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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.

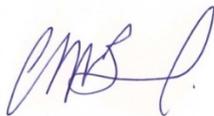
Intent vs outcomes

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 uncondusive 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,



Catherine Beard
Executive Director
ExportNZ and ManufacturingNZ