

# Research and development tax credit

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*Policy reports and briefing notes*

September 2018

*Prepared by Policy and Strategy, Inland Revenue*



## RESEARCH AND DEVELOPMENT TAX CREDIT DOCUMENTS

These documents are part of the advice provided to Ministers on the introduction of a research and development tax credit.

Other relevant documents are available at <https://www.mbie.govt.nz/info-services/science-innovation/agencies-policies-budget-initiatives/budget-initiatvies> and <https://treasury.govt.nz/publications/budgets/budget-2018-information-release>.

#	Date	Type	Title
1	17 November 2017	Policy report	<b>Introducing a research and development tax credit</b> Report number: IR2017/596
2	14 December 2017	Briefing note	<b>Further information on the tax treatment of research and development</b> Report number: BN2017/673
3	19 December 2017	Briefing note	<b>Consideration of the start date for an R&amp;D tax credit</b> Report number: BN2017/675
4	15 February 2018	Policy report	<b>Update on R&amp;D tax credit</b> Report number: IR2018/093
5	13 March 2018	Policy report	<b>Integrity within the R&amp;D tax credit</b> Report number: IR2018/132 (joint report with CallaghanInnovation and the Ministry of Business, Innovation & Employment)
6	5 April 2018	Policy report	<b>Speaking notes for research and development cabinet paper at DEV</b> Report number: IR2018/211





Inland Revenue  
Te Tari Taake

## POLICY AND STRATEGY

### Tax policy report: Introducing a Research and Development Tax Credit

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<b>Date:</b>	17 November 2017	<b>Priority:</b>	Medium
<b>Security level:</b>	In Confidence	<b>Report no:</b>	IR2017/596

#### Action sought

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	Action sought	Deadline
Minister of Revenue	<p>Agree to forward this Report to Ministers of Finance and Research, Science and Innovation</p> <p>Agree to convene a meeting of your Ministerial colleagues</p>	As your timetable permits

#### Contact for telephone discussion (if required)

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Name	Position	Telephone
Richard Braae	Senior Policy Advisor	Withheld under section 9(2)(a) of the Official Information Act 1982
Keith Taylor	Policy Manager	

**POLICY AND STRATEGY**

*Te Wāhanga o te Rautaki me te Kaupapa*

*National Office*

*Level 8  
55 Featherston Street  
PO Box 2198  
Wellington 6140  
New Zealand*

*Telephone 04 890 1500  
Facsimile 04 903 2413*

17 November 2017

Minister of Revenue

## **Introducing a Research and Development Tax Credit**

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### **Executive summary**

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1. Introducing a Research and Development (R&D) tax credit is one of the government's priorities.
2. All OECD countries provide support to business R&D, usually through some combination of tax credits and grants. Tax credits should be considered as a complement to grants rather than as an alternative. Tax credits and grants have different strengths and weaknesses. Having both enables each to be directed at their particular strengths.
3. A tax credit's strengths are likely to be greatest where it operates as neutrally as possible as per types of firms and levels of assistance and where there are boundary-type judgements, these are made in as explicit and rigid way as possible. Grants we would suggest are a better mechanism for targeting particular types of firms if that is a goal for developing the New Zealand R&D ecosystem.
4. There is an opportunity as part of the design of the R&D tax credit to learn from the experiences of other countries and from New Zealand's own previous experience to ensure the Government gets the best value from the policy while ensuring as far as possible risks are managed. Key risks to be managed are around the integrity of the tax system and protection of the revenue base.
5. Choices in the design and implementation of the credit will reduce but not eliminate these risks.
6. There will be trade-offs between policies that might maximise support for business R&D and measures that might undermine other parts of the tax system.
7. One way to manage the risks is a thorough policy and implementation design process. We consider 1 April 2019 is a feasible implementation date for an R&D tax credit, though there are some risks associated with this timeframe.

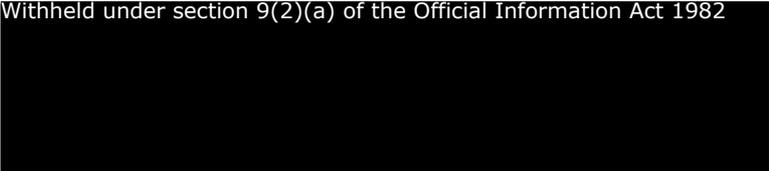
## Recommended action

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8. It is recommended that you:

- Forward this report to the Ministers of Finance and Research, Science and Innovation
- Convene a Ministerial sub-committee consisting of you and the Ministers of Finance and Research, Science and Innovation.

Withheld under section 9(2)(a) of the Official Information Act 1982



**Richard Braae**  
Senior Policy Advisor  
Policy and Strategy

**Hon Stuart Nash**  
Minister of Revenue  
\_\_\_\_ / \_\_\_\_ / 2017

## Background

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9. The previous Labour Government introduced an R&D tax credit in 2008. This was repealed by the National Government in 2009.
10. Introducing a 12.5% R&D tax credit was a policy your Party campaigned on during the election.
11. Though it has not been recognised as an immediate priority in terms of being on the 100-day Plan, we understand implementing this policy is a Government priority.
12. There are three Ministers who will have responsibilities relating to introducing the R&D tax credit. These are you, as Minister of Revenue, the Minister of Finance and the Minister of Research, Science and Innovation.
13. The purpose of this Report is to assist in your engagement with your Ministerial colleagues.

## Ways of supporting business R&D

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14. Governments have different ways of supporting business R&D, broadly divided into tax credits and grants.
15. Grants and tax credits are not interchangeable. Grants usually involve an application and pre-approval process. Tax credits are more non-discretionary – once eligibility has been defined, firms self-assess their eligibility and submit their claim for the credit without further bureaucratic intervention.
16. However, these distinctions are not hard and fast and some countries' grant schemes have features that bring them closer to tax credits and vice versa.
17. Their different characteristics mean that grants are perceived to work best for targeted interventions to grow particular types of R&D whereas tax credits, being non-discretionary, are more suited to providing broad support for all business R&D.
18. In New Zealand, R&D is currently supported via grants<sup>1</sup> provided by Callaghan Innovation and a tax loss cash-out scheme administered by Inland Revenue. The cash-out scheme is targeted to start-ups because these firms are more likely to face cash flow constraints, but eligibility extends to other companies. Projected expenditure on grants for 2017/18 is \$171 million and for the tax loss cash-out \$13 million.

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<sup>1</sup> There are three Grant schemes: Growth Grants, Project Grants and Student Grants.

19. We consider any consideration of an R&D tax credit should not happen in isolation but involve consideration of all of Government's objectives in this space and a matching of instruments (tax credits, grants, loans, tax-loss cash-outs) to where they can best advance government objectives.

## Perspectives on support for R&D

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20. The New Zealand tax system operates within a broad-base low-rate framework. The essence of this framework is that tax operates neutrally and as much in the background as possible.

21. One implication of this framework is that the tax system is generally not used to address externalities<sup>2</sup> – either positively or negatively. Inland Revenue's position is that there should be a high burden of proof before moving away from broad-base low-rate principles to using the tax system to address externalities. This is because there are many activities that proponents could support on the basis of a possible positive externality. Allowing concessions can quickly lead to a demand for further exceptions and an undermining of the coherence of the tax system. Inland Revenue's approach has been supported by successive tax reviews.

22. Nonetheless, all OECD countries provide some tax or non-tax incentives for business R&D. This is on the basis of the positive externalities that arise from R&D.

23. R&D is beneficial in terms of promoting productivity and economic growth but firms underinvest in R&D because they cannot capture all the benefits flowing from it for themselves. Government support is justified in terms of raising the amount of R&D from what it otherwise would have been so as to get more of the social benefits.

24. A majority of OECD countries provide tax credits as part of a programme of supporting R&D. Within the OECD, New Zealand is something of an outlier in not having an R&D tax credit.

25. Even though R&D is one of the activities for which there is the strongest empirical evidence for positive externalities, in the past we have argued against R&D credits on the grounds that the likely benefits of such a tax are likely to be outweighed by its costs. Costs include a reduction in the consistency and coherence of the tax system and a potential for considerable accounting activity being devoted to recharacterising expenses to benefit from tax credits. This continues to be our first-best advice. At the same time some of our concerns may be moderated by a well-designed R&D tax credit that draws on international best practice.

26. In introducing an R&D tax credit, we consider there needs to be attention to protecting the integrity of the tax system and protecting the fiscal base. Within the design of the tax credit, we anticipate there will need to be trade-offs between policies that might maximise support for R&D and measures that might undermine other parts of the tax system.

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<sup>2</sup> An externality, sometimes referred to as a spillover, arises where there are costs or benefits that affect a party that did not choose to incur that cost or benefit.

## Risks to be managed with an R&D tax credit

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27. The global history of R&D tax incentives is one of expenditure blow outs, followed by reviews, followed by tightening up. This is not conducive to scheme stability, which is important for growing business R&D.

28. We suggest there are two particular risks to be aware of. The first is recharacterisation of business activity as R&D. This means the Government spends money without gaining any of the externalities that it expects from subsidising R&D. It also weakens the tax system because if firms perceive they can exploit weaknesses in one part of the system this weakens the voluntary compliance framework on which our tax system is built.

29. Relatedly, there is a risk of unanticipated fiscal costs. In part, this is likely to reflect recharacterisation. But it appears, from overseas experience, that there are particular features of tax credit schemes that are more likely to lead to aggressive claiming by firms, or promotion of such by tax advisors.

30. Consequently, we think there are some features of the tax credit that will be important for minimising these risks, even though they cannot be avoided completely:

- introducing an R&D tax credit should be more than re-implementing the 2008 policy. Though the previous policy provides a good starting point, there is an opportunity to learn about what has changed since then in the way businesses operate and from other jurisdictions about what works well and to adjust our scheme accordingly;
- tax credits should be considered as a complement to grants rather than as an alternative. Tax credits and grants have different strengths and weaknesses. Having both enables each to be directed at their particular strengths;
- a tax credit's strengths are likely to be greatest if it operates as neutrally as possible as per types of firms and levels of assistance and where there are boundary-type judgements, these are made in as explicit and rigid way as possible. Grants we would suggest are a better mechanism for targeting particular types of firms if that is a goal for developing the New Zealand R&D ecosystem;
- the way R&D is defined and potentially excluding certain sectors or activities from the scheme are also ways of managing risk. This will include careful assessment of how to treat R&D expenditure on software and mining, and whether to extend the credit to R&D that is undertaken overseas. Importantly, our initial exploration of these issues suggests that the previous revenue protection measures in the 2008 rules may no longer be sufficient;
- clarifying our expectations of tax advisors and introducing an accountability framework for them will minimise risks around their adopting an aggressive tax-planning oriented approach;
- early and significant engagement, jointly with Callaghan Innovation, with firms undertaking R&D, will help us better understand these issues and also shape business expectations about how the tax credit is likely to work.

- we consider the cost of an R&D tax credit should be charged against the Vote: Business, Science and Innovation appropriation rather than being recorded as a reduction in company tax receipts, as this is more likely to focus attention on expenditure growing more rapidly than anticipated.

31. We note that New Zealand has some strengths that can assist in the development of a stable R&D tax credit regime:

- New Zealand's small size makes it easier to achieve good coverage of those firms likely to be interested in an R&D tax credit;
- Callaghan Innovation and MBIE know the sector;
- Inland Revenue has close working relationships with the accounting and tax advisory professions.

32. Because we anticipate introducing the R&D tax credit will involve more than re-implementing the 2008 policy, we have indicated to MBIE that 1 April 2019 is the earliest feasible commencement date for a new scheme. In doing so we have pointed out that we see three sets of risks associated with this timeframe:

- The capacity of applicant firms to be ready;
- The willingness of accounting software developers to provide systems that will support firms being able to integrate their R&D tax credit application with their normal business operations;
- Inland Revenue's operational capacity given Business Transformation and 100-day Plan projects.

33. The likelihood and scale of these risks will become clearer as the design of the R&D tax credit progresses.

34. MBIE has conveyed this advice to the Minister for Research, Science and Innovation.

35. Allowing time for policy and implementation design will allow good participation with the R&D sector in designing the rules, identification and mitigation of fiscal risks reducing policy instability, and engagement with other countries to ensure we are adopting current best practice.

## Next steps

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36. As previously stated, there are three Ministers with an interest in this policy, with each of you having particular areas of focus. MBIE has provided advice to its Minister (Briefing number 0890 17-18) and this has been forwarded to you. MBIE has also suggested there be a Ministerial sub-committee consisting of you, the Minister of Finance and the Minister of Research, Science and Innovation. We endorse this suggestion.

37. We therefore recommend you forward this report to your Ministerial colleagues and convene a meeting of these colleagues.

## Consultation

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38. In developing this report we have consulted with officials from MBIE, Treasury and Callaghan Innovation.

39. DPMC has been informed.

## Briefing note

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Reference: BN2017/673

Date: 14 December 2017

To: Revenue Advisor, Minister of Revenue – § 9(2)(a) [REDACTED]  
Private Secretary, Minister of Revenue – [REDACTED]

From: Keith Taylor

Subject: **Further information on the tax treatment of Research and Development**

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1. The Minister of Revenue, in a comment on report IR2017/596, has requested information on how research and development (R&D) is treated under the New Zealand tax system.

### **Allowable as a deduction**

2. Research and development expenditure is deductible for tax purposes provided that:
  - The expenditure has been incurred in deriving income or in the course of carrying on a business for the purpose of deriving income; and
  - The taxpayer treats the amount as an expense for accounting purposes by applying the asset recognition criteria contained in financial reporting standard NZ IAS-38.

### NZ IAS-38

3. Under NZ IAS-38, expenditure on "research" is expensed, while expenditure on "development" is expensed until the entity can establish that 6 criteria are met, in which case the expenditure is capitalised and depreciated. The recognition of an asset is a high threshold, resulting in the majority of development expenditure being expensed.
4. NZ IAS-38 defines "research" as "original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge or understanding." The term "development" is defined as "the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use."

## Loss continuity

5. A person that has incurred R&D expenditure may choose to allocate all or part of the deduction to a later income year. This ensures that deductions for R&D are not lost under the shareholder continuity rules for carrying forward losses when companies bring in new equity investors.

## Loss-cash out

6. Start-up companies are able to receive a payment up to 28 percent (the current company tax rate) of their tax losses from research and development expenditure in any given year, instead of carrying the losses forward to a future tax year.
7. A cashed-out loss is effectively an interest-free loan from the Government to be repaid from the taxpayer's future income.
8. To be eligible, a company must be a loss-making company resident in New Zealand, with a sufficient proportion of labour expenditure on research and development.
9. The amount of losses that can be cashed out has been capped as follows:

<b>Tax year</b>	<b>Amount of loss</b>	<b>Cash-out value</b>
2015-16	\$500,000	\$140,000
2016-17	\$800,000	\$224,000
2017-18	\$1.1 million	\$308,000
2018-29	\$1.4 million	\$392,000
2019-20	\$1.7 million	\$476,000
2020-2021 onwards	\$2 million	\$560,000

## Previous R&D tax credit

10. A tax credit for research and development was enacted in 2008, but repealed in 2009.

## Black hole expenditure

11. Black hole expenditure is business expenditure of a capital nature that is not immediately deductible for tax purposes and does not give rise to a depreciable asset, so cannot be deducted as tax depreciation over time.
12. Amendments were made in 2014 to allow deductions for certain black hole R&D expenditure, such as expenses incurred for the purpose of applying for a patent.

## Capital gains tax and R&D

13. New Zealand does not have a comprehensive capital gains tax. This indirectly incentivises R&D as when a business ultimately decides to sell its idea, it is not subject to tax.

## Implications of New Zealand's approach to R&D

14. As we do not have a tax credit for R&D expenditure, businesses have no incentive to separate out from other deductions the amount spent on R&D. This means that the amount spent on R&D may be under-reported to Statistics New Zealand.

## **Consultation with Treasury**

15. Treasury was informed about this briefing note.

Keith Taylor  
**Policy Manager**

9(2)(a) [REDACTED]





## Briefing note

Reference: BN2017/675

Date: 19 December 2017

To: Revenue Advisor, Minister of Revenue – s 9(2)(a)  
Private Secretary, Minister of Revenue – [REDACTED]

cc: Naomi Ferguson, Commissioner  
Cath Atkins, Deputy Commissioner  
Matt Benge, Chief Economist  
Emma Grigg, Policy Director  
David Carrigan, Policy Director  
s 9(2)(a) Executive Support Advisor to the Commissioner  
[REDACTED] PA to Deputy Commissioner  
Government & Executive Services (Ministerial Services)  
Policy records management (PAS RM)

From: Richard Braae

Subject: **Consideration of the start date for an R&D tax credit**

### Purpose

1. This Note outlines factors to consider in relation to the commencement date of an R&D tax credit. For the reasons set out below, Inland Revenue recommends a 2020 start date rather than a 2019 start date.

### Background and Context

2. There are three factors prompting this Note.
3. First, the incoming Government's policy is to re-introduce an R&D tax credit, with the goal of encouraging greater levels of business R&D. In taking this step, it is sensible to consider whether there are other parts of the tax system that might be frustrating firms from undertaking R&D.
4. Second, in response to the Supreme Court's decision in *Trustpower Limited v Commissioner of Inland Revenue* (the *Trustpower* decision), IR has been considering the approach to feasibility and black hole expenditure.
5. Finally, Minister Nash has received a letter from Business New Zealand, the Angel Association, New Zealand Private Equity and Venture Capital Association, and the Corporate Taxpayers Group. This letter argues that current tax law which prevents tax losses being carried forward if more than 51 per cent of ownership in a company changes hinders innovation in New Zealand. They instead propose the adoption of a same or similar business test.

6. These factors come together when considering companies in loss that are undertaking R&D and other productivity-enhancing expenditure– a relatively common outcome for start-ups. Will they be incentivised to undertake more R&D by the tax credit? Are there other settings in the tax system which are deterring them from undertaking R&D or treating them less favourably than other firms – perhaps older, larger and more established firms, that are in profit?

### **Relevant factors under current tax law**

7. General factors:
  - There is no R&D tax credit, but Government policy is to introduce one.
  - As a general principle, losses are carried forward rather than being paid out. This non-symmetrical treatment of losses (compared to profits) is motivated by protection of the tax base.
  - Where there is a breach of (ownership) continuity, losses cannot be carried forward. This too is motivated by protection of the tax base, but is an asymmetry that discourages taking risk.
8. Within the tax system, there are some factors that already provide more favourable treatment for firms undertaking R&D:
  - R&D expenditure is deductible (can be expensed) even though it is often contributing to the creation of an asset
  - For R&D intensive firms, there is a (capped) cashing out of tax-losses
  - R&D expenditure can be allocated, in total or in part, to a later income year<sup>1</sup>. This ensures deductions for R&D are not lost under the shareholder continuity rules when a company is sold.
  - Amendments were made in 2014 to allow deductions for certain black hole R&D expenditure, such as expenses incurred for the purpose of applying for a patent.
9. A final point is that there is currently no capital gains tax, which is potentially advantageous to start-ups. This issue, however, is within the terms of reference of the Tax Working Group.

### **Assessment of the current system**

10. Firms that have current profits (perhaps from some other line of business), are currently able to realise the full value of their deductions for R&D. For firms that don't have current profits, R&D deductions must be deferred until the firm has profits. This non-symmetric treatment of firms in loss compared with firms in profit can be considered as treating the latter more favourably than the former. Given that the typical high-tech start-up company will be in loss, this could be argued as creating a disincentive for them, and of their undertaking R&D.
11. If the R&D tax credit is not refundable (ie, is not paid out if a firm is in loss) – and IR argues strongly it should not be because of fiscal risks that arise when the tax credit is refundable – it will provide weaker incentives for start-ups to undertake more R&D.
12. At the same time, it can be noted that within the tax system there are already provisions which recognise the circumstances that might afflict firms undertaking R&D and compensates for these.
13. In addition, grants provided by Callaghan Innovation are a means for Government directly supporting firms at an early, pre-profit stage which are undertaking R&D. The treatment of firms should be considered from a wider perspective than just the tax system.

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<sup>1</sup> This provision will need to be considered in development of the R&D tax credit.

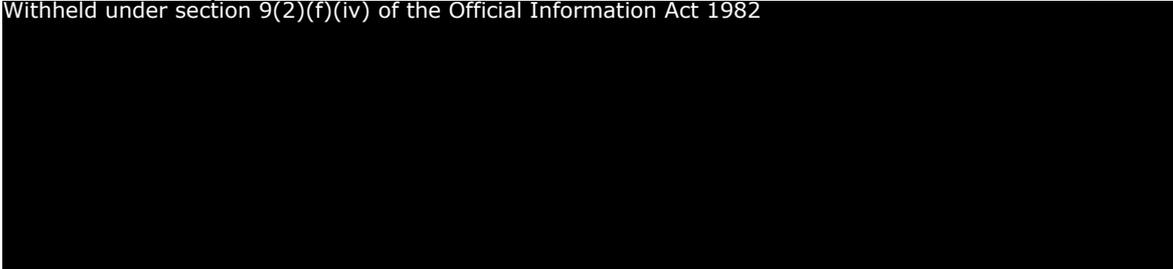
14. Nonetheless, it can be noted that the current system is not ideal. The concerns are:
- There is a patchwork of provisions that have been put in place to assist or compensate firms undertaking R&D. This creates complexity – complexity which is likely to be aggravated by the introduction of an R&D tax credit.
  - The patchwork creates fiscal risk if rationalisation of the rules is not undertaken at the same time any R&D tax credit is introduced.
  - Where these compensations have been put in place, they are tightly tied to R&D because this is a relatively tangible concept to define. However, there are innovative firms that are equally worthy of Government support, in terms of contributing to economic growth and the goals of a diverse, sustainable low-carbon economy, and these firms are not receiving special consideration.

### **Where IR would like to head**

15. Pulling together these factors, Inland Revenue considers the tax system should ideally move in the following directions (though noting that some of these concepts do not currently have funding committed for them):

- Introduce an R&D tax credit to address the spillovers arising from firms undertaking R&D

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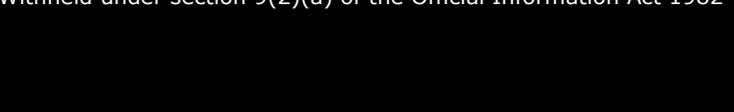
### **Implications for introduction date of an R&D tax credit**

17. In the cross-agency report on the introduction of an R&D tax credit (IR2017/644), Ministers are asked to consider introducing the credit on 1 April of either 2019 or 2020.
18. Inland Revenue has not previously expressed a strong preference with respect to these dates.
19. However, we now consider that ideally the R&D tax credit will be developed in the context of the above issues – particularly regarding loss continuity, to allow for consistent treatment of losses. The complexity of these issues and the time that will be required to resolve them leads us to recommend a 1 April 2020 start date for the R&D tax credit.

### **Consultation with Treasury**

20. Treasury was informed about this briefing note.

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Richard Braae  
**Senior Policy Advisor**







**Inland Revenue**  
Te Tari Taake

## POLICY AND STRATEGY

### Tax policy report: Update on R&D Tax Credit

<b>Date:</b>	15 February 2018	<b>Priority:</b>	<b>High</b>
<b>Security level:</b>	In Confidence	<b>Report no:</b>	IR2018/093

### Action sought

	Action sought	Deadline
Minister of Revenue	<b>Note</b> the contents of this report	19 February 2018

### Contact for telephone discussion (if required)

Name	Position	Telephone
Richard Braae	Senior Policy Advisor	Withheld under section 9(2)(a) of the Official Information Act 1982
Keith Taylor	Policy Manager	

**POLICY AND STRATEGY**  
*Te Wāhanga o te Rautaki me te Kaupapa*

**National Office**  
Level 8  
55 Featherston Street  
PO Box 2198  
Wellington 6140  
New Zealand  
Telephone 04 890 1500  
Facsimile 04 903 2413

15 February 2018

Minister of Revenue

## **Update on R&D Tax Credit**

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### **Executive summary**

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1. Officials from Inland Revenue (IR), MBIE, Treasury and Callaghan Innovation are working on a series of reports relating to the design of the R&D tax credit. You will be asked to make decisions that will inform a Discussion Document on the tax credit.
2. Officials from IR and the other departments recently met with Australian officials to learn about its tax credit. These discussions highlighted risks with an R&D tax credit that are relevant to the design of the New Zealand scheme.

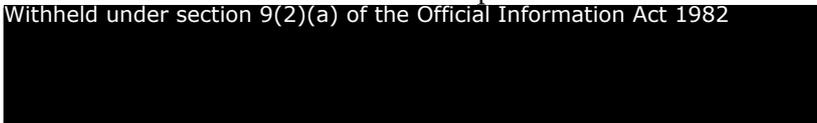
### **Recommended action**

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3. It is recommended that you:

**Note the contents of this report.**

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**Richard Braae**  
Senior Policy Advisor  
Policy and Strategy

**Hon Stuart Nash**  
Minister of Revenue  
/ /2018

## Background

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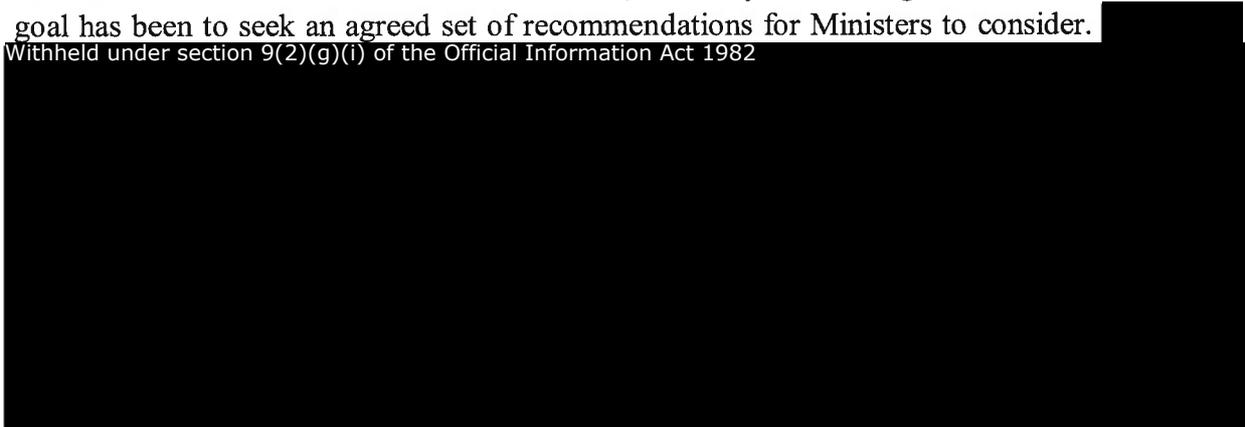
4. You will shortly receive a series of briefing papers on the R&D tax credit:
  - Two papers for you and Minister Woods seeking decisions on the tax credit for the Discussion Document
  - A report from officials (including IR) who travelled to Australia to learn about its tax credit
5. These reports may not be received by your office before your overseas travel. You will meet Minister Woods to discuss the reports on your return.

## Goals for the R&D Tax Credit

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6. Inland Revenue has worked with MBIE, Treasury and Callaghan Innovation and our goal has been to seek an agreed set of recommendations for Ministers to consider.

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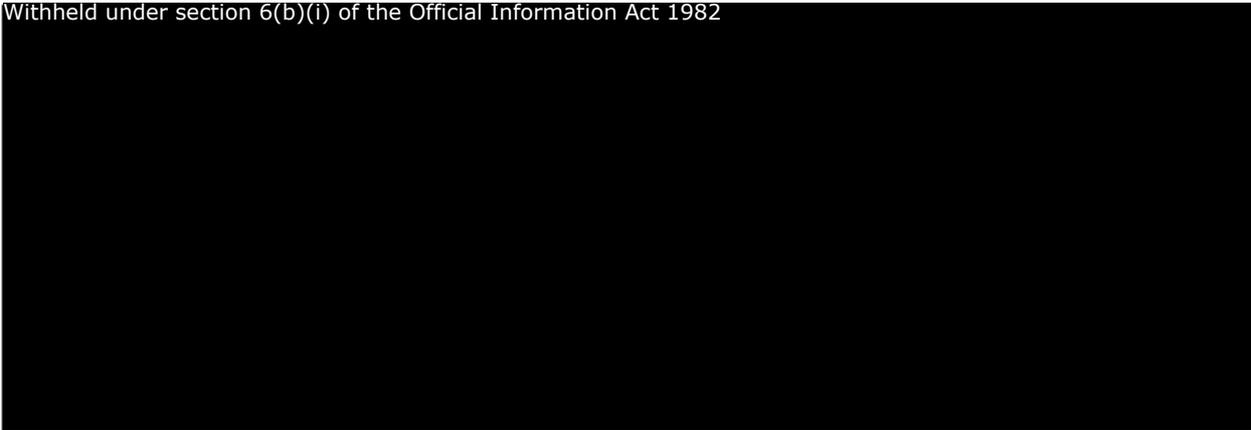


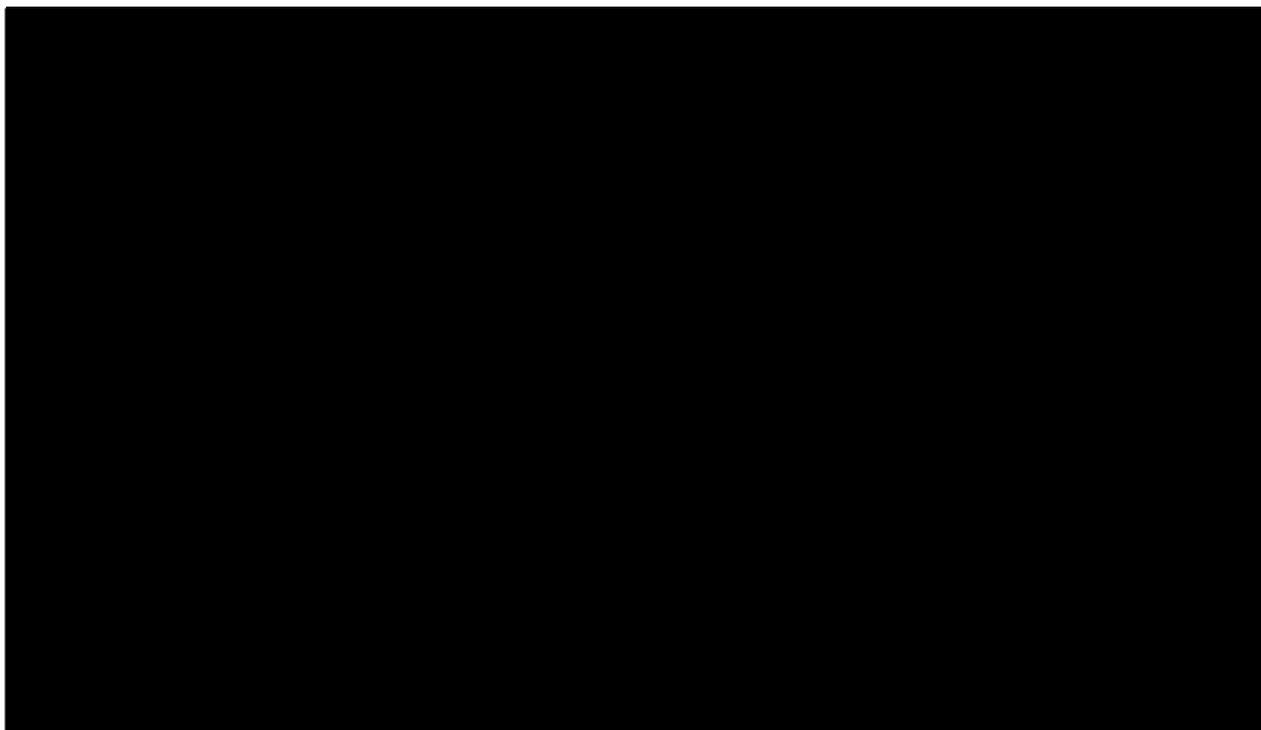
## Lessons from Australia

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8. The main lessons IR officials took from our Australian meetings were:

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POLICY AND STRATEGY

## Tax policy report: Integrity within the R&D Tax Credit

<b>Date:</b>	13 March 2018	<b>Priority:</b>	Medium
<b>Security level:</b>	In Confidence	<b>Report no:</b>	IR2018/132 2465 17-18

### Action sought

	Action sought	Deadline
Minister of Research, Science and Innovation	<b>Agree</b> to inclusion of proposals in the R&D Tax Credit Discussion Document	22 March 2018
Minister of Revenue	<b>Agree</b> to inclusion of proposals in the R&D Tax Credit Discussion Document	22 March 2018

### Contact for telephone discussion (if required)

Name	Position	Telephone
Keith Taylor	Policy Manager	Withheld under section 9(2)(a) of the Official Information Act 1982
Richard Walley	Manager, Innovation Policy	
Becci Whitton	Manager Stakeholder and Government Engagement	

9 March 2018

Minister of Research, Science and Innovation  
Minister of Revenue

## **Integrity within the R&D Tax Credit**

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### **Executive summary**

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1. This report seeks your approval to proposals to be included in the Discussion Document - *R&D Tax Incentive – building a diverse, knowledge-intensive economy through Research and Development*.
2. It responds to a request from Ministers for further advice around measures to ensure the integrity of the tax credit. It proposes certain adjustments to the definition of eligible R&D. It responds to a request from Ministers at DEV for advice about the penalty rules that would apply to inappropriate claims under the tax credit.
3. Integrity will be an important feature for the R&D tax credit. Perceptions that the scheme is rewarding claims that do not represent genuine R&D or that tax advisors are claiming too great a share of the expenditure will undermine the credibility of the scheme.
4. A review of claims from the 2008 tax credit highlights circumstances in which firms were able to receive the tax credit for business as usual expenditure. Consequently, officials propose tightening the rules in two areas – where there is dual purpose expenditure and where firms are being paid by a third party to undertake work.
5. Software is an important area of R&D expenditure. It is also an area where officials consider tightening of the rules that applied in 2008 could be warranted. We are working on developing a robust set of proposals for defining eligibility of software expenditure. We expect this to be complete by May 2018 and anticipate following this by targeted consultation with relevant stakeholders.
6. Officials consider the shortfall penalties framework that applies to all tax returns is a suitable basis for applying penalties to incorrect R&D tax credit claims. However, we also consider the risks around R&D tax credits may be greater when advisors are paid on a contingency basis. Therefore an extension to the framework is proposed where the offense is non-trivial and the advisor shares in the value of the claim.

## Recommended action

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We recommend that you

**Note** that a review of claims from the 2008 R&D tax credit indicated circumstances where applicants were able to receive the credit for business as usual expenditure

**Noted**

**Agree** that the Discussion Document include the proposals:

- that to be an eligible activity for the R&D tax credit, the activity must be for the sole purpose of R&D
- that eligible expenditure does not include expenditure when the R&D performing entity or its associate had received or could reasonably be expected to receive consideration

**Agreed / Not agreed**

**Agreed / Not agreed**

**Note** that limits or exclusions may be appropriate with respect to internal software development and certain types of activities within the software development process

**Noted**

**Agree** that once officials have developed proposals with respect to eligibility of software, they undertake consultation with targeted stakeholders

**Agreed / Not agreed**

**Agreed / Not agreed**

**Note** the shortfall penalties framework that applies to all tax returns will apply to the R&D tax credit

**Noted**

**Note** the risk of inappropriate claims may be greater where tax advisors are paid on a contingency basis

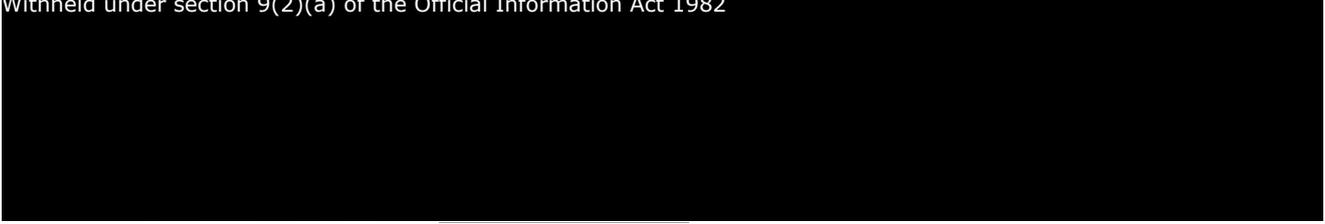
**Noted**

**Agree** that the Discussion Document include a proposal that the penalties framework be extended to apply to an advisor who receives a fee contingent on the R&D tax credit and the tax credit application demonstrates gross carelessness or a more serious offense.

**Agreed / Not agreed**

**Agreed / Not agreed**

Withheld under section 9(2)(a) of the Official Information Act 1982



**Richard Walley**  
Manager, Innovation Policy  
MBIE

**Keith Taylor**  
Policy Manager  
Inland Revenue

**Vic Crone**  
Chief Executive  
Callaghan Innovation

**Hon Dr Megan Woods**  
Minister of Research, Science and Innovation  
/ /2018

**Hon Stuart Nash**  
Minister of Revenue  
/ /2018

## Background

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7. Cabinet has agreed, subject to Budget decisions, to the introduction of a Research and Development (R&D) tax credit from 1 April 2019. (CAB-18-MIN-0056 refers) Officials have prepared a discussion document (2216 17-18, IR2018/133 refers) based on decisions by Ministers on the design features for the tax credit (1714 17-18, IR2018/083 and 1892 17-18, IR2018/084 refer)

8. As with any scheme involving expenditure of public money, there is a need to ensure the integrity of that expenditure. There are risks of inappropriate claims with an R&D tax credit.

9. This report responds to a request from Ministers for further advice around measures to ensure the integrity of the tax credit. It proposes certain adjustments to the definition of eligible R&D and seeks Ministers' approval for their inclusion in the Discussion Document. It also responds to a request from Ministers at DEV for advice about the penalty rules that would apply to inappropriate claims under the tax credit.

10. This report has three sections. The first outlines the framework for the R&D tax credit and how this supports its integrity. The second proposes some particular refinements to the definition of R&D that was described in the technical design features report in order to support appropriate expenditure. The third outlines possible new penalties for the R&D tax credit to complement existing penalty rules.

## How the framework supports integrity

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11. As noted in a previous report (1714 17-18, IR2018/083 refers), the objectives for designing an R&D tax credit are to provide easily accessible support to a broad range of business R&D, in a fiscally responsible way, while maintaining trust and confidence in the tax system. Each element of these objectives has integrity implications.

12. Providing easily accessible support means that the compliance burden associated with applying for the tax credit should be kept to a minimum. This requires the information requirements be consistent with normal business practices.

13. It also means there is as little ambiguity as possible as to what constitutes eligible R&D expenditure. This can be challenging as research and development, as it is used colloquially, doesn't have a precise definition. Firms may consider they are doing R&D because a project is innovative and challenging but not comply with the definition within the legislation. Consequently, an important aspect of the definition of R&D is to favour clarity as to what qualifies and what doesn't, even if – at the margin – this might disqualify some expenditure that is worthy of support.

14. It is also the case that government will learn with experience. There needs to be a flexible regulatory environment both to keep up with how R&D is changing for firms and to address what appears to be abuse of the scheme. Though stability of the scheme is an objective because this will be conducive to firms planning to undertake R&D, it has to be tempered by a commitment to adjust the legislation when warranted.

15. Applying the concept of fiscal responsibility to integrity is also challenging. On the one hand, increased expenditure as a result of firms undertaking more R&D is exactly what the scheme is aiming for. On the other hand, rapid increases in expenditure under the scheme may signal a proliferation of low value claims.

16. Perceptions that the scheme is rewarding claims that do not represent genuine R&D or that tax advisors are claiming too great a share of the expenditure will undermine the credibility of the scheme.

17. As stated in the Discussion Document, the Government is committed to monitoring the scheme and will have the ability to speedily identify and remedy issues that could compromise the integrity of the scheme. This sends a clear signal that the Government will maintain a focus on the scheme meeting its objectives and delivering value for money.

18. Being part of the tax system means that the tax credit will influence perceptions of that system. The tax system relies on voluntary compliance which in turn hinges on public confidence that the system is fair. An erosion of trust in one part of the system can undermine compliance in other parts of the tax system.

19. Inland Revenue will audit a selection of claims to test their validity and enforce compliance with the legislation. But this will not be a comprehensive safeguard so the transparency measures (discussed in 1892 17-18, IR2018/084) and integrity measures discussed in this report will be necessary adjuncts to support the integrity of the tax credit.

## **Refinements to the definition of R&D**

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20. The technical design features briefing (1892 17-18, IR2018/084 refers) outlined the definition of R&D, including eligible and ineligible activities and expenditure categories. Since finalising that report, officials have completed a review of claims from the 2008 R&D tax credit. This has led us to propose certain refinements to the R&D definition. These have been incorporated into the draft Discussion Document that has been presented to Ministers as an attachment to briefing 2216 17-18, IR2018/133.

21. A common theme from the 2008 claims is that firms undertook R&D as part of a broader project. The claim was for all the project; business as usual expenses were included as R&D. The result was claims many times greater than what the IR investigators considered was genuine R&D. However, applicants successfully argued that their claims were permissible according to the letter of the law.

22. For the 2019 tax credit, officials therefore propose the following adjustments to the previous definition in order to provide greater clarity and to better target the credit to genuine R&D.

### **Issue: Dual purpose R&D**

23. Withheld under section 81 of the Tax Administration Act 1994

24. Officials consider R&D can legitimately occur with respect to the operation of a manufacturing plant. However, the appropriate amount of eligible R&D expenditure would be the extra expenditure incurred over what it would have cost to manufacture the firm's output without any R&D. This would isolate the actual cost of the R&D from the business as usual costs of the entity.

25. One way to address this would be to introduce a "to the extent" test. This would mean that where an activity has an R&D purpose and another purpose (in this case manufacturing output), the applicant would be required to apportion expenditure to R&D and the other purpose.

26. The problem with this test is that its application is fact specific. This will potentially lead to a high administration and compliance costs associated with establishing how much of an activity is for an R&D purpose and how much for another purpose. There is also a risk that it would not be as robust as expected and still allow recharacterisation.

27. Officials therefore propose a clearer rule that to be eligible, an activity must be for the sole purpose of R&D. This would mean that dual purpose activities would not be eligible R&D expenditure. In the example above, this rule would have excluded the costs of the manufacturing operation as eligible R&D expenditure because there would have been an additional purpose of producing output for sale.

28. This rule would not exclude genuine pre-production trials and manufacturing innovation. For example, if a production process is run solely to trial an innovative new method, this could be eligible.

29. Nonetheless, there is a risk of over-reach with this exclusion – that is valid R&D is excluded or firms incur additional costs in order to separate R&D from other activities. However, officials note the approach is consistent with the brightline (a clear boundary) test used elsewhere in the tax system. It is also similar to that adopted in other jurisdictions<sup>1</sup>.

30. On balance, officials consider the benefits arising from clarity are likely to outweigh the possible costs. The proposal will be highlighted in the Discussion Document so will be tested through consultation.

31. **Proposal:** To be an eligible activity for the R&D tax credit, the activity must be for the sole purpose of R&D.

### Issue: Eligibility where there is commercial consideration

32. Withheld under section 81 of the Tax Administration Act 1994

<sup>1</sup> The US excludes research that is conducted after the beginning of commercial production; Ireland requires eligible expenditure to be wholly and exclusively for the carrying on of the research; Australia requires a production activity to be for the dominant purpose of supporting R&D.

- The 2008 scheme had an “at risk” rule - firms claiming the tax credit had to bear the risk of the R&D expenditure. The intention was that the party commissioning the R&D would claim for the R&D tax credit.
- Often the investigators considered the genuine R&D was a small part of the project but the applicant successfully claimed for most of the project cost. The rules applying in 2008 did not enable claims to be confined to the genuine R&D portion.

33. Officials consider these claims are not consistent with the intention of the scheme and therefore propose to strengthen the “at risk rule” by incorporating a restriction that is included in the Australian R&D tax credit. This specifies that eligible expenditure does not include expenditure when the R&D performing entity or its associate had received or could reasonably be expected to receive consideration.

34. This rule, in conjunction with the restriction on dual purpose R&D, would mean that where a commissioned project included R&D, the commissioning party could claim the credit provided the R&D-related portion was identified as a separate project. If the R&D performing entity undertook extra R&D separate from what it was commissioned to undertake, it could claim a credit for that extra R&D.

35. **Proposal:** Eligible expenditure does not include expenditure when the R&D performing entity or its associate had received or could reasonably be expected to receive consideration.

## Software development

36. Software R&D will be an area of significant expenditure within the R&D tax credit. It accounted for approximately 40% of all tax credit claims under the 2008 credit and Australian officials indicated it makes up a higher proportion of expenditure under its R&D tax credit.

37. Officials consider that software development activities should qualify for the R&D tax credit where the activity meets the core or supporting R&D activity definitions. However, across OECD countries, mapping the definition of R&D onto software is an acknowledged difficulty. Inland Revenue investigators reported that when they investigated claims it was difficult to distinguish between R&D and standard software development. In itself, this means that re-examination of the 2008 rules is warranted. Also, technological change means that rolling over the 2008 rules relating to eligible software expenditure may not be appropriate.

38. The only limit placed on software under the 2008 credit was a \$3 million cap for eligible expenditure on internal software development<sup>2</sup>. Internal software development was an area of particular concern for investigators of the 2008 claims. Officials are therefore considering whether internal software development should be excluded from eligible expenditure altogether, as is the approach in Australia.

39. Another approach adopted by other countries is to indicate, via guidelines or within legislation, the type of activities that would be eligible or ineligible for the tax credit. An example of the first could be developing new operating systems and of the second could be security testing. Officials consider that having a schedule of the software activities that would not qualify for the tax

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<sup>2</sup> This could be increased at the Minister of Finance’s discretion.

credit, with the ability to update that schedule more quickly than by primary legislation<sup>3</sup>, would make the tax credit more responsive to changes in the way software is developed and used.

40. Officials will continue to work on these issues. Having a robust approach to software will be important for the integrity of the R&D tax credit. It is anticipated that this work will be completed by May 2018.

41. Within the draft Discussion Document, this is flagged as an area where more work is being undertaken. Once more robust proposals have been developed, officials propose undertaking targeted consultation with relevant stakeholders.

## Penalty Rules

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42. Voluntary compliance is the fundamental basis of the tax system. Administration of the R&D tax credit will also rely on voluntary compliance by taxpayers. Guidance and education will be provided to assist taxpayers understand what is eligible and make correct claims.

43. However, there is a risk with the R&D tax credit of applicants submitting incorrect claims. Penalties are one factor that will deter this.

44. Within the tax system, the shortfall penalties framework applies to all tax returns. This establishes a hierarchy of offenses from lack of reasonable care at the lowest level to tax evasion involving fraud at the highest. Appropriate penalties are associated with each level of offense, with civil penalties applying to the lower level offenses and criminal penalties applying to the higher level offenses.

45. Officials consider the shortfall penalties framework provides a suitable basis for applying penalties to incorrect R&D tax credit claims. However, we also consider the risks around R&D tax credits may be greater when advisors are paid on a contingency basis as this means they gain an incentive to inflate the claim. For this reason it is proposed that:

- i. where it is found that the R&D tax credit application demonstrates gross carelessness<sup>4</sup> or a more serious offense:

and

- ii. if an external advisor has received or would have received a direct financial benefit from the claim (in the form of a fee contingent on the R&D tax credit),

the advisor will be joint and severally liable (with the taxpayer) for the appropriate penalty (including repayment of tax shortfall and interest).

46. This proposal has been included in the draft Discussion Document.

47. There are two further elements which officials are investigating as possible extensions to the penalties regime. These are not covered in the draft Discussion Document.

<sup>3</sup> Possible mechanisms could be Order in Council or Commissioner's (of Inland Revenue) Determination

<sup>4</sup> This means that the extension of the penalty would not apply if the taxpayer was found not to have exercised reasonable care

48. A risk is that advisors might promote template schemes<sup>5</sup> for claims under the R&D tax credit. Officials are doing further work to assess whether the current promoter penalties regime is adequate to cover this situation or should be revised.

49. Officials are also investigating whether there should be an over-ride to the standard secrecy provisions applying to tax records so that Inland Revenue could report a tax advisor associated with problematic claims to the appropriate professional body.

## **Consultation**

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50. The Treasury was consulted in the preparation of this report.

51. The Department of Prime Minister and Cabinet was informed.

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<sup>5</sup> This refers to where the same arrangement is offered to 10 or more taxpayers



## POLICY AND STRATEGY

### Tax policy report: Speaking Notes for Research and Development Cabinet paper at DEV

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Date:	5 April 2018	Priority:	Medium
Security level:	In Confidence	Report no:	IR2018/211

### Action sought

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	Action sought	Deadline
Minister of Revenue	Note the contents of this report	11 April 2018

### Contact for telephone discussion (if required)

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Name	Position	Telephone
Richard Braae	Senior Policy Advisor	Withheld under section 9(2)(a) of the Official Information Act 1982
Keith Taylor	Policy Manager	

**POLICY AND STRATEGY**  
*Te Wāhanga o te Rautaki me te Kaupapa*

**National Office**  
Level 8  
55 Featherston Street  
PO Box 2198  
Wellington 6140  
New Zealand  
Telephone 04 890 1500  
Facsimile 04 903 2413

5 April 2018

Minister of Revenue

## **Speaking Notes for Research and Development Cabinet paper at DEV**

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### **Executive summary**

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1. Jointly with Min Woods, you are taking the Cabinet paper Research and Development Tax Incentive Discussion Document to the DEV Cabinet Committee on 11 April.
2. You are seeking approval to publish the Discussion Document *Fuelling Innovation to Transform our Economy* that will underpin consultation on the proposed R&D tax credit. The Discussion Document does not commit the Government to any policy, but it signals the parameters of Government's intended support for the research, science and innovation sector.
3. This report provides you with suggested answers to possible tax-related questions from your Cabinet colleagues.

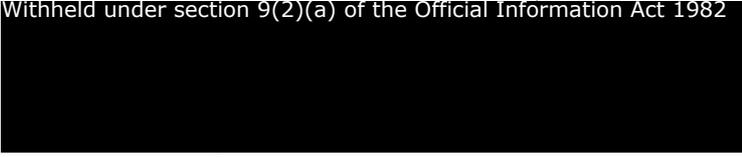
## Recommended action

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4. It is recommended you:

**Note the contents of this briefing**

Withheld under section 9(2)(a) of the Official Information Act 1982



**Richard Braae**  
Senior Policy Advisor  
Policy and Strategy

**Hon Stuart Nash**  
Minister of Revenue  
/ /2018

## Background

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5. Jointly with Min Woods, you are taking the Cabinet paper Research and Development Tax Incentive Discussion Document to the DEV Cabinet Committee on 11 April. (Briefing 2757 17-18, IR2018/205 refers.)
6. You are seeking approval to publish the Discussion Document *Fuelling Innovation to Transform our Economy* that will underpin consultation on the proposed R&D tax credit.
7. The Discussion Document does not commit the Government to any policy, but it signals the parameters of Government's intended support for the research, science and innovation sector.
8. We anticipate that Minister Woods will take the lead in introducing the item and responding to questions about how this policy fits into the wider picture of Government support business innovation. This briefing therefore addresses tax-related issues.

## Tax-Related Questions that may be raised

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9. **Q:** What's the difference between a tax incentive and a tax credit?
10. Minister Woods has requested the policy be referred to as a tax incentive because this provides a better description of the outcome sought. The instrument is a tax credit – that's the technical way it will be described in the tax legislation.
11. **Q:** How does the proposed rate of 12.5% compare with Australia's tax credit scheme?
12. The Australian scheme is more complex than what's proposed for New Zealand so it's not possible to make a simple comparison of the schemes' generosity. For small businesses, the Australian scheme is at a higher effective rate (16%) and is refundable, so is more generous. For large firms, the Australian scheme is at a lower effective rate (8.5%) and is not refundable, so is less generous.
13. **Q:** Is there a risk that the proposed definition will exclude firms undertaking valuable innovation that we want to be eligible for the subsidy?
14. With the definition, we are trying to balance two competing objectives:
  - Including worthy R&D, while
  - Excluding business as usual being recharacterised as R&D.

15. The purpose of consultation is to get feedback on whether we've got that balance right.

16. In addition, it won't be the case that all worthwhile innovative activity will be eligible for the tax credit. The credit is focused on subsidising the acquisition and application of new knowledge because this is where market incentives are likely to be weakest for firms. For other innovative activities, the market provides good incentives so there is less justification for a government subsidy.

17. **Q:** Many small R&D performing firms will be in loss. Why is the tax credit not refundable right from the start?

18. Officials agree that ideally there should be support for R&D firms in loss. However, the risks associated with refundability are greater than with non-refundability. That is why we are proceeding carefully before introducing this feature. The issues that need to be worked through are set out at paragraph 32 of the Cabinet paper. These are substantial issues and there is not the time to work through them and get legislation enacted to meet the April 2019 start date for the credit.

19. **Q:** How can we make sure that this scheme is not rorted?

20. There are several ways we are ensuring the R&D tax incentive will support genuine R&D.

- The definition of R&D, including the excluded activities and expenditure, will set out eligible expenditure and is designed to exclude business as usual expenditure. This definition incorporates lessons from the experience of the 2008 credit – for instance some of the additional exclusions that are being proposed are designed to defeat the types of claims that did not seem to be genuine R&D.
- Because the tax credit will be part of the tax system, we will make sure the standard shortfall penalties within the tax system will apply to claims made for the tax credit.
- Officials are investigating whether there are additional measures that need to apply to deter aggressive behaviour by tax advisors.

21. All these provide some measure of safeguard. However, they will not be an absolute protection. Therefore there will also be, in the legislation, a capacity to adjust the definition of R&D so that we can quickly remedy issues that suggest the scheme's integrity is being compromised.