

Regulatory Impact Statement: Research and Development Tax Incentive: Internal software

Decision sought	Cabinet Decision
Agency responsible	Inland Revenue
Proposing Ministers	<i>Minister of Finance</i> <i>Minister of Revenue</i> <i>Minister of Science, Innovation and Technology</i>
Date finalised	17 August 2026

The Research and Development Tax Incentive (RDTI) currently limits the amount a firm can claim in a single year for their internal software development expenditure. The proposal is to reduce the cap for non-administrative internal software development expenditure from \$25 million to \$3 million. This could improve the value for money and fiscal sustainability of the RDTI, while retaining some support for smaller internal software projects.

Summary: Problem definition and options

What is the policy problem?

Because of spillover benefits to other businesses and researchers, firms are unable to fully capture the benefits that their research and development (R&D) generates and may underinvest in R&D relative to the socially optimal level. The RDTI is a 15% tax credit to incentivise additional business R&D.

It can be difficult to determine if internal software spending qualifies for the RDTI. This leads to higher compliance and administrative costs, reclassification risks, and lower behavioural responsiveness compared to other forms of R&D. It increases the fiscal cost per dollar of additional R&D induced by the RDTI, compared with other types of R&D expenditure.

Current policy settings for non-administrative internal software

Internal software refers to software developed for use within a business, rather than software developed for sale or embedded in goods for sale (external software). Within internal software, the RDTI excludes software that is administrative in nature (for example, payroll, finance, or human resources systems), reflecting its close alignment with business-as-usual activity.

Non-administrative internal software remains eligible for RDTI support, subject to a \$25 million cap per business each year. The rationale for imposing a \$25 million cap on this kind

of internal software development is because it may have reduced spillover benefits when compared with external software development, as well as fiscal risk.¹

Internal software accounts for about 11% of total eligible RDTI expenditure. Around 14% of firms claiming the RDTI claim for some internal software development expenditure.

What is the policy objective?

The primary objective is to improve value for money of the RDTI. This includes minimising the fiscal cost per dollar to generate additional R&D expenditure and spillover benefits (such as new knowledge, technology and skills that benefit other businesses or the wider economy).

A secondary objective is to manage fiscal risk, particularly where additionality and eligibility are uncertain.

These objectives sit within the context of broader fiscal consolidation effort from the Government.

What policy options have been considered, including any alternatives to regulation?

Three options were assessed:

Option 1: Status quo. Retain existing settings for internal software expenditure. Firms can currently claim no credits for administrative internal software spending and a maximum of \$25 million for non-administrative internal software expenditure (equivalent to \$3.75 million of tax credits, per firm each year). This is the Ministry of Business, Innovation and Employment's (MBIE) preferred option.

Option 2: Reduce the cap to \$3 million on non-administrative internal software expenditure. The maximum tax credits that could be claimed on this expenditure would reduce to \$450,000 per business each year. This is Ministers' and the Treasury's preferred option.

Option 3: Exclude all internal software from eligibility. Remove eligibility for internal software development expenditure entirely. This is Inland Revenue's preferred option.

Options to further refine or redefine the boundary to better target software with higher spillovers were also considered but discounted. After reviewing other RDTI schemes, it was considered it would be difficult to develop completely new rules for software.

Non-regulatory options (such as enhanced guidance) were considered. However, the guidance was recently updated in 2025, and further guidance was considered unlikely to address the problem or achieve the policy objective of improving value for money.

What external consultation has been undertaken?

Insights from RDTI stakeholders were drawn from the independent five-year evaluation of the RDTI (completed in March 2025) and targeted consultation in late 2025 and June 2026 with the R&D Advisory Group,² professional services firms, and business representatives.

Stakeholders generally agreed that software is an area of ongoing contestability but most favoured relaxing rather than tightening eligibility.

In June 2026, the R&D Advisory Group met with officials to discuss the proposal to reduce the internal software cap to \$3 million announced at Budget 2026. Stakeholders raised concerns it was already difficult to determine if spending should be treated as internal or external

¹ Tax Information Bulletin, Vol 31, No 9, October 2019, p 28.

² A consultative committee, comprising officials and representatives from accounting firms and R&D businesses to function as a forum for identifying and resolving issues with the RDTI.

software. They considered a significant number of businesses and R&D spending could be adversely impacted with a \$3 million cap, so a higher cap should be considered.

Is the preferred option in the Cabinet paper the same as preferred option in the RIS?

Ministers' and the Treasury's preferred option is Option 2 (reduce the cap on non-administrative internal software expenditure to \$3 million). Inland Revenue's preferred option is Option 3 (exclude all internal software from RDTI eligibility) and MBIE prefers Option 1 (status quo).

Summary: Ministers' preferred option in the Cabinet paper

Costs

Description of costs and where they fall

Ministers' preferred Option 2 (reduce the cap to \$3 million) would reduce RDTI tax credits for firms spending more than \$3 million on internal software R&D. The most recent data from 2024 indicates 21 firms had software expenditure above \$3 million and 10 of these firms would have received around 50% fewer RDTI credits had a \$3 million cap been in place.

The lower cap would reduce the tax incentive for firms nearing or exceeding the \$3 million cap to conduct additional R&D if it is internal software spending. It may encourage inefficient decisions to defer further internal software projects, conduct activity offshore or spread spending over several years. For these firms there will also be increased pressure when determining the boundary between internal and external software development leading to potentially higher compliance costs or risk of disputes.

There may be some reduction in R&D activity and associated spillover benefits, although the size of this impact is indirect, uncertain and unable to be quantified.

Benefits

Description of benefits and where they fall

The main monetised benefit is the \$99 million reduction in fiscal cost over the forecast period to 2029/30. The option also reduces fiscal exposure to very large internal software claims, improving the sustainability of the RDTI within a constrained fiscal environment.

There are likely to be small reductions in compliance costs for some firms and administrative costs for Inland Revenue if fewer large and complex claims are submitted.

Balance of benefits and costs

Does the RIS indicate that the benefits of the Minister's preferred option are likely to outweigh the costs?

On balance, the RIS indicates that the benefits of the Minister's preferred option are likely to outweigh the costs. While it would reduce RDTI support for a small number of firms exceeding \$3 million of internal software expenditure, most firms that claim the RDTI would not be adversely impacted.

To the extent that the \$3 million cap reduces R&D spending on internal software this may generate fewer spillover benefits, but these benefits are indirect, uncertain and unable to be quantified. Inland Revenue considers they are likely to be outweighed by the Government's

alternative uses of the estimated \$99 million of fiscal savings or the deadweight cost on the economy of collecting \$99 million using taxes.

Implementation

How will the proposal be implemented, who will implement it, and what are the risks?

The proposal would be implemented through legislative amendment, applying prospectively from the 2027–28 income year. Inland Revenue would update guidance and administer the change using existing systems.

Implementation risks are low. Key risks relate to stakeholder understanding and transitional impacts for affected firms, which can be mitigated through clear communication and lead-in time.

Limitations and constraints on analysis

The analysis was constrained by Budget timeframes and processes, which restricted the ability to consider broader policy options (such as options to develop new software definitions or support software R&D outside of the RDTI) and the consultation on the potential impacts.

There is uncertainty about the amounts that firms will spend on internal software R&D in future years and therefore the estimated impacts of the options. We have used the latest available 2024 data and projected this by the forecast growth rate of general RDTI spending to estimate potential future impacts. This modelling assumes the 2024 data is accurate and indicative of future year spending and internal software spending grows at the same rate as overall RDTI spending. One stakeholder noted that the current data reported to Inland Revenue may understate internal software spending due to classification issues, tax return limitations, group aggregation rules, and reporting lags, but we are unable to estimate how significant this may be.

Despite these constraints, we consider there is sufficient information for Ministers to make an informed decision.

I have read the Regulatory Impact Statement, and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits, and impact of the preferred option.

s 9(2)(a)

Responsible Manager signature:

Claire McLellan
Acting Policy Lead
Inland Revenue
17 August 2026

Quality Assurance Statement

Reviewing Agency: Inland Revenue

QA rating: Meets

Panel Comment: An Inland Revenue quality assurance panel has reviewed the Regulatory Impact Statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS meets the quality assurance criteria to make informed decisions on the proposals in the paper.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

Research and Development Tax Incentive

1. The Research and Development Tax Incentive (RDTI) is the New Zealand's primary mechanism for supporting business investment in research and development (R&D). Introduced in 2019, the RDTI provides a 15% tax credit for eligible expenditure on eligible R&D activities, with the objective of increasing the level of R&D undertaken in New Zealand. The credit can be used to reduce a business's income tax liability, and, for loss-making firms, a portion of the credit can be refunded in cash.
2. The RDTI is designed to increase business R&D spending that involves scientific or technological uncertainty and that is expected to generate wider economic benefits.
3. In the context of R&D support, wider economic benefits refer to the knowledge, skills, or technologies generated through R&D that can be taken up by other firms or diffused through the economy (spillovers). Because firms cannot fully capture these benefits, they tend to underinvest in R&D relative to the socially optimal level, providing a rationale for government intervention.

Commissioning

4. As part of the Government's Going for Growth programme of work, Ministers asked MBIE and Inland Revenue to explore options to improve the RDTI. The objectives of the review were to improve value for money, reduce the compliance burden for businesses, and improve access for small business. Ministers requested that any package of options should generate savings or be fiscally neutral, in line with broader fiscal consolidation objectives.
5. Officials identified internal software as an activity supported by the RDTI that may have lower value for money than other activities.

Software and RDTI

6. During the design of the RDTI, software development was identified as an area presenting higher integrity and value-for-money risks. Experience in other jurisdictions suggested that internal software development can present material fiscal risks because it can be difficult to distinguish valid R&D from routine systems development (which does not meet the scientific or technological uncertainty requirement). In addition, internal software development can involve limited spillovers (the benefits are mostly captured by the firm using their own software) or may be systems investment that firms would undertake regardless of the RDTI (so providing a subsidy may not lead to additional R&D).
7. The scheme therefore distinguishes between three categories of software activity, each with different eligibility settings:
 - a. External software is software developed for sale to external customers (including licensing the software) or incorporated into goods that are sold. Expenditure on this software is generally treated in the same way as other eligible R&D expenditure.
 - b. Administrative internal software is software developed to support internal administrative functions, such as payroll, finance, or human resources. Expenditure on this category is excluded from the RDTI.

- c. Non-administrative internal software is software developed for non-administrative purposes, including software that supports or enhances other types of services provided to customers. Expenditure in this category is eligible for the RDTI, but subject to a cap of \$25 million per business per year. The rationale for imposing a \$25 million cap on this kind of internal software development is because it may have reduced spillover benefits when compared with external software development, as well as fiscal risk.³

Distributional information

- 8. Non-administrative internal software accounts for about 11% of total RDTI expenditure. Around 14% of firms claiming the RDTI claim for this type of expenditure. Further information about firms reporting internal software expenditure is contained in Annex 1. There is uncertainty about whether the data currently collected on internal software spending is accurate. One stakeholder noted that the current data reported to Inland Revenue may understate internal software spending due to classification issues, tax return limitations, group aggregation rules, and reporting lags, but we are unable to estimate how significant this may be.

Guidance and administration

- 9. Inland Revenue has published guidance to assist businesses in determining whether software development is internal and administrative (and therefore excluded), internal and non-administrative (and therefore subject to the cap) or external (uncapped). This guidance was updated in late 2025 to improve clarity based on operational experience.⁴
- 10. The guidance sets out two broad indicators of administrative activity. First, an activity is more likely to be administrative when it is relatively uniform across businesses of a similar size, regardless of industry. Second, an activity is more likely to be administrative when it has no direct connection to the goods or services provided to customers. For example, software developed to allow customers to track courier deliveries in real time is more likely to be non-administrative, whereas software developed to support internal logistics or driver management is more likely to be administrative.
- 11. The policy to exclude administrative internal software development has put significant pressure on the administrative/non-administrative boundary. For example, should software that supports quality assurance of some product be considered administrative because all businesses have systems in place to limit mistakes, or is it non-administrative because customers ultimately receive a better-quality product? This is an inherently difficult boundary for a scheme that is intended to provide a reasonable degree of certainty.

What is the problem?

- 12. While this guidance has improved clarity at the margins, determining if internal software development is eligible for the RDTI can be difficult in practice. It may be ineligible because it does not have a material purpose of resolving scientific or technological uncertainty or because it represents administrative internal software. Both businesses and Inland Revenue staff report ongoing challenges in interpreting and applying the current rules particularly for complex, integrated, or evolving software projects.
- 13. The eligibility issues for internal software give rise to three related problems that increase the fiscal cost per dollar of additional R&D.

³ Tax Information Bulletin, Vol 31, No 9, October 2019, p 28.

⁴ [ir1240.pdf](#) pp 85–88.

Problem 1: High administration and compliance costs

14. Administrative and compliance costs are high. Firms incur substantial costs in documenting, substantiating, and defending claims, often requiring specialist advisory support. Administrators incur correspondingly high costs associated with review, audit, and dispute resolution. Administrators estimate that claims involving internal software development take two to three times longer to resolve than other claims and take up a disproportionate amount of RDTI technical specialist time (estimated at 40% of Inland Revenue RDTI specialist time, when internal software comprises 9% to 13% of all eligible RDTI spending).⁵
15. These resource costs increase the economic and fiscal cost of accessing the incentive without increasing the amount of additional R&D undertaken.

Problem 2: Recharacterisation risk

16. Compared to other types of spending there is a greater risk that internal software development does not represent additional R&D. Internal software development often occurs alongside routine systems investment that firms would undertake regardless of the RDTI, particularly in sectors with large, ongoing digital transformation programmes.
17. When eligibility is difficult to verify, some expenditure near the boundary cannot be reliably screened out at reasonable cost. As a result, the RDTI is likely to be received for some internal software activity that is not intended to be supported. Similar challenges have been observed in other jurisdictions with R&D tax incentives.⁶

Problem 3: Uncertain eligibility

18. Ambiguity around eligibility, combined with high compliance burden and audit risk, reduces certainty about whether support will ultimately be received. We expect that firms may be discounting the value of the incentive when making investment decisions involving internal software, particularly for marginal projects. This weakens the effectiveness of the incentive in encouraging additional R&D spending.

Why intervention is required

19. Taken together, these issues suggest that compared to other types of R&D spending, providing RDTI support for internal software development is likely to be less cost-effective at achieving the policy goals of incentivising additional R&D and generating spillover benefits.
20. Even where individual claims meet eligibility criteria, the combination of high compliance costs, integrity risks, and reduced behavioural responsiveness implies a high fiscal cost per dollar of additional R&D, compared with other eligible R&D expenditure.

⁵ On average, approval of R&D involving internal software activities typically takes two to three times longer for MBIE to reach an assessment outcome compared to a typical application, which takes about 20 days to process. At the supplementary return stage, we estimate that 40% of Inland Revenue RDTI technical specialist time is spent on cases involving internal software. Claims involving internal software development also take significantly longer to resolve than other claims. The average number of working days to conclude a case involving internal software is 304 days (including assessors' and applicants' time). Other claims are concluded much earlier (RDTI supplementary returns are generally processed in less than 50 business days).

⁶ For example, the Australian Taxation Office put out the following tax alert relating to software expenditure being claimed under their RDTI [TA 2017/5 | Legal database](#)

Other support for software R&D

21. The Government has other support in place for R&D in the software sector. In particular, the Research and Development Loss Tax Credit (RDLTC) allows loss-making, R&D-intensive firms to cash out the tax value of R&D losses, improving cash flow in the early stages of development. The RDLTC uses the broader accounting definition of R&D in NZ IAS 38, which is more readily applicable to a wide range of software development activities. In addition, firms may access targeted, contestable innovation grants administered through MBIE that support early-stage R&D capability and project development.
22. For game development businesses, the Government provides a game development rebate, which gives a 20% refund on approved expenses capped at \$3 million per year, with a minimum annual expenditure of \$250,000 on eligible costs.

What objectives are sought in relation to the policy problem?

23. The primary objective is to improve the value for money of the RDTI. This includes minimising the fiscal cost per dollar to generate additional R&D expenditure and spillover benefits (such as new knowledge, technology and skills that benefit other businesses or the wider economy).
24. A secondary objective is to reduce complexity and integrity risks, particularly because it can be difficult to determine if an internal software activity qualifies for the RDTI. It can be unclear if it resolves the scientific or technological uncertainty required to claim the RDTI and leads to higher compliance costs, administrative costs, and reclassification risks.
25. These objectives sit within the Government's broader fiscal consolidation objectives.

What consultation has been undertaken?

Five-year evaluation

26. The first five-year evaluation of the RDTI (the evaluation) was completed in March 2025 by Motu Economic and Public Policy Research, in collaboration with the University of Otago.
27. The evaluation finds that the RDTI adopts a deliberately restrictive approach to the eligibility of software R&D (internal and external), reflecting its reliance on the OECD Frascati definition of R&D and a strong emphasis on demonstrating scientific or technological uncertainty. While this approach aligns with international norms and was intended to target support toward high-value R&D, the evaluation concludes that these criteria are particularly difficult to apply in the context of software, where innovation is often incremental, iterative, and integrative rather than characterised by discrete breakthroughs. The report identifies the technological uncertainty test as especially problematic for software activities, contributing to ambiguity for both firms and administrators.
28. The evaluation suggests that these settings have reduced eligibility for software-intensive firms relative to the previous Growth Grant regime. It noted that this shift required the introduction of Transitional Support Payments to manage the transition for firms whose software expenditure was previously supported but became ineligible under the RDTI. The evaluation interviewed a range of administrative staff, taxpayers and advisory firms and there was a consensus that internal software projects are among the most complex and resource intensive to assess, leading to longer processing times, higher compliance costs, and conservative claiming behaviour by firms.

29. The evaluation explicitly identifies the treatment of software R&D as a key policy setting warranting reconsideration, including whether the current rules are well-suited to the nature of software innovation and whether alternative approaches or complementary support mechanisms could better achieve the scheme's objectives.

Targeted consultation

30. MBIE and Inland Revenue undertook targeted consultation in late 2025 to get general feedback on the RDTI scheme from the R&D Advisory Group,⁷ professional services firms, and business representative groups. There was general agreement among those consulted that software is an area of ongoing contestability within the RDTI. However, most thought the software development settings should be relaxed rather than restricted further.
31. Members of the R&D Advisory Group and one professional services firm challenged the assumption that internal software in general delivered lower economic benefits for New Zealand. They commented that the requirement for the R&D to directly enhance services to customers (as emphasised in legislation and guidance) overlooked the economic benefits of R&D that occurs further upstream from the customer interface.
32. Another professional services firm considered the \$25 million cap could be limiting the software development occurring in New Zealand, and that there is a risk some companies will look offshore to carry out further R&D once the cap is met. They proposed raising the cap as a way of supporting New Zealand in remaining competitive in software development.
33. A third professional services firm suggested Inland Revenue revisit the policy setting relating to internal software as a matter of priority to provide greater clarity for firms. They suggested that more restrictive criteria may be preferable to the status quo if the new criteria provided more certainty and reduced processing caused delays.
34. Another stakeholder mentioned that internal software development is often excluded from eligibility despite its relevance to third-party services. It also raised the difficulty in applying the RDTI application criteria to software. The RDTI has "core" R&D activities" and "supporting" R&D activities. It is difficult to apply the core and supporting boundaries to software development because real-world processes are not linear.
35. In June 2026, the R&D Advisory Group met with officials to discuss the proposal to reduce the internal software cap to \$3 million announced at Budget 2026. Stakeholders raised concerns it was already difficult to determine if spending should be treated as internal or external software. A much lower cap will make the distinction between internal and external software important for more firms when determining eligible spending.
36. The group considered developments in how software is used makes the distinction between internal and external software less clear or relevant from both a policy and practical perspective. It noted that a lower cap would exacerbate existing concerns with the definition of internal software development and the scope of this definition should influence the level at which the cap should be set.
37. Some stakeholders consider a significant number of businesses and R&D spending could be impacted with a \$3 million cap. They believe Inland Revenue's current data may understate the potential number of businesses and amount of R&D spending affected by

⁷ A consultative committee, comprising officials and representatives from accounting firms and R&D businesses to function as a forum for identifying and resolving issues with the RDTI.

a \$3 million cap, due to classification issues,⁸ tax return limitations, group aggregation rules, and reporting lags. They suggested policymakers consider setting the cap at a higher amount to reduce the impacts on R&D businesses (while achieving a similar level of fiscal cost savings).

Feedback from passage of RDTI Bill in 2019

38. The Taxation (Research and Development Tax Credits) Bill (as introduced in 2019) proposed a cap on non-administrative internal software development expenditure of \$3 million. As far as we can tell, the \$3 million cap was largely rolled over from the design of the previous 2007 RDTI scheme. This amount was originally proposed as a cap because it was considered that it would allow manufacturing firms to claim credits for all R&D of factory automation software and at the same time be substantively less than the total (and potentially re-classifiable) software budgets of large firms where fiscal risk was considered more material.
39. Submitters to the Finance and Expenditure Committee argued that the proposed \$3 million cap on internal software expenditure was too low and would exclude a substantial amount of genuine R&D, particularly for larger and digitally intensive firms. A common concern was that the distinction between non-administrative internal and external software development was unclear and could produce arbitrary outcomes because customer facing software may not be sold separately, may later be commercialised, or may shift between internal and external use over time. Submitters noted that internal software development can still generate economic benefits through improved productivity, competitiveness, and profitability, even where the software is not sold.
40. Submitters also argued that the cap risked biasing the incentive against certain types of software-enabled innovation and against firms whose R&D is embedded in internal systems rather than stand-alone products. Submitters proposed lifting the cap, exempting certain customer facing non-administrative internal software from the cap, allowing firms to apply to exceed it, or committing to regular review to ensure the cap remained appropriate as experience with the scheme developed. In response to some of these concerns, the cap was lifted to \$25 million.

Section 2: Assessing options to address the policy problem

What criteria will be used to compare options to the status quo?

41. The criteria that will be used to compare options are:
 - Economic benefit (spillovers and additionality): The extent to which each option is likely to support R&D activity that generates additional investment and wider economic spillovers. It considers whether the expenditure supported under each option is likely to influence firm behaviour, rather than subsidise activity that would have occurred regardless of the RDTI, and the extent to which benefits extend beyond the firm undertaking the R&D.
 - Scheme integrity: How well each option targets support toward the types of R&D the RDTI is intended to encourage. It considers the clarity and enforceability of eligibility boundaries, the risk of recharacterisation or boundary-pushing behaviour, and

⁸ They considered firms may not understand the internal software definition and report on it correctly when they are far below the current \$25 million cap because more accurate reporting would not impact their overall tax position.

whether the option strengthens confidence that the credit is supporting genuinely eligible, higher-value R&D activity.

- Fiscal cost (including administrative costs): The cost to the Crown, including both the direct fiscal cost of RDTI credits paid and the administrative costs incurred by Inland Revenue in assessing and administering claims.
 - Compliance costs for taxpayers: The costs imposed on businesses in complying with the RDTI, including the need for specialist tax or technical advice, the time and resources required to prepare and support claims, and delays in receiving credits.
 - Policy stability for investment certainty: The extent to which each option provides a stable and predictable policy environment that supports long-term R&D investment decisions. It considers whether changes to settings are likely to improve or undermine firms' confidence in the RDTI, including the extent to which uncertainty over eligibility or frequent policy change could weaken the incentive effect by causing firms to discount the expected value of support.
42. In assessing the options, the primary weighting is placed on economic benefit, fiscal cost, and scheme integrity, reflecting the overarching objective of improving the value for money of public investment through the RDTI. Options that involve higher fiscal cost or weaker targeting relative to the economic benefits generated are assessed as less likely to meet this objective.
43. Policy stability and investment certainty are given relatively less weight in this assessment. Ministers have asked officials to identify changes to the scheme to improve value for money and fiscal sustainability, which necessarily involves some degree of policy change.

What scope will options be considered within?

44. One non-regulatory option considered was publishing further guidance for businesses and advisory firms to clarify eligibility for non-administrative internal software development expenditure. However, given the inherent complexity of distinguishing between different types of software development, especially as each software project can have specific factual differences, further guidance is unlikely to materially improve certainty, reduce disputes, or shorten assessment timeframes. The existing guidance was also recently updated in 2025.
45. Budget timeframes and processes restricted the ability to evaluate some broader policy options, that would require further consultation to develop. These options include developing new software definitions or designing grants that could potentially be used to support software R&D outside of the RDTI.
46. Options to further refine or redefine the boundary to better target software with higher spillovers were considered but not progressed. After reviewing other RDTI schemes, Inland Revenue officials concluded that developing completely new rules for software would be difficult. Given constant evolution of software products and their delivery (the increasing dominance of software as a service platforms for example), it is inherently hard to:
- a. define the boundaries between different categories of software (internal/administrative/external); or
 - b. develop new rules that reduce the uncertainty involved in assessing whether a specific software development project is eligible R&D spending.

47. Because of the complexity involved in developing new definitions for eligible software development expenditure, external consultation would be required to develop the definitions and assess their potential impacts.
48. Officials also provided advice to Ministers on alternative ways to reduce the cost of the RDTI to support their fiscal objectives. Reducing the RDTI credit rate and excluding overseas expenditure were both ruled out by Ministers. These options would not address the issues with internal software development.

What options are being considered?

Option 1: Status quo

49. Under this option, the current RDTI settings for internal software would be retained. Non-administrative internal software development would remain eligible for the RDTI, subject to the existing \$25 million annual expenditure cap per business, while administrative internal software development would continue to be excluded.

Option 2: Reduce the cap on non-administrative internal software expenditure to \$3 million

50. Under this option, non-administrative internal software development expenditure would remain eligible for the RDTI, but the annual expenditure cap would be reduced from \$25 million to \$3 million per business.
51. The cap amount of \$3 million was originally proposed when the RDTI was introduced to parliament in 2019. While a higher or lower cap is possible, \$3 million is considered to strike an appropriate balance between generating savings, reducing fiscal risk, and minimising the impact on firms (particularly smaller businesses). Applying a 15% credit rate to this expenditure reduces the maximum tax credit claimed on this expenditure from \$3.75 million to \$450,000 per business.
52. This option would continue to provide some support for non-administrative internal software development, particularly for firms with relatively modest levels of expenditure. There is some evidence that smaller firms are more responsive to subsidies, so this option could target the RDTI towards parts of the economy where economic benefits per dollar of fiscal cost are greater.
53. Applying a \$3 million cap would improve value for money by significantly reducing the fiscal cost of the RDTI support for non-administrative internal software development. Inland Revenue estimates it could reduce fiscal cost by \$99 million over the forecast period to 2029/30, relative to the status quo. The option also reduces fiscal exposure to very large internal software claims, improving the sustainability of the RDTI within a constrained fiscal environment.
54. This option is expected to mainly impact a small number of firms that spend above \$3 million on eligible internal software expenditure.⁹ These firms would receive \$450,000 of RDTI for their eligible internal software spending and would not be incentivised to increase their spending on internal software for that year. Firms that claim either zero or less than \$3 million of eligible internal software expenditure are expected to receive the same amount of RDTI support under this option as the status quo.

⁹ Since the introduction of the RDTI, 351 unique firms have claimed some internal software development expenditure. Of these, only 37 firms have ever claimed more than \$3 million in a single year. In the most recent year of available data (2024), 135 firms claimed some internal software development expenditure, with 21 firms exceeding the \$3 million threshold.

55. Firms nearing or exceeding the new \$3 million cap would have a reduced incentive to conduct additional R&D if it is internal software spending. This may encourage inefficient decisions such as spreading spending over several years to maximise their ability to claim RDTI or selling or licensing software products to other businesses rather than using their own internal software to deliver other types of services. It could also make it relatively more attractive to conduct additional internal software R&D offshore, particularly if the internal software spending would be eligible for tax credits in another country.
56. More generally, reducing the cap represents a significant policy change that would reduce policy stability and investment certainty for businesses that claim the RDTI.
57. A lower cap would not materially reduce administrative costs or delays because administrators would still need to assess eligibility and resolve disputes at the administrative versus non-administrative boundary. For firms nearing or exceeding the \$3 million cap there will also be increased pressure on determining the boundary between internal and external software development, leading to potentially higher compliance costs in substantiating a claim, administrative costs or risk of disputes in this area.

Option 3: Exclude all internal software from RDTI eligibility

58. Under this option, all internal software development would be excluded from RDTI eligibility, regardless of whether it is administrative or non-administrative in nature.
59. This option would directly address the value-for-money concerns identified with internal software expenditure by removing support for a category of R&D that is likely to have a higher fiscal cost per dollar to generate additional R&D expenditure.
60. This option would generate the largest fiscal savings relative to the status quo (estimated at \$183 million over the forecast period to 2029/30 and \$62 million per year in subsequent years), reflecting the removal of support for all internal software expenditure entirely.
61. However, this option would also reduce the scope of the RDTI (by removing support for about 11% of total eligible spending) and could reduce economic benefits to the extent that this results in less additional business R&D and spillover benefits. It would result in the biggest reduction in policy stability and investment certainty. It involves a large policy change and would affect a larger number of businesses than Option 2 who would no longer receive any tax credits for internal software expenditure.
62. Excluding internal software expenditure would be expected to significantly reduce assessment complexity and delays because internal software expenditure is one of the most frequently disputed expenditure categories. This would improve administrative efficiency and provide greater certainty to firms regarding eligibility.
63. On the other hand, it could also significantly increase pressure at the boundary between internal and external software development because external software would remain eligible while all internal software would become ineligible. This risk is heightened because whether software development is internal or external depends on whether the dominant purpose was to sell or license the software to external customers. It could lead to inefficient decisions by encouraging R&D businesses to sell or license software products to other businesses rather than using their own internal software to deliver other types of services. Officials would need to monitor this boundary and advise whether further changes were required.

How do the options compare to the status quo/counterfactual?

	Option 1 – <i>Status quo</i>	Option 2 – Reduce cap on non-administrative internal software expenditure to \$3 million	Option 3 – Exclude all internal software from RDTI eligibility
Economic benefit (spillovers and additionality)	0	-	--
Scheme integrity	0	+	++
Fiscal cost (including administrative costs)	0	+	++
Compliance costs for R&D firms and advisors	0	0 (for firms spending well below \$3 million on internal software) - (for firms near or above \$3 million)	-
Policy stability for investment certainty	0	-	-
Overall assessment¹⁰	0	+	+

- ++ much better than the status quo
- + better than the status quo
- 0 about the same as the status quo
- worse than the status quo
- much worse than the status quo

¹⁰ As explained in the criteria section, higher weight is placed on economic benefit, scheme integrity and fiscal cost. Lower weight is placed on policy stability for investment certainty.

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

- 64. On balance, Inland Revenue considers Option 3 (exclude all internal software from RDTI eligibility) is most likely to best address the policy problem and deliver the highest net benefits.
- 65. Option 3 most directly improves value for money, which is the primary policy objective. It removes RDTI eligibility for an expenditure category that compared to other types of R&D expenditure, Inland Revenue officials consider is less likely to generate additional R&D and spillover benefits, is associated with higher risks of recharacterisation, and has high administrative and compliance costs. Inland Revenue considers government grants could be a more cost-effective option for encouraging software R&D, but this option is outside the scope of the current RIS.
- 66. Option 2 (reduce the cap on non-administrative internal software expenditure to \$3 million) would limit fiscal exposure while retaining some support for internal software R&D. However, businesses and Inland Revenue would still be required to assess eligibility and resolve boundary disputes for internal software claims, meaning that the compliance and administrative costs contributing to the problem would largely persist.
- 67. Option 1 (status quo) preserves policy stability and avoids disruption to firms currently claiming internal software spending. However, compared to the other options it does not improve value for money.

MBIE's alternative view

- 68. MBIE recommends maintaining current policy settings (Option 1). While recognising the objectives underpinning the proposed changes, any reduction in support would involve trade-offs with impacts on the economic benefits generated through the scheme, and the stability and predictability of policy settings for firms making long-term R&D investment decisions.
- 69. MBIE notes that any exclusion or reduction to the cap may reduce support for a category of R&D that is becoming increasingly important in a digitally enabled and AI-driven economy. Software-related R&D is also among the more globally mobile forms of R&D activity. There is a possibility that reduced support could influence decisions about where some higher-value R&D activities and the associated jobs are located, though the size of this impact is difficult to quantify. More broadly, consistency and predictability are important features of effective innovation policy. Although the number of businesses directly affected is expected to be relatively small, significant changes to the treatment of a major category of R&D expenditure may contribute to perceptions of greater policy uncertainty and could influence business confidence in the long-term settings of the RDTI.
- 70. MBIE suggests that the administrative and compliance concerns raised could alternatively be addressed through guidance and targeted amendments to the legislative treatment of software. The difficulty in applying the current legislation has been raised by Inland Revenue and business feedback, and there is a risk that reducing the cap on internal non-administrative software could further increase pressure on businesses and Inland Revenue to assess the boundary between eligible and ineligible expenditure because a greater number of businesses will have software expenditure levels around the cap and would have stronger incentives to characterise software expenditure as external.
- 71. If Ministers place significant weight on fiscal savings, MBIE considers Option 2 preferable to Option 3. While both options would reduce support for software-related R&D, Option 2

would be more closely aligned with the policy intent of the RDTI and would retain a greater level of support for R&D activity while still contributing to the desired fiscal outcome.

Treasury's alternative view

72. The Treasury recommends Option 2 because it would improve value for money of the RDTI while most firms who claim the RDTI would not be adversely impacted by a \$3 million internal software cap.

Is Ministers' preferred option in the Cabinet paper the same as the agency's preferred option in the RIS?

73. Ministers' and the Treasury's preferred option is Option 2 (reduce the cap on non-administrative internal software expenditure to \$3 million). Inland Revenue's preferred option is Option 3 (exclude all internal software from RDTI eligibility) and MBIE prefers Option 1 (status quo).

What are the marginal costs and benefits of the preferred option in the Cabinet paper?

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of preferred option compared to taking no action			
R&D performing firms	Reduced RDTI tax credits: A \$3m cap could materially reduce RDTI tax credits for some firms. The most recent data from 2024 indicates 21 firms had software expenditure above \$3m and 10 of these would have received around 50% fewer RDTI credits had a \$3m cap been in place.	\$99m over forecast period to 2029/30, \$34m per year in subsequent years	Medium Uncertainty about amounts firms will spend on internal software R&D in future years.¹¹
	For firms nearing or exceeding the \$3m cap, reduced incentive to conduct additional R&D if it is internal software spending. May encourage inefficient decisions to defer further internal software projects, conduct activity offshore or spread spending over several years. Increased pressure on determining boundary between internal and external software development. Potentially higher compliance costs or risk of disputes.	Medium	Medium
Administering agencies	Increased pressure on determining boundary between internal and external software development. Potentially higher administration costs or risk of disputes.	Low	Low

¹¹ We have used the latest available 2024 data and projected this by the forecast growth rate of general RDTI spending to estimate potential future impacts. This assumes the 2024 data is accurate and indicative of future year spending and that internal software spending grows at the same rate as overall RDTI spending.

Others (other firms and researchers)	To the extent a \$3m cap reduces R&D spending on internal software this may generate fewer spillover benefits (ie, new knowledge, technology and skills that benefit other firms and researchers).	Low	Low
Total monetised costs		\$99m over forecast period to 2029/30, \$34m per year in subsequent years	
Non-monetised costs		Medium	
Additional benefits of preferred option compared to taking no action			
R&D performing firms	Small reduction in compliance costs for firms exceeding new \$3m cap as to extent their internal software spending exceeds the new cap, they will not need to consider if it is administrative software, claim tax credits or provide supporting evidence.	Low	Low
Administering agencies	Potential reduction in administrative costs for Inland Revenue and MBIE as for firms exceeding the cap, less internal software development expenditure will need to be approved. There may be fewer large and complex claims submitted.	Low	Medium
Wider Government	Fiscal savings from a forecast reduction in tax credits. Reduces fiscal exposure to very large internal software claims, improving the sustainability of the RDTI within a constrained fiscal environment.	\$99m over forecast period to 2029/30, \$34m per year in subsequent years	Medium
Total monetised benefits		\$99m over forecast period to 2029/30, \$34m per year in subsequent years	
Non-monetised benefits		Low	

74. Capping non-administrative internal software development expenditure at \$3 million per firm may reduce additional R&D spending and the spillover benefits generated by the RDTI. This may in turn reduce economic benefits, such as increased productivity and higher wages. However, the economic benefits are indirect, uncertain and are unable to be quantified.
75. Inland Revenue considers they are likely to be outweighed by the Government's alternative uses of the estimated \$99 million of fiscal savings or the deadweight cost on the economy of collecting \$99 million using taxes.

Section 3: Delivering an option

How will the proposal be implemented?

76. Legislation will need to be passed to give effect to the proposed changes. It is intended that these changes apply from the 2027–28 tax year. The legislative changes would be included in the 2026–27 Annual Rates Bill currently scheduled to be introduced in September 2026.
77. Implementation risks are considered low because there is already an existing cap and only a small number of businesses are expected to exceed the new \$3 million cap.
78. The proposed \$3 million internal software cap was announced on 28 May 2026 as part of Budget 2026, which allows affected businesses time to consider how the change may affect their internal software plans for future years.
79. Updates will be made to existing guidance material on the RDTI to aid businesses in their planning. The changes will also be communicated to affected businesses and tax advisors through webinars and other Inland Revenue channels explaining the package of proposed RDTI changes.

How will the proposal be monitored, evaluated, and reviewed?

80. Monitoring will focus on trends in internal software claims, including the number of firms nearing or exceeding the \$3 million cap, the total amount of internal software expenditure and any impact it may have on overall business R&D.
81. Officials will meet and seek feedback from the R&D Advisory Group on the impacts of the change and any practical or policy issues it creates including unintended consequences. Officials also regularly meet and discuss RDTI issues with a broad range of other stakeholders. Officials will advise Ministers of significant risks or issues if they arise. Some of these issues could be addressed by further guidance, process improvements or remedial amendments to the legislation, if warranted.
82. In addition, the RDTI legislation requires the Government to commission an evaluation of the regime every five years from the commencement of the scheme. The software changes would fall within the scope of the next evaluation scheduled for 2030.

Annex 1 – Further information on firms reporting internal software expenditure

Non-administrative internal software development expenditure has ranged from 9% to 13% of total eligible RDTI expenditure, year on year.

Table 1: Non-administrative internal software development expenditure and total expenditure 2020 to 2024 (provisional data for 2024)

Year	Non-administrative internal software expenditure	Total eligible expenditure	Non-administrative internal software as % of total eligible expenditure
2020	89,510,692	704,794,319	13%
2021	92,322,732	796,420,802	12%
2022	175,654,894	1,662,385,353	11%
2023	191,982,022	2,123,055,394	9%
2024	288,850,304	2,334,676,481	12%

Between 2020 and 2024, 351 firms have reported some non-administrative internal software development expenditure, with only 37 of these ever claiming more than \$3 million of this type of expenditure in a year. In the most recent year of available data (2024), 135 firms claimed RDTI for internal software expenditure and 21 firms exceeded \$3 million.

Firms that report internal software expenditure tend to concentrate their claims in this category. For more than half of these firms, internal software makes up over 90% of their eligible RDTI expenditure.

Most firms claiming internal software have less than \$1 million of expenditure, while a small number of firms claim expenditure amounts above \$10 million. A \$3 million cap could materially reduce RDTI tax credits for some firms. In 2024, 10 of the 21 firms with software expenditure above \$3 million would have received around 50% fewer RDTI credits had a \$3 million cap been in place.

Table 2: Firms reporting non-administrative internal software expenditure by expenditure bands (provisional data for 2024)

Non-administrative internal software expenditure	Number of firms
\$3 million +	21
\$300,000 – \$2.99 million	61
\$1 to \$300,000	53

Firms claiming some internal software expenditure span a range of industries. Over a third of firms are in the scientific, technical and specialist services (103 firms) industry category. These are primarily software-intensive professional and technical services firms. Firms with the largest amounts of eligible internal software expenditure (over \$3 million) provide financial services (10 firms) or utilities (6 firms).