KPMG R&D Update

20 December 2018

R&D is coming to town..

In a nutshell..

Submissions on the R&D Tax Bill

We managed to take some time to digest the R&D tax bill, and have put a submission to the Finance and Expenditure Committee. Invaluable feedback from industry, and experience in the 2008 regime helped to shape our recommendations.

The recommendations focused on making the regime user friendly and easier to understand, so that it is accessible to all businesses. These included changes to:

— The definition of R&D: to limit confusion, and clarify terminology.

— R&D with multiple parties: to streamline provisions and ensure clarity.

— Pre-approval: to ensure sensible timelines for approval, and clear criteria.

— Other Matters: including internal software, R&D in commercial production, record keeping, and Orders in Council.

We provide more detail on the submission below.

KPMG Submission Detail

While the draft legislation was largely as expected, we did identify a number of issues, and areas that could be improved.

What is R&D?

The core provisions (LY1, 2, 3) outlining what R&D is, had some language we believe was unhelpful or un-needed.

— Excluding "business-as-usual" activities from being R&D – we agreed in principle with the idea and understood the intention, however subsequent tests in the legislation dealt with the exclusion of business as usual activities. We also noted that entities whose core business was R&D may be precluded from claiming the credit. Our recommendation was to remove the "business-as-usual" provision.

— Including a "material purpose" test in the core activities provision – We agree that the main purpose of R&D activity should be the resolution of technical or scientific uncertainty and creating new knowledge, however there is always a competing intention to commercialise in all businesses. Our recommendation was to provide guidance on what "material purpose" means in the R&D context.

— Ensuring the R&D activity has its "day-to-day management" in New Zealand – We couldn't understand the addition of the provision, and contended that the sub-section added no value and confused the definition of R&D. There are also separate provisions to protect R&D results in New Zealand. Our recommendation was to remove the "day-to-day management" provision.

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Where multiple parties are involved in R&D

The tests for contracted R&D, and ownership of R&D results were confusing for the taxpayer, and required some consolidation or amendment.

— We proposed a consolidation of the "on-behalf-of" tests to ensure an easier reading and understanding of the law for taxpayers in a situation where multiple parties perform R&D. Our proposal was to consolidate the section and include an "on-**own**-behalf-of" test, more similar to the 2008 regime.

— Under the same provision, the contracting entity was expected to exclude any of the contractors ineligible R&D costs – We disagreed with the requirement to analyse (and even ask for) the contractor's cost breakdown in such a level of detail. Our recommendation was to completely remove the "Contracted R&D" section, allowing a credit for 100% of contracted R&D expenditure.

The pre-approval regime

While the pre-approval regime doesn't apply for year one of the credit, from year two, many taxpayers will be required to have their R&D activities pre-approved in the year the R&D is performed.

— The draft legislation didn't specify a timeline for pre-approval – We believe that taxpayers need a level of certainty when pre-approval applies. Our recommendation was that Inland Revenue should specify maximum timelines for in-year approval.

— The proposed pre-approval regime would only require the approval of your R&D activity – While we don't take any issue with approval of R&D activities, it's fair to say that R&D activities may change at any given point during the R&D process for a number of reasons. For this reason, our recommendation was that in year approval should take a more holistic view of a project and would include approval of the intended R&D result, supported by the Core and Supporting R&D activities.

Other Matters in the Tax Bill

We considered a number of other matters as part of our submission, including:

— The $3m cap for internal software development – We feel that a penalty is being imposed on some businesses due to their business model and an increased sophistication in business approach. Our recommendation was that the $3m cap should be a negotiable cap, and an application should be able to be made in the same way as an application would for R&D expenditure above $120m (i.e. there is a substantial benefit for NZ).

— R&D in commercial production – The Bill proposes that, where R&D is performed in a production environment, only the direct costs of employees are able to be claimed for the credit. No overhead costs will be eligible. We disagree with the approach on the basis that it is inequitable with other R&D environments, and does not reflect the true cost of R&D. Our recommendation was to allow eligible overheads as eligible R&D expenditure.

— Record Keeping – The bill makes no mention to when records should be created, nor any other mention of record keeping. Our recommendation was that Inland Revenue provide sufficient guidance on record keeping, especially **when** records should be created.

— Orders in Council – We proposed the extension of Orders in Council ability, so that amendment was able to quickly be made to the definition of R&D, on-behalf-of tests, and the $3m internal software cap.

In addition to the above noted points, we also sought clarity on the tax return process and timing (specifically whether the R&D credit would delay the process), and refundability for those taxpayers that may never be in a tax paying position (e.g. charities, levy bodies). While outside the scope of the Bill we also noted a misalignment of the tax incentive, and Callaghan Project Grants from a wider New Zealand R&D perspective.

Looking to next year

We're excited for what the new year holds, and the exciting projects that are underway in New Zealand. We also want to ensure you are best placed to maximise your tax incentive opportunity, so you can accelerate your R&D.

Ensuring your systems and processes can capture all of your R&D is essential to ongoing success and maximisation of your R&D funding, through either the Tax Incentive, or Callaghan Grants.

If you're planning projects in the new-year, have ongoing projects, or have any questions on the Tax Incentive or Grant funding, feel free to reach out to one of the team. Alternatively, take a look at our web page, which has some helpful summary documents.

Merry Christmas from the Innovation and Growth team.

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