R&D Update

A special focus for Taxmail readers

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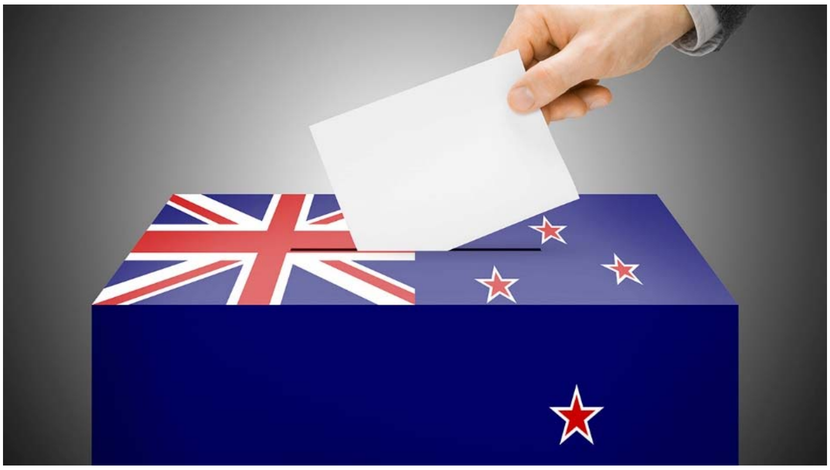
Regular commentary on government funding for business innovation



Key themes of our feedback on R&D reform:

- Stability
- Access
- Modernisation
- Control

Feedback on R&D Reform

Snapshot

Submissions on the new R&D tax credit closed on 1 July 2018. After consulting on the discussion paper with various clients and reflecting on our experience with the 2009 tax credit and Callaghan Innovation, KPMG provided feedback to government in this round of submissions.

In this update, we outline the key themes in our submission, being the need for stability regardless of the shape the regime takes, the importance of creating greater access for more businesses, modernising the definition of R&D, and endorsing the need for real time record keeping.

In the coming period, officials will work through the submissions received and prepare draft legislation, expected to be released by September. With this consultation phase now complete, it's a good time to look at the full package of support which Government promised it would deliver, with R&D tax credits only meant to be "one lever amongst many".

This update also recaps the dates for our pending R&D seminars in late July. We note that representatives from government will also be participating in these seminars.

Analyse full package of support as government promised tax credits only meant to be "one lever amongst many"

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Submission feedback: Stability, Access, Modernisation & Control

Our submission on Government's discussion paper addressed all 24 of their specific questions, in addition to several other issues. Below, we highlight the key themes from our submission.

Stability

The overarching theme of the feedback was the need for stability in the new regime. The constantly shifting R&D funding landscape creates a climate of uncertainty which risks alienating businesses, leading to poor efficacy.

To create stability, it's important that there's broad political support for the reforms. Certainly, the officials who drafted the proposals can't change future election campaign platforms, however, there are mechanisms which can be introduced to help generate broader support.

For this reason, we've recommend that there are regular feedback sessions between government and industry on the regime to allow for small incremental changes. This provides ongoing transparency to Parliament, and allows businesses to adjust their plans gradually rather than having to react to large reforms every few years.

Access

A key issue identified in the feedback was agreement with widening access to R&D funding. By way of example, over the five years of Callaghan, only about 300 Growth Grants were awarded, a rate of approximately 60 annually. For the one year of the 2009 R&D tax credit, about 1,000 organisations lodged R&D tax credit claims.

For this reason, our submission supported government's move away from a regime which requires financial audits and corporate due diligence which significantly limited access for many private businesses in the Growth Grant era as many found the paper work requirements to be an excessive commitment of time and resources.

Modernisation

A significant theme coming out of the feedback was the need to modernise the language used in the R&D definition. The original one was based on a 50 year old model created in the time of academic and industrial R&D, and is now outdated.

Innovation has moved on substantially in the past five decades, and modern times have seen software R&D become one of the key drivers of economic growth.

For this reason our submission recommended that technology and technical know-how be given greater emphasis as compared to pure science, and that references to scientific methods be scaled back.

Control

There was consensus in the feedback we received supporting the merit of government requiring businesses to have systems in place to record R&D activity in real time, rather than doing this at the end of the year.

Enthusiasm for this was particularly pronounced if government could connect real time R&D reporting with regular payments of the R&D incentive (e.g. quarterly or monthly).

For this reason, our submission identified merit in the concept of 'contemporaneous record keeping', which is mandated by other jurisdictions, but only if it ultimately leads to regular payments.

Where to from here: Government's promised 'package' of support

Officials will spend the coming period reviewing submissions and preparing draft legislation, expected to be released by September.

With this consultation phase now complete, it's a good time to look at the full package of support which Government promised it would deliver, as R&D tax credits are only meant to be "one lever amongst many".

The current landscape
To understand where we're going, it's important to first know where we are. The table below summarises the different sources of government R&D funding.

Fund	**Funding for Researchers** **$ millions**	**Funding for Business** **$ millions**
Marsden Fund	64	
Centres of Research Excellence	50	
Performance Based Research Fund	308	
Talent and science promotion	26	
Endeavour Fund	196	
Health Research Fund	93	
Catalyst Fund	13	
National Science Challenges	141	
Strategic Science Investment Fund	261	
Partnered Research Funds	37	
Regional Research Institutes	24	
Primary Growth Partnerships		50
Callaghan Innovation		225
Total	**1,213**	**275**

Source: Briefing for the Incoming Minister of Research, Science and Innovation – October 2017

From the above, it's clear that business R&D funding is only a fraction of total government investment in R&D. Accordingly, there is significant room to grow Government's aggregate spend on business R&D.

Features of the new package
Government has signalled that in reforming the R&D ecosystem, NZ should achieve competitiveness with other small, advanced economies e.g. Finland, Denmark, Ireland, Israel, Singapore and Switzerland.

There are two relevant features which are common across these countries:

1. They tend to have a hybrid system of R&D tax incentives and grants.
2. The degree to which grants are provided to industry are significant, especially in the startup and SME sectors.

We outline below how this could apply in NZ, which we will be sharing with officials in the coming period.

Larger enterprises

In other small, advanced economies, large enterprises contribute a significant amount to reported business expenditure on R&D. In NZ however, this is not the case.

The R&D tax credit should change this as large enterprises will be incentivised to record and report their R&D activity. Also, the R&D tax credit will have a significant impact on larger enterprises because the absolute value of dollars received is large enough to correlate directly with new full time hires for the R&D team.

For example, a company spending $1 million dollars on R&D will receive $125,000, enough to justify hiring an additional R&D employee. A company spending $10 million a year on R&D will receive $1.25 million, enough to justify hiring an additional 10 new R&D employees.

Accordingly, in terms of a package of R&D reforms, it's not critical at this time to introduce anything new for larger enterprises beyond the R&D tax credit.

Small to medium sized enterprises

For an SME spending the minimum of $100,000 on R&D, they will only receive $12,500 for the R&D tax credit. This does not justify hiring an additional employee, and may have a marginal impact on the business by defraying some expenses.

Even a larger SME spending say $300,000 on R&D will only receive $37,500 on R&D which is unlikely to spur the company into hiring a new full time R&D team member.

To address this challenge, the solution which many in our country-peer group use is business grants with a high rate of co-funding. Fortunately, we already have a similar program in the form of Callaghan Project Grants, so there is no need to start from scratch in creating an effective solution.

By way of background, Project Grants provide R&D co-funding of 40% for the first $800,000 of project size, dropping off to 20% co-funding for incremental expenditure above this level. So in the example of the two SMEs above, the first would receive $40,000 and the second $120,000, which likely changes the dynamics on hiring additional R&D team members.

However, for Callaghan's Project Grants to be an effective solution, we recommend the following reforms to the program:

1. **Definition of R&D:** For the same reasons as recommended for the R&D tax credit, the definition of R&D for Project Grants should be modernised as it currently leans toward scientific advancement and methodologies, which runs counter to the policy objective of supporting market-oriented innovation in business. Government may wish to use the new tax credit definition of R&D for Project Grants to capture the same sense of modern, commercially-minded innovation.

   A second order benefit of using the same definition is that it allows for seamless transition from Project Grants to R&D tax credits as the business grows.

2. **Transparency:** Government should publish anonymised examples of successful R&D project grant applications to help businesses quickly identify which part of their project is relevant R&D and what kind of information they need to collect to get started.

   Many businesses self-select out of R&D grants after seeing the reams of paper they need to complete. Having several easy to follow examples of successful applications will allay such concerns and create higher levels of engagement with the process.

3. **Self-registration**: Businesses should be allowed to self-register through an online portal to submit their Project Grant application (rather than first having to go through Callaghan, as is currently the case).

   Similar to the prior recommendation, businesses often self-select out of the Project Grant application process due to their perception of 'excessive paperwork'. An easy to follow portal, with access to examples per the prior recommendation, should create better levels of engagement.

4. **Two tier application:** Currently, one template is used for Project Grant applications regardless of project size, with minor exemptions from certain information requests for small projects. However, the risk to the government from a $40,000 grant compared to a $400,000 grant is very different, therefore the extent of information requested should be modified accordingly. This will create greater traction with businesses.

   Accordingly, we recommend creating a Project Grant 'Lite' for businesses requesting less than $100,000 of funding. The Lite grant will require less information about forecast revenues, commercial factors and similar features of the project, and will focus predominantly on the innovation in the project.

Startups

By startup, we mean the classic case of a couple of co-founders who've recently got together to give their idea a good go. (For those startups who have progressed beyond this point, the mechanisms already discussed above should be sufficient.)

R&D tax credits and co-funded project grants fail such newly founded startups as they generally have limited expenses because the founders are working on their idea without being paid.

However, experience overseas is that if the co-founders received a nominal sum to work on their idea full time for a few months, they can dedicate themselves full time to properly validating their idea.

Fortunately, a framework already exists for providing funding to startups under the repayable grant scheme. Under that program, startups who enter an accredited incubator can receive up to $600,000, with $450,000 being provided by Callaghan and $150,000 by the incubator. The startup repays the grant when it begins to generate revenue, in the form of a 3% royalty on its gross sales, at 3% interest per annum.

However, the fact that only 14 repayable grants were awarded in the 2016/2017 fiscal year illustrates that even though this scheme provides a useful framework, significant changes would be required for this to be an effective solution.

By way of example, Y-combinator, considered to be one of the leading accelerators/incubators globally, alone funded 240 startups at $120,000 each last year.

Below is a summary of our recommendations to modify the repayable grant framework into an effective solution for newly founded startups:

1. Reduce the funding to $50,000, paid over three months.
2. Have the funding paid directly by Callaghan rather than an incubator.
3. Provide an alternative to the royalty repayment method, by taking an equity stake in the startup (e.g. 3%; Y Combinator takes 7% in exchange for their $120,000).
4. The fund should be given a mandate to invest the majority (e.g. 60%) of its funds in newly founded startups to prevent it from becoming risk averse.

   The remaining balance of funds should be invested in startups that are between 6 and 12 months old. Any startup with a longer track record should be supported by one of the other tools already discussed.
5. The restriction for using the funds only on capital and operating costs should be removed. The goal of the regime is to fund the co-founders while they focus on validating their idea when working in the startup on a full time basis.

What you need to do

In late July, we will be holding R&D seminars around the country to go into further detail on the R&D reforms, the implications for businesses and how to be ready from day one. There will also be representatives from government participating in the seminars.

It would be great if you can join us for this discussion, and also share your thoughts as there is still time to shape the reforms over the coming months. The dates are as follows:

- Hamilton, Tuesday 24 July 2018
- Christchurch, Wednesday 25 July 2018
- Auckland, Thursday 26 July 2018
- Tauranga, Friday 27 July 2018

You should shortly receive a separate invite depending on your location – if you have not received an invite please get in touch with your KPMG contact, or alternatively Gwen Riley or Byran Theunisen and they can assist.

For further information

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