Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

Tax policy report: R&D Tax Incentive: Matters for consideration

Date:	24 November 2022	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2022/500

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to recommendations	5 December 2022
Minister of Revenue	**Agree** to recommendations	5 December 2022
Minister of Research, Science and Innovation	**Agree** to recommendations	5 December 2022

Contact for telephone discussion (if required)

Name	Position	Telephone
Chris Gillion	Policy Lead	s 9(2)(a) [redacted]
David Cuellar	Senior Policy Advisor	

24 November 2022

Minister of Finance
Minister of Revenue
Minister of Research, Science and Innovation

Executive summary

1. This report seeks joint decisions on three current tax matters in relation to the Research and Development Tax Incentive (RDTI). Those are:

    1.1 Not in scope

    1.2

    1.3 A technical amendment to the government grants exclusion due to the introduction of the New to R&D Grant.

Not in scope

Not in scope

Carve-out from government grants exclusion for the New to R&D Grant

12. R&D expenditure funded by government grants is generally excluded from being eligible for the RDTI as that expenditure does not require support provided by the RDTI to induce it.

13. The legislation provides for some carve-outs from this exclusion. For example, Callaghan Innovation Project Grants are carved out to the extent that R&D expenditure exceeds an amount contracted for under the Project Grant. This was intended to make any unexpected expenditure eligible for the RDTI given that amount is not supported by the Project Grant.

14. Project Grants have been phased out and the New to R&D Grant is being introduced in its place. The terms of the New to R&D Grant are similar to the Project Grant in that it provides for co-funding of up to 40% of the eligible R&D expenditure.

15. We recommend that a carve-out is made for the New to R&D Grant with respect to the RDTI government grants exclusion. This would be similar to the carve-out that was made for Project Grants. R&D expenditure by businesses that receive a New to R&D Grant would be carved out from the exclusion to the extent that their R&D expenditure exceeds the amount contracted for under the New to R&D Grant.

16. We estimate the fiscal impact of this amendment to be $75,000 per year. Baseline forecasts originally assumed R&D expenditure that was not eligible for other government grants would be eligible for the RDTI. Hence, agreeing to this amendment would have no fiscal impact, while not agreeing to this amendment would have a fiscal saving of $75,000 per year.

Recommended action

We recommend that you:

Not in scope

Not in scope

Carve-out from government grants exclusion for the New to R&D Grant

d) **agree** that the New to R&D Grant be carved out from the RDTI government grants exclusion to the extent that R&D expenditure exceeds the amount contracted for under the New to R&D Grant;

Agreed/Not agreed	Agreed/Not agreed	Agreed/Not agreed

e) **agree** to recommend the New to R&D Grant carve-out as a matter raised by officials in the officials' report to the Finance and Expenditure Committee on the Taxation (Annual Rates for 2022–23, Platform Economy, and Remedial Matters) Bill (No 2);

Agreed/Not agreed	Agreed/Not agreed	Agreed/Not agreed

f) **agree** that the New to R&D Grant carve-out applies for the 2022–23 and later income years;

Agreed/Not agreed	Agreed/Not agreed	Agreed/Not agreed

g) **note** that baseline forecasts assumed this category of R&D expenditure would be eligible for the RDTI, and a rough estimate of the impact of not agreeing to the New to R&D Grant carve-out is a fiscal saving of $75,000 per year.

Noted	Noted	Noted

s 9(2)(a)

Chris Gillion
Policy Lead
Policy and Regulatory Stewardship

Hon Grant Robertson	**Hon David Parker**	**Hon Dr Ayesha Verrall**
Minister of Finance	Minister of Revenue	Minister of Research, Science and Innovation
/ /2022	/ /2022	/ /2022

Introduction

17. The Research and Development Tax Incentive (RDTI) operates as a 15% tax credit for eligible R&D expenditure on eligible R&D activities. R&D tax credits are processed after the end of the income year.

18. This report seeks joint decisions on three current matters in relation to the RDTI.

19. Not in scope

20.

21. The third issue considers a technical amendment to the RDTI government grants exclusion due to the introduction of the New to R&D Grant. This is to ensure that amounts of R&D expenditure incurred by a business in excess of an amount the business has contracted for under the New to R&D Grant can still be eligible for the RDTI.

Not in scope

Not in scope

Not in scope

Not in scope

Carve-out from government grants exclusion for the New to R&D Grant

Background

48. The RDTI is available for eligible R&D expenditure on eligible R&D activities. Ineligible/excluded activities and expenditures are listed in the Income Tax Act 2007. One type of exclusion is expenditure or loss that is undertaken in conjunction with receipt of a government grant. Such expenditure is already being induced by a government grant and is occurring without RDTI support, so it is not necessary to allow R&D tax credits to encourage that expenditure.

49. The provision implementing this exclusion, however, unintentionally excludes from the RDTI some R&D expenditure that is not covered by those grants. As a result, that expenditure would not be eligible for either the government grant or the RDTI.

50. To correct this, the legislation provides some carve-outs to this exclusion. One example is Callaghan Innovation Project Grants, which are carved out from the exclusion to the extent that the business' R&D expenditure exceeds the amount contracted for under the Project Grant. This was intended to make any unexpected R&D expenditure eligible for the RDTI, given that amount is not supported by the Project Grant contract.

51. For example, a Project Grant contract for $500,000 would require the business to spend $300,000 and the grant would provide $200,000. If the project ended up costing $900,000, then the business will have spent an extra $400,000 to complete the project but that amount would not be covered by the Project Grant contract. However, the $400,000 would be ineligible for RDTI support due to the government grants exclusion. Carving out Project Grants from that exclusion to the extent that the overall expenditure ($900,000) exceeds the Project Grant contract amount

($500,000) ensures that the additional $400,000 of R&D expenditure can still be supported by the RDTI.

Carve-out from government grants exclusion for the New to R&D Grant

52. Project Grants have been phased out and New to R&D Grants have been introduced in their place. The New to R&D Grant encourages new businesses and businesses that are new to R&D to establish an R&D programme. They may then move onto the RDTI in the future.

53. The terms of the New to R&D Grant are similar to the Project Grant in that they provide for co-funding of 40% of the eligible R&D expenditure. The amount of government funding allocated to the grant is similar (approximately $22.5 million).

54. Unlike the Project Grant, which covered expenditure for particular R&D projects, the New to R&D Grant covers expenditure over two years up to a specified maximum amount. It Is also limited to businesses that have not performed a significant amount of R&D in the past and do not have R&D capabilities to begin with.

55. We have concluded that R&D expenditure incurred by a New to R&D Grant recipient beyond the maximum amount specified in a contract could be impacted by the government grants exclusion in a similar way that equivalent amounts under a Project Grant would have been if not for the carve-out. This means that some R&D expenditure that is not supported by the New to R&D Grant will be excluded from the RDTI.

56. We recommend that a carve-out to the RDTI government grants exclusion is made for the New to R&D Grant, similar to the carve-out that was made for Project Grants. R&D expenditure by businesses that receive a New to R&D Grant would be carved out from the exclusion to the extent that R&D expenditure exceeds the maximum amount covered in the New to R&D Grant contract.

57. This will ensure that R&D expenditure continues to be supported in cases where the business' R&D expenditure during the grant period exceeds the amount that is covered by the New to R&D Grant. This will make it easier for businesses to transition to the RDTI at the conclusion of their New to R&D Grant. The carve-out does not allow an amount of R&D expenditure to be subsidised by both the New to R&D Grant and the RDTI.

Fiscal implications

58. This carve-out is unlikely to have a significant impact on the cost of the RDTI because:

    58.1 Only a small number of New to R&D Grant recipients are likely to exceed the maximum amount of R&D expenditure permitted within the maximum two-year period allowed under a New to R&D Grant contract;

    58.2 To the extent that a recipient's R&D expenditure does exceed the maximum amount, the excess amount (that would be covered by the exclusion) is likely to be small; and

    58.3 The New to R&D Grant contract can be drafted to make clear that the grant only applies to R&D expenditure up to the maximum specified amount and does not apply to R&D expenditure incurred by the recipient in excess of that amount.

59. As the New to R&D Grant has not yet been introduced, there is no data we can use to accurately estimate the cost of this carve-out. Instead, we make the following assumptions using information currently available to provide a rough estimate:

59.1 To receive the maximum grant amount, a recipient would have to spend between $500,000 and $1,000,000[1] on R&D over the two-year period of the grant. Callaghan Innovation is currently expected to issue approximately 100 grants per year. We assume that only one (i.e., 1% of the total) will exceed the maximum grant amount in a given year.[2]

59.2 We assume that, on average, the one New to R&D Grant recipient per year whose R&D expenditure exceeds the maximum grant amount does so by $500,000.

60. Based on these assumptions, we estimate this amendment would impact $500,000 of R&D expenditure per year. With a tax credit rate of 15%, this corresponds to a fiscal impact of $75,000 per year.

61. It is important to note that baseline forecasts assumed that R&D expenditure that was not eligible for other government grants would be eligible for the RDTI (consistent with the original intent). This means that agreeing to this amendment would effectively have no fiscal impact, while not agreeing to this amendment would have a fiscal saving of $75,000 per year.

Consultation

62. MBIE, Callaghan Innovation, and the Treasury have been consulted on this report.

63. Not in scope

64.

65.

Next steps

66. Not in scope

[1] The Minister of Research, Science and Innovation has set the maximum grant amount at $400,000. This means that the maximum RDTI-eligible expenditure that could be covered is $1,000,000 (given a co-funding rate of 40%). However, up to half of the grant may be used to cover R&D setup costs that are not necessarily eligible for the RDTI.

[2] According to the 2021 R&D Survey results, 810 out of 2,346 R&D-performing businesses spent above $500,000 on R&D and 468 spent above $1,000,000 in the 2021 financial year. However, in almost all cases, these are well-established R&D-performing businesses. Due to the steep learning curve that the New to R&D Grant is specifically designed to alleviate, the probability of a business that qualifies for the New to R&D Grant reaching this threshold within its first two years of R&D activity is very low.

67. Not in scope

68. If you agree to the New to R&D Grant being carved out from the RDTI government grants exclusion, we will progress this amendment as a matter raised by officials in the officials' report to the Taxation (Annual Rates for 2022–23, Platform Economy, and Remedial Matters) Bill (No 2). The amendment would then apply for the 2022–23 and later income years.