are working in with Intellectual Property and R&D, without over-reimbursement.

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.

No response

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

It is important when extending the definitions for core activities as these relate to Software R&D to include any of the activities of the Software Development team (internal or consultants), that contribute to the Development of the new product. This can be qualified through as an exception to the rule that it must meet scientific method, if it meets the criteria of software development methods instead. The extension for Software to fit within this more appropriate definition of core activities will ensure that the significant R&D efforts of Software Developers are not excluded from the Tax Incentive scheme.

The rules of the R&D definition are already sufficient to prevent claims for Development of products where they fail to meet the requirement for solving problems that have not already been solved, and which will expand the existing knowledge base. And exclude claims for the reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information.

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

Start-ups businesses are always working with limited funds (the runway), most of which are being spent on R&D. Raising new Investor funds for start-ups is co-dependent on the availability of risk sharing government tax incentives. The investment community has options to choose between companies that are de-risked, through Government incentives, and those that carry 100% of the R&D risk themselves, which are by nature less attractive to investors. The withdrawal of the R&D Tax loss refunds will immediately shift more of the shared risk to Investors and cause knock-on effects to the flow of funding to Start-up businesses.

Start-up businesses have been devastated by the news of this wholesale withdrawal of the current scheme. While it is the intention of Government to revisit this in 2020-21 the real issue is what is going to happen in the mean-time. The paper on page 23 specifically refers to these issues and excuses the policy for being deficient in addressing these start-up businesses on the basis that it is complex. In the context that the current environment has already established a policy and process for the special group of loss making companies that are investing heavily in R&D, it would seem logical that the new Scheme include a continuation period of the old scheme for these companies that are already participating in the R&D Tax loss refunds, until the Government has had the time it needs to review this complex area. The fiscal impact would not be materially worse than the refunds being paid out to these companies today, and it is far more equitable, than leaving these companies out of the budget cycle for the next 2-5 years while they remain in tax losses, and are unable to benefit from the Government Incentive scheme until a later year. Implement the new tax incentive scheme without making immediate allowances for these tax loss companies is creating a bias in the R&D support

system to the larger and more profitable companies, and putting less support where it is needed most.

There is a real an immediate impact on the loss making companies that are losing the refund and the deferral of any future tax credit. The proposed Tax Incentive scheme has been put together without making any accommodation for the existing growth R&D companies, and it is contradicting all the values that is sets out to achieve of:

- greater certainty to business,
- complement and strengthen Governments coordinated package of support for research, science and innovation;
- increasing employment

By revoking an existing scheme from 1 April 2019 and potentially not replacing it until a later date, any loss making business in start-up has just had a material impact on their entire continuity. Where the R&D Tax loss refunds are already part of company plans – and many of these companies have presented these tax refunds as part of their cash flows to Investors and to Callaghan Innovation, as a major contribution to the company runway for the next 3 years, the immediate impact of this new policy is that R&D expenditure over the next three years by these companies will need to be reduced by 28% to compensate for the loss of the R&D Tax loss refund – creating the exact opposite effect of what the Government has stated as their goal to grow the expenditure on R&G as a % of GDP, increase employment and create certainty for business.

Illustrative example of R&D Plans before and after withdrawal of R&D Tax loss Cash refund:

Tax scheme	Old	New
R&D Labour	$920,000	$920,000
R&D Intensity	97%	97%
R&D Total Expenditure	$1,000,000	$1,000,000
Tax Loss	$1,180,000	$1,180,000
2018 Refund (May/June 2018)	immediate cash $257,600	none
2018 Credit (sometime in next 5 years)	-	future contingent asset $143,750

Revised Budget for 2019 : to offset loss of Tax refund :

Tax scheme	Old	New
R&D Labour	$920,000	$662,400
R&D Intensity	97%	97%
R&D Total Expenditure	$1,000,000	$800,000
Reduction	0%	$257k/$920k = 28%

The proposal has recognised that the Tax incentive may be lost in the growth cycle of R&D start-ups unless it is able to be carried forward, and not extinguished due to a lack of Shareholder continuity. This is true, but the wider issue is this is the most Fundamental change to the current R&D Tax loss refund as stands today. In the current system R&D Start-ups are able to recover cash losses with a cash refund. The proposal has withdrawn this 28% refund and replaced it with a credit against future tax payable, which in the Growth cycle of R&D start-ups means that the new scheme has effectively cancelled all their current cash flow benefits, the government has withdrawn their immediate support, and replaced it with the tax credits which are a possible future benefit that they cannot even recognise in the Balance sheet as an asset, as they represent a contingent asset.

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

Question 16: How important is a cap or a mechanism to go beyond the cap? Please provide further details. No response

Question 17: What features of a Ministerial discretion or pre-registration would make them most effective? No response

Question 18: What are your views on the proposed mechanisms to promote transparency and enhance evaluation?
I believe it is fair for Tax incentive recipients to be published and publicly available – just as the Grant system is today as this is use of Public Funds, and provides evidence of results and data for Policy development.

Question 19: Are there any other risks that need to be managed? Please describe.
Working for the University of Auckland, contracting out Research for over 12 years and selling in excess of $500,000,000 of Research contracts to Local and International business, it would always be helpful to the Publicly funded institutions to have Tax Incentives linked to settlement of any overdue invoices with Publicly Funded institutions. Callaghan Innovation has established similar tests prior to reimbursing claims to ensure the IRD accounts are all current.

It is unfortunate where businesses can recover grants and Tax incentives when they are holding off payment / or defaulting on accounts with Public Institutions, and the NZ Government should refuse to credit Tax Incentive until or contingent on these Public entities have been paid in full for Research contracts.

Question 20: What are the risks with making external advisors liable in this way?
Anyone working on a contingency basis for clients, would find this rule particularly dangerous and difficult to balance the risk of undertaking the work and the rewards. The client may be deceptive on what work and expenditure is eligible and how much time staff are allocated to this work, or the IRD may have a dispute over interpretation that could not have been reasonably understood by an advisor prior to submitting a claim. This will force advisors to increase their compliance costs around the claim process, and therefore is transferring costs and responsibility for monitoring and review from the IRD to the advisor, but the benefits are heavily in favour of the client not the advisor.

Question 21: What is the right level of information required to support a claim?
Same as that which is currently required in the R&D Tax Loss Refund portal : Financial reports, R&D Program summary, Key results, Future Research program

Question 22: What opportunities are there for customers to submit R&D Tax Incentive claims via third party software?
If a company can use their current financial software provider or an intergrated partner to this software provider to generate eligible expenditure reports, specified to the IRD eligibility criteria this would significantly streamline the current process for accounting for R&D Tax loss refund, which is calculated in spreadsheets then loaded in the MYIR portal manually.

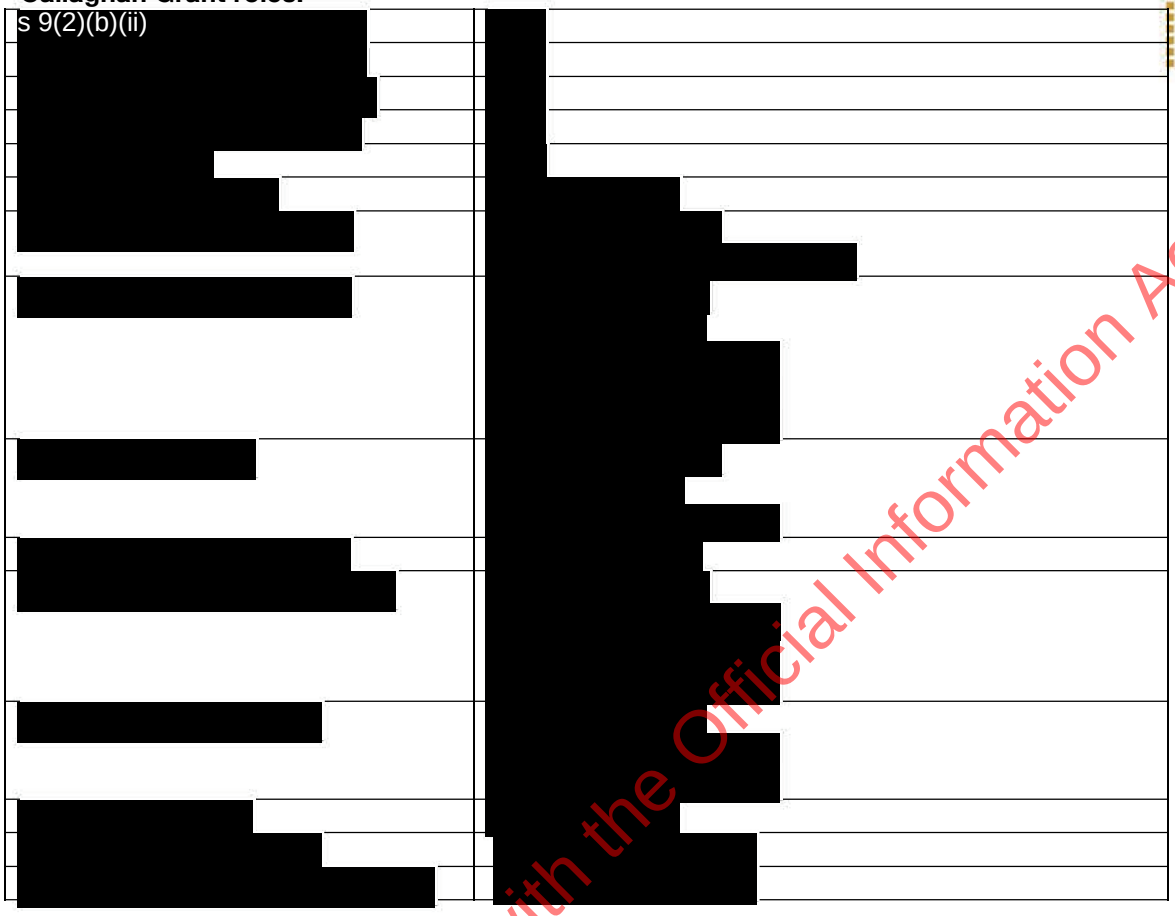
Question 23: What integrity measures do you think Inland Revenue should use?
Accounting Review certificate add an extra layer of independence to the application process, keeping the preparing accounting to a professional level of integrity.

Regards

s 9(2)(a)

Appendix 1:
Surestart involvement in Growth R&D Companies

Callaghan Grant roles:



[redacted]

PARTSTRADER
your suppliers · your parts · your choice

R&D tax incentive team
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

1 June 2018

Dear Sir / Madam

Fuelling Innovation to Transform Our Economy, Discussion Document

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

We, PartsTrader Markets Limited (PartsTrader), are submitting our views on the Discussion Document because we have experienced first-hand both the significant benefits access to Callaghan Innovation's Growth Grant scheme has provided, and the challenges of being an early stage R&D intensive business. As such we feel well placed to provide some insights and a 'real world' perspective which we hope will be of value as the Government works through this consultation process.

We feel strongly that continued support, specifically access to cash funding, for early-stage high growth R&D companies is pivotal to the Government achieving its goal of increasing business R&D to 2% of GDP by 2027.

Who are we?

PartsTrader is an online reverse-tendering market platform for auto-collision parts procurement – we provide an online market for auto-collision repair shops and parts suppliers. PartsTrader currently operates in New Zealand (since 2004) and the US (since 2012, via our 100% owned US subsidiary). The platform comprises s 9(2)(b)(ii)

The company is Wellington based with offices also in Chicago, employing 70 staff in New Zealand and 82 in the US. All R&D work is performed in New Zealand and all intellectual property is owned by the New Zealand parent company.

PartsTrader has significant NZ investors, including s 9(2)(b)(ii) and other investors with smaller holdings.

Impact of funding on PartsTrader's R&D to date

PartsTrader has benefited from a five-year Callaghan Innovation Growth Grant and this grant concludes 31 December 2019. This grant provided the business with certainty of cash-flow and enabled PartsTrader to build a 'scrum team' of seven comprising a product owner, developers, testers and system engineers to innovate and work through different and competing choices on offer. The

Growth Grant has directly funded an additional $1M per annum of R&D work that would not have taken place without access to the grant.

This additional R&D work has allowed PartsTrader to adapt quickly to a technology landscape that is constantly changing and fast moving. The additional scrum team has also resulted in additional, incremental R&D, over and above the R&D work funded by the Growth Grant. This would not have happened if the company without grant funding to support the creation of the team.

PartsTrader has also greatly appreciated the way the Growth Grant mechanism allows working capital to be managed effectively with quarterly claims settled quickly. The result is that cash has typically been received from Callaghan around four-five months after the company had spent it.

Support for loss making businesses

Based on our own experiences, we feel strongly that supporting early-stage, high growth R&D companies, is pivotal to increasing the overall level of business R&D in New Zealand and driving New Zealand's knowledge economy.

PartsTrader's entry into the US auto-collision parts business provided a major commercial opportunity, a big prize, and needed serious money to fund the business from the get-go. However, the founders of PartsTrader had a limited cash resource to draw on and simply was not sufficient to enter the large US market successfully. s 9(2)(b)(ii) [redacted] As a start-up, founder and external investor funding was the only source of seed funding for PartsTrader.

PartsTrader approached Banks, and financial institutions and other traditional sources of funding for financing but our bank made it plain that it would not lend money to a business that does not have any collateral to offer in the form of hard assets (property) and an unproven revenue track. Equally, the bank was not prepared to advance funds to PartsTrader because most of its revenue was generated in another country, the US.

PartsTrader's estimates of cash and time to establish ourselves in the US market was under estimated, a common feature of a start-up, and ultimately required three times more cash than first envisaged.

Most high-tech start-ups encounter similar issues and the result is that cash is critical to their survival. The cash funding received through the Growth Grant scheme provided a critical cash injection to the business and we are concerned by the lack of a solution for R&D businesses in a loss, or even a clear plan to identify one, in the Discussion Document. This uncertainty is, in itself, damaging to business and investor confidence, and while a clear plan has been announced in relation to the removal of funding there were only vague suggestions made in relation to a replacement.

While we appreciate the proposal that the R&D tax credit may be carried forward and used in a future year, for loss making companies like PartsTrader, that date may be so far into the future to render the tax credit effectively worthless.

Lastly, we are concerned about the cash-flow implications that moving away from a grant, with a quarterly claim process, to a tax system-based regime and presumably result in incentives being paid annually. PartsTrader greatly values the cash-flow benefits of the quarterly claim process under the growth Grant program. By contrast, if a claim is now to be processed as part of the tax return, given the time it may take for the income tax return and claim to be prepared and filed post year-end, there could be a delay of upto two years from the time cash is spent by the business before a tax credit is received.

We therefore submit that immediate consideration should be given to a solution for loss-making companies, either by making the tax credit refundable, or from some other means. Also, if it is to be refundable, consideration is given to whether cash-flows can be advanced to assist these businesses during a tax year, rather than months after the end.

Proposed continuity provisions

Despite being almost seven years post market launch, PartsTrader is still at an early stage and yet to become profitable. To fund the company through to profitability has necessitated multiple funding rounds to date. Some initial investors and shareholders have not been able to match other investors' ability to add more cash into the business and as a result, the company shareholding structure has changed disproportionately. These changes have meant PartsTrader has failed to meet shareholder continuity requirements for some past tax losses and these have been forfeited. This funding model is very common amongst early stage high growth R&D companies.

We understand from the Discussion Document that the Government is considering implementing shareholder continuity requirements in relation to the R&D tax credit incentive. If such a requirement is implemented it will render the tax credit largely valueless to a business like PartsTrader, and certainly would not be an incentive to carry out additional R&D. This is because the likelihood of the carried forward tax credits being lost due to shareholding changes as part of future capital raises is extremely high.

For this reason, we submit that shareholder continuity rules should not be implemented in relation to carried forward R&D tax credits.

General

We appreciate the opportunity to comment on the proposals and hope that our submission has provided you with some insight into how the issues being discussed impact real businesses on a day to day basis. Please let us know if you would like to discuss any of our comments in further detail.

Yours sincerely

s 9(2)(a)

PartsTrader Markets Limited

R&D tax incentive team
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

Sent via email: RDincentive@mbie.govt.nz

1 June 2018

Genesis Energy Limited submission - R&D Tax Incentive

Dear R&D tax incentive team

Thank you for the opportunity to comment on the Research and Development Tax Incentive Discussion Document (**the Discussion Document**). We appreciate that increasing R&D support in New Zealand is a key focus for this Government.

The energy sector in New Zealand, and globally, is transitioning towards an increasingly renewable future where emerging technologies that enable energy management are putting customers in control. Through a combination of solar, battery storage, renewable generation improvements, electric vehicles and software tools, the way consumers, and the energy sector itself, are thinking about energy is rapidly changing.

New Zealand, with an already highly renewable generation fleet and competitive market, has the ability to take advantage of this unique position to significantly expand on existing R&D to potentially take a world leading position if the right incentives are in place. This submission is made on behalf of Genesis Energy Limited (**Genesis**) in our capacity as its tax advisor in an effort to clarify eligibility for the new Government R&D tax incentive programme to ensure that New Zealand's energy sector can lead the evolution of new agile business models, disruptive processes and innovation that will both directly benefit New Zealand consumers, and be internationally desirable.

Submission

We submit that Genesis (and similar publicly listed companies under the mixed ownership model) should be eligible for the R&D tax incentive and that the Government needs to clarify this position.

We make this submission at the request of officials in order to assist them to clarify an area of apparent confusion.

Issue

In relation to the eligibility of Government entities for the R&D tax incentive the Discussion Document notes that (at page 15):

> *"The focus of the Incentive is on private businesses. The place for entities funded by government needs to be considered. State Owned Enterprises are not eligible for Growth Grants and Crown Research Institutes, District Health Boards, Tertiary Education Organisations, and subsidiaries under their control were not eligible for the 2008 tax credits."*

The principles behind this exclusion from eligibility are that:

i) The R&D tax incentive is intended to stimulate R&D by the private sector in addition to that already funded by Government; and
ii) Entities funded by Crown appropriation are already directly funded by Government for the R&D that has been approved as part of the entities' annual budget and appropriation cycles.

Those principles are coherent but when applied to a publicly listed company like Genesis, should result in Genesis being eligible for the R&D tax incentive.

Reasons Genesis should be eligible for the R&D tax incentive:

1. The Discussion Document is clear in its intent that Genesis should be eligible.

The Discussion Document is clear in reflecting the Government's intent that State Owned Enterprises (**SOEs**), Crown Research Institutes, District Health Boards, Tertiary Education Organisations, and subsidiaries under their control are not intended to be eligible for the R&D tax incentive.

As a factual matter, Genesis is a publicly listed company and is not an SOE, Crown Research Institute, District Health Board, Tertiary Education Organisation, or a subsidiary under any of those organisations' control.

We note that Genesis was intentionally removed from the list of State Enterprises outlined in Part A of Schedule 36 of the Income Tax Act 2007 with effect from 14 March 2014. This was as a consequence of the Government's decision to convert the company into a publicly listed company and sell 49% of the Government's shareholding to the public. Genesis has since been listed in Part B of Schedule 36 as a Mixed-ownership Enterprise.

As such, in terms of the Government's policy as expressed in the Discussion Document, Genesis is specifically intended to be eligible for the R&D tax incentive.

The current uncertainty created by the varying views from officials must reflect either an undisclosed change in Government policy since the Discussion Document was released, which would be disappointing, or signal internal confusion about the Government's policy intent, which is unsatisfactory and should be speedily resolved.

2. Genesis is not funded by Crown appropriation.

Genesis is an ordinary public company that is funded by equity owned by its shareholders, debt raised in the markets and working capital generated from its business. Genesis is not funded by Crown appropriations. The Crown through the shareholding Minister is simply an equity investor in Genesis, alongside thousands of other private investors. Alongside and pro-rata with the public shareholders,

the Crown receives a dividend return on its equity investment with the rate varying depending on the business performance of Genesis.

Genesis is part of the private sector and is not Government funded. It does not meet the two principles for exclusion from the credit outlined above and therefore should be eligible.

3. Genesis would be unfairly disadvantaged compared to its competitors

As intended under successive Government's energy industry policies, Genesis competes fairly in the market for business against other publicly listed and privately owned companies. Genesis is focused on innovating and transforming its energy management services to attract and retain customers, contribute to sustainable energy use in New Zealand, and provide an investment return to its shareholders. If Genesis is not eligible for the R&D tax incentive and its competitors are, that would be an unfair disadvantage.

The Government was able to successfully sell down its shareholding in Genesis to the public on the basis that the company would be operated independently as a publicly listed company. Differentiating Genesis from other competitors on the basis that the Crown has retained a 51% equity interest disadvantages the public shareholders of Genesis.

4. Genesis's efforts to innovate energy management align closely with Government objectives on sustainability and mitigating climate change.

Genesis is investing in innovation in energy management for customers which is technology led, providing customers with more information and advice about their energy use. Providing an enhanced customer experience and putting customers in control of their energy could allow energy to be used more efficiently, reducing long run demand and therefore contributing to reducing the negative climate impact of thermal generation. This innovation is being funded from business revenue and is not Government funded. This is exactly the type of R&D expenditure that aligns with the Minister of Research, Science and Innovation's commitment to increasing R&D expenditure to 2% of GDP over the next 10 years.

5. New Zealand shareholders would be disadvantaged compared to foreign companies.

The Minister of Science, Research and Innovation has stated that offshore companies will be eligible to receive the R&D tax incentive as a measure to attract international companies to set up and perform R&D in New Zealand (NBR 22 May 2018). This makes sense as New Zealand should benefit from any associated "spill over" effect if the innovation is undertaken in the country.

If Genesis is not eligible for the R&D tax incentive for innovation that it undertakes in New Zealand, but foreign companies are eligible, then Genesis's New Zealand public shareholders will be disadvantaged when compared to shareholders in foreign companies that undertake R&D in New Zealand. That would be poor policy and difficult to rationalise on a principled basis. It may also pose a political risk for a Government to favour foreign owned businesses over a domestically listed company.

Conclusion

In conclusion we submit that Genesis should be eligible for the R&D tax incentive because:

i) The company is a publicly listed company operating in the private sector;
ii) The company is not funded by Crown appropriations;
iii) The company is undertaking the type of innovation and R&D that is consistent with Government objectives and that the R&D tax incentive seeks to encourage; and
iv) Making the company ineligible for the R&D tax credit is an unfair disadvantage for the company and its public shareholders when compared to other market participants (including foreign owned entities undertaking R&D in New Zealand).

Please don't hesitate to contact us if you would like further information in support of this submission or would like to discuss any aspect in more detail.

Yours faithfully

s 9(2)(a)

s 9(2)(a)

FISHER & PAYKEL

R&D Tax Incentive Team
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
NEW ZEALAND

Via email: RDincentive@MBIE.govt.nz

1 June 2018

Dear Sir / Madam

RESEARCH & DEVELOPMENT TAX INCENTIVE FOR NEW ZEALAND

We refer to the discussion paper *"Fuelling Innovation to Transform our Economy"* (the Paper). We welcome the opportunity to submit on the design settings and proposals for the R&D tax credit.

EXECUTIVE SUMMARY

We believe a new tax incentive has the potential to significantly grow business expenditure in R&D (BERD), increasing demand for highly skilled and well paid jobs and generating a wealth of technical knowledge and capability in New Zealand. However, we feel certain design features proposed for the new regime overly restrict rather than incentivise real R&D activities, and could thereby undermine the incentive's chance of success.

- We believe the target of 2% in 10 years articulated in the Paper is not ambitious enough. Given that the current OECD average is 2.38% we suggest that 2% should be a starting point.
- We suggest increasing the tax credit rate to 15% to match the last tax incentive and to heighten motivation.
- We are opposed to the materiality test and dual purpose proposals in their current form on the basis they are too subjective and create significant uncertainty. We suggest these proposals are removed or replaced with clearer and more targeted mechanisms for distinguishing R&D from non R&D activities.
- We see no advantage in limiting eligible R&D spend to labour or applying a fixed percentage to overheads. Different industries and businesses will have vastly different R&D cost structures. Non-labour R&D expenses are both significant and critical.
- We do not support a blanket exclusion of costs. Costs which are wholly or mainly for the purpose of, required for, and integral to core R&D should be eligible.
- We strongly advocate for incentivising R&D undertaken in New Zealand under contract for commercial consideration from a foreign related entity. Many New Zealand R&D businesses, including ourselves, are subsidiaries of large multinationals and compete internally for R&D contracts within their groups. R&D activities in this category promise to generate a significant contribution to the incentive's goals.
- We believe that R&D capitalised for accounting purposes should be incentivised on the same basis as expensed R&D. Regardless of whether R&D is expensed or capitalised the use of highly skilled and paid labour is the same.
- Finally, we suggest the incentive should be a refundable credit to all from the start, as with the previous tax credit so that all R&D businesses can benefit. One of the disadvantages of moving from a grant to a tax credit is the matching of cash flow out with cash flow in. De-risking appropriate cash-flow challenged R&D projects is critical to lifting BERD.

Set out below is some background on our business followed by discussion on what we consider to be the key questions and issues from the Paper. We have not responded to questions which are of limited significance to us.

BACKGROUND

- Fisher & Paykel Appliances (FPA) is a global business which designs, manufactures, markets and distributes household appliances globally. Our headquarters and R&D facilities are located in New Zealand.

- Our R&D facilities located in Auckland and Dunedin currently employ over 370 technical staff which includes engineers, scientists, and technicians with qualification levels up to and including PhD. These staff have extensive product, process, research & development experience and knowledge. FPA has a long history of training and developing engineers to give them a strong R&D foundation that flows into the New Zealand R&D ecosystem.

- FPA is globally renowned for its innovation in household appliances and has an extensive patent portfolio.

- FPA is part of the Haier group of companies which is now the biggest appliance manufacturer globally with a turnover in 2017 of USD 38 billion. The group has R&D facilities in the following countries; New Zealand, USA, Europe, Japan and China which includes GE Appliances and Haier Asia International (HAI) which was formerly part of Sanyo Appliances in Japan. As a member of the group, FPA competes with other members to win R&D group work. We have already had success in this arena and the ability to win further R&D will continue to build knowledge, and grow our R&D resource based in New Zealand.

- Although FPA expenses most R&D costs, a significant portion is capitalised where appropriate in accordance with accounting standards. Capitalised development expenditure is typically amortised for accounting purposes over 3-5 years.

- In recent years FPA has faced significant currency and competitive challenges. Through this challenging period we have continued to invest heavily in R&D leading to tax losses in New Zealand. The cash flow boost provided by the prior R&D tax credit (refundable) and R&D Growth Grant have helped R&D investment continue and even grow during these more challenging periods.

TRANSITION

We consider that a smooth consultative transition from the R&D Growth Grant to R&D tax credit is important and are pleased the Government shares this view. A seamless transition should help ensure that existing planned R&D activities and associated contracting and funding arrangements are not disrupted.

It appears that the details of the 1 year transitional grant/credit may still be under development. We are interested learning more about the transitional arrangement and if appropriate working with officials as the details develop. Assuming we are successful in rolling over our existing R&D Growth Grant (due to expire 30 September 2018) we are interested in better understanding:

- Our options from 1 April 2019. It appears these may be to: (a) continue the R&D Growth Grant arrangement until 31 March 2020; or (b) elect into the 1 year transitional refundable credit/grant regime; or (c) elect into the standard permanent R&D tax credit regime.

- Likely quarterly reporting and other obligations for the 1 year transitional refundable grant/credit.

R&D TAX CREDIT DESIGN

In our view the definitions and rules used to determine eligible activities and expenditure under previous R&D tax credit regime generally worked well and were suitably balanced. In contrast certain new design features being contemplated for the new rules risk inappropriately lessening the value, scope, fairness and certainty of the incentive, to the point where appropriate legitimate activities would not be incentivised. These new design features do not appear aligned to the objective of increasing New Zealand's R&D.

Page 16 of the Paper refers to lessons learned from the previous R&D tax credit. We are unsure of exactly what these lessons were, but suggest these be specifically defined and where appropriate addressed with specific targeted measures. The risk of not doing this is that there could be an overreaction whereby certain "good" R&D activity that should qualify is inadvertently rendered ineligible.

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

We consider the definitions of core and support activities a reasonable description of R&D in our organisation. However, we would suggest the phrase "scientific method" is replaced by "systematic method". A scientific method infers an academic approach which is an aspect of R&D rather than a definition. A systematic method is more of an all-encompassing description that helps cover both public and private sectors.

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?

We do not support the materiality test as this would cause uncertainty.

We are unclear as to what a materiality test is or would be, including who would apply it and how they would be qualified to apply it or interpret it. We note that the Paper does not include a definition of materiality for the problem or intended advancement.

The double barrelled materiality test (to both the problem and advancement) appears to introduce significant subjectivity / uncertainty. We therefore suggest the materiality test be removed.

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

We are opposed to a blanket application of the core activity exclusions to support activities.

R&D is uncertain in nature and we believe there is a high likelihood that a blanket application of these exclusions to support activities would disallow genuine R&D activities.

Every activity in an R&D project should be judged on its own merits. An activity that is specifically excluded from core R&D should not automatically be excluded from qualifying as a support activity. Incentivising activities that are wholly or mainly for the purpose of, required for, and integral to core R&D seems entirely appropriate.

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?

We oppose the exclusion of dual purpose activities as, based on information within the Paper, this would introduce significant uncertainty.

We assume the intention of this clause may be to separate incidental discovery during business as usual from planned and targeted R&D. However, this is not clear as the discussion paper states *"if an*

activity was carried out for a R&D purpose and for a non R&D purpose then the entire activity would not qualify". This is far more limiting and taken literally would probably eliminate almost all R&D activities from being eligible.

The purpose of R&D is dual, to gain knowledge and to increase the wealth of the business through the continuous development of innovative new products which compete with the best rivals in price, capability and/or quality. Very few businesses are in a position to conduct R&D solely for knowledge's sake. To truly support the growth of R&D skills and technology in New Zealand the R&D tax credit should incentivise R&D whether dual purpose in nature or not.

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

We do not support this proposal as we believe it will be impossible to select a rate that suits all.

This approach may be being considered to simplify the process of tracking and claiming R&D, however, businesses such as ourselves already track all the costs allocated to a project by their nature - in our business such costs are required to be tracked in this way for both internal project management and financial reporting purposes. As such we should be able to claim all of these costs as the core non-labour R&D spend is significant and critical to carrying out R&D activity.

Disadvantages are:

- The labour cost element is only a portion of R&D cost and is not representative of the total R&D cost or activity. As our labour cost component is around 50% we would need the tax credit rate to at least double.
- Such an approach assumes that prototyping materials, consumables and outsourced research would be uniform across all industries. The rate would have to be high enough to avoid penalising companies with a low labour cost leading to winners and losers and distortions in the true value of R&D.
- There is a risk that this would not reward R&D / capital intensive company appropriately for the non-labour components. In an industry where materials used in R&D activities are more expensive than others e.g. steel over plastic or no materials (software development) this industry would be disadvantaged where the expenses required to carry out the activities in relation to the labour cost are significantly different to other industries which may have very little expenses outside of labour.
- The current growth grant captures non-labour direct R&D costs, as did the previous R&D tax credit. Other R&D tax credit regimes also typically allow for non-labour components to be included.

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?

We do not agree with this proposal as the overhead cost proportion to R&D spend varies between businesses too greatly.

In theory it may be easier to allocate overheads on a percentage basis. In practice, however, calculating an appropriate percentage that is suitable to all may be very difficult and inaccurate. In organisations for whom R&D is a key activity there is likely to be a higher overhead cost to support their operations, compared to organisations with no dedicated R&D personnel. If the percentage is set too low then large organisations would be claiming a lower BERD than they actual incurred. We prefer an approach where eligible supporting overheads are attributed based on a reasonable apportionment to R&D operations.

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.

We believe "good" R&D should be eligible for the incentive when commercial consideration is received from a foreign related entity.

Multinational groups that have global R&D centres will bias their research activities to the regions that give them the best commercial advantage. As a regional R&D centre grows there are many benefits to the local R&D and wider economy. Such benefits include hiring and training of local talent and the dissemination of knowledge. The fact that the research activities have been funded by a foreign related party and the ownership of registered IP may be outside of New Zealand does not diminish from the substantial employment, knowledge and associated spill-over benefits to New Zealand. As such, we suggest that appropriate R&D activities performed by New Zealand members of multinational groups should be incentivised regardless of whether the New Zealand entity is paid for its R&D services and/or the resulting IP is owned by a foreign related party.

As noted above FPA performs R&D services for foreign related parties. FPA developed a table top dishwasher on behalf of Haier for the China market. Haier funded this development but in addition to the income we received, FPA developed and retained substantial R&D skills and capability. There are now many other R&D projects within the Haier Group which are being undertaken by other R&D centres for example GE in the USA and Haier in China – both the USA and China provide incentives for qualifying R&D activities/entities. However, as FPA is paid at arm's length for these R&D services (pursuant to New Zealand's transfer pricing rules) and typically does not own any registered IP arising, this activity currently appears to be excluded from the incentive. This outcome seems contrary to the underlying policy rationale articulated in the Paper, e.g. the Paper recognises that lifting BERD will require growing and/or attracting large R&D performing firms and that this is essential to the New Zealand economy.

Where commercial consideration is received from a New Zealand entity the rules should quite rightly prevent double dipping.

CAPITALISED DEVELOPMENT

We consider that development costs capitalised for accounting purposes should be eligible for the tax credit, in a manner broadly similar (but enhanced) to the previous R&D tax credit regime. The accounting treatment alone should not be determinative; capitalisation for accounting purposes does not in any way detract from the highly skilled labour employed or knowledge gained and retained.

As noted above although FPA expenses most of its R&D a significant component of R&D expenditure (primarily employee remuneration concerning technical functions, development functions, electronics and chief engineers) where it considers this appropriate under accounting standards. We understand there are a range of accounting treatments adopted for development expenditure by New Zealand corporates for a range of reasons. One such reason may be the accounting rules themselves - as the OECD suggests[1] accounting rules (IAS38) appear to *"implicitly confer significant discretion to firms as to whether to capitalise"*.

We note that the existing R&D Growth Grant regime excluded development cost capitalised for accounting purposes. We suggest that this is a somewhat arbitrary distinction and arguably inconsistent with the underlying policy rationale.

Given the above, and the fact that the previous New Zealand R&D tax credit[2] and the current Australian R&D Tax Incentive regime both provide incentives for appropriate capitalised development expenditure we strongly suggest that the new R&D tax credit should do the same. We also question why, under the previous R&D credit regime, only certain core (and not supporting) capitalised costs qualified.

[1] OECD TIME-SERIES ESTIMATES OF GOVERNMENT TAX RELIEF FOR BUSINESS R&D - TAX4INNO Project 674888
[2] Refer to the now repealed sLH 5(1)(c)(ii)

BUSINESSES IN TAX LOSS

We consider that the R&D tax credit should be a refundable credit (to all not just certain R&D Growth Grant recipients under the transitional scheme) from its introduction in April 2019. A refundable credit would provide the cash flow certainty necessary for certain "borderline" R&D projects to proceed. As some R&D projects will proceed regardless, incentivising appropriate cash-flow borderline projects to proceed would seem to us to be critical to lifting BERD.

As noted above FPA has faced currency and competitive challenges leading to tax losses in New Zealand in some recent years. Pressure to meet short term profitability targets would have, in some organisations, led to cuts in R&D spend. However, we have made conscious decisions to continue to invest in R&D with the cash flow benefit provided by the prior R&D tax credit (refundable) and R&D Growth Grant being significant features in these decisions.

In more general terms, making the new R&D tax credit refundable to all from the start would help enable investment in R&D to continue (i.e. not be cut) during periods in which businesses face profitability and funding challenges.

ADMINISTRATION

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

The Paper suggests that the Inland Revenue will administer the R&D tax credit supported by Callaghan Innovation. Given Callaghan's expertise in R&D we believe they are best placed to make determinations on whether an R&D activity is eligible or not.

We suggest that a mechanism be developed to provide upfront certainty of eligibility for the incentive to organisations for which R&D is a significant activity. The objective of the mechanism would be to provide increased certainty and lower compliance costs for suitable taxpayers and the Government. Providing upfront certainty to taxpayers is critical to lifting BERD, as if taxpayers are unsure of their entitlement they are less likely to commit to expenditure and therefore BERD will not increase in the manner intended.

CONCLUDING COMMENTS

We trust the above comments are helpful and would welcome the opportunity to meet with officials to discuss our submission. If you would like to discuss any of the above, please contact s 9(2)(a)

Yours faithfully

s 9(2)(a)

Fisher & Paykel Appliances Ltd
78 Springs Road, East Tamaki, Auckland 2013, New Zealand
PO Box 58546, Botany, Auckland 2163, New Zealand
T +64 9 273 0600 F +64 9 273 0609
FISHERPAYKEL.COM

1 June 2018

R&D tax incentive team
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

Email: RDincentive@mbie.govt.nz

Dear Sir/Madam

Attached are the comments that the New Zealand Food & Grocery Council wishes to present on *Fueling innovation to transform our economy: a discussion paper on a Research and Development Tax Incentive for New Zealand*.

Yours sincerely

s 9(2)(a) [redacted]

s 9(2)(a) [redacted]

Fueling innovation to transform our economy: a discussion paper on a Research and Development Tax Incentive for New Zealand

Submission by the New Zealand Food & Grocery Council

1 June 2018

NEW ZEALAND FOOD & GROCERY COUNCIL

1. The New Zealand Food & Grocery Council ("NZFGC") welcomes the opportunity to comment on .

2. NZFGC represents the major manufacturers and suppliers of food, beverage and grocery products in New Zealand. This sector generates over $34 billion in the New Zealand domestic retail food, beverage and grocery products market, and over $31 billion in export revenue from exports to 195 countries – some 72% of total merchandise exports. Food and beverage manufacturing is the largest manufacturing sector in New Zealand, representing 44% of total manufacturing income. Our members directly or indirectly employ more than 400,000 people – one in five of the workforce.

OVERARCHING COMMENTS

3. NZFGC is supportive of R&D incentives and agree that all in New Zealand stand to benefit from a system that encourages and supports R&D conducted by New Zealand business irrespective of size, form or stage in maturity. Elements vital for business uptake are predictability, certainty, ease of participation, clarity of eligibility, and confidence in the system.

4. We comment on the rate of 12.5% being lower than previous schemes and not sending the right signals in terms of either New Zealand growth of R&D nor to attracting overseas involvement.

5. For system design, we comment on other forms of business R&D, the significance of defining key terms (eg 'scientific method), re-solving problems in new and innovative ways, the importance of piloting and trialling in R&D programmes and the significance of activities in the behavioural sciences as core R&D activities.

6. NZFGC supports the application and inclusion of support activities but queries some of the excluded activities. We are strongly supportive of a percentage of R&D expenditure conducted offshore being eligible but question whether the level proposed (10%) is a realistic amount. We also comment on direct and indirect labour costs for determining eligible R&D expenditure.

7. We support reconsideration of 'commercial consideration' and support a minimum threshold but suggest a lowering of that threshold might be more reasonable. We support both caps and mechanisms to go beyond caps favouring both options but for both to have statutory timeframes be applied with opportunities for government to 'stop the clock' under certain conditions.

8. On evaluation and transparency, we suggest longer timeframes to elements of both and NZFGC supports sustainability of programme administration for both businesses and Government. Documentation, systems and processes need to be designed that can leverage existing data and IT systems and processes. This design should be co-developed by Government and business. Finally, we are strongly supportive of guidance and information for claimants being available well in advance of commencement.

DETAILED COMMENTS

9. NZFGC is supportive of R&D incentives. In a globalised environment, businesses aim to locate R&D to capture benefits (such as incentives) and advantages not available within New Zealand. We agree that all in New Zealand stand to benefit from a system that

encourages and supports R&D conducted by New Zealand business irrespective of size, form or stage in maturity.

10. Predictability and certainty are vital elements to such incentives and while we recognise changes might need to be made over time, we make suggestions about timing. Ease of participation for smaller business, clarity of eligibility, and confidence in the system are all important attributes that have been identified in the paper.

Overall rate of Tax credit

11. We understand that 12.5% is below the rate of previous tax credit scheme (15% in the 2008 tax credit scheme and 20% (14.4% after tax) of the growth grant scheme. Locking in 12.5% does not send the right signal in terms of either New Zealand growth of R&D nor to attract overseas relocation.

Eligibility of Government entities

12. We note the focus of the incentive is private businesses. The paper also advises that State owned Enterprises (SOEs) were not eligible for Growth Grants and that Crown Research Institutes, District Health Boards and Tertiary Education Institutions and subsidiaries under their control were not eligible for 2008 tax credits.

Q1	If SOEs, Crown Research Institutes, District Health Boards and Tertiary Education Institutions and their subsidiaries are excluded from the tax incentive, what will the likely impact be on business R&D in New Zealand?

13. Partnership between agencies in a small country is a reality of operation and growth. Except for the Crown Research Institutes, none of the named agencies necessarily have research as a core activity. Providing for a partnership approach or a percentage of tax incentive to apply to entities funded by government might not crowd out businesses but rather 'expand the R&D pie'. We suggest MBIE model the impact to reach a decision on this proposals

Design

14. NZFGC supports the eligibility proposals of the R&D incentive to link with the tax system (eg meet the tax test of being in business) but has some concerns about control, bearing financial risk and owning the results of the R&D.

15. External investment is a feature in some R&D developments where control, risk and results may well be shared. We note provision has been made for industry cooperatives and levy bodies but no mention is made of joint ventures or business arrangements or forms that reflect private investment by individuals or other companies which may also feature. What provision has been made for these arrangements which often provide critical mass, generator capability and smoothing of risk in return for shared intellectual property, commercial capture or trade rights?

16. The definition of R&D is given as: '[a] those activities conducted using scientific methods that are performed for purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes or services; that are intended to advance science or technology through the resolution of scientific or technological uncertainty'.

Q2	How well does this definition [of R&D] apply to business R&D carried out in New Zealand?
Q3	Does this definition exclude R&D that you think should be eligible? Please illustrate with examples.

17. The food and grocery manufacturing industry is involved in all the tangibles identified for new knowledge or creation (materials, products, devices, processes or services). However, as the paper identifies, the definition of 'scientific methods' is pivotal to the scope of the programme whilst defining what is the threshold for 'advancing' science or technology and whether steps to resolving scientific or technological uncertainty also qualify are all areas of uncertainty. We understand that 'scientific methods' has been replaced by 'a systematic approach' and support this change.

Q4	Does the scientific method requirement exclude valid R&D in some sectors, please illustrate with examples?

18. The paper does not define 'scientific method' but as noted above, this is a critical element in setting the scope of the programme.

Q5	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 and technology?

19. The paper states that that the incentive is intended to support R&D that addresses 'a material problem' and 'anticipates a material advance in science or technology' but then goes on to say this is limited to 'solving problems that have not already been solved'. Many problems get solved in business one way or another and many have been solved over time but development does not stop and refinement, cost effectiveness, remodelling or reapplication might well re-solve problems in new and innovative ways and advance science and technology in the process eg alternative packaging systems and shelf life technologies for perishable goods.

20. It is possible that the necessary guidance on parameters of materiality for problems and advancement would need to be extensive and assessment may well be complex and difficult, defeating the objective of ease of use and agility in uptake.

21. We note that R&D does not have to be successful to be eligible for the tax incentive. We think this is practical and realistic. Research is by default the study of unknowns. Industry is not in the business of applying investment funds to failures but at times that is a reality. We wonder about the application of the incentive for a project that fails to deliver an advancement in one field but might deliver re-engineered or reimagined products or services in another if piloting or trialling proves successful. One project's failure can often be a key factor to the success in future work on the same issue. Market pilot testing is a test of materiality and part of defining the advance. We ask for consideration of including in core or support activity rather than being the subject of a blanket exclusion.

Support activities

22. Support activities are defined as '[b] those that are wholly or mainly for the purpose of, required for, and integral to, the performing of the activities referred to in paragraph (a) [core research activities]'. The example is given of activities that are part of an R&D project but do not, by themselves, advance science or technology such as literature searches.

Q6	How well does this definition apply to the business R&D carried out in New Zealand?

23. The food and grocery sector manufactures products often for direct consumption and use by consumers. Consumers are the ultimate arbitors of 'success' setting aside (mostly) safety matters. Pilot testing, panel testing, etc are essential elements to the direction and

success of scientific advances. From this perspective we consider them integral to business R&D core activities. However, we note an exclusion is 'market testing' or 'market development'.

24. The importance in the food environment for certain activities is mouth feel, taste and smell and these are relevant to R&D proceeding. Panel testing can be conducted 'in market' or in an R&D facility. Testing in an R&D facility or a similarly controlled environment we would propose is part of the R&D while 'in market' testing might be treated differently depending on breadth etc. The definition of 'support activities' therefore fits with food and grocery manufacturing business R&D carried out in New Zealand.

Activities excluded from the tax incentive

25. The paper provides a comprehensive list of exemptions (Attachment A) some of which are commented on in the preceding paragraphs. Two other exclusions of concern are pre-production activities and dual purpose activities (see commentary in response to Q9).

Q7	Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe

26. We are unclear if 'pre-production activities' refers to preparation for the R&D activity or to the commercialisation of R&D undertaken. Greater clarity of what pre-production activities mean is required. Experimentation on a commercial scale shortens the time to commercialising R&D and is simply an efficiency element in the research programme. We suggest true scale-up and experimentation on manufacturing facilities should be included in R&D programme boundaries.

27. Our understanding of trialling is that it is integral to R&D eg trialling the strength of packaging innovations to withstand handling or external pressures and impacts. Scientific trials and trial runs of theoretical models or experimentation are core R&D activities. Greater clarity of this term is required. Inter-laboratory ring trials might also be factored into this consideration.

Q8	Please provide any examples where social science research is/has been a core part of business R&D in New Zealand.

28. The test of success of R&D in food and grocery manufacturing is in consumer uptake and this often involves social science research in, for example, consumer behavioural science as just one example. Activities in the behavioural sciences should be eligible as core R&D activities.

Q9	What is the likely impact on business R&D in New Zealand if dual purpose activities are ineligible for the R&D Tax Incentive?

29. In relation to dual purpose activities, and we wonder if better definition would address misuse or past experiences rather than a blanket exclusion. The paper identifies four arguments against dual purpose activities – inclusion of business as usual (BAU) costs, better targeting of activities if exclusive, consistency with income tax rules and similar to those adopted in some other jurisdictions.

30. On BAU costs we suggest better definition of BAU or excluding BAU costs. On better targeting of R&D activities, we do not believe this to be the outcome of singular R&D but rather no R&D uptake in a small scale environment. Economies of scale in R&D are just as relevant as application of this aspect in other environments and dual purpose activities

may be the difference between R&D being conducted or not. It is also an offset in the event of failure by providing some return on investment.

31. We cannot comment on income tax boundaries but in relation to the limitations in other jurisdictions, we would suggest there are as many variations as there are R&D incentive schemes. We believe more thought could be applied on how the problems of misuse or misallocation of incentives might be remedied without excluding all dual purpose activities.

Overseas R&D

32. We appreciate that the incentive is about encouraging R&D to be conducted in New Zealand. The reality is New Zealand does not always have the equipment, expertise or population to conduct or apply the R&D a project requires. Examples are in clinical trials of foods and medicinal products, hosting international experts to work in New Zealand (and transfer knowledge) and facilities as close as Australia (eg the Multi-Axis Substructure Testing (MAST) system providing cutting-edge technology to test the integrity of new materials and structures in Melbourne and CSIRO) and beyond (eg Eurofins facilities). We are therefore strongly supportive of a percentage of R&D expenditure conducted offshore being eligible. We question the percentage level of 10% and while we support this as a bare minimum we suggest that this should be increased to 20% as a more realistic amount. We also suggest that expenditure on international experts temporarily hosted in New Zealand be considered domestic expenditure.

Eligible expenditure on R&D

33. Two approaches are proposed for determining eligible R&D expenditure: direct R&D labour costs and a broader range of direct and indirect costs.

Q10	If What are the advantages and/or disadvantages of limiting eligible expenditure to R&D labour cost?

34. While labour costs recognise the intellectual capital of the scientific process and would simplify decision-making by government, it is simply too narrow. This is particularly the case when Australia does not limit eligibility to its scheme to labour. Trans-Tasman activities are significant in the food and grocery sector. It is the only area where we share legislation (the Food Standards Code) and it is a major part of the Closer Economic Relationship of the two countries. While we are not advocating adoption of an Australian system, we do believe that in the area of eligible expenditure we should at least match Australian provisions.

35. Direct labour costs also ignores materials and equipment that the labour relies on and without which scientific methodologies are not undertaken or are sub-optimal.

Treatment of overhead costs

36. Two approaches are proposed for the treatment of overhead costs: apportioned overhead costs when they are incurred partly for R&D activities; calculate overhead costs as a set percentage of the direct labour costs for the R&D activity.

Q11	What are the advantages and/or disadvantages of setting overhead costs as a percentage of R&D labour costs?

37. Aside from the disadvantage identified in the paper, of creating bias against capital intensive R&D activities, it ignores the impact that such bias has on building R&D capacity. Plant and equipment can attract R&D talent, develop R&D capability and determine the extent of R&D sustainability. These would seem to favour the apportioning approach.

38. The paper provides a lengthy list of ineligible expenditure. We have no comments on this list.

Commercial consideration

39. It is proposed to strengthen the "at risk rule" that applied to the 2008 tax credit by adopting the Australian rule that excludes expenditure that relates to R&D activities for which the entity conducting the activity has received or could reasonably be expected to receive consideration.

Q12	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

40. Key reasons include that in-house R&D has been a feature of food business development over time. The proposal would unfairly penalise those businesses that have taken the initiative and investment to build R&D facilities within their businesses and provide employment for skilled New Zealand researchers through their careers. Again we would suggest that sustainability needs to provide for the initiators and developers, the pioneers of material solutions to material problems.

41. While we have in the foregoing supported consistency with Australia, where we can provide advantage, we should. A point of difference in R&D in the trans-Tasman environment could be as simple as reconsidering the 'commercial consideration' test.

Software R&D

42. While software is a key aspect of any business in the 21st century, we have no comments to make on these proposals and Q13 or Q14 at this time.

Minimum threshold and Approved Research Provider

43. A minimum threshold of $100,000 on R&D is proposed unless an Approved Research Provider is used.

Q15	Is the minimum threshold set at the right level? If 'no, please provide further details.

44. Small companies would be unlikely to undertake research within their facilities and would more likely utilise external facilities. From that perspective a threshold approach seems appropriate. However we question the appropriateness of setting the threshold at $100,000 and suggest a lower threshold should be applied with a review of uptake of this element conducted after two years to assess ongoing appropriateness

45. The criterion for Approved Research Provider concerning "have in New Zealand the facilities needed to perform the R&D activities" does not allow for the bulk of the activities to be conducted by an Approved Research Provider but other parts being provided by others. It is not clear.

Businesses in tax loss

46. We note the scheme would result in a refund of other taxes paid such that only those in a tax payable position would gain benefit. Has MBIE determined the level of exclusion this creates including to our largest companies? The paper identifies the largest companies generate the largest R&D investment. As well start-up businesses often have high R&D investment costs at the outset in a tax loss environment. These should both be factors in reconsidering the position on businesses in tax loss situations.

Maximum claims

47. A maximum of $120m on R&D is proposed for claiming a tax credit. Mechanisms for incentivising R&D spend above this level include: Ministerial discretion to waive the cap for claims; and pre-registration for large claims.

Q16	How important is a cap or a mechanism to go beyond the cap? Please provide further details.

48. The question might better be 'do we want to attract big R&D projects to New Zealand?' It would seem the answer to that is we want to develop R&D irrespective of size in which case the answer is that a mechanism to go beyond the cap is very important. There are companies operating in the food and grocery sector in New Zealand that globally have R&D expenditure vastly in excess of $120m. Attracting a small percentage to New Zealand is worthwhile.

49. In order to provide for going beyond the cap two mechanisms are proposed: Ministerial discretion or pre-registration.

Q17	What features of a Ministerial discretion or pre-registration would make them most effective?

50. NZFGC supports both since there will be circumstances when one will work well but a reserve option is needed. In both cases statutory time limits to reach decisions should be applied and in both cases, criteria setting down circumstances could provide for the statutory time limit to be subject to a 'stop the clock' pause. In addition, guidance on minimum information requirements would enhance the process.

Evaluation and Transparency

51. The intention is to adjust the incentive programme if the goals to benefit New Zealand are not being met. The intention is also to review the programme within four years of commencement.

Q18	What are your views on the proposed mechanisms to promote transparency and enhance evaluation?
Q19	Are there any other risks that need to be managed? Please describe.

52. Evaluation is essential but a review within four years seems too short a period. Monitoring is intended to continue throughout and will be essential for making adjustments to increase goal achievement. However, we suggest a sequenced programme of review of elements over the five years and a full review after five years to be a more practical approach.

53. On transparency, we don't believe a two year lag in the publication of names and amounts (in bands) to be long enough to protect commercially sensitive information. Even in the food industry, two years of exclusive capturable benefit is provided after the completion of R&D and development not during. The relative anonymity of data used in Statistics New Zealand application databases is acceptable.

Penalties

54. The proposal is to extend penalties where an advisor has or would have received a direct financial benefit from the claim (in the form of a fee contingent on the R&D Tax Incentive).

Q20	What are the risks with making external advisors liable in this way?

55. While extension of penalties may limit the form of payment to advisors, it should not limit the business of advising since other forms of payment are available.

Administration

Q21	What is the right level of information required to support a claim?
Q22	What opportunities are there for customers to submit R&D Tax Incentive claims via third party software
Q23	What integrity measures do you think Inland Revenue should use?

56. NZFGC supports comments concerning sustainability of programme administration for both businesses and Government. Documentation and processes need to be designed that can leverage existing data and IT systems and processes. This design should be co-developed by Government and business.

57. We also support the concept of making provision for dedicated R&D centres to be treated singularly in the administration process thereby reducing duplicative and repetitive research documentation. This may also encourage relocation decisions.

58. For efficiency in the claims process we are strongly supportive of guidance and information for claimants being in place well before commencement.

Attachment A

Proposed exclusions from R&D Incentive

- Prospecting, exploring or drilling for minerals, petroleum, natural gas and geothermal reserves
- Research in social sciences, arts or humanities
- Market research, market testing, market development or sales promotion (including consumer surveys)
- Quality control or routine testing of materials, products, devices, processes or services
- The making of cosmetic or stylistic changes to materials, products, devices, processes or services
- Routine collection of information
- Commercial, legal and administrative aspects of patenting, licensing or other activities
- Activities involved in complying with statutory aspects of patenting, licensing or other activities
- Management studies or efficiency surveys
- The reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information
- Pre-production activities such as demonstration of commercial viability, tooling up and trial runs
- Dual purpose activities.

R&D Tax Incentive

By email: RDincentive@mbie.govt.nz

Dear R&D Tax Incentive Review Team

Thank you for the opportunity to make a written submission on the design and makeup of the proposed research and development tax incentive.

Having reviewed the briefing documents and discussed the questions raised at the senior levels of Temperzone I am pleased to submit our views below.

1.Introduction to Temperzone

Temperzone Ltd ("Temperzone") is a New Zealand owned and operated business. Established in 1956 we are the largest and longest serving manufacturer of air conditioning products in Australasia.

Two manufacturing plants in Auckland and Sydney employee over 450 and 250 employees respectively and occupy 50,000m² of factory and warehousing.

We serve the market with offices and distributors right throughout Asia, Australasia and the Pacific Islands.

Temperzone has been a recipient of the Callaghan Growth Grant and Project Grant for the last 8 years and to a total value of s 9(2)(b)(ii). In that period Temperzone has spent s 9(2)(b)(ii) [redacted]

s 9(2)(b)(ii) [redacted]

2.R&D definition and eligible spend

The definition creates uncertainty over what is covered, and the extent to which the scientific methods could be interpreted. That said Temperzone has interpreted the definition of research and development and thereby the type of expenditure eligible for receipt of the tax credits to being aimed a theoretical research. "*activities which resolve scientific or technological uncertainty*"

Temperzone operates at the applied end of the research spectrum taking existing technology from within our industry or related industries and applying them to our product range.

Under the proposed definition Temperzone would see a large proportion of its current expenditure excluded.

The discussion paper raises the question as to whether eligible cost should include all material, labour and overheads or labour alone at a high rate. Being a manufacturer Temperzone's R&D spend includes a material amount of material and overheads so obviously supports it's inclusion as part of any claim. This could be simplified by introducing a safe harbour rate for material and overheads. I.e. a set percentage that can be claimed in lieu of calculating the actual costs.

3.Dual purpose activities

Within our R&D processes there are many elements that may be used for sales and marketing purposes afterwards to promote a product. – e.g. Seismic testing, test room results showing the range of environments that the new product works within. This information is a core part of the R&D testing. The primary reason the information was collated was for the R&D process, but it may be used to answer customer queries and promote a product subsequent to its general release to the market.

If dual purpose activities are excluded Temperzone will need to repeat the process at additional cost or exclude these amounts from its claim. Our submission would be that a degree of dual purpose activity be permitted.

4.Transitional arrangements confirmed.

The proposed timetable is poor as the R&D tax credit regime takes effect before legislation is enacted and guidance published. This provides no time for early adopters to set themselves up and information necessary to support claims may not be able to be formulated after the fact. The start date for R&D tax credits and end date for Callaghan growth grants needs to be extended by at least twelve months to ensure a smooth introduction.

The current timing requires business to make decisions regarding their R&D programmes and the funding regime in a state of uncertainty. We feel business need time to assess the final legislation and to be given guidance as to how this will be applied so we can adapt to this before implementation.

Being a June balance date and the indication being that recipients can only claim under the Callahan growth grant or the R&D tax credit, not both, we will have to

forgo a quarters funding at the point we transition. The transitional arrangements need to be amended to fully cover non March balance dates.

5.Administration

The introduction of the Inland Revenue Department (IRD) as the administrators of a stand-alone regime creates the need for new data capture process independent of current financial reporting. Securing funding will depend on our ability to adapt internal systems and funding arrangements. At this time and at the time the new regime is set to be introduced we will not know fully what information is needed.

Self-assessment and the IRD's punitive approach to errors seems incompatible with R&D which by its nature is subjective. Particularly in the early years where the IRD's interpretation of the legislation is unknown business will need to take an overly conservative and increasingly detailed approach to preparation of its claims. This will result in lower claims, greater internal effort and potentially the need for expensive external professional services oversight.

By comparison the Callaghan grant dovetails into existing financial systems, is governed by accounting standards and independently verified through the existing external audit processes.

While not entirely clear the proposal seems to be indicating information will be gathered on a project by project basis. The materiality provision will see small projects excluded. Temperzone does not see this as an efficient approach. Temperzone would suggests the recognition of an eligible R&D function with all cost incurred in the running of that function be claimable. R&D activities would be reported but costs would not specifically allocated at a project level.

We want a system that is easy for us to calculate eligible costs ourselves, without review from professional advisors. We do not want the calculations to be so complex that our advisors use proprietary software to prepare the information, meaning we have less control over how the calculation is achieved and what is included. If the complexity is included the advisors should be jointly liable – but we do not want them to take a very risk adverse position in calculating the claim either.

5.Cash Flow

The proposed tax credit will see cashflow change from regular quarterly instalments to annual payments, up to twelve months in arrears.

While there is potential for this to be managed through the adjustment of provisional tax payments it will be difficult to predict at least in the early years the extent of the tax credit entitlement.

There can be no question that this will limit business's ability to invest in R&D.

6.Summary

Temperzone believes the proposal, in its current form, will see less funding to our business's R&D programme due to the changes in eligibility, the reduced rate and increased compliance cost.

This will lead to reduced levels of expenditure on R&D in our business.

Kind regards

s 9(2)(a)

Temperzone

From: s 9(2)(a)
To: RD Incentive
Subject: R&D Tax Credits | Consultation Submission
Date: Tuesday, 15 May 2018 6:29:16 p.m.
Attachments: image001.png
image002.png
image003.png

Hi

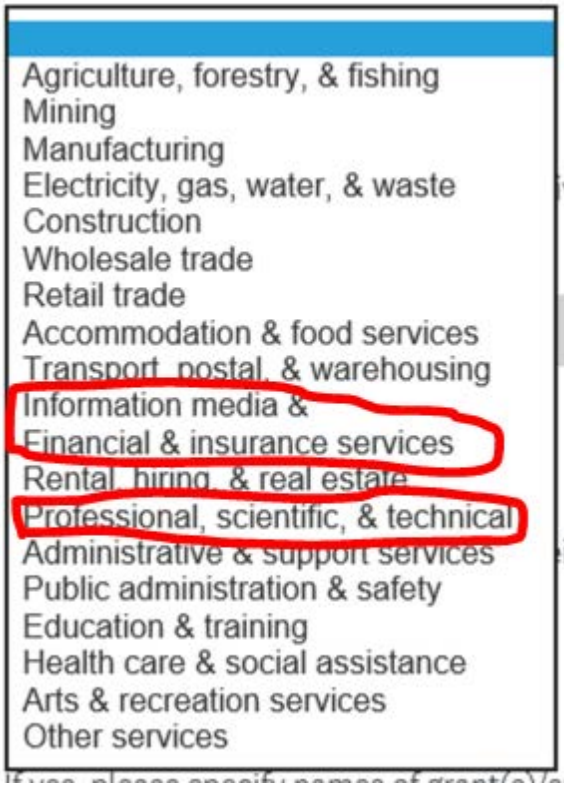
Thank you for the opportunity to make a submission. We are a NZ IT software company with global aspirations and clients as far away as Ecuador.

I am not sufficiently familiar with the detail of what is proposed to make specific recommendations, however would like to make a couple of more general submissions:

My submissions:

1. Growth companies who are cash-flow negative have presently been in a position to leverage both Project Grants and R&D cash outs (as opposed to carry forward), all of which have been incredibly valuable enabling more to be done with less. It would be a net negative for these companies if any changes reduced the effective funding available to these organizaitons.
2. I think Callaghan do a very good job and an ancillary benefit of the grants is that they get visibility to companies they likely would not otherwise, and are able to provide them with additional positive support. We've as a company been the beneficiary of a couple of iniatives along these lines, which I don't imagine would have been possible without the visibility we enjoyed with them through the grants (and info we had to provide them as part of the grant process).
3. As a Software as a Service SaaS company I applaud Callaghan's initiatives around SaaS.
4. From your online submission form (which I've not now submitted on) I suggest it would be good in future for an innovation organization to segment out software as it's own industry. I am not sure what value it provides you to lump them into either of the two potential places which I could see they could fit circled below. I am not sure how good a signal it sends out, which is a shame if it undermines the good work you do.

Kind Regards
s 9(2)(a)



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s 9(2)(a)

11Ants Analytics

Retail Growth Driven by Customer Science

s 9(2)(a)

www.11AntsAnalytics.com

Phone: s 9(2)(a)

Downer New Zealand Limited
info@downer.co.nz

130 Kerrs Road
Wiri, Auckland, 2104

Private Bag 93325
Otahuhu, Auckland, 1640

www.downer.co.nz
www.downercareers.co.nz

15 May 2018

R&D tax incentive team
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140

Dear Sir/Madam

R&D Tax Incentive Submission

Thank you for the opportunity to provide a submission on the discussion paper "Fuelling Innovation to Transform Our Economy" (dated April 2018).

This submission is in response to Question 13 "What variations or extensions to the definition of core activities are required to ensure it adequately captures R&D software activities?"

Background

By way of background, Downer New Zealand Ltd ("Downer") currently:

- s 9(2)(b)(ii) [redacted]

Examples of AI solutions

s 9(2)(b)(ii) [redacted]

Example 2: Providing a seamless customer service

Downer provides services to electricity and gas distributors, which in turn, supply electricity and gas to residential households.

If there was a severe storm, or natural disaster, then there may be significant failures across an electricity and/or gas network.

s 9(2)(b)(ii) [redacted]

s 9(2)(b)(ii) [redacted]

The potential economic benefits of AI in New Zealand

You may be aware that the AI Forum New Zealand (https://aiforum.org.nz/) issued a report earlier this month entitled "Artificial Intelligence Shaping a Future New Zealand" (copy attached).

The future value of AI to the New Zealand economy is well articulated in "Part Two: AI and the Economy" (PDF pages 46 to 49).

Submission

The definition of "core activities" should be broad enough to capture all costs incurred in building new AI technologies, including those developed by business outside the traditional software industry.

General

Please contact me if you have any questions.

Yours faithfully

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REF: 180514L

Submission on "A Research and Development tax incentive for New Zealand"

ANZCO Foods Limited

Introduction

ANZCO Foods Group (ANZCO) is a red meat producer, processor and marketer, and has a substantial business in added value food, ingredient and healthcare products. ANZCO Food and Solutions is the division focused on added value products and with the support of a Primary Growth partnership contract (FoodPlus), is investing in new product development across a range of raw materials, sectors and product types.

This submission is based on ANZCO's experience in managing research and development programmes for commercial outcomes.

If a tax credit incentive is going to increase the R&D activity of the taxpaying business sector, it needs to:

1. Recognise and incentivise the type of R&D in which the sector engages
2. Encourage connections with the market and the acquisition of insights that guide effective R&D
3. Encourage businesses to engage with research organisations where this delivers benefit.

Q2 How well does this definition apply to business R&D carried out in New Zealand?

For the type of R&D carried out by ANZCO and similar companies, not well.

The definition of core activities begins by describing the approach, namely the use of scientific methods. "Scientific methods" need to be defined. This definition must not exclude the type of development work that is mentioned later in the same sentence, and which probably makes up most of the R&D carried out by businesses in NZ.

The definition suggests that companies will carry out core activities to either "acquire new knowledge" or "create new or improved materials, products, devices, processes, or services". The "or" in this sentence is the problem as it implies that companies may carry out research to acquire new knowledge without intending to develop new products and services. This is not how businesses operate. Businesses carry out R&D to gain competitive advantage, in response to signals and pressures from the market and from competitors.

The final phrases of the sentence suggest that activities using the scientific methods are performed and "…are intended to advance science and technology through the resolution of scientific or technological uncertainty". From a business point of view this is round the wrong way.

Businesses seek to resolve scientific or technological barriers that stand in the way of achieving business targets. They achieve this by advancing science and technology. The aim is to resolve barriers to commercialisation and other forms of benefit, the means is by advancing science and technology. Businesses do not do R&D to "advance science and technology … through the resolution of uncertainty". Advancing scientific knowledge is not the end that is sought.

The reasoning behind this paragraph of the discussion paper appears to be flawed and that means that overall the policy appears to miss the point about why businesses do R&D, and what should be incentivised so that better outcomes are delivered.

Q3 Does this definition exclude R&D that you think should be eligible?

See the answer to Question 2. The purpose of business R&D is not to advance science and technology.

It is not clear whether the purchase of R&D from (for example) a CRI would be eligible expenditure. These costs should be included because they:

1. Apply appropriate capability to real industry problems and opportunities.
2. Enhance linkages between business and research organisations
3. Give research organisations a window into the commercial world that they struggle to gain without close links to businesses.

Q4 Does the scientific method requirement exclude valid R&D in some sectors?

Possibly.

Product development is often underpinned by the hypothesis-driven approach but is iterative. The hypothesis-driven approach is often not documented as such.

Q5 What would the impact be on business R&D in NZ if a materiality test was applied to both the problem the R&D seeks to resolve and the intended advancement of science and technology?

Government does not need to apply a materiality test.

A rational business will not invest money in tackling a non-material problem to get a 12.5% tax credit. Nor will such a business spend money to generate knowledge that already exists and is available to that business.

This question seems to be based on the idea that the R&D tax credit will determine companies' R&D strategies. Our submission is that companies will test the materiality of any R&D for themselves and will not invest unless they are satisfied on the materiality of the problem, and the materiality of advancement of knowledge.

The policy does not appear to be based on an understanding of how a company will behave when required to pay 100% of R&D costs up front, then after balance date claim a 12.5% rebate. Given the size of the rebate in relation to the company tax rate and the timing of that rebate relative to when the R&D costs are incurred, the tax incentive is not going to drive perverse decisions about the R&D that companies do.

As discussed under Q2, companies acquire new knowledge for a purpose. If necessary knowledge can be freely obtained or bought, a rational company will do so. If new knowledge is needed to solve a material problem, a rational company may choose to generate that knowledge through R&D. This is the materiality test in action; a company will only do R&D and generate knowledge that is material to the company and to a problem the company needs to solve.

Government needs to ensure that eligibility is tested, you cannot test the materiality as robustly as will a commercial business. There is a strong incentive for companies to test materiality for themselves and businesses will not invest scarce resources in problems that are not material.

Q7 Why should some exclusions not apply?

"Market research, market testing, market development or sales promotion (including consumer surveys)" should not be a blanket exclusion. The discussion document does note that these activities might qualify as support activities.

The motivation for carrying out much of NZ's business-based R&D is to deliver some form of product (physical product, service or some other "thing" for which someone will pay money). To be successful, new product development must deliver a solution to a real need – a real problem. For many products, those real needs can only be defined by understanding consumers, the market in which they are found and the way that market works. Companies that are proficient at product development begin their product development cycle by understanding these aspects of the market, and they use that understanding to guide product development. Developing that market understanding is a critical part of the research.

By suggesting that market research activities might be excluded from the tax incentive, the discussion document appears to ignore the importance of understanding markets in delivering outcomes from R&D.

Even if these market related activities qualify as supporting activities their characterisation as such sends a signal that they are somehow a lower value activity.

This proposed R&D tax credit is being put in place because Agencies believe it will affect behaviours in a way that is consistent with Government's objectives. The risk is that the policy and its implementation will indeed grow the amount of R&D as defined by the legislation and as calculated by the accountants, but at the same time, the policy will discourage the activities that underpin the success of some types of R&D. If a company can get a tax incentive for the physical work involved in developing a product, it will likely direct its activity and investment to that work, and away from the market research that should come before the product development. This could be described as a situation where Government gets the answer it wanted, but that answer doesn't make a difference in the real world.

It all comes back to what Government is trying to do with this policy. If it is to be able to talk about more R&D going on in NZ businesses, then these arguments don't matter too much. However, if NZ want to go further and have the increased R&D deliver maximum benefit and impact, NZ needs to have a policy that takes more account of how R&D works in the business world.

Summary

The discussion document appears to take too little account of why and how businesses carry out R&D, and the nature of the R&D that most businesses undertake. Unless some of these deficiencies are addressed, the risk is that the new tax credits will deliver a measured increase in R&D activity without a corresponding increase in the benefits derived from that activity.

Contact:
s 9(2)(a)
[redacted]