Submission

By

Business NZ

To The

Inland Revenue Department

On The

R&D Tax Credits

&

Market Development Tax Credits

Issues Papers

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R&D AND MARKET DEVELOPMENT TAX CREDITS
SUBMISSION BY BUSINESS NEW ZEALAND[1]
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1. INTRODUCTION

1.1 Business New Zealand welcomes the opportunity to comment on both the Research and Development (R&D) and Market Development (MD) Tax Credits Issues Papers, which provide technical details on areas such as definition, eligibility criteria and eligible expenditure in New Zealand. Business New Zealand has already made a lengthy submission on the original Business Tax Review (BTR) Discussion Document, in which we strongly recommended against the use of any type of tax credit. We continue to take that view in this submission, as we believe tax credits are simply the wrong option when trying to foster greater innovation, investment and improved productivity in this country. However, if such devices are to be introduced, we have provided comments regarding the best way in which to roll them out to ensure as little distortion as possible occurs.

1.2 In addition, we would also like to point out that the third arm of the tax credit consultation – skills training tax credits – has been submitted by Business New Zealand as a separate submission.

2. SUMMARY OF RECOMMENDATIONS

2.1 Business New Zealand's makes the following primary **<u>recommendations</u>** with regard to the R&D and Market Development Tax Credit Issues papers, namely that:

(a) **The proposals for targeted tax credits do not proceed, as they are considered by Business New Zealand to be the least favourable of all proposals outlined (p.5); and**

(b) **The Government view a drop in the company tax rate from 33% to 30% as the first immediate step of the Business Tax Review in ongoing falls in the company tax rate over the relative short-medium term to improve New Zealand's competitiveness (p.5).**

Notwithstanding the primary recommendations of Business New Zealand above, if the Government decides to implement tax credits for R&D and market development, we recommend that:

(c) **The process for any tax incentive scheme aims at minimising compliance and administrative cost to the business (p.5);**

(d) **A comprehensive review and cost-benefit analysis is undertaken after two years or no later than five years regarding the effect the introduction of tax incentives have had on innovation, investment and productivity in New Zealand (p.5);**

[1] Background information on Business New Zealand is attached in the appendix.

(e) **The second bullet point for the definition of R&D be 'Creating new or improved materials, products, production equipment, devices, processes or services' (p.6);**

(f) **The definition of 'research and development' be established in line with the parameters as outlined in the paper (p.7);**

(g) **All business structures have availability to the research and development grant (p.7);**

(h) **That the minimum threshold of research & development spending be at least $20,000, while Business New Zealand would not object to this value increasing (p.7);**

(i) **The overseas concession for up to 10% of the total cost of the project proceeds (p.8);**

(j) **Foreign ownership should not limit access to the concession as long as research and development is carried out in New Zealand (p.8);**

(k) **The list of what is deemed to be eligible expenditure for research and development is clearly and concisely stipulated to those eligible for the tax credit (p.8);**

(l) **Other mechanisms should be proposed to rectify perceived problems in the areas of market development and skills training (p.9);**

(m) **The Government clarifies their position on whether market development tax credits will replace enterprise development grants, and whether the funds will be diverted as part of the Business Taxation Review (p.10);**

(n) **The $50 million turnover threshold proceed (p.10);**

(o) **The definition of businesses eligible for the tax credit as outlined in the paper proceeds (p.10);**

(p) **The definition of "place of origin" used in the guide is not taken from the Fair Trading Act. Instead, a sufficient definition from an existing international trade agreement that New Zealand has entered into would be preferable (p. 11);**

(q) **The alternative of allowing the credit to be claimed in relation to actual and reasonable expenditure, up to a specified amount does not proceed (p.11);**

(r) **The alternative of enabling firms to claim the traveling costs of both spouses if the expenditure meets the test of ordinary deductibility for tax purposes proceeds (p.11);**

(s) **What qualifies for market development tax credits has a relatively narrow focus, and what is finally classified as qualifying and non-qualifying categories of expenditure is clearly stipulated to business (p.11);**

(t) **The minimum expenditure level in order to qualify for a market development tax credit be set at $20,000 (p.12); and**

(u) **No consideration is given towards extending the market development tax credit expenditure cap above $1 million, and that anti-avoidance rules are introduced (p.12).**

2.2 The remainder of this submission is broken up into six main sections:

- Part A - Overall Impressions and Observations of Tax Credits (p.4);
- Part B – R&D Tax Credits (p. 6); and
- Part C – Market Development Tax Credits (p.8).

PART A: OVERALL IMPRESSIONS AND OBSERVATIONS OF TAX CREDITS

3.1 Business New Zealand's primary recommendations for the BTR have been cuts to tax rates, both at a company and personal level. As discussed in our prior submission, we view these as the most efficient and broad based way in which all businesses can experience increased innovation, investment and productivity.

3.2 As there is still no indication from the Government regarding the fiscal package allocated for the BTR, there is still no opportunity to make informed trade-offs in terms of the options outlined in the review. In terms of specificity around the three tax incentive options, the Government has provided a very broad estimate for R&D cost to the tax base ($45-$350m), and as yet has not provided any indication of the fiscal cost for MD or skills training. Also, the original BTR discussion document outlines proposed tax credits of between 7% to 15% for all three types of proposals. This would equate to allowing a deduction for 121% to 145% for eligible expenditure.

3.3 While we appreciate that definition and eligibility criteria are key components of establishing some sort of concrete cost to the tax options, there is still significant uncertainty for submitters. Once definitions and criteria are set out, the total cost for tax credits may crowd out more worthwhile options outlined in the BTR, such as tax rate cuts.

3.4 Also, given changes are to be implemented by 1 April 2007, the fact that the Government has still not entered into any type of estimation (or at least publicly) regarding the cost of the various tax incentives shows how rushed the thinking and development of some of the options appears to be. Other proposed changes such as company tax rate cuts are relatively simple to implement almost immediately, whereas tax incentive approaches have historically shown to have various fish hooks during development (not to mention after they have been introduced).

3.5 As stated in our previous submission, our overall view of tax incentives is that they will create winners and losers, as certain sectors and businesses have more ability to initiate such incentives than others. Business New Zealand has always taken the view that New Zealand's tax system should remain broad based and as least distortionary as possible, especially when other options such as cuts in tax rates are proposed as an alternative option. Tax incentives can lead to the very 'lolly scramble' approach that the Government has stated during this BTR process it does not want to occur.

3.6 Overall, tax incentives of these kind means business practices may significantly change only to obtain the tax credits, not because there is a real desire to undertake what the incentive was set up for. While we appreciate the three documents on tax incentives are trying to establish boundaries for use, there is still significant opportunities for inefficient allocation of resources. In its worst form, anecdotal evidence from Australia shows that some businesses have hired people in a full-time capacity, just to identify what they can claim under the incentive, even though there may be no actual increase in R&D taking place.

3.7 Lastly, taking into account the various tax incentive approaches in New Zealand during the 1960s and 1970s that were largely ineffectual and inefficient, our primary view is that all three forms of tax incentives should not proceed.

Recommendation: That the proposals for targeted tax credits do not proceed, as they are considered by Business New Zealand to be the least favourable of all proposals outlined.

Recommendation: That the Government view a drop in the company tax rate from 33% to 30% as the first immediate step of the Business Tax Review in ongoing falls in the company tax rate over the relative short-medium term to improve New Zealand's competitiveness (p.5).

3.8 Notwithstanding the fact that we take the primary view that none of the three tax incentive approaches should proceed, we would like to take the opportunity to discuss both some general tax incentive issues, as well as specific issues relating to the R&D and MD approaches (Part B), if the Government decides to introduce such incentives as part of the BTR.

GENERAL ISSUES

Compliance Costs

3.9 Business New Zealand acknowledges that if the tax incentive approach proceeds, there is a balance between ensuring that such options are not open to abuse, while at the same time not heaping so many compliance and administrative requirements on businesses, that they simple find the process too difficult and frustrating to even consider taking up.

3.10 Any tax incentive scheme needs to ensure that the process is as simple as possible, so as to minimise compliance elements that may outweigh the gains made from accepting such incentives.

Recommendation: That the process for any tax incentive scheme aims at minimising compliance and administrative costs to the business.

3.11 Also, we believe it is vital that the success or otherwise of the three forms of tax incentives be rigorously reviewed after two years or no later than five years of implementation to ascertain whether there has been any meaningful increase in innovation, investment and productivity on a national basis due to these tax incentives being introduced. The review should involve a comprehensive cost-benefit analysis with end recommendations outlining whether such incentives should continue.

Recommendation: That a comprehensive review and cost-benefit analysis is undertaken after two years or no later than five years regarding the effect the

introduction of tax incentives have had on innovation, investment and productivity in New Zealand.

PART B: RESEARCH & DEVELOPMENT TAX CREDITS

4.1 The paper for R&D tax credits outlines a variety of issues. Although Business New Zealand opposes the use of R&D tax credits, we wish to provide comments on certain issues that we feel would at least minimise any negative consequences of introducing such incentives to the New Zealand economy.

Definition of Research and Development

4.2 We are pleased to see that the Government has taken the opportunity to investigate definitions for tax incentive provisions in four countries, including Australia. There is a significant amount of international precedence with which any R&D incentive approach introduced to New Zealand could draw from.

4.3 The document states that the definition of R&D would be:

(1) Systematic, investigative and experimental activities that either seek to resolve scientific or technological uncertainty or involve an appreciable element of novelty and that are carried on for the purposes of:

- *Acquiring new knowledge or*

- *Creating new or improved materials, products, devices, processes or services;*

(2) Other activities that are required for, and integral to, the carrying on of the activities in (1).

4.4 Business New Zealand would like to make one small change to the definition. We would like the last bullet point to read *'Creating new or improved materials, products,* ***production equipment****, devices, processes or services'*, as the creation of production equipment is fundamental to creating new products, and including that term would help clarify the terms for those applying for an R&D credit..

Recommendation: That the second bullet point for the definition of R&D be 'Creating new or improved materials, products, production equipment, devices, processes or services'.

4.5 Overall, Business New Zealand does not have any particular comments regarding the list of what would be excluded from 'systematic, investigative and experimental activities'. However, we would like to point out that we agree that research in the arts, humanities or social sciences should not be included as part of R&D incentives. While we support research into these areas, we believe these will not bring about the level of innovation, investment and productivity that the Government is seeking. Instead, research in these fields is more of a by-product of an economy that has already developed a sound infrastructure, and shows strong economic growth.

Recommendation: That the definition of 'research and development' be established in line with the parameters outlined in paragraph 2.2 of the paper.

Who Should Qualify for the Tax Credit?

4.6 We agree with the conclusions drawn in the paper in terms of the entity structure, that is, if tax concessions are implemented, they should be available to all businesses regardless of the legal form of the business.

4.7 Any attempt to restrict particular entities would mean re-structuring if an R&D tax incentive were to be claimed, which would place further unnecessary compliance and administrative costs on the business in question.

4.8 However, despite the best intentions to create a watertight definition to try and prevent any adverse behaviour, past experience offshore tells us that abuse of the incentive will still occur or at least be attempted, despite the introduction of checking mechanisms such as random audits. Even then, certain expenditure claimed under tax incentives may not be technically illegal by definition, but may not be in line with what the approach was designed to do. The key is to minimise such behaviour as much as possible.

Recommendation: That all business structures have availability to the research and development grant.

4.9 The paper outlines a minimum amount of R&D that would have to occur in order to qualify for the tax concession, which is similar to practices overseas. A minimum of $20,000 per year of eligible expenditure has been recommended, which as stated in the paper is equivalent to a part-time salary and some related overhead costs. While Business New Zealand has no firm view on whether this is an appropriate figure, we are disappointed that the paper lacks any summary that actually shows what the minimum thresholds are in other countries, including Australia, with which to compare.

4.10 Given our concerns regarding potential abuse of the tax incentives, we would not want the minimum threshold to be any lower than $20,000, and we would not object to this threshold increasing.

Recommendation: That the minimum threshold of research and development spending be at least $20,000, while Business New Zealand would not object to this value increasing.

R&D Carried Out Overseas

4.11 Business New Zealand views the recommendations in the paper that R&D costs incurred overseas would be eligible for the concession for up to 10% of the total cost of the project as a pragmatic outcome. As noted in the paper, New Zealand may not have complete capability to do the work locally, so foreign R&D jurisdiction requirements and customisation of a product for a particular market may need to take place in that market.

Recommendation: That the overseas concession for up to 10% of the total cost of the project proceeds.

Foreign Ownership

4.12 We agree with the views expressed in the paper that foreign ownership should not limit access to the concession as long as the R&D is carried out in New Zealand.

Recommendation: That foreign ownership should not limit access to the concession as long as research and development is carried out in New Zealand.

Eligible Expenditure

4.13 The chapter on eligible expenditure provides a variety of expenditure incurred by a business that the Government believes should attract the R&D tax credit. While we have no particular comments regarding the list outlined in the paper, we do want to touch upon the broader issue of the administrative and compliance elements in terms of businesses ensuring they understand exactly what is and is not included regarding eligible expenditure.

4.14 Establishing the boundaries of eligible expenditure for tax incentives could have the potential to end up being an administrative nightmare for some businesses, which may take up a considerable amount of time and resources for a business. If the boundaries are not clearly defined, this may well deter many from even considering applying for it. Businesses already see tax compliance costs as the largest priority[2] during their day-to-day running of the firm, and a tax incentive approach that causes confusion and administrative headaches will only exacerbate the problem.

Recommendation: That the list of what is deemed to be eligible expenditure for R&D is clearly and concisely stipulated to those eligible for the tax credit.

PART C: MARKET DEVELOPMENT TAX CREDITS

Overall Considerations

5.1 Business New Zealand believes that there is a real scope for change in terms of how MD and indeed skills training are treated in New Zealand. Having the correct measures and systems in place in these areas would certainly provide the opportunity for increased competitiveness and economic growth. However, we do not endorse strategies involving tax incentives in these areas as the best step forward.

[2] See Business NZ/KPMG Compliance Cost Surveys (2003-2006).

Recommendation: That other mechanisms should be proposed to rectify perceived problems in the areas of market development and skills training

5.2 Like R&D, the paper for MD tax credits outlines a variety of issues. Again, although we oppose the use of MD tax credits, we wish to provide comments on certain issues that we feel would at least minimise any negative consequences of introducing such incentives to the New Zealand economy.

5.3 The paper states *"the objective of a market development tax credit is to support market development activities by exporters to countries other than Australia, subject to limits on eligibility and maximum and minimum expenditure"*. The paper also states that the MD tax credit is broadly designed to deliver assistance for the same sorts of activities covered by the Market Development Assistance Scheme (MDAS). However, the Government believes a tax credit would have the advantage of greater visibility, would be available to more firms, and as the credit claimed would be a refund through the tax return process than the formal grant application, hence reducing compliance issues for firms.

5.4 However, what is not clearly stipulated in the paper is whether the MD tax credit will replace the MDAS scheme, or both will co-exist, or the MDAS will be heavily scaled down in favour of tax credits? Given the listing of advantages in the paper that tax credits have over the MDAS scheme, Business New Zealand assumes that the MDAS scheme will be at least scaled back or fazed out if tax credits for MD are introduced, however, further clarification on this issue would be appreciated.

5.5 If the fazing out of MDAS schemes in favour of MD tax credits goes ahead, one question that arises is whether it will be the case that taxpayers' funds that go into those schemes would be diverted towards the unknown fiscal pool for the BTR?

5.6 The Government has recently conducted an expenditure review of business assistance programmes, which Business New Zealand submitted on. The fundamental issue we had with the schemes wasn't whether spending on such programmes could be funded in some sort of sustainable basis but whether spending, properly assessed, constituted a worthwhile use of resources from an overall community perspective. The exact same argument can be placed on the use of tax credits for MD, R&D or any other such proposal.

5.7 Although extracting an exact number is difficult, latest figures show that the total Enterprise Development Fund from which the MDAS comes out of comes to around $31 million. Total expenditure on business assistance programmes outlined in the review Business New Zealand submitted on was around $200 million, and is estimated to increase.

5.8 There is no detail as yet regarding the fiscal level and pool from which tax credits are going to come from. We believe that if there is going to be a significant shift away from grants to the use of tax credits, the funding allocated for such grants should be transferred to the BTR, and ensure that further money is freed up towards more preferable uses such as cuts in tax rates (both company and personal).

5.9 Another factor to consider is if MD tax credits and business assistance grants are going to co-exist, what would be the economic justification for doing so? Would the Government again review business assistance programmes after tax credits are introduced, as the introduction of tax incentives has the potential for significantly changing the landscape for business assistance funding.

Recommendation: That Government clarifies their position on whether market development tax credits will replace enterprise development grants, and whether the funds will be diverted as part of the Business Taxation Review.

Eligibility Criteria

Limitations on the Size of the Firm

5.10 The paper stipulates that availability of the market development tax credit is restricted to those firms with less than $50 million turnover (GST inclusive). This would be the same limit as the MDAS grant, and is one way to ensure the tax credit is aimed to help small and medium-sized firms to become large firms.

5.11 Business New Zealand agrees that if an export development tax credit is to be introduced, a cap by size of firm by turnover should be instigated to limit those most likely to be able to fund their own market development offshore.

Recommendation: That the $50 million turnover threshold proceed.

Businesses Eligible for the Credit

5.12 Like the proposed R&D tax incentive, all New Zealand tax-resident businesses will be eligible for the market development credit. Business New Zealand agrees that a simple approach should be taken of avoiding the exclusion of various New Zealand sectors or businesses, to ensure a simple framework.

Recommendation: That the definition of businesses eligible for the tax credit as outlined in the paper proceeds.

Defining Goods and Services

5.13 Business New Zealand does not believe the "place of origin' definition used in the guide to interpreting the Fair Trading Act is sufficient to claim that the good or service is New Zealand produced. The definition is fine for domestic purposes, but not for international trade issues which is what the market development tax credits are designed for. Instead, a definition as part of an international trade agreement that New Zealand has entered into would be preferable.

Recommendation: That the definition of "place of origin" used in the guide is not taken from the Fair Trading Act. Instead, a sufficient definition from an existing international trade agreement that New Zealand has entered into would be preferable.

ELIGIBLE EXPENDITURE

5.14 We agree with the views in the paper that the alternative to the structure for an MD tax credit of allowing a credit to be claimed in relation to actual and reasonable expenditure, up to a specified amount would in most instances incur higher compliance costs on businesses. Therefore, we would not support that approach.

Recommendation: That the alternative of allowing the credit to be claimed in relation to actual and reasonable expenditure, up to a specified amount, does not proceed.

Expenditure on Spouse

5.15 Business New Zealand agrees that there are many small businesses in New Zealand that are 'husband and wife teams', in which both share the day-to-day running of the business. In many cases, it is imperative that if there is a strong business case that both are able to claim for justified market development opportunities. Therefore, we would support the approach to enable firms to claim traveling costs of both spouses if the expenditure meets the test of ordinary deductibility for tax purposes.

Recommendation: That the alternative of enabling firms to claim the traveling costs of both spouses if the expenditure meets the test of ordinary deductibility for tax purposes proceeds.

Non-Qualifying Categories of Expenditure

5.16 Business New Zealand takes the view that what qualifies as categories of expenditure for MD tax credits (and indeed other forms of tax incentives) should be as narrow as possible, to ensure minimisation of distortions and abuse of the system. Overall, we agree with what has been defined as non-qualifying categories of expenditure in the paper.

5.17 Any categories that other submitters would wish to see included should have to meet a high threshold mark for justification. We also recommend what does and does not qualify as categories of expenditure be clearly stipulated amongst the business community to ensure there is no confusion for business planning purposes.

Recommendation: That what qualifies for market development tax credits has a relatively narrow focus, and what is finally classified as qualifying and non-qualifying categories of expenditure is clearly stipulated to business.

Minimum and Maximum Expenditure Limitations

5.18 Business New Zealand agrees that having a minimum level of expenditure ensures there is a greater likelihood that a firm is serious about developing the new market at a sizeable level and reflects what a firm needs to spend in order to make a viable and sustained entry into a new market. While the paper has recommended the minimum expenditure level in order to qualify for a tax credit be set at $20,000, we would not recommend any lower figure than that amount, given the existing MDAS grant is available for those firms that spend at least $40,000.

Recommendation: That the minimum expenditure level in order to qualify for a market development tax credit be set at $20,000.

5.19 Business New Zealand also agrees that there should be a maximum expenditure cap placed on the MD tax credit. The total cost of the scheme could easily skyrocket to extremely large amounts if a cap has not been instigated. Although Business New Zealand has no firm views on the exact level of the cap, $1 million (GST-inclusive) would seem reasonable, but we would certainly not want it raised any higher. However, we reiterate our point earlier in this submission that since the funding available is still unknown at this stage, the tradeoffs between funding and thresholds for expenditure limitations is difficult to ascertain.

5.20 Lastly, we agree that anti-avoidance rules need to be introduced to ensure forms of business structures does not circumvent minimum and maximum thresholds.

Recommendation: That no consideration be given towards extending the market development tax credit expenditure cap above $1 million, and that anti-avoidance rules are introduced.

APPENDIX

6. About Business New Zealand

6.1 Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 65-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

6.2 In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

6.3 Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.