MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Dr Megan Woods	**Portfolio**	Research, Science and Innovation
Title of Cabinet paper	Extending Refundability for the Research and Development Tax Incentive	**Date to be published**	12 July 2019

List of documents that have been proactively released		
Date	**Title**	**Author**
14 May 2019	Extending Refundability for the Research and Development Tax Incentive	Office of the Minister of Research, Science and Innovation, Office of the Minister of Revenue
22 May 2019	Cabinet Economic Development Committee minute: DEV-19-MIN-0119	Cabinet Office
10 May 2019	Regulatory Impact Statement: R&D Tax Incentive – Refundability	MBIE, IR
13 November 2018	R&D Tax Incentive: Phase 2	MBIE, IR
13 February 2019	R&D Tax Credit: Phase 2 Policy Proposals	MBIE, IR
11 April 2019	Draft Cabinet paper: R&D Tax Incentive – Refundability	MBIE, IR, Callaghan Innovation
2 May 2019	R&D Tax Incentive: Ministerial meeting to discuss refundability	MBIE, IR
17 May 2019	Talking points for the DEV Cabinet paper: Extending Refundability for the R&D Tax Incentive	MBIE
27 June 2019	R&D Tax Incentive – refundability and small innovative firms	MBIE, IR

Information redacted **YES / ~~NO~~** *(please select)*

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982.

In Confidence

Office of the Minister of Research, Science and Innovation

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

EXTENDING REFUNDABILITY FOR THE RESEARCH AND DEVELOPMENT TAX INCENTIVE

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to proposals to extend refundability of the Research and Development (R&D) Tax Incentive so that legislation can be drafted for introduction to Parliament in June 2019.

Executive summary

2. The R&D Tax Incentive has come into effect from the start of the 2019/20 income year.

3. This scheme provides for limited refundability of R&D tax credits for firms in tax loss or with limited income tax liability. We have consistently signalled extending the refundability provisions once further policy work had been completed.

4. This paper seeks agreement to draft legislation that will broaden the refundability provisions. We propose that from the 2020/21 income year, refundability is broadly available. This broader refundability would be subject to a cap based on the amount of 'payroll'[1] taxes paid by a firm in each year (proposed cap). The proposed cap would not apply to tax credits resulting from payments to approved research providers, and would not apply to R&D tax credits refunded to levy bodies.

5. We have considered whether tax exempt organisations should be eligible for refundability. We believe that **all tax exempt organisations, except organisations receiving tax exempt income under section CW 9 and 10[2] of the Income Tax Act, should be ineligible for the R&D Tax Incentive.**

Background

6. The R&D Tax Incentive provides tax credits to firms undertaking R&D. Reducing the amount of income tax paid by these firms lowers the cost of their R&D, thereby incentivising firms to undertake more R&D. This is a key policy to support the

[1] Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).
[2] CW 9 applies to dividends derived from foreign companies and CW 10 applies to dividends within New Zealand wholly-owned groups.

Government's goal of raising the amount of R&D undertaken and grow a more innovative economy.

7. The Taxation (Research and Development Tax Credits) Bill has been enacted and the R&D Tax Incentive scheme has commenced from 1 April 2019 for most businesses[3].

8. The R&D Tax Incentive was developed under tight timeframes. Consequently, there was insufficient time to resolve some complex issues before the legislation was drafted. The major issue requiring further consideration was refundability of tax credits.

9. Refundability refers to paying out R&D tax credits if a business has insufficient income tax liability. That is, if a business has made a tax loss or its income tax liability is less than the R&D tax credits it has earned. An alternative to refunding the credit is to allow firms to carry their surplus credits forward and use them when they move into a tax paying position.

10. Cabinet agreed to a limited approach to refundability for the first year of the R&D Tax Incentive. We committed to review the policy that would apply from the second year.

11. This paper seeks agreement to a proposal for broader availability of refundability of tax credits that will apply from the 2020/21 income year.

12. This proposal also addresses the position of organisations that receive tax exempt income (tax exempt organisations). Because these organisations generally do not have an income tax liability, the only way they will benefit from the R&D Tax Incentive is if their credits are refunded. In general, we propose that tax exempt organisations should not be eligible for the R&D Tax Incentive, but we consider an exception should be made for levy bodies.

Refundability is an important feature in the R&D Tax Incentive

13. Providing a refund ensures that all firms doing R&D are able to immediately benefit from the tax credits they are eligible for under the R&D Tax Incentive. For instance, an established business can apply its tax credits to offset tax it would pay on profits generated in other parts of the business. Similarly, a large conglomerate can support a loss-making R&D division through profits from other parts of a business. By contrast, an early stage R&D intensive firm may not be able to benefit from the tax credit until a much later date, if at all if it never attains profitability or experiences a breach in shareholder continuity.

14. Refundability provides the financial incentive for R&D when it is most needed. In most cases, a firm will incur R&D expenditure prior to receiving revenue from commercialising its product. Therefore, not only are early stage R&D-intensive firms more likely to be in loss, they are also more likely to be cash constrained. For these firms, cash today will be much more valuable than a credit that is carried forward,

[3] The R&D Tax Incentive applies from the beginning of the 2019/20 income year, which means the date from which it applies depends on the balance date of each individual claimant. For most standard balance date (31 March) claimants, the R&D Tax Incentive will apply from 1 April 2019.

especially as they risk losing their credits if they breach the R&D tax credit shareholder continuity rules[4].

15. Enabling firms in tax loss to have their credits refunded provides a more powerful incentive for them to undertake R&D.

16. However, paying out to businesses, rather than reducing the amount of tax they pay, increases the risk of fraud. This could destabilise the R&D Tax Incentive and has been an issue in other jurisdictions[5]. The risk is not particular to R&D tax credits and arises in other parts of the tax system such as donor tax credits and GST refunds.

17. Refundability also increases the likelihood that firms will claim the R&D Tax Incentive, which will result in a higher fiscal cost. In countries where credits are refunded, growth in the amount of R&D claimed, and hence fiscal cost growth, is faster amongst those firms getting refunds. Discussions with officials in Australia and the UK suggest that some of this increased R&D is of marginal quality. Cash payments for small, start-up firms are highly attractive for some firms so encourage reclassifying other expenditure as R&D or claiming for activity that is not R&D.

18. These conflicting drivers are reflected in how refundability is treated in other countries. Across the OECD, though most countries have an R&D tax credit, only half provide refundability. Of those that do, almost all apply further constraints. Australia, for instance, only has refundability for small to medium sized firms and has introduced legislation to cap the amount that is refunded. The UK is also consulting on a proposal to cap the refund for small and medium sized firms.

19. We note that New Zealand's R&D Tax Incentive contains features to promote integrity of the scheme and ensure its sustainability over the long term. These include the requirement for R&D activity to primarily occur in New Zealand, the system of in-year approval (starting in 2020/21), and the exclusion of claims if a firm's R&D expenditure is below a $50,000 threshold. Nonetheless, we consider it sensible to be aware of how risks have emerged in other countries and therefore how we can build safeguards into the New Zealand scheme.

Proposals for refundability for firms in loss

20. Our starting point is that refundability is a desirable policy because it will encourage more firms to undertake R&D. However, to ensure the scheme's long-term sustainability, we consider it prudent to constrain how much can be refunded.

21. The principles we have applied in developing the proposals in this paper are:

    21.1 The policy should be simple for firms to understand and comply with.

[4] The R&D tax credit shareholder continuity rules are very similar to the tax loss shareholder continuity rules. They require businesses to maintain shareholder continuity of 49% or more to carry forward their R&D tax credits from one period to the next.

[5] For instance the UK Treasury and HMRC have released a consultation document 'Preventing abuse of the R&D Tax Relief for SMEs'.

21.2 Consistent with the underlying approach to the R&D tax incentive, refundability should be broadly available rather than applying selectively to particular types of firms.

21.3 We have avoided situations where a change in a firm's circumstances alters its eligibility for refundable tax credits. In Australia, if a firm's turnover grows to exceed $20 million per year, it is no longer eligible to have its credits refunded.

22. The recommended proposal on refundability for firms is:

22.1 All firms should be entitled to a refund of their R&D tax credits, to the extent their R&D tax credits are equal to or less than the amount of 'payroll' taxes paid by a firm in the relevant income year (proposed cap)[6].

22.2 The proposed cap would not apply to limit refundability of tax credits resulting from payments to approved research providers.

22.3 The proposed cap would not apply to R&D tax credits refunded to levy bodies.

23. The proposed cap is designed to prevent refundable tax credits being paid out to firms who are fraudulently claiming the tax credit. Some overseas jurisdictions counter this risk by limiting R&D tax credit refunds to the amount of PAYE paid by the firm. This is a simple and unobtrusive test but overlooks that some firms may legitimately pay little PAYE[7]. Consequently, we propose that additional payroll-related taxes paid and payments to approved research providers be included to reduce the impact of this constraint.

24. Nonetheless, we anticipate that some firms may not be able to receive a full refund of their tax credits in the year in which they are earned as a result of this policy.

25. We note that the R&D Tax Incentive is not the only instrument that can assist the early stage firms that may be affected by this policy. MBIE, in conjunction with Inland Revenue and Callaghan Innovation, is leading a programme of work to review our interventions for R&D intensive start-ups in light of the shifting R&D funding environment. This includes: a review of Callaghan Innovation's R&D Project Grants; reviewing the R&D tax loss cash out scheme; and a commitment to a refreshed and more ambitious Technology Incubator Programme. MBIE is also leading work, through the New Zealand Venture Capital Fund, to deepen capital markets to support high-growth/scale-up firms involved in disruptive technology.

Tax exempt organisations

26. There are different types of tax exempt organisations, including charities, some levy bodies, public authorities and local authorities, sports promoting bodies, and science

[6]Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).

[7] For instance, many start-up firms will limit their financial risk by employing staff on contract rather than recruiting them as permanent members of staff. These staff employed on contract may choose to have withholding tax (WT) paid by the firm on their behalf.

and industrial research promoting bodies. A common feature is that they do not pay income tax, so have no income tax liability against which to offset their R&D tax credits. Therefore, these organisations will only benefit from the R&D Tax Incentive if their credits are refunded.

27. There are arguments for and against these types of organisations having their tax credits refunded. In general, the argument for is that the R&D they undertake is potentially valuable and enabling them to benefit from the tax credit could stimulate them to do more R&D.

28. The argument against is that these organisations are outside the tax system so should not benefit from incentives provided from within the tax system

29. However, the specifics of these arguments vary with the type of tax exempt organisation, so it is useful to consider each type separately.

Levy bodies

30. Levy bodies receive levy payments from their members, which are generally taxable businesses. These payments are then used to fund levy bodies' R&D activities, which are performed for the benefit of levy body members. The R&D performed by and funded through levy bodies is fundamentally business R&D.

31. Levy bodies are not by definition tax exempt organisations, but some may receive tax exempt income. A carve-in is proposed for them, as these entities do not receive the same tax concessions as charities (such as donee tax credit status, GST and FBT concessions)

32. We propose that levy bodies would have fully refundable R&D tax credits[8].

Charities

33. Charities also undertake valuable R&D. However, we propose that charitable organisations be ineligible for refundable tax credits, even though they are not currently excluded from receiving the Growth Grant.

34. Charities do not pay income tax, they receive GST concessions[9], and are exempt from FBT. Also, they benefit from the donor tax credit regime (which provides tax credits to those who donate to charities), as these credits incentivise individuals and businesses to donate to charities. In short, charities receive Government support. These benefits mean that charities' cash flow is enhanced by provisions in the tax system, and they do not have their profits top-sliced as a tax paying organisation does. Therefore, we do not consider it appropriate to extend further benefits to charities through the tax system.

35. Charities are currently treated as carrying on a business in New Zealand for the purposes of determining eligibility for the R&D Tax Incentive. We propose removing

[8] Levy bodies that receive other Government funding for some of their R&D activities would only be eligible for R&D tax credits to the extent their R&D activities are not already subsidised by the Government.
[9] The current GST treatment of charities is concessionary, relative to other organisations, because it allows charities almost full input tax deductibility even if very few taxable supplies are made.

this rule for consistency and excluding them from being eligible for the R&D Tax Incentive.

36. Excluding charities means that businesses wholly-owned by charities are excluded, because these are also considered charities. However, we are not proposing to include broader association rules. This means if a tax paying business donates to a charity, even a business controlled by that charity, this would not invalidate the business's access to the R&D Tax Incentive. It would also mean that a charity could set up a partially controlled business entity, subject to the rules within the constitution of the charity, that could be eligible for the R&D Tax Incentive.

Māori businesses

37. Māori businesses may structure their affairs differently from non-Māori businesses for a variety of reasons. The R&D Tax Incentive has broader eligibility for different forms of business entities than the Callaghan Innovation Growth Grant regime, which required specific entity eligibility rules to allow some Māori businesses to qualify.

38. Māori authorities are not tax exempt - they pay tax at 17.5% rather than at the company rate of 28%. Māori organisations that carry out R&D activities should be eligible for the R&D Tax Incentive. A small number of post-settlement governance entities have registered as charities, but businesses that are partially controlled by these entities would not be charities so would be eligible for the R&D Tax Incentive.

Other tax exempt organisations

39. For the avoidance of doubt, we propose that other tax exempt organisations including local authorities be ineligible for the R&D Tax Incentive. This was the original policy intent, established as part of the initial policy development of the Incentive, but this exclusion was not included in the Taxation (Research and Development Tax Credits) Bill. Local authorities have the ability to raise the revenue required to perform R&D activities through rates. The R&D tax incentive should not be required to incentivise R&D activities by local authorities.

40 Within the Income Tax Act, there is provision for income from dividends in certain circumstances (CW 9 and CW 10) to be tax exempt. In the original legislation we provided for receipt of such income to not affect eligibility for the tax incentive or refunds. We propose this should continue to be the case.

Anticipated further work

41. Establishing a robust policy on refundability rounds out the work programme for establishing the R&D Tax Incentive, but we anticipate other refinements and developments in the years ahead. These include, but may not be limited to:

    41.1 Changes to make the R&D Tax Incentive more attractive for recipients. An important issue for many firms is when they will receive R&D tax credit payments. Growth Grant recipients receive payments quarterly, and during stakeholder engagement, firms raised the lack of quarterly payments as a negative aspect of transitioning from Growth Grants to the R&D Tax Incentive. At present, Inland Revenue systems only allow for end of year payments but, once Inland Revenue's Business

Transformation is more advanced, a system of in-year refundability may be possible[10].

41.2 There is also a commitment for further policy work to be undertaken as part of the Tax Incentive to simplify administrative processes for small to medium enterprises. This work will ensure that the compliance costs for applicants are commensurate with the benefits they receive. Examples of this could be allowing small firms to use a 'labour cost plus mark-up' approach to establishing their eligible expenditure.

41.3 A review of complementary policies, including the R&D tax loss cash out and Callaghan Innovation Project Grants. With the R&D Tax Incentive in place, the Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation will undertake further work to ensure other instruments in the system of government support for R&D are complementary to the R&D Tax Incentive.

41.4 There will be ongoing monitoring of the R&D Tax Incentive, plus a formal review once it has been in place for five years. We anticipate these processes will identify areas for improvement.

Stakeholder engagement

42. This refundability policy has benefited from input from a wide array of organisations.

43. The importance of broad refundability in incentivising business investment in R&D was a strong theme from the consultation conducted by the Ministry of Business, Innovation and Employment, Inland Revenue, and Callaghan Innovation following the release of the Government Discussion Document on the R&D Tax Incentive in mid-2018. The need for broad refundability was also emphasized in submissions received by the Finance and Expenditure Select Committee on the Taxation (Research and Development Tax Credits) Bill, and through additional stakeholder meetings.

44. The Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation have discussed the refundability proposals with the Corporate Taxpayers' Group; Chartered Accountants Australia and New Zealand; representatives from PwC, KPMG, Deloitte and EY; approximately 25 representatives from R&D performing businesses in tax loss or with insufficient taxable income to fully utilise non-refundable R&D tax credits; some large established R&D performers; levy bodies; charities; cooperatives; Federation of Maori Authorities; and Māori business representatives. These discussions have helped shape the refundability proposals and have highlighted the desirability of broad eligibility and an accessible process.

45. As part of the broader refundability discussions, stakeholders were asked to consider the impact of a PAYE cap. A PAYE cap, which would limit the amount of R&D tax credits refunded to a firm to the amount of PAYE paid by the firm in the relevant year, was seen as problematic.

[10] Though other pre-conditions are likely before in-year refundability can be offered..

46. Stakeholders advised that a PAYE cap could constrain the benefit loss-making early stage R&D intensive firms would derive from the credit. Many of these firms use contractors over employees because of the flexibility afforded by contracting arrangements. R&D intensive start-ups may have fewer non-R&D employees (compared with larger firms), and may also have a higher proportion of non-employee R&D expenditure (such as expenditure on capital assets or consumables).

47. As a result of this stakeholder engagement, a broader range of taxes paid by firms have been included in the proposed cap, along with any tax credits resulting from payments to approved research providers.

Consultation

48. The Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation prepared this Cabinet paper.

49. The following agencies have been consulted during the development of this paper: Treasury, Te Puni Kōkiri, Department of Internal Affairs and Ministry of Primary Industries.

50. The Department of the Prime Minister and Cabinet was informed.

Financial implications

51. Broadening the policy on refundability will make the policy more attractive and therefore incentivise firms to undertake and claim more R&D under the Tax Incentive. A consequence is that the cost of the R&D Tax Incentive will be higher than what it otherwise would be under the limited refundability that will apply in the first year.

52. However, this does not require any additional appropriation from that which Cabinet approved for the R&D Tax Incentive in September 2018.

53. In the paper that approved the appropriation, Cabinet agreed to limited support for businesses in tax loss starting April 2019 and noted that the design features for refundability would be broadened in subsequent years (DEV-18-MIN-0174). Therefore, the broader refundability policy proposals fall within the scope of what Cabinet has already agreed.

54. The fiscal cost estimates that were used to justify that appropriation were based on the assumption that from the Incentive's inception all firms, including those in loss, would claim and receive the full amount of the tax credits in the year in which they are earned, even without full refundability. Therefore, the appropriation has already allowed for the costs associated with the policies we are proposing.

55. As a sensitivity test, officials have also considered the possibility that the broader approach to refundability will drive faster growth in R&D and therefore higher costs of the Incentive than is predicted on the standard assumptions. There is a large degree of uncertainty around these estimates but they nonetheless suggest that even with this additional cost, the estimated cost of the R&D Tax Incentive would still fall within the current appropriation.

Legislative implications

56. Implementing these proposals requires changes to the Income Tax Act 2007 and the Tax Administration Act 1994.

57. If approved, we propose developing draft legislation for changes resulting from these recommendations in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill, scheduled for introduction in June 2019. We also anticipate this drafting will include some minor remedial matters relating to the Tax Incentive legislation already enacted.

Impact Analysis

58. MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Regulatory Impact Statement prepared by MBIE. The Panel considers that the information and analysis summarised in the Regulatory Impact Statement meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.

Human Rights

59. There are no human rights implications arising from the proposals in this paper.

Gender Implications

60. There are no gender implications arising from the proposals in this paper.

Disability Perspective

61. There are no specific disability considerations arising from the proposals in this paper

Publicity

62. We will make an announcement on this policy once Cabinet decisions have been made. We will also make an announcement when the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill is introduced. A commentary on the Bill will be released at this time. Details will be posted on the Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation websites.

Proactive release

63. We propose to proactively release this Cabinet paper, associated minutes, and key advice papers in whole within 30 working days of Cabinet making final decisions.

Recommendations

We recommend that the Cabinet Economic Development Committee:

1. **Note** legislation introducing an R&D tax credit has been enacted;

2. **Note** that this provides limited refundability of the tax credit for firms in loss or with insufficient tax liability to offset the tax credit;

3. **Note** we have previously signalled our intention to review the policy applying to the refundability of the tax credit;

4. **Agree** that R&D tax credits will be refundable for firms in loss or with insufficient tax liability to offset their tax credits, subject to a maximum equal to the amount of payroll taxes paid by a firm in each year plus any tax credits resulting from payments to approved research providers;

5. **Agree** that levy bodies are eligible for a refund of their tax credits and their refunds are not limited by the cap proposed at 4 above;

6. **Agree** that all tax exempt organisations, except organisations receiving tax exempt income under section CW 9 and 10 of the Income Tax Act 2007, be ineligible for the R&D Tax Incentive;

7. **Note** that local authorities would be ineligible for the R&D Tax Incentive.

8. **Agree** to delegate authority to the Ministers of Research, Science and Innovation and Revenue to make any adjustments of a minor and technical nature to the policy on refunding R&D tax credits as necessary, to achieve its policy intent;

9. **Agree** to delegate authority to the Ministers of Research, Science and Innovation and Revenue to make any adjustments of a minor or technical nature or as required to achieve the intent of the R&D Tax Incentive policy, and where the adjustments can be funded from within the existing appropriation;

10. **Invite** the Ministers of Research, Science and Innovation and Revenue to instruct Inland Revenue to draft legislation to give effect to the policy proposals and their intent contained in this paper;

11. **Approve** the inclusion of legislation to implement recommendations 1 to 10 above in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill;

12. **Note** that it is expected the Bill will be introduced no later than 26 June 2019;

13. **Note** that this Cabinet paper, the associated Cabinet minute, and key advice papers will be released on the Ministry of Business, Innovation and Employment's, Inland Revenue's and Callaghan Innovation's websites.

Authorised for lodgement

Hon Dr Megan Woods
Minister Research, Science and Innovation

Hon Stuart Nash
Minister of Revenue

DEV-19-MIN-0119

Cabinet Economic Development Committee

Minute of Decision

Extending Refundability of the Research and Development Tax Incentive

Portfolios **Research, Science and Innovation / Revenue**

On 22 May 2019, the Cabinet Economic Development Committee:

Background

1 **noted** that legislation introducing a research and development tax credit (the R&D Tax Incentive) has been enacted [LEG-18-MIN-0150];

2 **noted** that the legislation provides limited refundability of the R&D Tax Incentive for firms in loss or with insufficient tax liability to offset the tax credit;

3 **noted** that the Minister of Research, Science and Innovation and the Minister of Revenue (the Ministers) have previously signalled their intention to review the policy applying to the refundability of the R&D Tax Incentive [DEV-18-MIN-0174];

Extending refundability

4 **agreed** that the R&D Tax Incentive be refundable for firms in loss or with insufficient tax liability to offset their tax credits, subject to a maximum equal to the amount of payroll taxes paid by a firm in each year plus any tax credits resulting from payments to approved research providers;

5 **agreed** that levy bodies be eligible for a refund of their R&D Tax Incentives, and that their refunds not be limited by the cap referred to in paragraph 4 above;

6 **agreed** that all tax exempt organisations, except organisations receiving tax exempt income under section CW 9 and 10 of the Income Tax Act 2007, be ineligible for the R&D Tax Incentive;

7 **noted** that local authorities would be ineligible for the R&D Tax Incentive;

8 **authorised** the Ministers to make any adjustments of a minor and technical nature to the policy on refunding the R&D Tax Incentives as necessary, to achieve its policy intent;

9 **authorised** the Ministers to make any adjustments of a minor or technical nature or as required to achieve the intent of the R&D Tax Incentive policy, and where the adjustments can be funded from within the existing appropriation;

Legislative implications

10 - **invited** the Ministers to issue drafting instructions to Inland Revenue to draft legislation to give effect to the above paragraphs and their intent, as outlined in the paper under DEV-19-SUB-0119;

11 - **agreed** that the above proposals be included in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill;

12 - **noted** that it is expected the Bill will be introduced no later than 26 June 2019.

Janine Harvey
Committee Secretary

Present:
Hon Grant Robertson (Chair)
Hon Phil Twyford
Hon Dr Megan Woods
Hon Nanaia Mahuta
Hon Stuart Nash
Hon Iain Lees-Galloway
Hon Jenny Salesa
Hon Kris Faafoi
Hon James Shaw
Hon Julie Anne Genter

Officials present from:
Office of the Prime Minister
Officials Committee for DEV

Hard-copy distribution:
Minister of Research, Science and Innovation
Minister of Revenue

Coversheet: Research and Development Tax Incentive - Refundability

Advising agencies	Ministry of Business, Innovation and Employment (MBIE) Inland Revenue (IR) The Treasury Callaghan Innovation
Decision sought	Broader refundability for the R&D Tax Incentive
Proposing Ministers	Hon Dr Megan Woods (Minister for Research, Science and Innovation) Hon Stuart Nash (Minister of Revenue)

Summary: Problem and proposed approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

The Taxation (Research and Development Tax Credits) Act (the Act), implements an R&D Tax Incentive in New Zealand. The R&D Tax Incentive applies from 1 April 2019 for most businesses. Under the scheme, firms can receive a tax credit equal to 15% of their eligible R&D expenditure. Profitable firms will be able to use this tax credit to reduce their income tax liability. The Act allows for certain firms that have little or no income tax to pay to receive a R&D tax credit refund of up to $255,000 per income year. Credits that are not refunded can be carried forward to future income years provided shareholder continuity criteria are met.

The limited refundability rules in the Act are based on the R&D Tax Loss Cash Out scheme. Under these rules, eligibility for refunds is restricted to unlisted companies that meet a 20% R&D wage intensity test and do not derive non-dividend exempt income.

These criteria mean that many businesses will not be eligible for refundable tax credits under the R&D Tax Incentive. Partnerships, trusts, listed companies, and companies who receive some exempt income or do not meet the wage intensity test will be excluded. Additionally, certain atypical organisations, such as levy bodies, some Māori entities, charities, and local authorities, will be excluded. It is desirable to ensure the law provides clarity as to whether these entities should benefit from the R&D Tax Incentive through the design of a more comprehensive refundability policy.

The limited timeframe for developing the Act meant it was not possible to design broad refundability rules for year one. The Government has committed to developing a more comprehensive policy for refundability to apply from year two of the Tax Incentive.

The rationale for the R&D Tax Incentive and the importance of raising business expenditure on R&D (BERD) was explained in the previous Regulatory Impact Statement (RIS) for the R&D Tax Incentive (http://taxpolicy.ird.govt.nz/publications/2018-ria-rdtc-bill/overview).

This RIS is focused on options to broaden the refundability of the R&D Tax Incentive. If refundability is not broadened, it is expected that the Tax Incentive will not be as effective as intended at incentivising additional R&D.

Proposed Approach

How will Government intervention work to bring about the desired change? How is this the best option?

Broadening eligibility for refundability

The proposed approach is to change the existing limited refundability rules so that R&D tax credit refunds are available to more businesses.

It is proposed that all businesses would be eligible for refundability, irrespective of their legal form or whether they are listed. The 20% wage intensity test would also be removed.

We expect that making the tax credit available to more R&D-performing firms (and higher incentives for firms to engage in R&D) will increase the amount of R&D undertaken, which will in turn result in an increase in knowledge creation, employment, and labour productivity growth. Knowledge created by R&D flows between firms because of worker mobility, product imitation and reverse engineering.

This means firms do not capture the full benefits of their R&D and so they underinvest relative to the socially optimal level. This is why most governments have a policy that will stimulate firms to undertake more R&D.

Providing refundable tax credits will enhance the effectiveness of the R&D Tax Incentive at stimulating growth in BERD, because it provides cash closer to the point when firms, particularly R&D intensive firms in the early stages of their development, are undertaking their R&D.

This means the tax credit is more likely to incentivise the performance of additional R&D by businesses, which is the goal of the policy.

Broadening the refundability available from that provided for year one of the R&D Tax Incentive has always been the intent, and will broaden the reach and effect of the R&D Tax Incentive.

Ensuring integrity and managing fraud risk

In addition to extending refundability to all businesses, it is proposed to remove the existing $255,000 cap on refundability. Instead, it is proposed to limit the amount of credits refundable to businesses through a cap based on the amount of payroll taxes paid by each business. This payroll cap would include PAYE, fringe benefit tax (FBT), employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT) paid by a business.

A payroll cap will help ensure the integrity of the scheme is maintained. It is necessary to reduce the risk of fraudulent claims for R&D tax credit refunds which have been problematic (along with an associated fiscal risk) in other jurisdictions with refundable R&D tax credits.

The payroll cap would not apply to limit refundability of R&D tax credits resulting from payments to Approved Research Providers because it will be easy to verify that these payments have been incurred by a business.

The payroll cap would not apply to limit the R&D tax credits refunded to levy bodies. Levy bodies are empowered to collect levies by statute, definitely have an economic presence in New Zealand, and consequently pose a reduced risk that refunded R&D tax credits will be unrecoverable.

Exempt income recipients

Recipients of exempt income are currently ineligible for limited refundability, unless the only exempt income they receive is from dividends.

Without refundability, entities that only derive exempt income, such as charities, are unable to receive any cash benefit from the R&D Tax Incentive. This is because they do not have any income tax to pay. As these entities are outside the tax system, it is proposed that they should not benefit further from incentives provided from within the tax system and that they should be ineligible for the R&D Tax Incentive.

It is proposed that an exception apply for levy bodies, however, which do not receive the same tax concessions as charities (such as donee tax credit status, GST and FBT concessions). The R&D performed by and funded through levy bodies is fundamentally business R&D. Accordingly, it is proposed that levy bodies are eligible for the R&D Tax Incentive (including refundability), even if they receive exempt income.

Further details and the implications of this proposal for particular atypical organisations (including charities, Māori businesses, and local authorities) are discussed further at 3.2.

Section B: Summary impacts - benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
Businesses in tax loss, or with insufficient income tax liability to fully utilise non-refundable tax credits, will be the main beneficiaries from broader refundability. Refundability can be particularly beneficial for young, innovative firms, at the stage of investing in developing and launching their products (Appelt et al., 2016). The population of firms performing R&D and in a tax loss position is estimated at 750-1200. These are the expected beneficiaries. Under current rules only 350-650 firms are expected to qualify for refundability, and of those 65-130 are expected to hit the cap on refundability. Partnerships, trusts, listed companies, companies who receive some exempt income or do not meet the wage intensity test, and atypical organisations such as levy bodies and some Māori business entities will also benefit from the R&D Tax Incentive through the design of a more comprehensive refundability policy.

Where do the costs fall?

Fiscal costs

The budget for the Tax Incentive provides for the fiscal cost of full refundability. In Budget 2018 the Government appropriated $1,020 million over the first four fiscal years for the R&D Tax Incentive. On 10 September 2018, Cabinet agreed to reprioritise the remaining funding ($528 million) already allocated for Growth Grants over the same period [CAB-18-MIN-0434 refers].

We anticipate that allowing broad refundability will increase the take-up of the Tax Incentive compared to limited refundability. This in turn will increase the R&D expenditure performed by firms, and the amount claimed under the Tax Incentive. These fiscal costs will be borne directly by Government and indirectly by the taxpayer.

Additional fiscal cost due to broader refundability, compared with the limited refundability available in year one of the R&D Tax incentive, could be for the below reasons:

- Increased R&D activity from existing R&D performers
- Firms new to R&D enter the scheme

We have estimated the fiscal costs of the R&D Tax Incentive with full refundability to be approximately $1,345 million over the first four fiscal years for the R&D Tax Incentive (from when it comes into effect on 1 April 2019 through until 30 June 2022). The model used to prepare these estimates assumed that firms claim the full amount of the eligible R&D expenditure to which they are entitled in the year in which it is incurred. More specifically, it assumes that firms in loss claim the full amount of the Tax Incentive, even without full refundability.

Anecdotal evidence from overseas jurisdictions shows that those that have allowed more generous refundability have experienced much greater rise in the costs of their R&D tax incentives. In Australia, R&D in the part of the scheme that was refundable (which applied to small-and-medium enterprises) grew at approximately 15 percent per annum whereas R&D in the non-refundable part experienced no growth.

We cannot extrapolate exactly from the Australian experience to New Zealand because in New Zealand broad refundability will be available to all businesses, regardless of size (subject to exclusions discussed above). Moreover, without further analysis, it is not possible to conclude that the presence of refundability drove all the higher growth in Australia; a number of other factors are likely to have also contributed. Nevertheless, if New Zealand were to experience R&D growth equivalent to the refundable part of the Australian scheme, we have estimated that it might add approximately $40 million (over the period of the appropriation) to our estimates of the fiscal costs of the R&D Tax Incentive.

Administration costs

The increased attractiveness of the regime will increase legitimate claims but may also increase fraudulent claims. The increased risk of fraudulent claims may mean more administrative costs to ensure the legitimacy of claims. However, as the R&D Tax Incentive scheme has already been designed with relatively thorough checks on the R&D activities that are the subject of the claims, it is expected that any increase in administrative costs resulting from broader refundability will be negligible.

Compliance costs

Compared with the limited refundability rules in year one, compliance costs to firms

under broader refundability should either decrease or stay the same. The year one refundability rules use the existing corporate eligibility and wage intensity criteria from the R&D tax loss cash-out rules, which are relatively complex. The proposed eligibility rules from year two are simpler, so compliance costs could decrease under the proposals. In addition, more firms will have their credits fully refunded rather than carrying them forward. This reduces the complexity of tracking historic credits and testing for continuity breaches.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

Risks

There are three main risks associated with broader refundability which must be considered as part of the design. These are fiscal risk, fraud risk, and integrity risk.

Fiscal risk

Overseas experience indicates that R&D and hence fiscal cost growth is faster for the refundable parts of R&D tax credit schemes. This is not a risk in and of itself, because an increase in expenditure because of increased R&D would go towards achieving the objective of the incentive. A 'payroll' cap is proposed to help mitigate fiscal risk associated with illegitimate R&D tax credit claims. If the Government decided to constrain expenditure on the incentive in future, the tax credit rate of 15% could be adjusted downwards.

Fraud risk

This is the risk of a person deliberately attempting to extract money from the tax system dishonestly. Broader refundability provides additional incentives to perpetrate fraud and allows additional opportunities to perpetrate fraud. It is more difficult to recover money paid out in cash via a refund than to cancel a tax credit.

To minimise the risk of fraudulent claims, the proposed 'payroll' cap ensures the existence of a business and its economic presence are verified before a R&D tax credit refund is paid to the business.

The risk of fraudulent claims will also be mitigated through the following steps:

- An in-year approval process (included in the Act), which requires claimants to obtain approval of their R&D activities before they file a claim for their R&D tax credits.
- A $50,000 minimum threshold of eligible expenditure[1] (included in the Act). Experience in other countries, such as the United Kingdom, indicates that without a minimum threshold there can be a flood of smaller, lower-quality tax credit claims.

Integrity risk

This is the risk that compliance with the R&D Tax Incentive scheme may deteriorate if it is perceived to be abused by some claimants. This risk can be mitigated by ensuring the Tax Incentive is seen to be robust. In-year approval (included in the Act) and the proposed 'payroll' cap should help mitigate this integrity risk.

Learning from overseas experience

Most overseas R&D tax credit schemes with refundability have some constraints,

[1] There is an exception for R&D activities carried out by an Approved Research Provider.

such as capping the amount of refundable tax credit to the amount of other taxes paid by a business (such as PAYE paid on behalf of employees). Appendix 1 summarises the policies applied in other OECD countries that provide refunds and describes the strengths and drawbacks of each policy.

There is no uniformity as to how constraints are applied, but some broad observations are:

- Some constraint on refundability is the norm. A system with no restrictions on refundability would be an outlier amongst OECD countries.
- The different ways in which refundability is limited often reflect differences in the underlying tax incentive scheme.
- Some countries limit refundability to SMEs and start-ups.
- It is relatively common to limit refunds by reference to other taxes paid by the firm.

A common approach in other jurisdictions is to limit refunds to the amount paid in other taxes such as PAYE.[2] This ensures a firm has a tangible economic presence in the country where the claim is being made, the amount refunded is commensurate to activity in the jurisdiction and it reduces the risk that the claim is made by a non-existent entity. Considering the risks associated with refundability and learnings from overseas, we propose broadening the refundability available in year one but having some constraints to mitigate risk.

Constraints to mitigate the risks associated with broader refundability

The proposal to broaden eligibility for refundability includes a 'payroll' cap on refunds to mitigate the fraud, fiscal, and integrity risks associated with paying out cash.

It is proposed that all firms are entitled to a full refund of their R&D tax credits, to the extent their R&D tax credits are equal to or less than the amount of 'payroll' taxes paid by a firm in the relevant income year (proposed payroll cap).[3]

The proposed payroll cap would not apply to limit tax credits resulting from payments to Approved Research Providers.

The proposed payroll cap would not apply to R&D tax credits refunded to levy bodies.

The proposed payroll cap is designed to prevent refundable tax credits being paid out to firms who are fraudulently claiming the tax credit. Limiting R&D tax credit payments to the amount of PAYE paid by a firm, as is done in many overseas jurisdictions, is a simple and unobtrusive measure but overlooks that some firms may legitimately pay little PAYE.[4] Consequently, it is proposed that additional payroll taxes paid be included to reduce the impact of this constraint.

Payments to Approved Research Providers will not be capped as it will be easy to verify that these payments have actually been incurred by a firm. That is, R&D credits generated from eligible expenditure on Approved Research Providers will be refundable, even if a business has not paid any payroll taxes.

Levy bodies may have low 'payroll' taxes where R&D is largely contracted out, but

[2] For most firms, the amount of PAYE they pay on behalf of employees will exceed 15% of the amount of R&D they undertake because all employees in the firm will contribute to the PAYE total whereas R&D is usually only one part of the firm's activities. There will, however, be some firms that (quite legitimately) do not pay PAYE.

[3] Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).

[4] For instance, many start-up firms will limit their financial risk by employing staff on contract rather than recruiting them as permanent members of staff. These staff employed on contract may choose to have withholding tax (WT) paid by the firm on their behalf.

they are not subject to the cap due to reduced risk that refunded R&D tax credits will be unrecoverable.

Conclusion

The above constraint is not anticipated to restrict refunds for the vast majority of R&D performers. It means that all firms would have some immediate benefit and a few would have less than full refundability. Given the R&D Tax Incentive scheme is relatively broad and accessible, the proposed refundability restrictions do not fundamentally alter the incentives of the scheme. Overall, and compared with most other jurisdictions, the proposed policy for New Zealand represents a comprehensive approach to refundability.

Identify any significant incompatibility with the Government's "Expectations for the design of regulatory systems".

There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

We are confident of the evidence that refundable R&D tax credit schemes are effective at increasing business R&D. This is based on a range of international studies. It is difficult to predict the actual level by which R&D will increase as a result of broader refundability. Written and oral submissions on the Act emphasised the importance of refundability for supporting R&D. Consultation recently undertaken with businesses on broader refundability has reaffirmed the importance of refundability for incentivising R&D intensive firms to continue to invest in and grow their R&D activities.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:

MBIE's Regulatory Impact Analysis Review Panel has reviewed this Regulatory Impact Statement.

Quality Assurance Assessment:

The Panel considers that the information and analysis summarised in the Regulatory Impact Statement meets the criteria necessary for Ministers to make informed decisions.

Impact Statement: R&D Tax Incentive - Refundability

Section 1: General information

Purpose
This analysis and advice has been produced to inform key policy decisions to be taken by Cabinet around broadening the refundability available under the R&D Tax Incentive. MBIE and IR are solely responsible for the analysis and advice set out in this Regulatory Impact Assessment, except as otherwise explicitly indicated.
Key limitations or constraints on analysis
Estimating the impact of broader refundability on the amount of R&D undertaken and its overall impact on the economy is complicated. Evidence on the impact on both of these is imprecise. There has been no analysis on or impact evaluation of the R&D tax incentive implemented in New Zealand in 2008 (which was fully refundable). So there is no New Zealand evidence to guide our analysis of the impacts of refundability. As a result, the estimates of the anticipated response are based upon evidence from international studies that may not correspond to the situation in New Zealand. Nevertheless, this is the best information available.
Responsible Managers (signature and date)
   Kirsty Hutchison Manager – Innovation Policy Ministry of Business, Innovation and Employment 10 / 05 / 2019      Keith Taylor Policy Manager Inland Revenue 10 / 05 / 2019

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?
New Zealand has a low overall expenditure on R&D[5] primarily due to low business investment in R&D in New Zealand. New Zealand's low business investment in R&D can be explained, in part, by its industrial structure. New Zealand firms have low R&D intensity (Mazoyer, 1999); the size of traditionally R&D intensive industries (such as pharmaceuticals and aircraft manufacturing) in New Zealand is small (Di Maio and Blakeley, 2004); and there are few very large firms, who tend to be more research-active (OECD, 2017). Evidence suggests that there are other reasons for the low business investment in R&D. These include returns to innovation being relatively low in New Zealand

[5] New Zealand's R&D spending in 2018 was equal to 1.37 percent of gross domestic product.

(Wakeman and Conway, 2017), which means New Zealand firms do not have the same incentive to invest in activities that will increase their innovative output. The average rate of public support for business R&D is also "well below the socially efficient level indicated by international empirical studies" (OECD, 2017). This evidence indicates that there is scope for productivity gains from increasing the overall level of support for R&D expenditure.

The Government announced a goal of increasing New Zealand's R&D expenditure to 2 per cent of GDP by 2027. To reach this target, a significant amount of the growth in R&D expenditure is expected to come from business.

New Zealand BERD is relatively low and remains concentrated among a small set of firms. To achieve a further boost in BERD, as well as to transform the economy to become more knowledge intensive, requires broadening the base of R&D performing firms within New Zealand while continuing to increase the R&D expenditure of existing R&D-performing firms.

R&D performing firms, particularly at the early phase of their development, will often be loss-making. Therefore, providing refundable tax credits to businesses in tax loss is a key element of the effectiveness of the R&D Tax Incentive in achieving significant growth in BERD. Without a refundable tax incentive businesses in tax loss will have minimal incentive to invest in additional R&D.

2.2 What regulatory system, or systems, are already in place?

The Taxation (Research and Development Tax Credits) Act (the Act), introduced in October 2018, implements an R&D tax incentive in New Zealand. The R&D Tax Incentive scheme applies from the beginning of the 2019/20 income year. The Act allows for firms that make a loss for tax purposes and satisfy certain criteria to receive a refund of up to $255,000 of tax credits per income year. Credits that are not refunded can be carried forward to future income years provided shareholder continuity criteria are met.

Appendix 2 provides examples that illustrate how without refundability, firms do not receive a cash benefit from a tax credit if they are in loss or have insufficient income tax liability.

The Act also includes an in-year approval process, which requires claimants to obtain approval of their R&D activities before they file a claim for their R&D tax credits.

In addition to the R&D Tax Incentive, there are Callaghan Innovation grants which provide R&D subsidies.

These grants include:

- Growth Grants: A non-discretionary grant paid to all businesses that spend more than $300,000 and 1.5 per cent of revenue on R&D over the prior two years. The grant funds 20 per cent of a business R&D programme up to a limit of $5 million per year (i.e., $25m of R&D spending), initially for a period of three years with automatic two-year extensions conditional on continuing to meet the criteria. The aim is to provide experienced R&D performers with the funding certainty and stability they need to grow their R&D spending in the long term. There were 316 recipients in 2017/18 at an (estimated) fiscal cost of $172.2M. The Growth Grant scheme will cease on 31 March 2021. No new applications can be made, but existing Growth Grant recipients can extend their Growth Grants until the scheme end date.

- Project Grants: A discretionary grant, allocated to less-experienced R&D performers that do not meet the conditions for a Growth Grant for R&D. It funds 40 per cent of the first $800,000 of the eligible costs of a pre-specified project and 20 per cent of the remainder. There were 344 recipients in 2017/18 at an estimated fiscal cost of $20.3M.

There are restrictions on the availability of the R&D Tax Incentive for recipients of existing grants.

New Zealand also provides support for businesses performing R&D through the R&D loss tax credit (also known as the R&D tax-loss cash out). New Zealand-resident businesses are able to apply for 28 per cent of their losses associated with eligible R&D expenditure (up to a cap) to be paid out in cash, rather than carrying forward those losses until future years. 350 firms currently claim R&D loss tax credits.

There are also tax deductions available for R&D expenditure, and the ability to defer these tax deductions so as not to lose them due to a breach of the shareholder continuity rules.

2.3 What is the policy problem or opportunity?

The objective of the R&D Tax Incentive is to address New Zealand's low levels of R&D, specifically by increasing BERD, which has a central role in driving innovation and economic growth.

The R&D Tax Incentive as introduced in the Act has limited refundability. Limited refundability is available to unlisted companies who satisfy corporate eligibility and wage intensity criteria, up to a cap of $255,000. Any remaining R&D tax credits can be carried forward to the next income year provided shareholder continuity requirements are met.

Entity eligibility

Limited refundability is not available for entities, such as levy bodies, which receive tax exempt income (other than dividends). Discussions of the proposals with levy bodies has indicated that should levy bodies be ineligible for refundable R&D tax credits, this could lead to some levy body members preferring to fund their own R&D. The incentive is not intended to change business behaviour in this way.

Limited refundability is also not available for listed companies, partnerships, or trusts. This is problematic, because it is likely that – without refundability – some of these businesses will have insufficient income tax liability to benefit from their R&D tax credits. The Tax Incentive is intended to have broad application and treat all businesses the same, irrespective of their legal form. However, excluding some types of firm from the Tax Incentive biases it toward firms in traditional arrangements (particularly, limited liability companies).

Capped refundability

Some businesses may be eligible for limited refundability but unable to cash out all of their R&D tax credits because of the $255,000 cap. These businesses will have to carry their R&D tax credits forward into future years until they have sufficient income tax liability to utilise their credits. The ability to carry the credit forward is subject to a shareholder continuity rule that requires a minimum of 49% shareholder continuity to be maintained in order for R&D tax credits to be carried forward. This is problematic, because R&D intensive start-ups are more likely to undergo a significant change in their shareholder base when they seek to raise capital through new investors.

2.4 Are there any constraints on the scope for decision making?

The Government has introduced the R&D Tax Incentive and indicated that it wants to expand the coverage of refundability.

The Government has committed to developing a more comprehensive policy for refundability from year two of the Tax Incentive (corresponding to businesses' 2020/21 income year). There is a need to use existing legislative vehicles to achieve enactment of policy changes in time for them to apply from year two of the Tax Incentive.

2.5 What do stakeholders think?

This proposal has been informed by input from a wide array of private sector organisations.

The importance of broad refundability in incentivising business investment in R&D was a strong theme from the consultation conducted by MBIE, Inland Revenue and Callaghan Innovation following the release of the Government Discussion Document on the R&D Tax Incentive in mid-2018. The need for broader refundability was also emphasized in submissions received by the Finance and Expenditure Select Committee on the Bill, and through additional stakeholder meetings.

MBIE, Inland Revenue and Callaghan have discussed refundability proposals with the Corporate Taxpayers' Group; Chartered Accountants Australia and New Zealand; representatives from PwC, KPMG, Deloitte and EY; approximately 25 representatives from R&D performing businesses in tax loss or with insufficient taxable income to fully use non-refundable R&D tax credits; levy bodies; charities; and Māori business representatives. These discussions have helped shape the broader refundability proposals, and have highlighted the desirability of broad eligibility and an accessible process.

Agencies asked stakeholders to consider the impact of a $5 million cap and a PAYE cap (used as a proxy to test tangible economic presence).

Feedback on $5 million cap

Stakeholder engagement revealed that there were a small number of established R&D performers who would be constrained by a $5 million cap. For example, a business in a loss making position undertaking around $80 million of R&D annually would be eligible for $12 million of R&D tax credits. Under a $5 million cap the business would receive a $5 million refund and would have to carry forward the remaining $7 million of R&D tax credits into future years. Because the business spends a large amount of R&D on an on-going basis they are unlikely to be able to fully cash out their accumulation of R&D credits carried forward.

There were also a number of established R&D performers who valued the security refundability would bring to their R&D programmes. These businesses are mainly in a tax-paying situation but depending on market fluctuations they could be in a temporary loss-making position in future. Refundability would give these firms surety, allowing them to continue their R&D investment during market down-turns. Some of these established R&D performers would also be constrained by a $5 million cap.

The proposal for broader refundability removes the previously proposed $5 million cap on refundability.

Feedback on PAYE cap

The PAYE cap, which would limit the amount of R&D tax credits refunded to a firm to the amount of PAYE paid by the firm in the relevant year, was seen as problematic.

Stakeholders advised that a PAYE cap would significantly constrain the benefit that loss-making start-ups would get from the credit. Many start-ups that perform R&D have few employees and rely on contractors to develop their business because of the comparative flexibility afforded by contracting arrangements. R&D intensive start-ups may have fewer non-R&D employees (compared with larger firms), and may also have a higher proportion of non-employee R&D expenditure (such as expenditure on capital assets or consumables).

Tangible economic presence test

As a result of the stakeholder feedback on the two options above, officials explored a tangible economic presence (TEP) test. The TEP test developed would have allowed firms that did not satisfy a PAYE cap to be verified for TEP from either an external certifier (such as a chartered accountant or lawyer), or directly from Inland Revenue through additional checks.

Stakeholders preferred the availability of alternatives to the PAYE cap, and thought that multiple ways of establishing tangible economic presence were preferable to a one-size-fits-all approach.

Payroll taxes cap

Discussions with United Kingdom (UK) officials found that the risks of fraud in relation to refundability are more pervasive than previously considered.[6] UK officials suggested that relying on a chartered accountant or practising lawyer for certification of TEP may not be robust, and that additional Inland Revenue checks might lead to administration resources being focused on audit rather than the approval of R&D activity.

As a result of this feedback, we have included an option that would include a 'payroll' taxes cap based on PAYE and other taxes paid by firms (including fringe benefit tax (FBT), employer superannuation contribution tax (ESCT) and tax voluntarily withheld from contractor payments (WT)) in order to lessen the impact on affected firms. It is also proposed that any tax credits resulting from payments to Approved Research Providers be fully refundable (so not subject to the 'payroll' taxes cap).

Stakeholder engagement on including additional payroll taxes (such as FBT, ESCT and WT) in the cap indicated that this would be an improvement over a PAYE cap. Although only a small proportion of contractors have opted into the voluntary withholding scheme, more may decide to opt into it if the payroll taxes cap were implemented.

Other mechanisms for providing support to R&D intensive start-ups will also be considered as part of further policy work, including reviewing the R&D tax loss cash-out and the Callaghan Innovation Project Grants.

[6] In the UK, HM Treasury and HMRC have released a consultation document 'Preventing abuse of the R&D tax relief for SMEs', April 2019, which proposes that a PAYE-related cap is reintroduced to the R&D tax credit scheme for SMEs. This policy has been driven by a concern over growing levels of fraud within the scheme since the removal of the PAYE cap.

Section 3: Options identification

3.1 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The framework for assessing the key policy elements and trade-offs of the options under consideration is captured by the following criteria:

Criteria for which entities will be eligible for a refund

- Incentivise business expenditure on R&D.
- Tax-exempt organisations that sit outside the tax system (do not pay income tax) should not benefit further from incentives provided from within the tax system.
- Provide clarity about which organisations are eligible for the R&D Tax Incentive.

Criteria for constraining the amount that is refundable

- Increased business R&D expenditure
- Mitigation of fraud risk/maintaining the scheme's integrity
- Minimise compliance costs for firms
- Maximise business certainty over time
- Administratively feasible
- Minimise fiscal costs/risk

3.2 What options are available to address the problem?

There are a range of options for how refundability could be broadened, including the types of entities that are eligible and the constraints that are placed on the scheme to manage risks that refundability creates, particularly to the integrity of the Tax Incentive.

Options for which entities will be eligible for a refund

The main options available are:

- The status quo
- General business entities
- Levy bodies
- Charities
- Local authorities
- Other tax-exempt organisations

Status quo

Under the status quo, limited refundability rules restrict eligibility for refunds to unlisted companies that meet a 20% R&D wage intensity test and do not derive non-dividend exempt income. These criteria mean that many businesses will not be eligible for refundable tax credits, including partnerships, trusts, listed companies, and companies who receive some exempt income or do not meet the wage intensity test. Additionally, certain atypical organisations, such as levy bodies, some Māori entities, charities, and local authorities, will be excluded.

General business entities

This change would make listed companies, partnerships and trusts eligible for refundability, and there would be no wage intensity requirement. This change will allow most Māori organisations to be eligible.

Levy bodies

Levy bodies would be eligible for refundability under this option.

Charities

Under this option charitable organisations that perform eligible R&D activities would be ineligible for refundable tax credits. Charities are currently treated as carrying on a business in New Zealand for the purposes of being eligible for the R&D Tax Incentive. Excluding charities means that this rule would be removed for consistency to ensure they are excluded from being eligible for the R&D Tax Incentive.

Excluding charities means that businesses wholly-owned by charities are excluded, because these are also considered charities. However, this option does not exclude other associated entities. This means if a tax paying business donates to a charity, even one controlled by that business, this would not invalidate the business's access to the R&D Tax Incentive. It would also mean that a charity could set up a partially controlled business entity, subject to the rules within the constitution of the charity, which could be eligible for the R&D Tax Incentive.

In relation to Māori organisations, a small number of post-settlement governance entities have registered as charities. As discussed above, businesses that are wholly-owned by these charitable entities would also be ineligible. Businesses that are partially controlled by these charities would be eligible for the R&D Tax Incentive.

Local authorities

Under this option local authorities would be ineligible for the R&D Tax Incentive. However, council controlled organisations would be eligible.

Other tax-exempt organisations

This option excludes tax-exempt organisations from being eligible to receive refunds. The exclusion would not apply to entities that receive exempt income from dividends (no change from the status quo) or to levy bodies.

Options for constraining the amount that is refundable

The main options available are:

- The status quo
- A PAYE cap
- A tangible economic presence (TEP) test
- A 'payroll' taxes cap

Status quo

The status quo limited refundability rules allow firms with eligible R&D expenditure that meet the corporate and wage-intensity eligibility rules to claim a maximum refund per year of $255,000.

A PAYE cap

A PAYE cap would allow firms with eligible R&D expenditure to have their R&D tax credits refunded up to a maximum amount equal to the amount of PAYE paid by the firm in the relevant income year.

A TEP test

A TEP test would allow firms with eligible R&D expenditure to have their R&D tax credits refunded as long as they satisfied a test of tangible economic presence, up to a maximum of $5 million per year. A TEP test would be designed to ensure that a

firm has 'skin in the game', and that it physically exists with premises and staff, rather than just existing on paper as a shell company.

A TEP test would be met where at least one of the following applied:

- A business's PAYE for the year is equal to or greater than their R&D tax credit claim. This ensures a proportionate TEP because the firm is paying tax on behalf of its employees and cannot take out more than it puts in to the tax system.
- A chartered accountant or practising lawyer has certified that a business has TEP. The certifier would testify to the firm's TEP, having actually met the staff/seen the premises.
- Inland Revenue has completed a review (for example, checking the tax-paying history of a business; visiting a business's site; and/or confirming the identity of shareholders or directors) and is satisfied that a business has TEP.
- A business's R&D tax credit claim only includes amounts paid to an approved research provider to perform R&D activities on their behalf. This provides an easily verified audit trail to determine TEP.
- If an organisation is established under statute (such as a levy body), the organisation would be deemed to have TEP.

The proposal – a 'payroll' taxes cap

Under the Proposal, firms that have insufficient tax liability would have their credits fully refunded, subject to the following constraint:

- R&D tax credits are refundable to the extent they are equal to or less than the amount of 'payroll' taxes paid by a firm in the relevant income year.[7]
- The proposed cap would not apply to limit tax credits resulting from payments to approved research providers.
- The proposed cap would not apply to R&D tax credits refunded to levy bodies.

Excess credits that are not refunded in a particular year can be carried forward subject to the continuity rules and can be refunded in future years, subject to the same conditions.

3.3 What other options have been ruled out of scope, or not considered, and why?

We have assumed the continuation of the R&D Tax Incentive with at least its existing limited refundability, so we have not considered the option of no tax incentive or no refundability.

[7] Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).

Section 4: Impact analysis

Entity eligibility for refunds

	General business entities	Levy bodies	Charities	Local authorities	Other tax-exempt organisations
Incentivising BERD	(++) This change would remove limitations on refundability by entity type, except for the existing exclusion of tax-exempt organisations. This would allow listed companies, partnerships and trusts to be eligible for refundability, and there would be no wage intensity requirement. This will allow most Māori organisations to be eligible. Making refundability broadly available to these entities would have a significant impact on incentivising BERD.	(++) The R&D performed by and funded through levy bodies is fundamentally business R&D and may result in benefits that are not fully captured by the relevant industries. Providing levy bodies with refundability is expected to positively impact BERD by encouraging industry-wide collaboration through levy bodies.	(0) Charities may perform R&D as part of their charitable purposes. The Tax Incentive is focussed on incentivising BERD, rather than all R&D generally. Charities that perform R&D already receive support from the tax system for their activities. A charity could set up a partially controlled business entity, subject to the rules within the constitution of the charity, which could be eligible for the Tax Incentive. This would also apply to a small number of post-settlement governance entities that are registered as charities. The exclusion for charities is not expected to have a significant impact on BERD.	(0) Although local authorities would not be eligible, council controlled organisations would be eligible. The exclusion for local authorities is not expected to have a significant impact on BERD.	(0) Although other tax-exempt organisations would not be eligible, they could still participate in joint ventures with other businesses that could be eligible. The exclusion for other tax-exempt organisations is not expected to have a significant impact on BERD.

	General business entities	Levy bodies	Charities	Local authorities	Other tax-exempt organisations
Tax-exempt organisations that sit outside the tax system (do not pay income tax) should not benefit further from incentives provided from within the tax system	(++) These entities generally sit within the tax system.	(0) Levy bodies receive levy payments from their members, which are generally taxable businesses.	(--) Charities sit outside of the tax system so do not pay income tax, receive GST concessions, and are exempt from FBT. These benefits mean that charities' cash flow is already enhanced by provisions in the tax system. They also benefit from the donor tax credit regime (which provides tax credits to those who donate to charities), so already receive government support.	(--) Apart from receiving tax exempt income, local authorities have the ability to raise the revenue required to perform R&D activities through rates.	(--) These entities generally sit outside of the tax system and do not pay income tax.
Clarity about which organisations are eligible	n/a	(+) Provides clarity that levy bodies are eligible for refundable R&D tax credits. Levy body members will not be disincentivised to fund their R&D through their levy body.	(+) Provides clarity that charities and their wholly-owned entities will be ineligible for the Tax Incentive, while partially controlled business entities could be eligible.	(+) Provides clarity for local authorities, as well as entities controlled by or associated with local authorities. Excluding local authorities was part of the original policy intent of the Tax Incentive, but this exclusion was not included in the Bill.	(+) Provides clarity that other tax-exempt organisations will be ineligible for the Tax Incentive.

Constraints on refundable amount

	Status quo	A 'payroll' taxes cap	TEP test	PAYE cap
Increased BERD	This is expected to limit refundability in year one to approximately 350-650 firms of whom 65-130 are expected to hit the cap on refundability and not be able to claim the full amount of the credit.[8] Evidence from overseas schemes indicates that refunds provide a more powerful incentive for firms to undertake R&D.	(++) A 'payroll' taxes cap would allow for broader refundability with wider coverage. It could constrain the benefit that some loss-making start-ups get from the credit, where a firm has a higher proportion of non-staff R&D expenditure (such as expenditure on capital assets or consumable). If applicable to year one, it would be expected to enable approximately 750-1200 firms to benefit from a full or partial refund.[9] The wider coverage and increased cash flow to businesses performing R&D is expected to lead to increased investment by those firms in R&D.	(++) A TEP test would provide a pathway for all genuine businesses to access refundability. This would have a positive impact on business expenditure on R&D. If applicable to year one, it would be expected to enable approximately 750-1200 firms to benefit from a full refund. The wider coverage and increased cash flow to businesses performing R&D is expected to lead to increased investment by those firms in R&D.	(+) A PAYE cap would allow for broader refundability with wider coverage, but would significantly constrain the benefit that loss-making start-ups would get from the credit. Many start-ups that perform R&D have few employees and rely on contractors to develop their businesses, because of the comparative flexibility afforded by contracting arrangements. R&D intensive start-ups may have fewer non-R&D employees (compared with larger firms), and may also have a higher proportion of non-employee R&D expenditure (such as

[8] The numbers of firms potentially eligible for refundability, and the amount of firms expected to hit the cap under the limited refundability rules are based on extrapolated numbers from multiple sources of data including the 2016 R&D Survey, the 2017 Business Operations Survey, information from Callaghan Innovation about Growth Grant recipients, and information from Inland Revenue about firms that access the R&D tax-loss cash out.

[9] The numbers of firms potentially eligible for refundability are based on extrapolated numbers from multiple sources of data including the 2016 R&D Survey, the 2017 Business Operations Survey, and information from Callaghan Innovation about Growth Grant recipients.

	Status quo	A 'payroll' taxes cap	TEP test	PAYE cap
				expenditure on capital assets or consumables). This would limit the impact on business R&D expenditure undertaken by this sector.
Mitigation of fraud risk / maintaining the scheme's integrity	Limited refundability mitigates some risk of large, one-off fraud, but does not provide protection against potentially high numbers of smaller fraudulent claims.	(++) A 'payroll' taxes cap would significantly mitigate the risk of fraudulent claims, as firms could not take out more from the tax system than they put in.	(0) A TEP test would mitigate some of the risk of fraudulent claims. However, overseas experience suggests that certification of TEP by external professionals may not be sufficiently robust, and that requiring Inland Revenue to conduct additional checks for TEP might lead to administration resources being focused on audit rather than the approval of R&D activity.	(++) A PAYE cap would significantly mitigate the risk of fraudulent claims, as firms could not take out more from the tax system than they put in.
Minimise compliance costs	The year one refundability rules use the corporate eligibility and wage intensity criteria from the R&D tax loss cash-out rules, which are relatively complex.	(0) Compliance costs to firms under a 'payroll' taxes cap should either decrease or stay the same. The proposed constraint on refunds will not apply to the majority of claimants and is easy to understand. Overall, compliance costs are likely to	(-) A TEP test with a range of measures that businesses could choose from would mean they could select the one that imposes the least additional compliance costs. However, if a firm chose to obtain professional certification or undergo	(0) A PAYE cap would be simple and have low compliance costs for firms. Overall, compliance costs are likely to decrease, but this effect is likely to be small.

	Status quo	A 'payroll' taxes cap	TEP test	PAYE cap
		decrease, but this effect is likely to be small.	additional checks by Inland Revenue there would potentially be material compliance costs. Overall, compliance costs may be higher.	
Maximise business certainty over time	Provides some uncertainty as firms' eligibility for refundability depends on meeting the wage intensity criteria each year. It also generates uncertainty about ability to take advantage of the Tax Incentive because the low cap on refundable amounts means more credits must be carried forward to future years and may be lost due to shareholder continuity breaches	(+) A 'payroll' taxes cap would provide increased business certainty, with broad and simple eligibility for refundability. Receipt of cash refunds each year rather than having to carry forward credits that may be lost due to continuity breaches will increase business certainty.	(+) A TEP test would provide business certainty that refundability could be accessed by pursuing one of the available options. Receipt of cash refunds each year rather than having to carry forward credits that may be lost due to continuity breaches will increase business certainty.	(+) A PAYE cap would provide relative business certainty, with the refundable amount changing based on what a firm pays to its employees. Receipt of cash refunds each year rather than having to carry forward credits that may be lost due to continuity breaches will increase business certainty.
Administratively feasible	Based on high-level estimates, Inland Revenue's cost of administering the R&D Tax Incentive is forecast to be up to $6m per annum.	(0) A 'payroll' taxes cap would be easy to administer and is expected to have no or negligible additional effects on administrative feasibility.	(-) Most options under a TEP test would be easy to administer, but completing Inland Revenue reviews could increase administrative costs and timeframes. Administrative resources may	(0) A PAYE cap would be easy to administer, and is expected to have no or negligible additional effects on administrative feasibility.

	Status quo	A 'payroll' taxes cap	TEP test	PAYE cap
			also be required to focus more on audits rather than approving R&D activity.	
Minimise fiscal costs/risk	Fiscal costs are forecast to be $1,345 million (direct costs) plus $19.5 million (administration costs) from 1 April 2019 to 30 June 2022. In Budget 2018 the Government allocated $1,020 million for the R&D Tax Incentive, in addition to the $528 million already allocated for Growth Grants.	(-) We anticipate that allowing refundability under a 'payroll' taxes cap will increase the uptake of the Tax Incentive. This in turn will increase the R&D expenditure performed by firms, and the amount claimed under the Tax Incentive. An increase in claims lends itself to increased fiscal costs. However, the appropriation for the Tax Incentive in Budget 2018 already allows for the fiscal cost of full refundability. This is because the existing fiscal cost model assumed no constraint on refundability. As discussed previously, if New Zealand were to experience R&D growth equivalent to the refundable part of the Australian scheme, we have estimated that it might add approximately $40 million (over the period of the	(-) We anticipate that allowing refundability under a TEP test will increase the uptake of the Tax Incentive. This in turn will increase the R&D expenditure performed by firms, and the amount claimed under the Tax Incentive. An increase in claims lends itself to increased fiscal costs. The increased potential for fraudulent claims leads to a potentially higher fiscal risk. The $5 million cap would provide a limit on refundable tax credits, but would not constrain the amount of eligible tax credits that could be carried forward and would still be a fiscal cost. However, the appropriation for the Tax Incentive in Budget 2018 already allows for the fiscal cost of full refundability. This is because the existing fiscal cost model assumed no	(-) We anticipate that allowing refundability under a PAYE cap will increase the uptake of the Tax Incentive. This in turn will increase the R&D expenditure performed by firms, and the amount claimed under the Tax Incentive. An increase in claims lends itself to increased fiscal costs. However, the appropriation for the Tax Incentive in Budget 2018 already allows for the fiscal cost of full refundability. This is because the existing fiscal cost model assumed no constraint on refundability. As discussed previously, if New Zealand were to experience R&D growth

	Status quo	A 'payroll' taxes cap	TEP test	PAYE cap
		appropriation) to our estimates of the fiscal costs of the R&D Tax Incentive. If this $40 million were added to the forecast costs of full refundability, it would still be within the existing appropriation (which has an approximate buffer of $200 million). Therefore, no further appropriation is being requested.	constraint on refundability. As discussed previously, if New Zealand were to experience R&D growth equivalent to the refundable part of the Australian scheme, we have estimated that it might add approximately $40 million (over the period of the appropriation) to our estimates of the fiscal costs of the R&D Tax Incentive. If this $40 million were added to the forecast costs of full refundability, it would still be within the existing appropriation (which has an approximate buffer of $200 million). Therefore, no further appropriation is being requested.	equivalent to the refundable part of the Australian scheme, we have estimated that it might add approximately $40 million (over the period of the appropriation) to our estimates of the fiscal costs of the R&D Tax Incentive. If this $40 million were added to the forecast costs of full refundability, it would still be within the existing appropriation (which has an approximate buffer of $200 million). Therefore, no further appropriation is being requested.

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Which entities will be eligible for a refund

Based on the above analysis, the preferred combination of options is for general business entities and levy bodies to be eligible for refundability, and for charities, local authorities, and other organisations that receive (non-dividend) exempt income to be ineligible. The effect of these options is that many more business entities would be eligible for refundability, while not bringing in entities that already receive substantial benefits from operating outside of the tax system. This would be a positive change for listed companies, partnerships, trusts, levy bodies and Māori businesses, and would explicitly exclude charities, local authorities, and other tax-exempt organisations, providing clarity in the law.

Constraints on refundable amount

Based on the above analysis, the two leading options are a 'payroll' taxes cap and a PAYE cap. Both options would significantly mitigate the risk of fraudulent claims, as firms could not take out more from the tax system than they put in. They would be simple, have low compliance costs for firms, and be easy to administer. They would provide increased business certainty, with broad and simple eligibility for refundability. The preferred option is to constrain refundability by a 'payroll' taxes cap, because this would have a greater impact on BERD, with a comparatively lesser constraint imposed on the benefit received by loss-making start-ups in particular.

Benefits of proposed broader refundability

The broader refundability proposed will better support the Government's objectives of incentivising increased BERD. Providing refundable tax credits to businesses that have insufficient tax liability is a key element of the effectiveness of the R&D Tax Incentive in achieving significant growth in BERD.

Broadening the refundability available from that provided for year one of the R&D Tax Incentive will broaden the reach and effect of the R&D Tax Incentive. Businesses will receive the financial support of the R&D Tax Incentive earlier or, in some instances, will actually get a benefit where they previously would not have.

The key advantage to a refundable tax credit is it provides cash closer to the point when firms, particularly R&D intensive firms, are undertaking their R&D. Broader refundability will provide increased certainty to businesses, with broad and simple eligibility, and receipt of cash refunds each year rather than having to carry forward credits that may be lost due to continuity breaches.

The refundability available in year one is expected to be limited to approximately 350-650 firms, and 65-130 of those are expected to hit the cap on refundability. The proposed broader refundability has simpler eligibility criteria, and would be available to a larger number of firms, estimated at 750-1200 firms in 2019 (or 550-1100 firms, after allowing for some firms to remain on the Callaghan Innovation Growth Grant).

The wider coverage and increased cash flow to businesses performing R&D is expected to lead to increased R&D investment by those businesses.

Increased coverage of R&D-performing firms (and higher incentives for firms to engage in R&D) is expected to result in an increase in innovative activity,

employment, and labour productivity growth, particularly among firms that did not qualify for limited refundability. A higher level of R&D expenditure will result in greater spillover benefits to other participants in the economy.

The proposed constraint on refundability is not anticipated to restrict refunds for the vast majority of R&D performers. It means that all firms would have some immediate benefit and a few would have less than full refundability. Given the R&D Tax Incentive scheme is relatively broad and accessible, the proposed refundability restrictions do not fundamentally alter the incentives of the scheme. Overall, and compared with most other jurisdictions, the proposed policy represents a comprehensive approach to refundability.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment: *nature of cost or benefit, risks*	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
R&D performing firms	Compliance costs	No need to quantify because negligible.	
Administering agency	Administration costs	No need to quantify because negligible.	
Wider government	Higher fiscal costs because of wider coverage of firms and more incentive to claim. The cost of the Tax Incentive will continue to be met from Vote: BSI and managed by MBIE in a similar way.	Potentially higher fiscal costs of R&D Tax Incentive, up to approximately $40 million (over the period of the appropriation). No change required to appropriation which includes full refundability and covers additional $40 million 'estimate' (within an approximate buffer of $200 million).	Low
Other parties	No anticipated costs.	$0	
Total monetised cost		Higher fiscal costs of R&D Tax Incentive, of up to approximately $40 million (over the period of the appropriation). No change required to appropriation which includes full refundability and covers additional $40 million 'estimate' (within an approximate buffer of $200 million).	Low
Non-monetised costs		n/a	

Expected benefits of proposed approach, compared to taking no action			
R&D performing firms	Eligible firms will receive a refundable tax credit equivalent to 15% of their eligible R&D expenditure, up to a cap of the amount of 'payroll' taxes paid per year, plus tax credits resulting from payments to approved research providers[10]. For existing Growth Grants this is roughly equivalent to a 20% pre-tax subsidy (as per the Growth Grant),[11] all else being equal.[12] For non-recipients of a Growth Grant this will be an increased subsidy. These benefits are equivalent to the costs to wider government (as above). In addition, firms receiving new or additional funding are expected to employ more staff and increase labour productivity growth, but effects have not been monetised.	Higher R&D up to potentially an additional $250 million, with corresponding spillovers.	Medium Medium
Administering agency	None	0	n/a
Wider government	Higher investment in R&D and resulting business innovation expected to result in more productivity growth over time, leading to higher incomes and hence tax paid, but effects have not been monetised.	Medium	Low
Other parties	Higher investment in R&D is expected to generate positive spillovers to rest of the economy (other firms,	Medium	Low

[10] The cap will not apply to organisations established by statue.

[11] Given a 28% corporate tax rate, a 20% subsidy pre-tax corresponds to 14.4% subsidy after tax, which is less generous than a 15% tax credit for firms that have a sufficient tax liability (or will have in the future) against which to apply the tax credit. Firms with insufficient tax liability will be able to refund their 15% tax credit, up to the proposed cap amount. The maximum amount paid under a Growth Grant to firms in tax loss is $5 million per year.

[12] Assuming eligible R&D expenditure is the same.

	researchers, etc.), but effects have not been monetised.		
Total monetised benefit		Higher R&D up to potentially an additional $250 million, with corresponding spillovers.	Low
Non-monetised benefits		High	
General business entities	Listed companies, partnerships and trusts will be eligible for refundability, and there will be no wage intensity requirement. This will allow most Māori organisations to be eligible. This provides clarity and will support investment in business R&D	Medium	Medium
Levy bodies	Levy bodies will be eligible for refundability. This will support investment in business R&D and provides clarity that ensures levy body members will not be disincentivised to fund their R&D through their levy body.	High	High
Charities	Clarity is provided that charities and their wholly-owned entities will be ineligible for the Tax Incentive, while partially controlled business entities could be eligible.	0	
Local authorities	Clarity is provided that local authorities, as well as entities controlled by or associated with local authorities, will be ineligible for the Tax Incentive.	0	
Other tax-exempt organisations	Clarity is provided that other tax-exempt organisations will be ineligible for the Tax Incentive.	0	

5.3 What other impacts is this approach likely to have?

There is a potential risk that by providing broader refundability, businesses are motivated to recharacterise non-R&D expenditure as R&D expenditure or make fraudulent claims.

The Tax Incentive has been designed to reduce the likelihood of, and opportunities to recharacterise non-R&D expenditure. This includes requiring a close nexus between the R&D activity and the expenses claimed.

The proposal to broaden eligibility for refundability includes a 'payroll' taxes cap on refunds to mitigate the fraud, fiscal, and integrity risks associated with paying out cash.

Businesses would be entitled to a full refund of their R&D tax credits, to the extent their R&D tax credits are equal to or less than the amount of 'payroll' taxes paid in the relevant income year.[13]

Payments to Approved Research Providers are not included in the cap as it will be easy to verify that these payments have actually been incurred by a firm. Levy bodies are not subject to the cap due to reduced risk that refunded R&D tax credits will be unrecoverable, and some may have low 'payroll' taxes where R&D is largely contracted out.

Additional measures to mitigate risk include a sample of claims being audited each year, and an in-year approval process (included in the Act), which requires claimants to obtain approval of their R&D activities before they file a claim for their R&D tax credits. The $50,000 minimum threshold of eligible expenditure (included in the Act) is also an important measure in preventing a flood of smaller, lower-quality claims.

5.4 Is the preferred option compatible with the Government's "expectations for the design of regulatory system"?

There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Legislation will need to be enacted to give effect to broader refundability. It is proposed that broader refundability come into effect from businesses' 2020/21 income year. Therefore, it is proposed that the legislative changes needed to give effect to broader refundability be included in a tax bill scheduled to be introduced in June 2019, which would make changes to the Income Tax Act 2007 and the Tax Administration Act 1994.

Inland Revenue is leading implementation of the R&D Tax Incentive through the tax system, and will also be responsible for implementing broader refundability. Inland Revenue will identify and mitigate operational risk so that broader refundability can be delivered successfully. Inland Revenue has the necessary capabilities and capacity to implement broader refundability through its systems.

[13] Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).

It is expected that broader refundability will pose minimal compliance and administrative costs. No material change is expected for the R&D supplementary return. Instead of carrying forward non-refundable R&D tax credits, most firms will be able to receive R&D tax credit refunds. Any increase in administrative costs would be negligible, because Inland Revenue intends to carry out checks and reviews on claims from year one. The existing core team of Inland Revenue and Callaghan Innovation officials will continue to work on claims after broader refundability is introduced.

Inland Revenue, working with the other agencies, will develop guidance material on the broader refundability proposals and the impact of these on business. Since broader refundability expands on the new R&D Tax Incentive, there are no particular transition issues. Credits not refunded in respect of the 2019/20 tax year, and carried forward to the 2020/21 tax year, may be refunded in that latter year or subsequent years.

The proposed eligibility criteria for broader refundability are simpler than the existing eligibility criteria that apply to limited refundability in year one. This may result in a simpler process that is easier for businesses to comply with, so may in fact lead to reduced compliance costs.

Officials from all agencies (MBIE, Callaghan Innovation, and IR) have engaged, and will continue to engage, with interested stakeholders. This includes accounting firms, businesses, and Chartered Accountants Australia and New Zealand (CAANZ).

For some taxpayers, the legislation is expected to receive Royal Assent after the beginning of their 2020/21 income years. This is unlikely to create significant issues, however, because claims will be submitted with taxpayers' income tax returns which are due after the end of their income year, by which point it is anticipated the legislation will have been enacted. No credits will be refunded under the broader refundability rules until legislation has been enacted.

6.2 What are the implementation risks

In submissions on the R&D Tax Incentive, a clear theme was the need for low compliance costs, to the extent this is possible. Feedback highlighted the need for clear guidance and education material. Businesses engaged with on the broader refundability proposals reaffirmed the need for simple rules and low compliance costs.

As mentioned above, the broader refundability proposals contain eligibility criteria that are simpler than the year one limited refundability criteria. The proposed broader refundability rules do not require corporate eligibility and wage intensity tests to be satisfied, and rely on the existing (easier) rules of the R&D Tax Incentive. Allowing for broader refundability also reduces the need for continuous tracking of shareholder continuity, because once refunded credits are no longer at risk of being extinguished through breaches of shareholder continuity rules. This is particularly beneficial for smaller, R&D intensive start-ups which may regularly seek new investors to boost funding for their R&D projects.

Implementation risks arise where businesses re-characterise non-R&D expenditure as R&D expenditure in order to claim a larger tax credit. The incentive for re-characterisation is greater with broader refundability, because firms can receive cash refunds (rather than having to wait until they come into profit to utilise their R&D tax credits). The policy and legislation has been developed to manage this risk, although

it cannot be eliminated. The proposed 'payroll' taxes cap on refunds will be backed up by existing administrative processes, such as in-year approval and IR audits.

There needs to be strong uptake of the R&D Tax Incentive by businesses for the incentive to be successful. As indicated by the submissions received on the Bill, broader refundability is an important part of ensuring businesses transition to the scheme. Inland Revenue, Callaghan Innovation and MBIE officials have engaged with stakeholders on the broader refundability proposals. Guidance will also be developed by Inland Revenue, which will sit alongside the tax legislation, to provide claimants with more information about the broader refundability proposals.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

The impact of the broader refundability proposals will be monitored as part of the system-level monitoring of the R&D Tax Incentive. The R&D Tax Incentive will be monitored as part of the Research, Science and Innovation portfolio (for example, through publication of the annual System Performance Report).

As part of the R&D Tax Incentive, the Government is required to commission an evaluation of the incentive every five years from the commencement of the scheme. This evaluation would include an evaluation of broader refundability.

In addition to the 5-year evaluation of the incentive, the business R&D surveys run by Statistics New Zealand can also be used to evaluate the R&D Tax Incentive scheme (which would include broader refundability). This will provide additional information to measure the impact of the R&D Tax Incentive and the broader refundability proposals.

7.2 When and how will the new arrangements be reviewed?

In addition to the legislated 5-year evaluation of the R&D Tax Incentive, MBIE and IR will monitor the policy in the shorter term. This is so that any issues associated with broader refundability that could compromise the integrity of the Incentive can be quickly identified and remedied.

The R&D Advisory Group (RDAG) is a consultative committee comprising representatives from accounting firms and other businesses that functions as a forum for identifying and resolving problems with the R&D Tax incentive. RDAG had its first meeting in January 2019. Officials also have regular meetings and discussions with a broader range of stakeholders, at which policy and implementation issues are discussed. It is expected that RDAG and these regular stakeholder discussions will enable officials to conduct on-going monitoring and review of the impact of broader refundability.

Bibliography

Appelt, S., M. Bajgar, C. Criscuolo, & F. Galindo-Rueda (2016). R&D Tax Incentives: Evidence on design, incidence and impacts. *OECD Science, Technology and Industry Policy Papers, No 32*.

Di Maio, M., & N. Blakeley (2004). "Business Research and Development and Industry Structure". New Zealand Treasury.

Mazoyer, P. (1999). "Analysis of R&D structure and intensities". Wellington, New Zealand: Ministry of Research, Science & Technology.

OECD. (2017). *OECD Economic Surveys: New Zealand 2017.* Paris: OECD Publishing.

Statistics New Zealand (2017). *Research and Development Survey: 2016. https://www.stats.govt.nz/information-releases/research-and-development-survey-2016*

Statistics New Zealand (2018). *Business Operations Survey: 2017. https://www.stats.govt.nz/information-releases/business-operations-survey-2017*

Wakeman, S. & P. Conway (2017). *Innovation and the performance of New Zealand firms.* Wellington: New Zealand Productivity Commission Working Paper.

Appendix 1

The following table sets out key features of how refundability is applied in key OECD countries.

Country	Refundability policy	Other relevant factors
Australia	Limits refundability to: • firms with turnover less than A$20m & • subject to a A$4m annual cap.	The cap is proposed but legislation not yet passed. It is designed to reduce the costs of the scheme. The cap equates to A$10m eligible expenditure
UK – SMEs	Firms in loss can cash out their tax credit at a discount to their value.[14] The UK government is currently consulting on introducing a cap relating to PAYE payments.	The SME scheme is more generous than the large firm scheme. SMEs must have: • fewer than 500 employees and • turnover less than EUR 100m.
UK – large firms	For non-SMEs, the tax credit is paid before tax, so loss making firms benefit equally with profitable firms, subject to not exceeding the amount of PAYE and National Insurance Contribution paid.	
Norway	Full refundability for tax paying entities.	The tax credit operates with a very low cap. The maximum credit is (approx.) NZ$2m, and in most cases is NZ$1m. The tax credit is not available to non-taxpayers.
Ireland	Full refundability, but paid in instalments over 3 years, and subject to limits relating to amounts of corporate income tax paid or amounts of payroll tax paid.	
Netherlands	Full refundability but limited to a firm's payroll tax liability.	
Canada	The credit is fully refundable for Canadian Controlled Private Corporations up to an expenditure limit of CAD 3 million. Higher expenditure is only 40% refundable.	The tax credit rate is 35% up to eligible expenditure of CAD 3 million, and 15% for higher amounts.

[14] Firms in loss can cash out 14.5% of surrenderable losses (these are the lesser of their trading loss and 230% of the R&D spend).

The table above demonstrates different mechanisms can be used for constraining refundability. Here are some brief comments on each of them:

Eligibility for refundability based on firm characteristic (generally a measure of size such as turnover)

- can target refundability to firms that, potentially, benefit most from it – ie, smaller or early stage firms
- creates boundaries which might disincentivise desired behaviours – eg, a firm may choose not to grow to keep turnover below the threshold
- relatively simple to understand but measurement would introduce complexity

Refundability applies up to a cap; credits above cap carried forward

- refundability addresses cash flow needs
- less of a boundary issue so less likely to impact on firm behaviours (though incentive to increase R&D spend may diminish above cap)
- relatively easy to understand and apply

Limit refundability based on other taxes paid

- if based on PAYE paid, more like a backstop rather than a fiscal cap as for most businesses the amount of PAYE across the whole firm will exceed 15% of the cost of R&D
- useful as a possible fraud deterrent as it should ensure a firm has a tangible economic presence, and may also prevent exploitation of a loophole if that involved claiming credits for high non-wage costs
- operates as some form of integrity and fiscal constraint measure, in that a firm cannot "take out" more than it is "putting in" to the tax system.
- some firms may not pay PAYE – eg, staff are not employees and are either shareholders who are paid a shareholder salary, contractors or provide sweat equity. This suggests either using a wider definition of taxes paid[15] or making a provision for firms to apply for an exemption
- administratively easy to understand and apply (subject to exceptions for firms without employees)

Refund credits at a discount

- supports loss making firms while providing an incentive to become profitable
- provides firms with a choice whether to refund the credit or carry it forward
- perhaps less easy to understand but relatively easy to apply

Spread refundability over several years

- more complex to track a firm's position
- for a firm in a long-term loss making position, will produce similar results to full year refundability after a few years
- creates a tail of Government liability

Target refundability based on R&D intensity

This mechanism is not used by any other country for targeting refundability (though in Australia R&D intensity influences the credit rate for large enterprises) but is worth considering as it is the basis of the year one scheme.

- can target refundability to those most deserving of it

[15] One possibility would be to include adding withholding taxes paid.

- creates a boundary that might give rise to perverse behaviours
- different measures of R&D intensity may favour different types of R&D performing firms
- though relatively easy to understand, adds complexity to compliance and administration.

Appendix 2

The examples below provide a practical illustration of how without refundability, firms do not receive a cash benefit from a tax credit if they are in loss or have insufficient income tax liability.

This table provides a simple example of how a profitable firm uses a tax credit to reduce the amount of tax it has to pay in a year:

Profitable firm (refundability makes no difference)	
Income	400
Expenses (includes 100 of eligible R&D)	300
Net profit/(loss)	100
Income tax liability (28% x Net profit)	28
R&D tax credit (15% x eligible R&D)	15
Net tax to pay	13

This table shows how a loss-making firm does not receive an immediate benefit from a tax credit without refundability:

Loss-making firm (without refundability)	
Income	300
Expenses (includes 100 of eligible R&D)	400
Net profit/(loss)	(100)
Income tax liability (28% x Net profit)	0
R&D tax credit (15% x eligible R&D)	15
Unused R&D tax credits to carry forward to future years	15

This table provides a simple example of a profitable firm that has insufficient income tax liability to receive the full benefit of a tax credit without refundability:

Profitable firm with insufficient income tax liability (without refundability)	
Income	310
Expenses (includes 100 of eligible R&D)	300
Net profit/(loss)	10

Income tax liability (28% x Net profit)	2.8
R&D tax credit (15% x eligible R&D)	15
Unused R&D tax credits to carry forward to future years	12.2

This table shows how a loss-making firm receives an immediate benefit from a refundable tax credit:

Loss-making firm (with refundability)	
Income	300
Expenses (includes 100 of eligible R&D)	400
Net profit/(loss)	(100)
Income tax liability (28% x Net profit)	0
R&D tax credit (15% x eligible R&D)	15
R&D tax credits refunded in cash	15

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Inland Revenue
Te Tari Taake

BRIEFING

R&D Tax Incentive: Phase 2

Date:	13 November 2018	**Priority:**	Medium
Security classification:	In Confidence	**Report no:**	MBIE 1560 18-19 IR 2018/688

Action sought		
	Action sought	**Deadline**
Hon Dr Megan Woods **Minister of Research, Science and Innovation**	**Agree** that officials conduct further work on Phase 2 of the R&D Tax Incentive in line with the parameters set out in this briefing .	23 November 2018
Hon Stuart Nash **Minister of Revenue**	**Agree** that officials conduct further work on Phase 2 of the R&D Tax Incentive in line with the parameters set out in this briefing .	23 November 2018

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Richard Walley	Policy Director, MBIE	04 901 4134	Privacy of natural persons	✓
Keith Taylor	Policy Manager, IR	04 890 2808	Privacy of natural persons	✓
Michael Contaldo	Policy Advisor, MBIE	04 901 8330		
Richard Braae	Senior Policy Advisor, IR	04 890 3010		

The following departments/agencies have been consulted
The Treasury, Callaghan Innovation

Minister's office to complete:

- ☐ Approved
- ☐ Noted
- ☐ Seen
- ☐ See Minister's Notes
- ☐ Declined
- ☐ Needs change
- ☐ Overtaken by Events
- ☐ Withdrawn

Comments

R&D Tax Incentive: Phase 2

Purpose

To seek agreement that officials conduct further work on Phase 2 of the Research and Development (R&D) Tax Incentive in line with the parameters set out in this briefing note.

Recommended action

The Ministry of Business, Innovation and Employment and Inland Revenue recommend that you:

Agree that officials do further work on Phase 2 of the R&D Tax Incentive, particularly to:

i. Look at how to put in place a comprehensive policy on refundability by April 2020;

ii. Consider whether any changes need to be made to the R&D tax loss cash out scheme; and

iii. Consider how to align the R&D tax loss cash out scheme with the R&D Tax Incentive.

Agree / Disagree

Privacy of natural persons

Richard Walley
Policy Director
Labour, Science and Enterprise, MBIE

13 / 11 / 2018

Privacy of natural persons

Keith Taylor
Policy Manager
Inland Revenue

13 / 11 / 2018

Hon Dr Megan Woods
Minister of Research, Science and Innovation

..... / ..... / .....

Hon Stuart Nash
Minister for Revenue

..... / ..... / .....

Background

1. The Taxation (Research and Development Tax Credits) Bill reflects the policy decisions taken to date by Cabinet for the R&D Tax Incentive as part of "Phase 1". The tight timeframes has meant that some issues were deferred. These will be addressed under Phase 2.

2. Cabinet has agreed that by April 2020 a more comprehensive policy will be in place to support businesses in loss so they can better benefit from the R&D Tax Incentive. This followed from the advice provided on how to support loss-making firms [MBIE 3950 17-18; IR2018/499 refers].

3. This paper provides further details on work to be undertaken in order to meet the commitment that a new policy on refundability will be in place by April 2020. It also sets out the work that will be done on the R&D tax loss cash out scheme in parallel.

Supporting businesses in loss

Refundability enables business in loss to benefit from the R&D Tax Incentive

4. Refundability refers to the policy of paying out in cash the tax credit for firms in loss. As part of the work around design and implementation of the R&D Tax Incentive, we have been considering further actions that need to be undertaken as part of "Phase 2" of the scheme, including on the issue of refundability.

5. The R&D Tax Incentive encourages businesses to perform R&D by reducing the amount of tax they have to pay when they have undertaken R&D. However, firms in loss do not pay tax. This is particularly a challenge for new and start-up business where the evidence suggests that R&D intensive firms typically spend their early years in a tax loss position. Such firms also have a lower probability of becoming profitable (at least in short term) so cannot use tax credits to improve their cash-flow position.

6. This issue also has resonance for atypical businesses, some of which are structured never to incur an income tax liability, and therefore would never be eligible for refunds of their tax credit. It is likewise an issue for businesses that do not make a stable profit.

Refundability in Year One will be limited

7. The Government has already signalled that it recognises the importance of supporting businesses that undertake R&D but that are not yet making a profit, therefore having insufficient taxable income to effectively use any tax credits.

8. It has partially responded to the issue of providing support for firms in loss in the current design of the R&D Tax Incentive by providing a limited form of refundability from 1 April 2019 (the first year of the new scheme). To make this straightforward to administer and to meet legislative timeframes, officials have largely adapted the parameters operated under the existing R&D Tax Loss Cash Out scheme in order to help provide refunds under the new R&D Tax Incentive.

9. R&D Tax Loss Cash Out was introduced in 2015. It was designed to help R&D-intensive start-up or other small firms that might be struggling with cash flow issues, especially before they have been able to take products or services to market, by allowing them to "cash out" a proportion of their tax losses rather than carry them forward. As a condition of receiving this

support, at least 20 percent of the firm's labour costs must be R&D related, and the maximum eligible R&D spend that can be claimed is capped at $1.7m (in 2019/20).[1]

10. The decision to mirror these provisions for the R&D Tax Incentive was a combination of expedience and cautiousness, in that the constraints with the R&D Tax Loss Cash Out are more restrictive than are likely to apply subsequently, and broadly it is easier to relax rather than tighten constraints over the longer term. In Year One of the R&D Tax Incentive at least 20% of claimant labour costs must be R&D related, and eligible businesses can "cash out" up to $225,000 of their R&D losses (or 15 percent of $1.7m).

Parameters for Phase 2

11. Such eligibility constraints are unlikely to work effectively as a policy on refundability in the long term because they limit the amount of benefit that firms in loss can achieve from the R&D Tax Credit unless they carry their credits forward. The Government has therefore committed to putting in place a more effective policy from April 2020. It has also indicated that it will use this opportunity to review the operation of the R&D Tax Loss Cash Out scheme.

12. A number of countries in the OECD (such as the Netherlands, Norway, the UK and Australia) allow for a measure of refundability as part of their fiscal incentives to incentivise R&D investment. Therefore addressing the issue will ensure that the proposed New Zealand regime is competitively attractive in international terms.

13. Nevertheless, for a number of reasons we recommend that refundability be approached with some caution. Firstly the Government needs to protect against the risk of fraudulent claims. Where tax systems are based on self-assessment, as in New Zealand, there is a tension between processing returns in a timely way and investigating whether they are genuine. Tax administrators rely on being able to investigate returns after they have been processed. Where funds have been paid out, but the claim is fraudulent, the entity may have disappeared leaving no ability to recoup the funds.

14. Secondly, evidence from other jurisdictions suggests that the fastest growing portion of their costs relating to their R&D tax incentives has been refunds for small firms in loss. This has particularly been an issue of concern in Australia and has led to subsequent changes in design after concerns about increased affordability of the scheme. Discussions with officials in those countries suggest that this rapid growth is associated with more spurious claims, including some re-characterisation of non-R&D expenditure.

Issues for further examination

15. There are a number of design features that officials need to consider in order to design an effective and sustainable refundable tax credit for the long term. These include:

    a. ***The safeguards that need to be built in to manage risk and ensure the integrity of the tax system while supporting the wider policy goals of the initiative:***

    It is important to ensure that any ultimate policy reduces fiscal risks from illegitimate or uneconomic claims. This might be done, for example, through the use of caps, turnover and pre-approval measures, as well as refunds at a discount, deferral of receiving refunds, and the time-bound eligibility for refunds.

    b. What can be learnt from international comparisons:

    We need to consider the approaches used by other countries, particularly those within

[1] The cap has been rising by $0.3M per year, starting from $0.5M in the 2015/16 year.

the OECD; and how the NZ R&D Tax Incentive is positioned in relation to those.

c. ***Whether entities not structured to derive taxable income should be refunded (- atypical businesses including charities and levy bodies):***

There are a range of organisations of different types that might fall within this group – for example, atypical businesses, Māori-owned businesses, charities, levy bodies, and tolling operations. As well as considering whether such a policy would incentivise more or have little impact on the amount of R&D they currently conduct, we also need to consider whether it is reasonable to treat them the same as taxpaying businesses, despite them not being taxpayers in some cases.

Other issues to consider within Phase 2

16. Alongside the question of refundability, we recommend undertaking a review of the R&D Tax Loss Cash Out scheme to avoid any misalignment between the two initiatives. Many of the firms currently eligible for the R&D Tax Loss Cash Out will also be eligible for the R&D Tax Incentive so questions arise as to how each policy complements the other and how to reduce compliance burdens for applicants. This would include:

- Considering how the R&D Tax Loss Cash Out has been performing over the past 3 years in areas such as take-up and fiscal cost, and what impact it has made on R&D activity. It would be useful also to consider its interaction with other policy areas such as loss continuity (as this impacts on desirability of cashed out losses), as well as to consider whether any further targeting or safeguards are required as part of its operation.

- Reviewing policy goals for R&D Tax Loss Cash Out and whether these need adjusting in light of the R&D Tax Incentive's introduction, so that overall budgetary costs can be managed sensibly while government provides support to where it is needed most. This might include harmonisation in areas such as eligible activity, R&D definitions, eligible entities, and eligible expenditure.

17. Finally, though it will be too early to have gained operational insights into the legislation, it is possible that issues will have been identified that require remedial attention.

Potential Phase 3 issues

18. There are also additional measures that officials consider should be considered in "Phase 3" – that is they would be introduced from the third year of the Tax Incentive (April 2021) or later. This could include in-year payments for businesses in loss, and the development of software packages that could automate a firm's claim for eligible expenditure. There are also other changes that could simplify firms' compliance, such as alternate rules for calculating overheads. In addition, as experience is gained with the operation of the Incentive, there may be a need to make further adjustments to the scheme.

Timelines and next steps

19. Legislation for the R&D Tax Incentive has now been introduced into Parliament with its First Reading on 1 November. Legislation associated with Phase 2 policy which would make changes to the R&D Tax Incentive could therefore not be practically introduced until the Phase 1 legislation has been enacted (not expected before the end of second quarter 2019).

20. However, we believe it is important to begin work now internally amongst officials to consider the issues in depth in order to help develop appropriate policy options. This would mean that changes to legislation can then effectively be carried out during the first quarter of 2019, and would ensure that revised legislation could be put forward as early as September 2019 (as soon as Phase 1 legislation is enacted).

21. We also recommend consulting with public stakeholders to better understand the impacts of any proposed policy on businesses. One option is to conduct a full consultation alongside the lines of the earlier Discussion Document that was issued in April. This would require the agreement of Cabinet.

22. However, we think this may risk "consultation fatigue" as in November and December the Select Committee will already be seeking submissions from the public on the current round of legislation. Additionally, March 2019 will be close to the go-live date for Inland Revenue's Business Transformation Release 3, and so tax and professional services stakeholders will be busy supporting their customers. Instead we recommend a less formal but still structured approach. This would seek views from those represented on the R&D Tax Advisory Group to be established by IR. Additionally we would run 4 workshops across the country that would bring together key stakeholders to examine the issues in more depth. This would include representation from businesses in profit and loss, as well as atypical businesses.

Suggested timetable

November – December 2018	Officials develop policy proposals for Phase 2
January – February 2019	Officials seek feedback from Ministers as whether these should form the basis of stakeholder engagement
February – March 2019	Workshops and engagement
March – April 2019	Finalise policy positions and seek Ministerial agreement
June 2019	Seek Cabinet approval
July 2019	Prepare Phase 2 legislation
August – September 2019	Introduce Phase 2 legislation (it may be possible to use another tax bill as the legislative vehicle).
April 2020	Policy on refundability in place

Inland Revenue
Te Tari Taake

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

POLICY AND STRATEGY

Policy report: R&D Tax Credit: Phase 2 Policy Proposals

Date:	13 February 2019	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2019/005 2296 18-19

Action sought

	Action sought	Deadline
Minister of Research, Science and Innovation	**Agree** that officials commence stakeholder engagement on phase two of the R&D tax incentive including on the issues of refundability, tax exempt organisations, and options for the future of the tax loss cash out.	22 February 2019
Minister of Revenue	**Agree** that officials commence stakeholder engagement on phase two of the R&D tax incentive including on the issues of refundability, tax exempt organisations, and options for the future of the tax loss cash out. **Agree** to forward this report to Minister of Finance.	22 February 2019

Contact for telephone discussion (if required)

Name	Position	Telephone
Keith Taylor	Manager, Policy Internal Revenue	04 890 2808 Privacy of natural persons
Kirsty Hutchison	Manager, Innovation Policy Ministry of Business, Innovation and Employment	04 901 4131 Privacy of natural persons

13 February 2019

Minister of Research, Science and Innovation
Minister of Revenue

R&D Tax Incentive: Phase 2 Policy Proposals

Executive summary

1. With legislation to introduce the Government's R&D tax incentive progressing through Parliament, officials are now considering the following policy issues that had been deferred to a secondary phase:

   - A comprehensive policy on refundability (the Bill currently provides for limited refundability to loss-making and pre-profit businesses)
   - Treatment of tax-exempt organisations (the first-year policy on refundability excludes entities that receive tax exempt income)
   - Options for the future of the R&D tax loss cash out (this policy was introduced in 2015 to address the effect of distortions in the tax system on R&D intensive start-ups)

2. A key aim of the Government's R&D tax incentive is to expand access to R&D support to a wider and more diverse range of firms and to provide firms with the certainty and confidence to increase their investment in R&D. The policy intent is to create a regime that is accessible, internationally competitive and sustainable.

3. These objectives have guided our thinking on the following proposals which we propose form the basis of stakeholder engagement. The stakeholder engagement will be used to seek feedback on and test the implications of the options described below (noting that Ministers have not yet taken final policy decisions).

Refundability and treatment of tax-exempt organisations

4. We propose that refundability of the R&D tax credit for firms in loss or with insufficient profit should be widely available. This is consistent with the objective of providing broad-based support for R&D. However, in order to manage the risks that refundability creates to the sustainability of the scheme, officials propose that the amount paid to an organisation in a single year would be limited by:

   - the amount of PAYE paid (this ensures a firm has a tangible economic presence and that what firms receive from the tax system does not exceed what they have contributed); and
   - a cap on refunds of $5 million (this will ensure that Growth Grant recipients are not worse off by moving to the tax incentive).

5. We are aware that some firms legitimately do not pay PAYE and we will use the stakeholder engagement to explore the extent of this issue and the appropriateness of using alternative taxes paid as a constraint on refundability.

6. The quality of, and positive externalities from, R&D undertaken by tax-exempt organisations is likely to be similar to that of taxable entities. Therefore, from the perspective of growing New Zealand-based R&D, it makes sense for the tax incentive to be refundable for tax-exempt organisations with no further restrictions than those that apply to taxable entities. However, we intend to use

the stakeholder engagement as an opportunity to build a better understanding of the type and amount of R&D that is undertaken by tax-exempt organisations.

The R&D tax loss cash out

7. The tax loss cash out is intended to mitigate distortions in the tax system that particularly affect R&D intensive start-up companies. The policy allows qualifying firms to receive cash for their losses that relate to R&D rather than waiting until the firm is profitable to obtain the benefit of a tax deduction. About 350 firms have registered for the scheme. The introduction of the R&D tax incentive provides an opportunity to consider options for the future of the tax loss cash out including:

   - Retaining it as a separate instrument but with some amendments such as aligning the definition of R&D with the tax incentive and tightening its eligibility criteria, or
   - incorporating it as an additional support for start-up firms delivered via an extension to the tax incentive, or
   - ceasing the tax loss cash out.

8. The engagement with stakeholders provides an opportunity to test our understanding of the impact that the tax loss cash out has had on firms, to seek insights into administrative issues such as the value of aligning the R&D definition with the tax incentive, and to explore whether it would create confusion to retain the two separate instruments.

9. If Ministers agree to these proposals, officials will commence a process of stakeholder engagement. We anticipate providing you advice in April so that Cabinet approval and legislation can follow later in the year.

Recommended action

10. The Ministry of Business, Innovation and Employment and Inland Revenue recommend that you:

    10.1 **Agree** that officials commence stakeholder engagement on phase 2 of the R&D tax incentive

    10.2 **Agree** that the proposals that will form the basis of this engagement are:

        10.2.1 Refundability of the tax credit for firms in loss or with insufficient profit should be widely available, with the only constraints being that the amount paid to an organisation in a single year would be limited by the amount of PAYE paid and capped at $5 million.

        10.2.2 No further restrictions would apply to tax-exempt organisations.

        10.2.3 Options for the future of the R&D tax loss cash out could include:

            - aligning it with the tax incentive and tightening its eligibility,
            - incorporating it as an additional support for start-up firms delivered via an extension to the tax incentive, or
            - ceasing the tax loss cash out.

    10.3 **Agree** to refer this report to the Minister of Finance

10.4 **Note** that officials will report back to you following the stakeholder engagement.

Kirsty Hutchison
Manager, Innovation Policy
MBIE

Keith Taylor
Policy Manager
Policy and Strategy, Inland Revenue

Hon Dr Megan Woods
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Purpose

11. This report seeks joint Ministers' agreement to proposals that are to be the subject of stakeholder engagement. The proposals relate to:

    - How refundability of the tax credit could apply from 1 April 2020
    - Whether there should be limits on refundability for non-tax paying organisations
    - Options for the future of the R&D Tax Loss Cash Out

12. Your agreement to these proposals does not represent final Government decisions. The proposals will form the basis of officials' engagement with stakeholders. Officials will brief you following this engagement and recommend proposals you can take to Cabinet for final decisions.

Context and background

13. The R&D tax incentive was developed under tight timeframes. Consequently, there was not time to resolve some complex issues before the legislation was drafted.

14. Cabinet agreed to provide limited refundability for firms in loss for the first year of the tax incentive and you committed to review the policy that would apply from the second year. The two-year transition for Growth Grant recipients meant firms were not disadvantaged, relative to their current situation, in this delay to establishing the longer-term policy.

15. The R&D tax loss cash out is a separate policy from the R&D tax incentive. But the advent of the tax incentive and the high overlap between recipients under each policy means it is timely to review it.

16. You have previously agreed to the scope and timeframes for this Phase 2 policy work (1560 18-19; IR2018/688 refers). If you agree with these proposals, we will hold workshops with stakeholders to get their feedback. We anticipate providing you advice in April so that Cabinet approval and legislation can follow later in the year.

Refundability

Why it is an issue

17. Refundability refers to paying out the tax credit if the business has insufficient tax liability. The alternative to refunding the credit is for firms to carry it forward and use it when they become profitable.

18. Providing a refund ensures that all firms doing R&D receive equal support. For instance, an established business can support R&D through profits from its existing products, and therefore can immediately benefit from a tax credit. Similarly a large conglomerate can support a loss-making R&D division through profits from other parts of a business. By contrast, a start-up firm will not have offsetting profits from other activities and – unless its credits are refunded – may not be able to benefit from the tax credit until a much later date, if at all.

19. Refundability provides financial support for R&D when it is most needed. In most cases, a firm will engage in R&D expenditure prior to receiving revenue from commercialising its product. Therefore, not only are R&D-intensive firms more likely to be in loss, they are also more likely to be cash constrained. For these

firms, cash today will be much more valuable than a credit that is carried forward until the firm becomes profitable.

20. Additionally, credits carried forward while a firm is in loss are at risk if the firm breaches shareholder continuity rules relating to the credit. This is more likely to occur where there is significant new equity investment in a firm before it reaches profitability.

21. However, paying out to businesses, rather than reducing the amount of tax they pay, increases the fraud risk for Inland Revenue. This is not particular to R&D tax credits but is seen with other parts of the tax system such as donor tax credits and GST refunds.

22. Refunds also increase the fiscal cost of a scheme. In countries where credits are refunded, fiscal cost growth is faster amongst those firms getting refunds. Discussions with officials in Australia and the UK suggest that some of this increased cost is associated with marginal quality R&D – cash payments for small, start-up firms are a powerful lure for some firms so encourage reclassifying other expenditure as R&D or claiming for activity that is not R&D. In those countries, a large number of claims has made it difficult to counter this risk through audit.

23. In summary, providing refundability generates positive net benefits but adds risk to the tax incentive scheme. Therefore, the question is not whether to have refundability or not but how to manage the risks associated with it.

International approaches

24. In developing a proposal for New Zealand, we have taken note of other countries' policies.

25. Across the OECD, most countries have R&D tax credits but fewer than half provide refundability. Australia, being the country with which New Zealand businesses most readily make comparisons, only has refundability for small to medium sized firms.

26. Appendix 1 summarises the policies applied in other OECD countries that do provide refunds and describes the strengths and drawbacks of each policy.

27. There is no uniformity as to how constraints are applied, but some broad observations are:

- Some constraint on refundability is the norm; a system with no restrictions on refundability would be an outlier amongst OECD countries
- the different ways in which refundability is limited often reflect differences in the underlying tax incentive scheme
- some countries limit refundability to SMEs and start-ups
- it is relatively common to limit refunds by reference to other taxes paid by the firm.

Refundability in relation to other features of the R&D Tax Incentive

28. New Zealand's tax incentive differs from most other countries through its lack of targeting. The three countries we studied in most depth in designing the New Zealand scheme either have higher credit rates for smaller companies (Australia and UK) or have such a low cap the scheme is effectively limited to SMEs (Norway). New Zealand's scheme has neither of these features.

29. Another aspect of the R&D tax incentive is that it is replacing the Growth Grant. Though not explicitly stated by the Government, Growth Grant recipients have an expectation that they will not be disadvantaged by moving to the tax incentive.

30. Loss-making firms can receive up to $5 million per year from a Growth Grant. Under the tax incentive this would equate to incurring around $33 million of eligible expenditure. This is a relatively high level of R&D expenditure. Based on Growth Grant recipients, only 5 New Zealand organisations currently exceed it and of these 2 are loss making. There will be some non-Growth Grant recipients who may also exceed this level but we are less certain of the number.

31. By comparison, the maximum level of eligible expenditure for refundability in Australia is around A$10 million.

32. These factors suggest that targeting refundability exclusively to small and medium-sized businesses would be incompatible with other features of the tax incentive and that a cap for eligible expenditure under $33 million would be perceived as less generous than the Growth Grant.

Fraud and fiscal risks

33. One reason to constrain refundability is fraud risk. Despite efforts to restrain it, determined organisations are frequently able to find ways to fabricate losses, and once payments have been made it can be difficult if not impossible to recover the funds.

34. A common approach in other jurisdictions is to limit refunds to the amount paid in other taxes such as PAYE[1]. This ensures a firm has a tangible economic presence, and therefore means it is less likely to be operating fraudulently. It also operates as something of an integrity measure for the tax system because it means what firms receive from the tax system does not exceed what they have contributed.

35. Administratively, checking how much PAYE is paid by a firm is straightforward.

36. In-year approval of the R&D activity, which will apply from year 2, will provide a further element of robustness because it will potentially give an early warning of suspicious claims.

Stakeholder views

37. An indication of what stakeholders think is provided by their submissions on the Taxation (Research and Development Tax Credits) Bill to the Finance and Expenditure Committee.

38. All submitters who have commented on this issue think the tax credit should be refundable to a greater extent than it will be in the first year. Some of them argue for no limits on refundability. Others contemplate some form of refundability such as:

- Limited by level of firm turnover or a tax incentive less than a certain amount (Corporate Taxpayers Group)
- A cap of $5 million on the amount of tax credit refunded (EY).

Proposals for refundability

39. In terms of establishing the policy on refundability, the key question is whether it should be unrestrained or whether there should be some restrictions. On balance, we think there should be some restrictions, for the following reasons:

[1] For most firms, the amount of PAYE they pay will exceed 15% of the amount of R&D they undertake because all employees in the firm will contribute to the PAYE total whereas R&D is usually only one part of the firm's activities. There will, however, be some firms that (quite legitimately) do not pay PAYE.

- Some form of constraint linked to other taxes paid can make fraud less likely.
- The R&D tax incentive is new and not all the risks are well understood. Maintaining some constraint will be useful until there is a better understanding of how the scheme is operating.
- Given the proposed R&D tax credit is relatively broad and accessible, the proposed refundability restrictions do not fundamentally alter the incentives of the scheme.
- Other countries offering R&D tax incentives have generally put constraints on refundability in place.
- If the constraints are relatively light-handed they are unlikely to have a material impact on the amount of R&D encouraged by the tax incentive.

40. It is therefore recommended that the proposals on refundability with which officials will engage externally are:

- The amount of tax credit refunded in any one year cannot exceed the amount of PAYE the firm has paid in the same year, and
- The maximum tax credit paid out in any year is $5 million.
- Excess credits that are not refunded in a particular year can be carried forward subject to the credit continuity rules and can be refunded in future years, subject to the above conditions.

41. Framing the constraints in this way is not anticipated to restrict refunds for the majority of R&D performers. It means that all firms would have some refund and a few would have less than full refundability. This differs from the Australian approach where there is a hard boundary in the form of a turnover threshold which means that if a firm grows, it switches from receiving refunds to not receiving any.

42. Overall, and compared with most other jurisdictions, the proposed policy for New Zealand represents a comprehensive approach to refundability. We therefore consider it will be reasonably well received. Issues that might be contentious, and which we would want to explore with stakeholders, include:

- Some firms may pay little or no PAYE. For instance, their staff are not employees and are paid a shareholder salary or provide sweat equity. We are interested in understanding how prevalent this issue might be amongst R&D performers and whether an alternative definition of taxes paid[2] would be more appropriate.
- The impact of the $5 million cap. We think some cap on refunds would be prudent as a backstop but this would have to be balanced against any evidence that it would disincentivise firms from expanding their R&D.

Tax exempt organisations

Which organisations are tax-exempt

43. Within the Income Tax Act, there are different types of tax-exempt organisations, including charities, public authorities and local authorities, sports promoting bodies, and science and industrial research promoting bodies. In some cases, the legislation deems these bodies to be tax-exempt and in other cases the

[2] One possibility would be to add FBT, withholding tax on scheduler payments (WT) and employer superannuation contribution tax (ESCT) paid.

organisation elects to have the tax-exempt status. These categories include levy bodies.

44. Māori authorities are not tax-exempt (they pay tax at 17.5% rather than at the company rate of 28%), but some post-settlement governance entities have registered as charities and Māori organisations often have charitable entities within their structures. Consequently, tax-exempt organisations include organisations considered Māori organisations.

Why it is an issue

45. The first-year policy on refundability excludes entities that receive exempt income. They are eligible for the tax incentive but, because they do not have an income-tax liability, they will not benefit from the incentive without refundability.

46. The main argument for making the credit refundable for these organisations is that the quality of their R&D and the spillovers arising from it are not likely to be any different from private-sector organisations. Therefore, from the perspective of growing New Zealand-based R&D it makes sense to include them.

47. Some tax-exempt organisations, such as levy bodies, may already be receiving government financial support from a different programme[3]. However, the rules applying to the tax incentive mean that R&D that has been funded by another government grant is not eligible for the tax incentive, so providing for refundability of the R&D that is eligible should not lead to double dipping.

48. Finally, there is an argument that organisations that have chosen to be tax-exempt organisations should not subsequently receive benefits from the tax system. One concern is that organisations that are not paying tax can accumulate assets faster than comparable taxpaying businesses so are better able to fund investments including R&D. Another concern is that organisations may choose to place their profitable operations in a tax-exempt structure while treating their loss-making parts as taxable entities.

Proposal for tax-exempt organisations

49. Officials are in the process of getting a better picture of the type and amount of R&D that is undertaken by organisations that are tax-exempt. We consider the stakeholder engagement will be an opportunity to extend our knowledge.

50. However, we are conscious that these types of discussions could raise expectations amongst tax-exempt organisations that they will be eligible for refunds of their tax credits if they are eligible for the tax incentive.

51. Also, we consider there may be allegations of unfairness if organisations that are undertaking R&D are shut out of the tax incentive as a result of not providing refundability for tax-exempt organisations.

52. We consider the arguments in favour of refundability for tax-exempt organisations are stronger than the arguments opposing it. Consequently, the proposal is that the stakeholder engagement would be based on the premise that tax-exempt organisations would be eligible for the refund of their R&D tax credits, with only the restrictions applying to taxpaying firms applying to them.

[3] For example, the Endeavour Fund or Primary Growth Partnership

The R&D Tax Loss Cash Out

Background

53. The R&D Tax Loss Cash Out was introduced in 2015 and allows some firms that perform R&D to cash out their losses, up to the amount of their R&D spend, so they receive 28% of the relevant amount[4].

54. The scheme has been designed to support R&D intensive firms. R&D intensity provides a way of targeting firms in the early phase of their development[5]. This group of firms have been selected for support because:

    - They are likely to be cash-constrained. Their R&D might not yet have developed a viable product so they will struggle to attract investors and the absence of a commercial product means they are not earning revenue.
    - They are more likely to be at risk of breaching the loss continuity rules within the tax system so the losses are no longer available for the firm[6].

55. In terms of the immediate cash benefit provided by the policy, it functions like a 28% tax credit. However, an important difference from a standard tax credit or grant is that because the payment cancels an equal amount of the firm's losses, the tax-credit payments are more in the form of a loan from the government which is "repaid" if the firm becomes profitable[7]. Other events (liquidation, sale of the company or of IP) also trigger repayment obligations.

56. The scheme is tightly targeted to a subset of R&D-intensive firms through imposing a wage-intensity test. This screens out many R&D performers and has meant the scheme operates on a small scale. About 350 firms have registered with slightly fewer actually applying for the credit. Its cost is about 10% of expected expenditure on the tax incentive.

57. The advent of the R&D tax incentive has led Inland Revenue to review the R&D tax loss cash out. This review is summarised as follows.

How is the R&D tax loss cash out working?

58. The tax loss cash out scheme was introduced in 2015 with effect from the 2016 year. There are two full years of results (2016 and 2017) and one part year (2018).

59. Uptake of the scheme has grown, with 350 firms now registered and the number of approved firms slightly less than 300. In aggregate, the scheme has provided $50m to firms undertaking R&D, over the past 3 years[8]. The average amount received per firm has grown from $73,000 in year 1 to $105,000 in year 3.

60. Recipients are generally smaller enterprises employing fewer than 20 employees. There is a mix of stand-alone entities and firms that are part of a group. Of the latter, some have a foreign parent or are associated with a foreign entity that exercises control over the functions and business activities of the firm.

[4] Technically, it is the lesser of their R&D send or 1.5 x the amount spent on employees engaged in R&D.
[5] The standard pattern is that as a firm's R&D is successful and it commercialises its product, its R&D intensity will decline.
[6] Generally, a firm loses it losses if there is more than a 50% change in ownership. This can be triggered either by the current shareholders selling or by an injection of fresh equity capital. Within the tax system there is a discretion for firms undertaking R&D to defer the recognition of their R&D expenditure so that the losses associated with their R&D expenditure are not lost.
[7] Repayment occurs because a firm starts paying tax earlier than it would if it had carried losses forward.
[8] $13.7 million was paid out for the 2016 tax year, $23.2 million was paid out for 2017, and – part year only - $16.3 million has been paid out for the 2018 year.

Is the scheme achieving its objectives?

61. An assessment of the scheme's impact is difficult because many recipients also receive other forms of government assistance (such as Callaghan Innovation grants or support from the NZ Venture Investment Fund). It is not possible to discern the impact of this scheme alone on the amount of R&D that is being carried out.

62. IR officials administering this scheme indicate there is some evidence of the scheme providing needed financial support. Some firms use the credit to pay instalments on tax debt or to offset debt not under arrangement. Inland Revenue officials consider the credit has on occasion saved a company from liquidation or relieved the financial strain of tax debt.

63. The eligibility criteria are designed to target New Zealand-based firms that are:

- Currently loss-making firms but will potentially become profit making and tax paying
- Firms for whom R&D is a central feature of their operations
- In the start-up phase because these firms are most likely to be cash constrained
- Not otherwise readily able to tap into non-government sources of finance.

64. An analysis of recipients of the scheme suggests that the current criteria are letting in these types of firms but also letting in firms that don't meet the criteria. For instance, in the first year though the majority of recipients had incorporated in 2012 or later, at least 20% were more than 10 years old, so could not be considered still in the start-up phase. Additionally, firms within a wholly owned group with a listed company have been eligible, despite their access to significant non-government finance.

65. A feature of the scheme is the obligation to repay the credit once the firm has become profitable or other conditions are met. However:

- Because the scheme has only been in operation for a short time, there is not a clear picture of whether firms are moving to profitability
- Some firms have become profitable but still have other losses carried forward so are not yet paying tax
- A very small number of firms have triggered the other repayment obligations
- These other criteria are hard to monitor and Inland Revenue is reliant on self-reporting by firms
- Some corporate structuring arrangements can result in perpetual loss making companies, despite significant revenue arising from commercialisation of the research and development.

Definition of R&D

66. The scheme works off the accounting standard definition of R&D. This is different from the definition used in the R&D tax incentive.

67. The accounting definition was consciously chosen when the scheme was developed because, given the target recipient was a small start-up firm, it was considered this would be the easiest concept for firms to apply.

68. However, it is anticipated that the vast majority of firms eligible for the tax loss cash out will also be eligible for the R&D tax incentive. Therefore, the advent of the R&D tax incentive means that firms will have to apply two different definitions of R&D.

Confidential advice to Government

[redacted]

[redacted] Confidential advice to Government [redacted]

[redacted]

[redacted]

[redacted]

Next steps

80. If Ministers agree with the proposals set out in this report, we will proceed with a programme of stakeholder engagement. This will focus on a series of workshops in diverse locations and with different types of organisations in order to canvas a broad spectrum of views.

81. However, as agreed by Ministers (1560 18-19: IR2018/688 refers), we will not release a discussion document nor engage in formal consultation. This is to avoid consultation overload given the extensive consultation that has already occurred through the tax incentive's development.

82. Officials will update you on the finalised stakeholder engagement plan by early March. This will likely cover the list of attendees invited and topics for discussion. It may also signal the additional analysis that needs to be undertaken to support the consultation eg quantifying the number of tax-exempt organisations that qualify for the R&D Tax Incentive.

83. We anticipate coming back to Ministers in April with proposals. Any implementation of the proposals outlined in this report will require legislative change so we anticipate a process of Cabinet approval and legislative drafting in mid-2019, with a target enactment date of 1 April 2020.

Appendix 1 – International Comparisons of Refundability policies

84. The following table sets out key features of how refundability is applied in key OECD countries.

Country	Refundability policy	Other relevant factors
Australia	Limits refundability to: • firms with turnover less than A$20m & • subject to a A$4m annual cap.	The cap is a recent feature aimed at fiscal affordability. The cap equates to A$10m eligible expenditure.
UK – SMEs	Firms in loss can cash out their tax credit at a discount to their value[11].	The SME scheme is more generous than the large firm scheme. SMEs must have: • fewer than 500 employees and • turnover less than EUR 100m.
UK – large firms	For non-SMEs, the tax credit is paid before tax, so loss making firms benefit equally with profitable firms, subject to not exceeding the amount of PAYE and National Insurance Contribution paid.	
Norway	Full refundability for tax paying entities.	The tax credit operates with a very low cap. The maximum credit is (approx.) NZ$2m, and in most cases is NZ$1m. The tax credit is not available to non-taxpayers.
Ireland	Full refundability, but paid in instalments over 3 years, and subject to limits relating to amounts of corporate income tax paid or amounts of payroll tax paid.	
Netherlands	Full refundability but limited to a firm's payroll tax liability.	
Canada	The credit is fully refundable for Canadian Controlled Private Corporations up to an expenditure limit of CAD 3 million. Higher expenditure is only 40% refundable.	The tax credit rate is 35% up to eligible expenditure of CAD 3 million, and 15% for higher amounts.

The table above demonstrates different mechanisms can be used for constraining refundability. Here are some brief comments on each of them:

[11] Firms in loss can cash out 14.5% of surrenderable losses (these are the lesser of their trading loss and 230% of the R&D spend).

Eligibility for refundability based on firm characteristic (generally a measure of size such as turnover)

- can target refundability to firms that, potentially, benefit most from it – ie, smaller or early stage firms
- creates boundaries which might disincentivise desired behaviours – eg, a firm may choose not to grow to keep turnover below the threshold
- relatively simple to understand but measurement would introduce complexity

Refundability applies up to a cap; credits above cap carried forward

- refundability addresses cash flow needs
- less of a boundary issue so less likely to impact on firm behaviours (though incentive to increase R&D spend may diminish above cap)
- relatively easy to understand and apply

Limit refundability based on other taxes paid

- If based on PAYE paid, more like a backstop rather than a fiscal cap as for most businesses the amount of PAYE across the whole firm will exceed 15% of the cost of R&D
- Useful as a possible fraud deterrent as it should ensure a firm has a tangible economic presence, and may also prevent exploitation or a loophole if that involved claiming credits for high non-wage costs
- Operates as some form of integrity and fiscal constraint measure, in that a firm cannot "take out" more than it is "putting in" to the tax system.
- Some firms may not pay PAYE – eg, staff are not employees and are either shareholders who are paid a shareholder salary, contractors or provide sweat equity. This suggests either using a wider definition of taxes paid[12] or making a provision for firms to apply for an exemption
- Administratively easy to understand and apply (subject to exceptions for firms without employees)

Refund credits at a discount

- Supports loss making firms while providing an incentive to become profitable
- Provides firms with a choice whether to refund the credit or carry it forward
- Perhaps less easy to understand but relatively easy to apply

Spread refundability over several years

- More complex to track a firm's position
- For a firm in a long-term loss making position, will produce similar results to full year refundability after a few years
- Creates a tail of Government liability

Target refundability based on R&D intensity

This mechanism is not used by any other country for targeting refundability (though in Australia R&D intensity influences the credit rate for large enterprises) but is worth considering as it is the basis of the year one scheme.

- Can target refundability to those most deserving of it
- Creates a boundary that might give rise to perverse behaviours
- Different measures of R&D intensity may favour different types of R&D performing firms

Though relatively easy to understand, adds complexity to compliance and administration

[12] One possibility would be to include adding withholding taxes paid.

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Inland Revenue
Te Tari Taake

CallaghanInnovation

BRIEFING

Draft Cabinet paper: R&D Tax Incentive – Refundability

Date:	11 April 2019	**Priority:**	High
Security classification:	In Confidence	**Tracking number:**	3068 18-19 IR2019/159

Action sought

	Action sought	Deadline
Hon Dr Megan Woods **Minister of Research, Science and Innovation**	**Provide** feedback to officials on the attached draft Cabinet paper. **Forward** the attached draft Cabinet paper to the Minister of Finance.	15 April 2019
Hon Stuart Nash **Minister of Revenue**	**Provide** feedback to officials on the attached draft Cabinet paper.	15 April 2019

Contact for telephone discussion (if required)

Name	Position	Telephone		1st contact
Kirsty Hutchison	Manager, Innovation Policy	04 901 4131	Privacy of natural persons	✓
Keith Taylor	Policy Manager, Inland Revenue	04 890 2808	Privacy of natural persons	
Becci Whitton	Manager, Stakeholder and Government Engagement, Callaghan Innovation		Privacy of natural persons	

The following departments/agencies have been consulted

The Treasury

Minister's office to complete:

- ☐ Approved
- ☐ Noted
- ☐ Seen
- ☐ See Minister's Notes
- ☐ Declined
- ☐ Needs change
- ☐ Overtaken by Events
- ☐ Withdrawn

Comment

BRIEFING

Draft Cabinet paper: R&D Tax Incentive – Refundability

Date:	11 April 2019	**Priority:**	High
Security classification:	In Confidence	**Tracking number:**	3068 18-19 IR2019/159

Purpose

To provide you with a draft Cabinet paper on the design of the longer term refundability policy to replace the limited refundability policy that applies for year one of the R&D Tax Incentive.

This paper also provides advice on:

- The R&D tax loss cash out scheme
- A supplementary order paper for the *Taxation (Research and Development Tax Credits) Bill*
- Legislative vehicle and timings for refundability.

Recommended action

The Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation recommend that you:

		Min. RS&I	**Min. Revenue**
a	**Note** that the refundability proposal has to balance objectives of ensuring firms in loss benefit from the R&D Tax Incentive while managing the risks around the sustainability of the scheme	*Noted*	*Noted*
b	**Note** on balance officials recommend a refundability proposal that will help ensure the sustainability of the R&D Tax Incentive scheme over time	*Noted*	*Noted*
c	**Note** this proposal will disadvantage some R&D intensive start-ups but the Ministry of Business, Innovation and Employment is currently leading review work on other interventions in the Research, Science and Innovation portfolio that could be used to support start-ups and innovative firms	*Noted*	*Noted*
d	**Agree to the proposed refundability option based on:** • inclusion of a hard cap based on payroll taxes • the proposed cap would not apply to eligible payments to approved research providers	*Agree/ Disagree*	*Agree/ Disagree*

•	the proposed cap would not apply to R&D tax credits refunded to statutory bodies		
e	**Agree** that all tax exempt organisations, except organisations receiving tax exempt income under section CW 49 of the Income Tax Act , be ineligible for the R&D Tax Incentive	*Agree/ Disagree*	*Agree/ Disagree*
f	**Agree** that local authorities, as well as entities controlled by or associated with local authorities, be ineligible for the R&D Tax Incentive	*Agree/ Disagree*	*Agree/ Disagree*
g	**Agree** not to set an additional $5 million cap on refundability in order to incentivise large established R&D performers (who will still be subject to the $120 million cap on R&D expenditure)	*Agree/ Disagree*	*Agree/ Disagree*
h	**Agree** to release the supplementary order paper that is attached to this briefing before the Committee of the Whole House stage of the *Taxation (Research and Development Tax Credits) Bill*	*Agree/ Disagree*	*Agree/ Disagree*
i	**Agree** to including remedial amendments in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill in relation to provisions identified in the reported back version of the *Taxation (Research and Development Tax Credits) Bill* that do not fully achieve the policy intent	*Agree/ Disagree*	*Agree/ Disagree*
j	**Note** officials will continue to work on the regulatory impact assessment and will send you a final version before the Cabinet paper is submitted to Cabinet Economic Development Committee on 16 May 2019	*Noted*	*Noted*
k	**Note** that officials will use the draft Cabinet paper to undertake inter-departmental consultation	*Noted*	*Noted*
l	**Note** any feedback on the Cabinet paper will be required by 15 April 2019, or as soon thereafter as possible, to meet the lodgement date for Cabinet Economic Development Committee on 16 May 2019	*Noted*	*Noted*
m	**Agree** to forward the attached Cabinet paper to the Minister of Finance.	*Agree/ Disagree*	*Agree/ Disagree*

Privacy of natural persons

Kirsty Hutchison
Manager, Innovation policy
Labour, Science and Enterprise, MBIE

11 / 04 / 19

Privacy of natural persons

Keith Taylor
Policy Manager
Inland Revenue

11 / 04 / 19

Privacy of natural persons

Becci Whitton
Manager, Stakeholder and Government Engagement
Callaghan Innovation

11 / 04 / 19

Hon Dr Megan Woods
Minister of Research, Science and Innovation

..... / ..... / .....

Hon Stuart Nash
Minister of Revenue

... / ..... / .....

Background

1. Draft legislation introducing the R&D Tax Incentive from the 2019/20 tax year is currently before the House and provides for the R&D Tax Incentive scheme to commence from 1 April 2019 for most businesses.[1]

2. Refundability of tax credits is an important part of the R&D Tax Incentive and will help incentivise R&D for firms in tax loss. Refundability refers to paying out the R&D tax credit to firms who are in a tax loss position, or have insufficient income tax liability to offset the credit against. Providing a refund ensures that all firms doing R&D receive the benefit of the tax credits they are eligible for under the R&D Tax Incentive.

3. Cabinet agreed to provide limited refundability for firms in a tax loss position for the first year of the R&D Tax Incentive scheme and noted that the design features for refundability will likely change in subsequent years (DEV-18-MIN-0174 refers).

4. The limited refundability mechanism in the *Taxation (Research and Development Tax Credits) Bill* caps refundable tax credits available in the 2019/20 tax year to $255,000. The eligibility criteria are the same as in the R&D tax loss cash-out scheme.

5. Officials developed a longer term refundability proposal to use for discussion with key stakeholders (IR2019/005; 2296 18-19 refers). The basis of the proposal was that refundability would be widely available to firms in a tax loss position. This is consistent with the objective of providing broad-based support for R&D. However, in order to manage the risks that refundability creates to the sustainability of the scheme, officials proposed that the amount of credits refunded to firm in a year would be limited to the lesser of:

   - the amount of PAYE paid by a firm; and
   - a cap of $5 million.

6. Officials engaged on this proposal during February and March 2019, with a range of organisations including:

   - Corporate Taxpayers' Group (and a selection of their members in a loss making position including Xero and Fisher and Paykel Appliances); Chartered Accountants Australia and New Zealand; representatives from PwC, KPMG, Deloitte and EY;
   - Approximately 25 representatives from R&D performing firms in loss or with insufficient taxable income to fully utilise non-refundable R&D tax credits;
   - Other large established R&D performers, including Fonterra, Zespri, LIC Automation and Ballance Agri-Nutrients;
   - Levy bodies; charities; and Māori business representatives.

   Annex Two includes a list of organisations who took part in the stakeholder engagement process.

Refundability

7. The draft Cabinet paper attached at **Annex One** sets out the design of the longer term refundability policy for inclusion in the *Taxation (1st 2019 Omnibus Issues, and Remedial*

[1] The R&D Tax Incentive applies from the beginning of the 2019/20 income year, which means the date from which it applies depends on the balance date of each individual claimant. For most standard balance date (31 March) claimants, the R&D Tax Incentive will apply from 1 April 2019.

Matters) Bill. Incorporated in it are proposals developed as a result of the engagement process outlined above and additional policy analysis.

8. The draft Cabinet paper recommends the following refundability policy option for the Tax Incentive:

   - *All firms would be entitled to a full refund of their R&D tax credits, to the extent their R&D tax credits are equal to or less than the amount of 'payroll' taxes paid by a firm in the relevant income year (proposed cap)[2]:*

     i. The cap would not apply to R&D carried out by approved research providers;

     ii. The cap would not apply to R&D tax credits refunded to statutory bodies.

   - *All tax exempt organisations, except organisations receiving tax exempt income under section CW 49 of the Income Tax Act, will be ineligible for the R&D Tax Incentive;*

   - *All local authorities, as well as entities controlled by or associated with local authorities, will be ineligible for the R&D Tax Incentive.*

Existing measures to protect the integrity of the scheme

9. The R&D tax incentive scheme has a range of measures built into it to ensure its sustainability over the long term:

   - Qualifying for the R&D Tax Incentive requires R&D activity to be primarily undertaken in New Zealand. This closes off some of the fraud risks experienced in other jurisdictions associated to R&D occurring offshore.

   - The minimum R&D expenditure threshold of $50,000 reduces the risk of a large number of very small claims being submitted. This means that more resources can be focused on working with applicants during the in-year approval process.

   - The in year-approval system, with a single point of contact between business and the core R&D team within Inland Revenue, will help identify fraudulent claims through the flagging of unusual R&D applications and/or behaviour.

10. These measures will provide robustness and integrity for the scheme. However, given the experience of overseas jurisdictions, we are not confident they would be sufficient to manage the risks associated with refundability and consequently we have proposed a cap on payroll taxes.

Cap based on payroll taxes

11. Our recommended refundability policy option, which involves a cap based on payroll taxes[3], means **full** refundability will not be as widely accessible as some firms would like.

Stakeholder engagement revealed early stage R&D intensive firms are disadvantaged by a PAYE cap, options to soften the impact were explored, including a tangible economic presence test

12. Some types of firms would be disadvantaged by a PAYE cap for a number of reasons. This includes early stage R&D intensive firms who choose to have contractors over employees to reduce their financial risk, start-ups where people work on an unpaid basis in return for a stake in the company, and small to medium-sized software firms where it is more common to

[3] Payroll taxes would include PAYE, fringe benefit tax, employer superannuation contribution tax and withholding tax on schedular payments

have flexible work arrangements[4], and firms where capital is used over labour. Representatives from KPMG considered that flexible work arrangements are becoming more commonplace across all sectors and they expect the trend to continue in future.

13. As a result of the stakeholder engagement officials explored alternatives to a hard PAYE cap, specifically a tangible economic presence (TEP) test. The TEP test developed by officials required firms to choose one of the following measures to satisfy the test:

    - PAYE paid by the firm is greater than the amount of tax credit to be refunded;
    - Obtaining verification of TEP from a chartered accountant or practising lawyer;
    - Obtaining verification from Inland Revenue that a firm has TEP.

14. The TEP test is an attractive option that has broader reach and impact for firms who most need refundability support, but it is not sufficient to address the risks of fraud. Discussions with United Kingdom (UK) officials found that the risks of fraud in relation to refundability are more pervasive than previously considered. UK officials suggested that relying on a chartered accountant or practising lawyer for certification of TEP may not be robust, and additional Inland Revenue checks might lead to administration resources being focused on audit rather than the approval of R&D activity.

Officials recommend including a hard cap on PAYE to address fraud risk, but recommend broadening it to 'all payroll taxes' to soften the impact

15. Early stage R&D intensive firms are important participants within the innovation system both as a source of value-add employment and the development of a more productive and diversified economy. To ensure these firms can benefit as much as possible from the scheme we have broadened the proposal to include:

    - all payroll taxes;
    - R&D tax credits resulting from payments to approved research providers.

16. Based on analysis undertaken by Inland Revenue, broadening the definition from PAYE to include fringe benefit tax and withholding tax on schedular payments does not have a large impact (around 1.5 per cent increase). However, a recent legislative change allows firms and contractors to enter into voluntary schedular arrangements and deduct withholding tax. We would anticipate that firms who would otherwise be disadvantaged by the cap based on payroll taxes paid could use this provision.

17. Officials are investigating the impact of a payroll cap on firms. Officials will report to you on this, through its incorporation into the regulatory impact assessment (RIA).

18. The most consistently voiced theme during consultation is how crucial cash is to the survival of early stage R&D intensive firms. Therefore the recommended option will ensure refundability is available to most firms in a tax-loss position (either as a partial or full refund of tax credits). It will also be simple to administer.

19. It is a conservative approach with reduced benefits for some firms. On balance, we recommend this option because it manages the problems seen in other jurisdictions[5]. Officials consider this option to be a viable starting position for introduction of the legislation and we will continue to explore how other jurisdictions manage risks and enable refundability.

[4] For example, staff may choose to be contractors rather than employees to give them maximum flexibility over their working arrangements

[5] In the UK, HM Treasury and HMRC have released a consultation document 'Preventing abuse of the R&D tax relief for SMEs', April 2019, which proposes that a PAYE-related cap is reintroduced to the R&D tax credit scheme for SMEs. This policy has been driven by a concern over growing levels of fraud within the scheme since the removal of the PAYE cap.

There are other mechanisms in the Research, Science and Innovation portfolio that are currently under review that can be used to further support R&D intensive start-ups

20. In addition to the *Tax Incentive*, the Research, Science and Innovation portfolio has a suite of other interventions that can be used to support R&D intensive start-ups.

21. MBIE, in conjunction with Inland Revenue and Callaghan Innovation, is leading a programme of work to review interventions for R&D intensive start-ups in light of the shifting R&D funding environment. This includes: a review of Callaghan Innovation's R&D Project Grants; reviewing the R&D tax loss cash out scheme; and a commitment to a refreshed and more ambitious Technology Incubator Programme. MBIE is also leading work, through the New Zealand Venture Capital Fund, to deepen capital markets to support high-growth/scale-up firms involved in disruptive technology.

22. There is also a commitment for further policy work to be undertaken as part of the *Tax Incentive* to simplify administration processes for small to medium enterprises.

Removal of the $5 million cap

23. Our recommended option removes the previous proposed $5 million cap on refundability.

A small number of large established R&D performers will be constrained by a $5 million cap on refundability

24. Stakeholder engagement revealed that there were a small number of established R&D performers who would be constrained by the $5 million cap. For example a company[6] in a loss making position undertaking around $80 million of R&D annually, would be eligible for $12 million of R&D tax credits. Under the proposed cap the company would receive a $5 million refund on its R&D tax credits and would have to shift the remaining $7 million credits into future years. But because the company spends a large amount of R&D on an on-going basis they are unlikely to be able to cash out fully their accumulation of carry-forward R&D credits.

25. There are a number of established R&D performers who valued the security refundability would bring to their R&D programmes. These companies are mainly in a tax-paying situation but depending on market fluctuations they could be in a temporary loss-making position in future. Refundability would give these firms surety, allowing them to continue their R&D investment during market down-turns. Some of these established R&D performers would also be constrained by a $5 million cap.

Removing the $5 million cap will incentivise large established R&D performers to undertake more R&D and increase the attractiveness of the scheme off-shore

26. The removal of the $5 million cap reduces inequity for large established R&D performers. While the number of New Zealand firms who would be constrained by a $5 million cap is small their contribution to the innovation system is significant. In 2016, 26 per cent of all BERD was carried out by six firms that spent $25 million or more on R&D. Removing the $5 million cap will help incentivise these firms to undertake greater levels of R&D.

27. Removal of the cap may also help attract R&D performing multi-national corporations (MNCs) to New Zealand. New Zealand currently lacks the very large MNCs which tend to drive R&D expenditure in other countries. The removal of the $5 million cap, while retaining the cap based on payroll taxes, will ensure that MNCs are contributing to New Zealand's economy at a minimum through benefits such as providing employment opportunities in New Zealand.

28. The $120 million cap on R&D expenditure with discretion to exceed it through a pre-registration process would continue to apply to all R&D performers.

[6] Details withheld

29. Officials understand that Ministers might prefer the assurance that a maximum cap on refundability brings to the scheme in terms of fiscal budgeting and public perceptions. If Ministers choose to include a cap on refundability (additional to the cap based on payroll taxes), then we suggest it should be set at $5 million, on the basis that loss-making firms currently receive up to $5 million per year from Callaghan Innovation's R&D Growth Grants.

30. If Ministers prefer to include a cap on refundability then officials will provide further advice on threshold options to ensure firms are not disadvantaged.

Treatment of tax-exempt organisations

31. Our recommended option ensures that levy bodies, some of whom are tax exempt, are eligible for refundability but recommends that other tax exempt organisations are excluded from the R&D Tax Incentive.

Levy bodies were intended to be part of the scheme and will only benefit from refundability

32. Cabinet agreed to include levy bodies in the R&D Tax Incentive (DEV-18-MIN-0174).

33. Levy bodies are not by definition tax exempt organisations, but some may be tax exempt because of section CW 49 of the Income Tax Act 2007. Section CW 49 provides that the income of certain entities is exempt income, if the entities are established for the main purpose of promoting or encouraging research. It is proposed that tax exempt organisations, such as charities, be ineligible for the R&D Tax Incentive. However, a carve-in is proposed for entities that receive exempt income under CW 49, so that these entities are eligible for the R&D Tax Incentive. Entities who receive income under section CW 49 do not receive the same tax concessions as charities (such as donor tax credit status, GST and FBT concessions), and are specifically established for the main purpose of promoting or encouraging research. The amount of R&D tax credits refundable to these entities would still be subject to the proposed cap based on payroll taxes, unless the relevant entity is established by statute. As a result, levy bodies established by statute would have fully refundable R&D tax credits.

34. Engagement revealed that levy bodies undertake research projects independent of MBIE science investment funding. If levy bodies are eligible for refundable R&D tax credits, the amount they invest in independent research would likely increase.

Charities sit outside of the tax system and should be excluded from the tax incentive but a charity with a partially controlled business entity is eligible in order to address post-settlement governance entities

35. Some charities, particularly in the health sector, undertake R&D that would qualify under the R&D tax incentive. But the estimated amount of R&D conducted in the charitable sector appears to be small[7]. Charities also sit outside the tax system giving them preferential tax treatment over firms. On this basis we do not consider it appropriate to extend further benefits to charities through the tax system as would be the case if they were eligible for the R&D tax incentive.

36. There are a small number of post-settlement governance entities (e.g. Ngāi Tahu) that are registered as charities. To ensure they are not unduly penalised for a governance structure imposed on them we propose not including broader association rules in relationship to charities. This would mean that a charity could set up a partially controlled business entity, subject to the rules within the constitution of the charity, which would not have tax exempt status and therefore be eligible for the R&D Tax Incentive. We understand that post-settlement governance entities generally have more scope to set up partially controlled

[7] The 2018 R&D survey showed that $99 million of funds for internal R&D comes from 'other funding sources'. Specific questionnaire wording is 'Other funding sources (e.g. the Lotteries commission, cancer society and charities)'.

business entities than standard charities. We also understand it is reasonably difficult for a charity to change the rules of its constitution without putting its charitable status at risk.

Tax loss cash out

Policy issues around the 'tax loss cash out' scheme are complex and further policy work is required before reform is possible

37. Our previous advice noted our intention to review the R&D tax loss cash out scheme. During stakeholder engagement we explored the value of this scheme to firms and the potential interactions it has with refundability of the R&D tax credit.

38. This provided useful information but also confirmed the issues are relatively complex and require consideration of the scheme itself, its interaction with the R&D Tax Incentive, and how it fits with other government policies both in the tax system (for instance the loss continuity rules) and with regard to government support for R&D intensive start-ups and innovative firms.

39. Because of time pressures associated with developing the broader refundability policy so that it can be incorporated in legislation in 2019, we propose it is sensible to decouple changes to the R&D tax loss cash out and refundability. Officials will continue to work on possible reform of the R&D tax loss cash out and anticipate discussing options with Ministers later in 2019. This will mean that policy changes are not likely to be implemented until the 2021/22 income tax year[8].

Taxation (Research and Development Tax Credits) Bill supplementary order paper

40. We have identified we will need a supplementary order paper (SOP) for the *Taxation (Research and Development Tax Credits) Bill*.

41. The current Bill allows Inland Revenue to communicate information about tax credits to Callaghan Innovation. However, Inland Revenue's legal department has indicated this is insufficient for Callaghan Innovation's role as co-administrator of the tax incentive. The SOP will enable Inland Revenue to provide access to its systems so that Callaghan Innovation can function effectively as a co-administrator of the tax incentive.

42. The SOP will amend clause 37B of the Bill, which amends clause 39 of schedule 7 of the TAA[9] by adding a new 39(3). Subsection (3) provides for personnel from Callaghan Innovation to access the information necessary for administering the tax incentive.

43. The SOP also makes a small number of minor typographical corrections. **Annex Three** sets out the SOP for inclusion into legislation.

Remedial legislative issues

44. We have identified a small number of issues where the legislation in the reported back version of the Taxation (Research and Development Tax Credits) Bill does not fully achieve the policy intent. Issues identified relate to allocating R&D tax credits to members of joint ventures; the time available for businesses to complete the R&D tax credit claim disputes

[8] From the 2020/21 income year most applicants for the R&D Tax Incentive will go through an in-year approval, while the R&D loss tax cash out is an end-of-year process. For customers that are eligible for both schemes this may result in a suboptimal claim experience. Officials will seek to make service improvements, until policy changes can be made.
[9] Schedule 7 was inserted by the Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Act 2019 (ARMTARM Act). The version of the Tax Administration Act 1994 published on the New Zealand Legislation website does not yet include schedule 7 because the ARMTARM Act received royal assent on 18 March 2019.

process; and the R&D certifier regime. These issues will not have any practical impact until claims are submitted in respect of the 2019/20 income year. This means that they need to be corrected by 1 April 2020. Officials propose that rather than correcting these issues through a SOP, these issues would instead be corrected through remedial legislative changes included in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill.

Regulatory impact assessment

45. The regulatory impact assessment (RIA) is being reviewed by officials from the Ministry of Business, Innovation and Employment. Changes will be made to the RIA to incorporate feedback from this review process.

46. The assessment will be finalised in time for submission of the Cabinet paper to the Economic Development Committee on 16 May. The RIA will be provided to your office before the end of April.

Next Steps

47. We recommend you provide feedback to officials on the Cabinet paper by 15 April, or as soon thereafter as possible. We will incorporate your feedback and provide you with a revised draft Cabinet paper which you can use for consultation with your colleagues, coalition partner and confidence and supply partner. Officials will use the same draft Cabinet paper to undertake interdepartmental consultation.

48. In order to meet the legislative timetable, we recommend the Cabinet paper is lodged on 16 May 2019, for consideration at Cabinet Economic Development Committee on 22 May 2019.

49. Subject to Cabinet agreement, the expected introduction of refundability through the *Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill* will be June 2019. **Annex Three** sets out timings for refundability legislation.

Annexes

Annex One: Cabinet Paper, Refundability within the Research and Development Tax Incentive

Annex Two: List of organisations who took part in refundability consultation

Annex Three: Taxation (Research and Development Tax Credits) Bill supplementary order paper

Annex Four: Legislative timings for refundability

Annex One: Cabinet paper, Refundability within the Research and Development Tax Incentive

Annex Two: List of organisations who took part in refundability consultation

Accounting firms

1. EY
2. Deloitte
3. PwC
4. KPMG

Other organisations

1. Chartered Accountants Australia and New Zealand
2. Corporate Taxpayers' Group
3. Quadrent (Investment fund)
4. PM's Business Advisory Council (represented by Peter Beck)
5. Federation of Maori Authorities
6. NZ Tech

Businesses

1. Biotelliga
2. EcoPortal
3. SMX Email
4. COMPAC / TOMRA
5. Rakon
6. Vend NZ
7. New Zealand Steel
8. Avertana
9. CustomerEcho / Interacto
10. Beca
11. GPS-it
12. Core Builders Composites
13. Parkable
14. CS-VUE
15. Blerter
16. Volpara Health Technologies
17. Mt Kemble Ltd
18. Signal
19. Roger Ford (New Zealand Software Association)
20. Advanced Management Systems
21. The Property Crowd
22. Smart Parking Technology Limited
23. WSP
24. Air New Zealand
25. Xero
26. Fisher and Paykel Appliances
27. Fisher and Paykel Healthcare
28. Parininihi ki Waitotara

Levy bodies and charities

1. Malaghan Research Institute
2. Beef + Lamb
3. Horticulture New Zealand
4. New Zealand Cancer Society
5. Forest Growers Owners Association

Co-operatives

1. Fonterra
2. Zespri
3. LIC automation
4. Ballance Agri-Nutrients

Annex Three: Taxation (Research and Development Tax Credits) Bill supplementary order paper

Annex Four: Legislative timings for refundability

DEV covering report + Cab paper + RIS to Ministers	Thursday 11 April (draft), Thursday 2 May (final)
Drafting finalised	Monday 13 May
Bill to Justice for BORA VET	Thursday 16 May
Papers submitted to Cab office for DEV	Thursday 16 May
DEV	Wednesday 22 May
Cabinet approval of policy	Monday 27 May
Papers submitted to Cab office for LEG	Thursday 13 June
LEG	Tuesday 18 June
Cabinet approval of Leg	Monday 24 June
Caucus and support party approval	Tuesday 25 June
Introduction	From Wednesday 26 June
First reading and FEC referral	Tuesday 23 July

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Inland Revenue
Te Tari Taake

BRIEFING

R&D Tax Incentive: Ministerial meeting to discuss refundability

Date:	2 May 2019	**Priority:**	High
Security classification:	In Confidence	**Tracking number:**	3372 18-19 IR2019/233

Action sought		
	Action sought	**Deadline**
Hon Dr Megan Woods **Minister of Research, Science and Innovation**	**Provide** feedback to officials the draft Cabinet paper, *Extending Refundability for the Research and Development Tax Incentive*	6 May 2019
Hon Stuart Nash **Minister of Revenue**	**Provide** feedback to officials on the draft Cabinet paper, *Extending Refundability for the Research and Development Tax Incentive*	6 May 2019

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Kirsty Hutchison	Manager, Innovation Policy	04 901 4131	Privacy of natural persons	✓
Keith Taylor	Policy Manager, Inland Revenue	04 890 2808	Privacy of natural persons	

The following departments/agencies have been consulted
Callaghan Innovation

Minister's office to complete:

☐ Approved ☐ Declined
☐ Noted ☐ Needs change
☐ Seen ☐ Overtaken by Events
☐ See Minister's Notes ☐ Withdrawn

Comment

BRIEFING

R&D Tax Incentive: Ministerial meeting to discuss refundability

Date:	2 May 2019	**Priority:**	High
Security classification:	In Confidence	**Tracking number:**	3372 18-19 IR2019/233

Purpose

To provide you with additional information to support your discussions on the refundability proposal in the draft Cabinet paper: *Extending Refundability for the Research and Development Tax Incentive* (3068 18-19, IR2019/159 refers).

Recommended action

The Ministry of Business, Innovation and Employment (MBIE) and Inland Revenue recommend that you:

		Min. RS&I	Min. Revenue
a	**Note** that Ministers (Minister of Research, Science and Innovation and the Minister of Revenue) are meeting on Monday 6 May at 5.30pm to discuss the refundability proposal in the draft Cabinet paper, *Extending Refundability for the Research and Development Tax Incentive*	*Noted*	*Noted*
b	**Note** that subject to your agreement to a final draft of the cabinet paper, the paper will need to be lodged on 16 May 2019 for consideration at the Cabinet Economic Development Committee on 22 May	*Noted*	*Noted*

Privacy of natural persons

Kirsty Hutchison
Manager, Innovation Policy
Labour, Science and Enterprise, MBIE

02 / 05 / 19

Hon Dr Megan Woods
Minister of Research, Science and Innovation

..... / ..... / .....

Privacy of natural persons

Keith Taylor
Policy Manager
Inland Revenue

02 / 05 / 19

Hon Stuart Nash
Minister of Revenue

... / ..... / .....

Background

1. Ministry of Business, Innovation and Employment (MBIE) officials met with Minister Woods on Monday 29 April to discuss the draft Cabinet paper on the refundability proposal. Minister Woods suggested that she and her colleague Minister Nash meet to discuss the draft Cabinet paper, *Extending Refundability for the Research and Development Tax Incentive* (3068 18-19/IR2019/159 refers).

2. This brief provides you with additional information to support your discussions on the refundability proposal included in the draft Cabinet paper.

The Cabinet paper proposes broad-based refundability

3. The draft Cabinet paper, *Extending Refundability for the Research and Development Tax Incentive,* outlined a proposal for the design of the longer term refundability policy to replace the limited refundability that applies for year one of the R&D Tax Incentive (Tax Incentive) scheme.

4. The Tax Incentive has been designed to be a broad based scheme, providing easily accessible R&D support for eligible businesses regardless of their size, revenue or profit or loss position. The refundability proposal as recommended by officials is consistent with this overarching policy objective.

5. Officials have proposed that refundability is broadly available to all firms in loss whose R&D activities qualify for the Tax Incentive. We propose that Levy bodies are eligible for the Tax Incentive but that charities, local authorities and other tax-exempt organisations are ineligible.

6. We are also proposing a cap based on payroll taxes to constrain how much of the R&D tax credit can be refunded in any one year. This is to manage the risks that refundability poses to the integrity of the scheme. A cap based on payroll taxes ensures the amount a firm receives from refundability is not more than the amount the firm puts into the tax system. It is also simple to understand and easy to administer.

An alternative is to target refundability to SMEs, or to apply a cap

Targeting refundability to small-medium-enterprises (SMEs)

7. Our analysis shows that two-thirds of Growth Grant recipients are in loss. It also shows that 73 per cent of Growth Grant recipients are not SMEs (i.e. they have more than 20 full-time-equivalents (FTEs)). This analysis indicates that there would be a significant number of Growth Grant recipients who would not receive the benefit of refundability if it were targeted to SMEs only.

Limiting refundability by introducing a cap on the amount that can be refunded

8. If there was a less restrictive form of targeting, for example a cap on the amount of R&D tax credits that can be refunded then fewer firms would be impacted. Analysis shows there are between four to six New Zealand based R&D performers who are likely to be negatively impacted by a $5 million cap (i.e. they are in loss and also undertake more than $30 million worth of R&D activity per year).

9. If Ministers choose to limit refundability to a specific capped amount then officials consider that it would be necessary to provide further advice on threshold options or ways to treat atypical businesses such as cooperatives to ensure such firms are not disadvantaged. Additional policy options are likely to add further complexity to the scheme.

Examples of firms that would be impacted by targeted refundability

10. During our consultation on the Tax Incentive, and as part of stakeholder engagement on refundability, we have built up a picture of the type of R&D being conducted by large R&D performers in New Zealand. This information is commercially sensitive but has been given to us to help develop robust policy options. Examples of businesses that would be negatively impacted by targeting refundability to SMEs, or by limiting refundability with a cap (for example a $5 million cap):

- Commercial Information

- **Exporters.** New Zealand has a number of R&D performing firms that are exporters. These include large firms that can undertake significant amounts of R&D activity in any year. These firms may be profit making so not affected by refundability, but some could be in temporary loss-making positions because of international factors including transfer pricing rules applied in other jurisdictions as well as market and exchange rate fluctuations. Being eligible for refundability would support exporters to continue their R&D investment independent of external factors.

- Commercial Information

- **Multi-national-corporations (MNCs).** A cap on refundability could also weaken the attraction of the Tax Incentive for MNCs who might be considering relocating their R&D activities to New Zealand. If these firms did move their R&D operations to New Zealand, the payroll cap would incentivise economic activity such as investment and employment, even if other linkages or tax contributions to the New Zealand economy are not large.

Commercial Information

Additional analysis of the proposed payroll cap

11. Our recommended refundability policy option limits the amount of the R&D tax credit that is refundable to the amount of payroll taxes[2] paid in the same tax year. In our previous briefing we undertook to investigate the impact a payroll cap has on firms and report back on this (3068 18-19, IR2019/159 refers).

12. We investigated the impact a payroll cap will have on smaller firms, by assessing how it would affect current Callaghan Innovation Project Grant recipients. Project Grants are designed for businesses new to or trying to expand their R&D. Officials selected Project Grants recipients for our analysis because we are able to identify Project Grant recipients in the Inland Revenue system and they are a proxy for early stage R&D intensive firms. However, no adjustment has been made for Project Grant recipients who have an estimated level of eligible R&D below the $50,000 per year threshold.

13. There are 326 firms in the Project Grant sample, of these:

    - 20 per cent are in profit, so would receive the benefit of an R&D tax credit
    - The remaining 80 per cent did not report income or are in loss. Of this 80 per cent:
        - 43 per cent did not report income or are in loss, but pay sufficient payroll taxes to get all or most of their R&D tax credits refunded
        - 18 per cent did not report income or are in loss and only pay a small amount of payroll taxes so would need to carry forward a relatively large proportion of their R&D tax credits
        - 39 per cent did not report income or are in loss and do not pay any payroll taxes so would be unable to receive any refund of their R&D tax credit, and would carry forward all their R&D tax credits

14. However, there are significant caveats[3] around this analysis which means it should only be considered as indicative for early stage R&D intensive firms. Nonetheless, it indicates that a notable proportion of early stage R&D intensive firms may not receive a full refund of their R&D tax credits. This is consistent with feedback received from the stakeholder workshops.

15. The introduction of the Tax Incentive does not change firms' access to Project Grants. And some firms receiving Project Grants will also have additional R&D expenditure that qualifies for the Tax Incentive.

16. As noted previously the Tax Incentive is not the only tool to support start-ups. Officials are in the process of reviewing Project Grants and the R&D Tax Loss Cash Out policy to identify improvements to these instruments. Changes to the R&D Tax Loss Cash Out policy will unlikely to be in place when the revised refundability policy will commence in April 2020, but changes to Project Grants could be.

[2] Payroll taxes would include PAYE, fringe benefit tax, employer superannuation contribution tax and withholding tax on schedular payments. It is also proposed that eligible payments to Approved Research Providers would not be subject to the cap.

[3] The assessment of R&D expenditure could be an under estimate of the firm's eligible expenditure under the R&D Tax Incentive. We have not taken into account any behavioural changes, for instance firms and contractors entering into voluntary schedular arrangements to deduct withholding tax or firms being able to adjust the level of net income they report so that the tax credit offsets any tax liability. Some firms will be part of a corporate group so the amounts of payroll taxes paid may be greater than what we have assessed.

Feedback from agency consultation on local authorities' eligibility for the Tax Incentive

17. The draft Cabinet paper recommends that all local authorities, as well as entities controlled by or associated with local authorities, are not eligible for the Tax Incentive. In its feedback on the draft Cabinet paper, the Department of Internal Affairs suggested that the underlying rationale for excluding local authorities was sound, but pointed out that companies minority owned by councils operated in the commercial sphere and therefore could be considered for eligibility.

18. We think this is a sensible adjustment, as it would bring these minority-owned entities of councils onto the same footing as minority owned entities of Crown Research Institutes, District Health Boards and tertiary organisations.

Next Steps

19. We will incorporate your feedback and provide you with a revised draft Cabinet paper which you can use for consultation with other Ministers and their offices.

20. In order to meet the legislative timetable, we recommend the Cabinet paper is lodged on 16 May 2019, for consideration at Cabinet Economic Development Committee on 22 May 2019.

21. The regulatory impact statement is being assessed by the review panel. We expect to be able to provide this to your office next week.

22. The timetable for Cabinet and LEG approval on 24 June 2019 is dictated by other items that will be in the Tax Omnibus Bill.

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

AIDE MEMOIRE

Talking points for the DEV Cabinet paper: Extending Refundability for the R&D Tax Incentive

Date:	17 May 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3482 18-19

Information for Minister(s)
Hon Dr Megan Woods **Minister of Research, Science and Innovation**

Contact for telephone discussion (if required)

Name	Position	Telephone		1st contact
Kirsty Hutchison	Manager, Innovation Policy	04 901 4131	Privacy of natural persons	✓
Xavier Watts	Senior Policy Advisor, Innovation Policy	04 901 4173	Privacy of natural persons	

The following departments/agencies have been consulted
Inland Revenue

Minister's office to complete:

- ☐ Approved
- ☐ Noted
- ☐ Seen
- ☐ See Minister's Notes
- ☐ Declined
- ☐ Needs change
- ☐ Overtaken by Events
- ☐ Withdrawn

Comments

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

AIDE MEMOIRE

Talking points for the DEV Cabinet paper: Extending Refundability for the R&D Tax Incentive

Date:	17 May 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3482 18-19

Purpose

This aide memoire provides talking points for the Cabinet paper on *Extending Refundability for the Research and Development Tax Incentive*. The paper has been lodged for discussion at the Economic Development Committee (DEV) on Wednesday 22 May 2019

Kirsty Hutchinson
Manager, Innovation Policy
Labour, Science and Enterprise, MBIE

17 / 05 / 2019

Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive

1. The Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive has been lodged for discussion at the Economic Development Committee (DEV) on 22 May. The paper seeks DEV's agreement to the design of the refundability policy of the R&D Tax Incentive from year 2 of the scheme so that legislation can be drafted for introduction to Parliament in June 2019.

2. The paper reflects decisions made by you and the Minister of Revenue based on advice informed by stakeholder engagement, and further analysis by officials. The paper also incorporates feedback from other government departments, and lessons from other jurisdictions.

3. Talking points for the Cabinet paper are provided at Annex One. Possible questions and proposed answers are provided at Annex Two.

4. Subject to Cabinet approval, the next step will be to draft legislation. We plan to provide you and the Minister of Revenue with draft legislation by early June. This R&D legislation will be part of the next Tax Omnibus Bill.

Annexes

Annex One: Talking points on the Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive

Annex Two: Q&As

Annex One: Talking points on the Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive

Background

- The R&D Tax Incentive is now live. Legislation has been enacted.
- The current legislation only allows for limited refundability. The Government has committed to a more comprehensive policy on refundability from year 2 of the Incentive.
- The R&D Tax Incentive has been designed to be a broad based scheme, providing easily accessible R&D support for eligible businesses regardless of their size, revenue or profit or loss position.
- Delivering a broader refundability policy is important, or the Incentive will not be as effective as intended.

Refundability proposal

- The core proposal is that firms in loss can have all their tax credits refunded for expenditure with an Approved Research Provider, and all other tax credits can be refunded subject to a cap based on the amount of payroll taxes paid by a firm. Payroll taxes will primarily comprise PAYE (which includes withholding taxes on schedular payments to contractors), but will also include payments for Fringe Benefit Tax and Employer Superannuation Contribution Tax.
- All businesses will be eligible for refundability, consistent with eligibility for the Incentive. Levy bodies are included as the R&D they perform is fundamentally business R&D.
- Charities and other tax-exempt organisations will be excluded from the Tax Incentive. These organisations are outside the tax system so they should not benefit from incentives provided from within it. In particular, charities already receive several tax concessions so it is not appropriate to extend further benefits to them.
- Because these rules would not apply a broad association test, businesses that are partially owned by a charity, such as a post-settlement iwi organisation, would not be excluded.

Payroll cap

- A payroll cap will help ensure the integrity of the Incentive through reducing the risk of fraudulent claims which have been problematic (along with an associated fiscal risk) in other jurisdictions with refundable R&D tax credits.
- A payroll cap means firms do not get more from the tax system than they put in, which combats the use of shell companies.
- The UK had this policy in place for SMEs but removed it in 2011. The consequence was a sharp increase in the incidence of fraud. The UK Government has recently announced its intention to reinstate the policy.[1]

Next steps

- Subject to Cabinet approval to the proposed refundability design, legislation will be introduced to Parliament in June 2019.

[1] The UK Treasury and HMRC have released a consultation document “Preventing abuse of the R&D Tax Relief for SMEs’.

Annex Two: Q&As

Does the refundability proposal increase the fiscal cost of the Incentive?

- No. The Incentive's fiscal cost model assumes that firms in loss will claim the full tax credit. Treasury have confirmed that they are comfortable that allowing refundability as proposed will have no further impact on the appropriation.
- The 2018 R&D survey results show higher growth in R&D than previously forecast. However, the updated fiscal cost estimates still fall within the existing appropriation.

What impact will the payroll cap have on small companies?

- A small proportion of companies, most often smaller ones, quite legitimately pay little or no PAYE. They may employ staff on contract rather than as employees, or owners may take drawings rather than a salary. On the surface, these firms may receive little initial benefit from the proposed refundability policy.
- However, the impact on small companies should be manageable:
    - Some of the firms that do not pay PAYE appear to do limited amounts of R&D so would not meet the $50,000 threshold.
    - Where a firm's R&D is via a contract with an Approved Research Provider, all its tax credit will be refunded.
    - Because the cap is based on all payroll taxes, there will be scope for firms to enter into an agreement with contractors and deduct withholding tax. Such payments would increase the amount of tax credit that would be refunded.
    - There is, and will continue to be, other support that such firms could potentially access rather than the Tax Incentive. Possibilities include project grants, the R&D tax loss cash out, the Technology Incubator Programme, and the New Zealand Venture Capital Fund.
- Officials are continuing to investigate the impact this policy may have on smaller R&D intensive firms and will provide further advice prior to the policy being considered at Select Committee if it seems necessary.

Why are large companies eligible for refundability?

- Larger firms are less likely than smaller firms to be cash constrained so their need for refunds may be less. However, the following reasons support refunding the tax credit for all firms (subject to the payroll cap):
    - The policy provides for even handed treatment of firms in profit and loss, thereby incentivising all of them to undertake additional R&D.
    - Meeting the government's target of growing R&D to 2% of GDP requires growth in R&D from large as well as small firms.
    - Some larger firms that are major R&D performers are in a tax loss position. These firms would get no benefit from credits carried forward; the only way they will benefit from credits is if they are refunded.
    - In addition to performing R&D in New Zealand, these large companies would still have to be contributing to the New Zealand economy through payments to employees or contractors, as the payroll cap prevents them from taking more out of the New Zealand tax system than they put in.

- If the Committee is unwilling to support full refunds for large companies, officials would recommend a cap on the amount that is refunded rather than any targeting to SMEs.
- There is a default cap of $18 million (being 15% of the maximum eligible expenditure of $120m per year).
- We would suggest a cap should be at least $5 million if the Tax Incentive is to be perceived at least as favourably as the Growth Grant.

Why are tax exempt organisations not eligible for refundability?

- This position is based on these organisations being outside the tax system so they should not benefit from incentives provided from within it. In particular, charities already receive several tax concessions so it is not appropriate to extend further benefits to them.
- Because these rules would not apply a broad association test, businesses that are partially owned by a charity, such as a post-settlement iwi organisation, would not be excluded.

Are local authorities eligible for refundability?

- Local authorities would be ineligible for the R&D Tax Incentive. However, council controlled organisations would be eligible.

Why are levy bodies and payments to Approved Research Providers not subject to the cap?

- Payments to Approved Research Providers will be easy to verify, posing a lower fraud risk.
- Levy bodies are empowered to collect levies by statute, definitely have an economic presence in New Zealand, and consequently pose a reduced risk that refunded R&D tax credits will be unrecoverable.

What other forms of R&D support does the government provide?

- Over time we intend to have a full package of support for New Zealand's innovation system. The R&D Tax Incentive will be one support amongst many.
- Other forms of current government support for business R&D include: R&D Project and Student grants, advice, and support in kind; and a limited R&D tax loss cash out.
- Officials are reviewing the R&D tax loss cash out and project grants to ensure R&D intensive start-ups have adequate R&D support. There is a commitment to a refreshed and more ambitious Technology Incubator Programme. MBIE is also leading work, through the New Zealand Venture Capital Fund, to deepen capital markets to support high-growth/scale-up firms involved in disruptive technology.

How does the refundability proposal compare internationally?

- Most overseas R&D tax credit schemes with refundability have some constraints. A system with no restrictions on refundability would be an outlier amongst OECD countries.
- The different ways in which refundability is limited often reflect differences in the underlying tax incentive scheme. Some countries limit refundability to SMEs and start-ups.
- It is relatively common to limit refunds to the amount paid in other taxes such as PAYE. This ensures a firm has a tangible economic presence in the country where the claim is being made, the amount refunded is commensurate to activity in the jurisdiction and it reduces the risk that the claim is made by a non-existent entity.

What are stakeholders' views on the proposal?

- This proposal has been informed by input from a wide array of organisations.
- Many submissions on the Tax Incentive legislation were in favour of broader refundability.
- Further engagement undertaken specifically with smaller R&D performers indicated that a PAYE cap could restrict the tax credit refunds available to these firms. The proposed cap now brings in FBT and ESCT in addition to PAYE, as well as expenditure on Approved Research Providers.
- These changes to the cap will reduce its impact for some of these firms. In addition, the current ecosystem of support (which includes project grants and the R&D tax loss cash out) for these smaller R&D performers will continue.
- MBIE, Inland Revenue and Callaghan have discussed refundability proposals with the Corporate Taxpayers' Group; Chartered Accountants Australia and New Zealand; representatives from PwC, KPMG, Deloitte and EY; approximately 25 representatives from R&D performing businesses in tax loss or with insufficient taxable income to fully use non-refundable R&D tax credits; levy bodies; charities; and Māori business representatives.
- These discussions have helped shape the broader refundability proposals, and have highlighted the desirability of broad eligibility and an accessible process.

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Inland Revenue
Te Tari Taake

R&D Tax Incentive – refundability and small innovative firms

Date:	27 June 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3584 18-19 IR2019/303

Action sought

	Action sought	Deadline
Hon Dr Megan Woods **Minister of Research, Science and Innovation** Hon Stuart Nash **Minister of Revenue**	**Note** that most loss-making firms will benefit from the refundability proposal but the payroll cap will restrict access to refundable tax credits for some early stage firms with little or no PAYE. **Note** that MBIE will provide further advice on the funding landscape for small innovative firms	4 July 2019

Contact for telephone discussion (if required)

Name	Position	Telephone		1st contact
Kirsty Hutchison	Manager, Innovation Policy, MBIE	04 901 4131	Privacy of natural persons	✓
Xavier Watts	Senior Policy Advisor, Innovation Policy, MBIE	04 901 4173	Privacy of natural persons	
Keith Taylor	Policy Manager, IR	04 890 2808	Privacy of natural persons	
Richard Braae	Senior Policy Advisor, IR	04 890 3010	Privacy of natural persons	

The following departments/agencies have been consulted

Callaghan Innovation

Minister's office to complete:

☐ Approved ☐ Declined
☐ Noted ☐ Needs change
☐ Seen ☐ Overtaken by Events
☐ See Minister's Notes ☐ Withdrawn

Comment

BRIEFING

R&D Tax Incentive – refundability and small innovative firms

Date:	27 June 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3584 18-19 IR2019/303

Purpose

This briefing provides additional information about the impact on small early stage firms of limiting R&D tax credit refunds by the payroll tax cap. It also provides information on other R&D funding instruments that these types of firms can access.

Recommended action

The Ministry of Business, Innovation and Employment (MBIE) and Inland Revenue recommends that you:

		Min. RS&I	**Min. Rev**
a	**Note** that most loss-making firms will benefit from the refundability proposal but the payroll cap will restrict access to refundable tax credits for some early stage firms that have little or no PAYE.	*Noted*	*Noted*
b	**Note** that MBIE intends to review the funding landscape for small innovative firms and will report back with a proposed terms of reference.	*Noted*	*Noted*
c	**Agree** that MBIE can proactively release this briefing (with only information withheld to protect the privacy of natural persons) as part of the proactive release of the Cabinet paper *Extending Refundability for the Research and Development Tax Incentive*.	*Agree / Disagree*	*Agree / Disagree*

Privacy of natural persons

Kirsty Hutchison
Manager, Innovation Policy
Labour, Science and Enterprise, MBIE

27 / 06 / 19

Hon Dr Megan Woods
Minister of Research, Science and Innovation

..... / ..... / .....

Privacy of natural persons

Keith Taylor
Policy Manager
Inland Revenue Department

27 / 06 / 19

Hon Stuart Nash
Minister of Revenue

..... / ..... / .....

Background

1. Minister Woods and Minister Nash met on 6 May 2019 to discuss the draft Cabinet paper, *Extending Refundability for the Research and Development Incentive*. At the meeting officials undertook to:

    - Continue to refine our analysis of the impact a payroll cap will have on small innovative businesses, including through engagement with selected stakeholders who work with startups.

    - Provide you with information on other R&D funding support available for these firms.

The payroll cap addresses the risks that refundability creates for the integrity of the tax system

1. The objectives of the broader refundability proposal are to support as much genuine R&D as possible in a way that is simple to administer and that maintains the integrity of the tax system

2. The refundability proposal agreed by Cabinet is:

    - All firms are entitled to a refund of their R&D tax credits, to the extent their R&D tax credits are equal to or less than the amount of 'payroll' taxes paid by a firm in the relevant income year (payroll cap).

    - The payroll cap would not limit refundability of tax credits resulting from payments to approved research providers.

    - The proposed cap would not apply to R&D tax credits refunded to levy bodies.

3. The purpose of the payroll cap is to manage the risks that refundability poses to the integrity of the tax system, thereby supporting the sustainability of the R&D Tax Incentive scheme. The refundability proposal is both generous and broad-based (does not target firms of a particular size) in comparison to other jurisdictions.[1]

4. A payroll cap is simple to administer, ensures firms have tangible economic presence in New Zealand, and is used by some other jurisdictions[2] that provide refundable R&D tax credits. However, a payroll cap may limit refunds for businesses that have little or no PAYE.

Most loss-making firms that qualify for the Tax Incentive will benefit from refundability

5. Our previous analysis on the impact of the payroll cap on small innovative businesses (3372 18-19 IR2019/233 refers) was based on 326 firms in receipt of a Callaghan Innovation Project Grant. Project Grant recipients are a proxy for certain types of firms that are most at risk of not benefiting from the refundability policy (i.e. startups), and we were able to gauge the impact of the refundability policy by using Inland Revenue and Callaghan Innovation data.

[1] 33 out of 46 international schemes do not provide refundability provisions. 12 out of 28 OECD governments currently offer preferential tax treatment to SMEs or young firms.

[2] For example, the UK, Ireland, the Netherlands (2296 18-19; IR2019/005 refers).

6. The initial analysis indicated that 101 of these firms either did not report income, or were in loss and may not receive a refund of their R&D tax credits because they did not pay any payroll taxes. There were a number of significant caveats around the initial analysis, including that it did not take into account the $50,000 minimum expenditure threshold which would have excluded many of these firms from being eligible for the Tax Incentive.

7. We have subsequently updated our analysis using more robust R&D expenditure values[3] and filtering for firms that did not consistently meet the $50,000 R&D expenditure threshold during the project grant period.

8. The revised results indicate that the number of firms whose access to refunds is restricted by the payroll cap is smaller than initially identified.

9. The results show 21 firms with possibly no refund. However, taking into account entities with holding companies (which may give group access to payroll taxes) would leave 12 firms (4% of the sample) with possibly no refund. These firms could still potentially use Approved Research Providers or withholding taxes from voluntary schedular arrangements with contractors to access refundability. More detailed analysis is provided in Annex One.

Stakeholders had mixed views on the impact of the refundability proposal on startups

10. Building on our earlier engagement with stakeholders on the refundability policy, we met with selected stakeholders to test our understanding of the impact a payroll cap will have on small innovative businesses.

11. The discussions with tax advisors (EY, Deloitte, CAANZ, PwC, KPMG) suggest that early stage startups in the software or digital sectors in particular are unlikely to benefit from the refundability proposal due to their reliance on labour from founders or contractors, for which PAYE is not being withheld. To benefit, these firms would need to enter into voluntary withholding arrangements or engage the services of an Approved Research Provider (ARP).

12. Voluntary withholding arrangements are simple to enter into but have only been available from 2017 and have perceived compliance costs, e.g. contractors may have pre-existing arrangements. Some firms may benefit from the ARP expenditure exclusion from the cap, e.g. businesses engaged in scientific-oriented R&D that work with universities or crown research institutes. Firms in the software or digital sectors are less likely to use ARPs. We are unable to estimate the proportion of businesses that may benefit from expenditure with an ARP being excluded from the cap.

13. In contrast, our discussions with other organisations that work with startups on a day to day basis (Astrolab, Level Two and Dotterel) suggest that the refundability proposal will benefit young innovative firms. These organisations observed that contractors are often used for temporary or specialist projects, and that most startups, particularly those building a company around deep technology, need to build a dedicated team of employees.

14. We expect submissions to the Select Committee to reflect the views above. We will report back to Ministers following the submissions process on feedback received and our proposed response.

[3] This now includes additional R&D expenditure reported by firms to Callaghan Innovation. Not all firms choose to record additional data. Officials have used Project Grant R&D values in the absence of self-reported figures.

Stakeholders generally understood that the Tax Incentive is not the only instrument available to support startups

15. The Tax Incentive is the centrepiece of government support for business R&D. However, there are a range of other mechanisms currently available and targeted to small innovative businesses and startups which address the needs of firms that do not qualify for the Tax Incentive (because of the $50,000 threshold or the definition of R&D), or who may be deterred because of compliance costs relative to the benefit they will receive.

16. A brief overview of other funding sources currently available is provided in Annex Two. These measures provide support to early stage innovative businesses to invest in, commercialise and scale up their R&D and to build entrepreneurial capability.

17. For example, firms that just meet the $50,000 R&D expenditure threshold would receive tax credits worth $7,500 (at a 15% tax credit rate). Firms spending less than $50,000 on R&D, may be better off accessing the Getting Started Grant (up to $5,000), the Capability vouchers (up to $5,000) and Project Grants (40% of eligible expenditure). These grants provide a stepping stone to either larger Project Grants or the Tax Incentive.

18. If a firm in a tax loss position qualifies for the Tax Incentive but does not pay any payroll taxes (including at a group level) and does not have any eligible expenditure with an ARP or contractors who agree to voluntary withholding arrangements, then it will be better suited to accessing the other support mechanisms available

19. At the current time, firms that meet the criteria for the R&D Tax Loss Cash Out scheme (generally small R&D-intensive firms) can also receive cash for up to 28% of their tax losses from R&D expenditure, subject to a maximum of $476,000 in the 2019/20 tax year.[4]

We propose to undertake further work on the funding landscape for small innovative firms

20. As noted in some of our earlier briefings on the R&D Tax Incentive, the natural next step following the introduction of the Tax Incentive is to review the wider landscape of support for smaller innovative businesses, including startups. This review will complement the work underway on early stage capital markets (led by the Minister for Economic Development). A focus of this work will be how existing supports other than the R&D tax incentive can be shaped to ensure there is support for firms for whom the tax incentive may not be ideal. We will report back to you on the scope of this project and proposed terms of reference. Our intention is to have initial options explored prior to our response to submissions to Select Committee.

Proactive release

21. We propose to include this briefing (with only information withheld to protect the privacy of natural persons) in the proactive release of the Cabinet paper *Extending Refundability for the Research and Development Tax Incentive* which is currently in process.

Annexes

Annex One: Analysis on the impact of the payroll cap

Annex Two: Other sources of government funding for small innovative businesses

[4] It is proposed to review this scheme now that the R&D Tax Incentive is in place.

Annex One: Analysis on the impact of the payroll cap

1. The table below summarises the results of both our previous analysis and our updated analysis that filters for the impact of the $50,000 threshold and which also benefits from more robust R&D expenditure values.[5]

2. Based on the updated analysis, the number of firms that would not benefit from refundability due to the payroll cap is smaller than under the previous analysis.

Project Grant sample (326 firms)	Results from previous analysis	Results from updated analysis (filtered for firms that consistently meet the $50,000 threshold)
Did not report income or were in loss	260 firms	109 firms
Did not report income or were in loss and paid sufficient payroll taxes	112 firms	45 firms
Did not report income or were in loss and only paid a small amount of payroll taxes (limited refund)	47 firms	43 firms
Did not report income or were in loss and did not pay any payroll taxes (no refund)	101 firms	21 firms

3. Under the updated analysis 21 firms would potentially get no refund. These firms may receive a refund if they have access to withholding taxes through the use of contractors, use an Approved Research Provider, or have a holding company with the potential to pay payroll taxes at the group level.

4. Expenditure on contractors was not available for firms included in the above analysis. However, analysis of data from the R&D Tax Loss Credit scheme (which includes information on R&D contractor spend) shows that withholding taxes from voluntary schedular arrangements with contractors could significantly reduce the number of firms affected by the payroll cap.

5. 9 of the 21 firms have holding companies, so may be able to access payroll taxes at a group level. This would potentially leave 12 firms (4% of the sample) without any refund.

[5] This now includes R&D expenditure reported by firms. Not all firms choose to record this data. Officials have used Project Grant R&D values in the absence of self-reported figures.

Annex Two: Other sources of government funding for small innovative businesses

Measure	Description	Amount
R&D Getting Started Grants *Callaghan Innovation*	Getting Started Grants help a business initiate R&D activity. They can be used for basic prototyping, project planning, technical feasibility studies, developing an IP strategy and accessing technical support.	40% of eligible R&D project costs, up to $5000.
R&D Project Grants *Callaghan Innovation*	Project Grants are designed to help businesses growth their investment in R&D and build R&D expertise.	40% of eligible R&D project costs; reducing to 20% for eligible expenditure over $800,000 or when the business has had multiple grants.
NZTE Capability voucher scheme and Business mentors	Capability vouchers offset the costs of approved training to help grow a business. Business mentor service provides knowledge and skills and expert guidance for a low fee.	The grant covers up to 50% of the cost of training up to a maximum of $5000.
Technology Incubator programme	Technology incubators invest in and help commercialise complex technologies	Incubators have access to pre-incubation grants and repayable loans (up to $750,000) for eligible projects.
Founder incubators	Business support and networks	Incubators may invest in eligible businesses but the equity stake is typically small and not the primary means of funding a business.
Accelerators	Business acceleration programmes focused on rapid and intensive product development to establish an investment ready startup.	Provides access to funding networks and expertise.
R&D Tax Loss Cash Out scheme	Allows business losses from eligible expenditure associated with R&D to be cashed out instead of carried forward.	Up to 28% of a business's tax losses from R&D expenditure, subject to a maximum of $476,000 in the 2019/20 tax year.
Seed Co-investment fund	Equity investment fund aimed at high growth potential, small to medium sized businesses at start-up staged of development.	The fund can invest up to $1.5 million alongside accredited angel and seed co-investment partners.
New Zealand Venture Fund (NZVIF)	NZVIF invests in early stage capital market via a fund of funds approach in privately run venture capital funds	Around $300 million for investment in early stage capital markets.

6

[6] In addition Work and Income New Zealand provides a range of grants to help with the costs of starting a business and to pay for business skills training.