

NZRise Submission on: Research and Development Tax Incentive for New Zealand

Preface - NZRise is a membership based organisation promoting and supporting the growing Digital Technology sector, representing the views of NZ owned businesses in this space.

We consider these proposed changes have the potential to drive more and more jobs, NZ owned businesses and R&D activities offshore, the thresholds selected and compliance described will exclude SME's, startups, early stage and growth companies from realising any benefits for their R&D investment. This will result in NZ companies starting and designing themselves to realise R&D advantages in other jurisdictions which is contrary to benefit of our economy, or the Labour / NZFirst goal of ICT as the 2nd largest contributor to GDP by 2025.

We note MBIE included a statement with regards Callaghan and Transition from Growth Grants, yet did not address this within the 23 questions supplied. We would strongly recommend while the growth grants regime is not meeting NZ's goals an alternative, incentive aligned, opportunity focused mechanism should be considered.

Q1 - 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?

As a community of New Zealand owned Digital Technology businesses, NZRise members would expect the Government funded sector to continue to invest in Research and Development activities and meet their obligations to stimulate the economy through engaging NZ Owned companies, or joint venture (or equivalent) models with NZ owned businesses.

Therefore we would support the exclusion with the explicit expectation that this will not result in a reduction of R&D activity by those organisations.

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

NZRise agree with the path of leveraging internationally recognised definitions. This definition, while not specifically reflective of the Software Industry does broadly categorise the activities our members undertake - however the use of the term "scientific methods" does concern us with new, emerging and leading edge technology R&D pushing the boundaries of the widely understood definition. We consider this places NZ at risk of being left behind should the term be applied too rigidly in a legacy manner.

A broader definition similar to UK government one would be more appropriate for the ICT / digital technology / software industry:

"Projects that count as R&D

The work that qualifies for R&D relief must be part of a specific project to make an advance in science or technology. It can't be an advance within a social science like economics or a theoretical field like pure maths.

The project must relate to your company's trade - either an existing one, or one that you intend to start up based on the results of the R&D.

To get R&D relief you need to explain how a project:

looked for an advance in science and technology
had to overcome uncertainty
tried to overcome this uncertainty

couldn't be easily worked out by a professional in the field

Your project may research or develop a new process, product or service or improve on an existing one.

source: <https://www.gov.uk/guidance/corporation-tax-research-and-development-rd-relief>"

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

At this stage MBIE have not supplied enough information to clearly understand treatment of Software based R&D under this definition (and not Q13 strengthens this assertion).

We would recommend MBIE look to the Australian Federal Governments eligibility practice of self assessment (see definition below) noting their system is designed to stimulate growth of newer and early stage businesses vs MBIE's proposal which is designed to only benefit large, established and multi-national businesses.

Australian Federal Government Eligibility:

You assess for yourself whether or not your entity is eligible to register R&D activities and claim R&D tax offsets in any given year.

Broadly speaking, your eligibility to claim R&D tax offsets will depend on whether or not you are an R&D entity and, if you are, whether or not you have incurred notional deductions of at least \$20,000 on eligible R&D activities.

You don't have to use a registered person to access the program but there do seem to be entities offering assistance in formulating applications in exchange for a % fee of the rebate.

More info: <https://www.ato.gov.au/business/research-and-development-tax-incentive/about-the-program/>

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

The Labour / NZ First Government has a stated goal that the ICT sector become the 2nd largest contributor to GDP by 2025. This will involve a number of levers be applied to achieve that goal. One of these is keeping New Zealand owned businesses in NZ - R&D is just one of the reasons software companies leave, or choose to undertake R&D in other jurisdictions (where the benefits are far greater than proposed here).

Software R&D by it's nature is leading edge where the "scientific methods" are developed in parallel with the research itself. For NZ to meet it's goals the interpretation and use of the terminology will need to be flexible enough to enable high growth in the ICT / digital technology / software industry. NZRise is concerned a traditional or legacy scientific interpretation will force NZ companies to leave our shores.

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?

NZRise agree with the statement "The outcome of R&D is inherently uncertain; it is not necessary that the R&D activity be successful to be eligible for the tax incentive." We consider application of a material test would severely disadvantage startups, early stage and growing NZ owned businesses and would provide established,

listed and multi-national businesses with a significant competitive advantage. We would strongly discourage this materiality test be applied.

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

Bringing a software product to market does, by its nature include aspects of the exclusion list prior to any revenue derived eg: market validation which can in turn lead to pivots in research and development activities so could be considered as an important element.

NZRise consider applying such a rigid standard could disadvantage the ICT / digital technology / software industry. Taking a broader approach, such as the UK model, designed to stimulate business growth would be more appropriate than an inclusion / exclusion test.

UK Government model:

The UK Govt provides R&D credits ranging from 26% if the business is profitable to 33.35% if the business is not profitable as long as the org spends a minimum of £20,000 on R&D. These seems to be wide ranging examples of what qualifies and also the existence of services to help organisations claim their refunds (for example. PwC has this online tool which takes a percentage of the resultant claim: <https://www.niftyforms.co.uk/pricing>)

There are also significant tax incentives available to investors who invest in early stage/risky companies. The Seed Enterprise Investment Scheme (SEIS) offers both income tax and capital gains tax relief to qualifying investors who subscribe for shares in qualifying companies. In detail:

- Investors can obtain 50% relief for income tax on the cost of shares, on a maximum annual investment of £100,000.
- No capital gains tax is paid on profits earned on shares held for more than three years. Capital gains which are realised before three years has expired, but which are reinvested into qualifying SEIS shares, will also be exempt from capital gains tax. Again, the annual limit is £100,000
- Loss relief – Should the company go bankrupt, investors may claim loss relief on their investment which is equal to half of their total investment multiplied by their tax rate.
- 100% inheritance tax relief (provided the investments have been held for at least two years at time of death).

source: <https://www.gov.uk/guidance/corporation-tax-research-and-development-rd-relief>

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

NZRise agree with “the assumption that this type of research is not a focus of business R&D may no longer be valid because it is becoming more embedded in digital R&D” however we note that many of the excluded activities do apply to a digital world eg: copyright, patent and licensing are of increasing relevance and in themselves as new technologies emerge the creation of those assets themselves involve elements of R&D to define and protect.

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

NZRise note an increase number of new digital technology / ICT / software businesses are working in the social science space and will therefore need to be eligible for the same incentives as other industries. These lines in a digital world are blurry which will continue for years to come so this legislation needs to be future proof.

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?

Should this be adopted NZRise consider businesses could separate recording and reporting of activities to prevent this scenario.

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

Overseas - the commercial reality in the ICT / digital technology / software industry is we undertake our R&D in the jurisdiction most supportive and beneficial for our businesses eg: the UK or Australia or even specific states of Australia. These proposed changes will drive more and more jobs, NZ owned businesses and R&D activities offshore, therefore while we support this notion the wider context of excluding SME's, startups, early stage and growth companies from realising any benefits for their R&D investment will result in NZ companies starting and designing themselves to realise advantages in other jurisdictions which is contrary to benefit of our economy.

Expenditure - NZRise would support option 2 - "on a broader range of direct and indirect costs (including options for determining appropriate overhead expenditure)" as would serve to encourage more NZ owned businesses to undertake R&D activities.

Direct Labour Costs - NZRise agree with elements of this approach to the extent it seems sensible with the preferred outcome of increasing jobs - HOWEVER - the proposed threshold "A business will need to spend a minimum of \$100,000 on eligible expenditure, within one year, to qualify for the Tax Incentive." will leave these R&D benefits inaccessible to the majority of New Zealand owned businesses - again providing material advantages to multi-nationals, disadvantaging startups, early stage and growth companies and will result in more and more NZ owned companies electing to undertake their R&D (and therefore employment growth) in other jurisdictions.

We recommend MBIE seriously consider the impact on the Labour / NZ First government's goal of ICT as the 2nd largest contributor to GDP when applying such a limitation.

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

NZRise would support either approach to a greater or lesser extent. While we understand this proposal may not be attractive to capital-intensive sectors we would strongly recommend the growing ICT / digital technology / software sector is weighted as important when considering overhead costs set as a percentage of R&D labour costs and will make this proposal more attractive for our sector.

We draw MBIE's attention to the Australian Federal eligible entities approach:

The Research and development (R&D) tax incentive replaced the R&D tax concession from 1 July 2011. It provides targeted R&D tax offsets designed to encourage more companies to engage in R&D.

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.

As stated software R&D is increasingly important to our economy. NZRise members undertake R&D for the explicit purpose of creating commercial products, the majority of which is funded through other revenues re-invested or through capital raised. An attractive R&D regime will directly support creation and growth of the

ICT / digital technology / software industry to support the government's GDP contribution goals. Many of our most successful businesses (Datacom, Catalyst etc) have grown through this method.

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

NZRIse again draw MBIE's attention to the UK and Australian approaches, designed specifically to enable job and economic growth in the software industry and recognising loss making as a stage in that growth cycle. We recommend rather than further entrenching compliance regimes such as defining core activities for software that MBIE consider a growth focused model designed to encourage more companies to engage in R&D.

eg: **Australia (Federal)**

The Research and development (R&D) tax incentive replaced the R&D tax concession from 1 July 2011. It provides targeted R&D tax offsets designed to encourage more companies to engage in R&D. The incentive has two core components. Entities engaged in R&D may be eligible for:

- a 43.5% refundable tax offset for eligible entities with an aggregated turnover of less than \$20 million per annum, provided they are not controlled by income tax exempt entities
- a 38.5% non-refundable tax offset for all other eligible entities (entities may be able to carry forward unused offset amounts to future income years).

Eligibility:

Companies assess for themselves whether or not their entity is eligible to register R&D activities and claim R&D tax offsets in any given year. This significantly reduces the opportunity cost of applying for the tax incentives while light touch inspections before payment and retrospective audits prevent system abuse. The ability to withdraw the R&D credits as cash or credit towards other tax accounts (i.e. PAYG tax, GST, etc) also supports startups who may be unprofitable in search of growth pathways.

Broadly speaking, the eligibility to claim R&D tax offsets will depend on whether or not the company is an R&D entity and, if you are, whether or not they have incurred notional deductions of at least \$20,000 on eligible R&D activities.

More info: <https://www.ato.gov.au/business/research-and-development-tax-incentive/about-the-program/>

or the **UK**:

There are also significant tax incentives available to investors who invest in early stage/risky companies. The Seed Enterprise Investment Scheme (SEIS) offers both income tax and capital gains tax relief to qualifying investors who subscribe for shares in qualifying companies. In detail:

Investors can obtain 50% relief for income tax on the cost of shares, on a maximum annual investment of £100,000.

No capital gains tax is paid on profits earned on shares held for more than three years. Capital gains which are realised before three years has expired, but which are reinvested into qualifying SEIS shares, will also be exempt from capital gains tax. Again, the annual limit is £100,000

Loss relief – Should the company go bankrupt, investors may claim loss relief on their investment which is equal

to half of their total investment multiplied by their tax rate.

100% inheritance tax relief (provided the investments have been held for at least two years at time of death).

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

NZRise agrees there should be a minimum R&D expenditure limit for the reasons described HOWEVER we disagree with the MBIE suggestion of \$100,000 and the MBIE assertion this is the cost of a Full Time Equivalent employee (perhaps for Government employees) does not reflect the median wage of \$49,868 as published by StatsNZ. We would recommend the Australian example of \$20,000 will provide SME's, startups, early stage companies and those who are new to undertaking R&D with an opportunity to access this credit. As currently stated we consider again this threshold materially advantages established, large and multi-national businesses.

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

No. As stated in our answer to Q14, NZRise consider the minimum threshold to be too high and will not create the stimulation this legislation is seeking to gain by excluding startups and early stage businesses from participating in the R&D credit process.

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

As stated the test is to ensure R&D claims of this size are genuine, therefore a cap and mechanism for application and additional scrutiny to ensure very large claims are genuine would be a sensible approach. MBIE could consider a proportion to revenue model as an alternative bar for very large claims, this could serve as an effective mechanism to stimulate R&D investment in NZ within very large and multi-national businesses as means of accessing their claim.

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

NZRise support these concepts at the threshold noted - not at a lower threshold.

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

NZRise support Open Government and Transparency at every level.

We note and understand MBIE's case for multi-nationals to undertake R&D in New Zealand. We would recommend consideration for IP retention and continued investment in employment growth (as a result of those R&D initiatives) staying in New Zealand noting current examples where R&D is undertaken in NZ yet commercialised in other jurisdictions resulting in no economic growth realised within the NZ economy.

We again remind MBIE of the Labour / NZ First government goal to have the ICT sector as the 2nd largest contributor to GDP, and the associated goal of closing the digital divide by 2020 - these cannot be realised through multi-nationals alone. To truly transform our economy we need a thriving ecosystem of early stage companies growing into Xero and Datacom sized businesses, therefore R&D incentives that are accessible and designed to stimulate growth at the early stage are pivotal.

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

Creating an R&D credit system as a “one size fits all” will risk disadvantaging the ICT / digital technology / software industry through over compliance, high entry level R&D commitments and limited incentives for new businesses to be formed. It is our understanding that this sector invests heavily in R&D, ahead of NZ norms, so providing conditions to attract, retain and grow this sector holds significant advantages over continuing to back winners and **keep NZ on the grass** (which is a flawed strategy).

The real risk to NZ is ICT / digital technology / software companies with either a) not incorporate in NZ or b) elect to undertake R&D and growth in more attractive jurisdictions resulting in a stagnating economy. We should be looking to what countries like Australia and the UK to support new innovative, future focused businesses to choose NZ.

Many NZRise member companies already undertake R&D activities in both the UK and Australia now for precisely this reason under the current regimes - NZ is not attractive enough for them to continue this investment here. The risk of undertaking these changes is NZ will become less attractive.

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

NZRise consider any system or process adopted by government should be open and accessible enough to operate without advisors otherwise the only participants will be those with deep pockets who can engage advisors - therefore we would recommend MBIE keep it simple to participate.

That said we agree extending penalties to external advisors for the large claims is a reasonable position to take.

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

Submission of (unaudited) financial accounts, a simple project proposal form describing the R&D activity and the potential for a process-light follow-up questionnaire for claims under \$1m. Over \$1m a more rigorous process should be applied.

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

NZRise assumes MBIE is keen to outsource this to Xero or similar. We strongly advise this is a “red herring”, a simple form for submission will be adequate directly submitting to the IR or MBIE website. For examples Jobs for NSW uses google forms. We recommend the delivery mechanism be decoupled from the legislation discussion.

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

The NZ taxation system in NZ is based on a reasonable level of trust, use of qualified tax advisors and our generally accepted uncorrupt businesses practises. We consider IR should apply these same principles for claims under \$1m, more rigour be applied to claims over that threshold.