MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Dr Megan Woods	**Portfolio**	Research, Science and Innovation
Title of Cabinet paper	Providing Transitional Support to R&D Performing Businesses	**Date to be published**	25 May 2021

List of documents that have been proactively released		
Date	**Title**	**Author**
7 April 2021	Providing Transitional Support to R&D Performing Businesses	Office of the Minister of Research, Science and Innovation
7 April 2021	Providing Transitional Support to R&D Performing Businesses – Minute of Decision	Cabinet Office

Information redacted **YES / <u>NO</u>**

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In Confidence

Office of the Minister of Research, Science and Innovation

Cabinet Economic Development Committee

Providing Transitional Support to R&D Performing Businesses

Proposal

1 This paper seeks agreement to a transitional support mechanism to assist businesses transitioning from the Growth Grant programme to the Research and Development Tax Incentive (RDTI).

Relation to government priorities

2 The Government has announced a goal of increasing New Zealand's R&D expenditure to 2 per cent of GDP by 2027. The RDTI is the primary government initiative to achieve this target. This paper proposes a mechanism to provide additional support to businesses transitioning to the RDTI to maintain business certainty and levels of R&D expenditure through the transition.

Executive Summary

3 The RDTI is a broad-based mechanism to support and incentivise R&D across the economy. It is the Government's flagship initiative for achieving our goal of increasing New Zealand's R&D expenditure to 2 per cent of GDP by 2027. The RDTI came into effect in April 2019.

4 Implementation in most areas has been proceeding well, but there are indications that the take-up of the RDTI is lower than expected and that some businesses are finding aspects of the scheme challenging. I have received feedback that a number of Growth Grant recipients (the previous R&D support programme, now replaced with the RDTI) are having issues meeting the definition of eligible R&D activity under the RDTI. This is creating uncertainty about whether they will be able to receive the same level of support under the RDTI, creating a risk that businesses will reduce their R&D expenditure or move their R&D overseas. Recipients of the Growth Grant were given a two-year extension to ease the transition to the RDTI. The extension ended on 31 March 2021.

5 Work has recently been completed to clarify the eligibility criteria, but embedding these changes and evaluating their effectiveness will take some time and require ongoing refinement. While this occurs, I seek Cabinet's agreement to offer additional support to former Growth Grant businesses.

6 This support will take the form of an adjustment to a business's RDTI entitlement that will bring them up to the level they were receiving under the Growth Grant. It will

help to maintain business certainty and R&D expenditure. This support mechanism will be fiscally neutral because the budget for the RDTI was set on the assumption that businesses would claim the same amount of R&D expenditure under the RDTI as they reported under the Growth Grant.

7 In order to implement this support mechanism, I seek agreement Cabinet's agreement to:

7.1 create a new appropriation, and the transfer of funds from the existing RDTI appropriation, to fund the adjustments

7.2 make operational and policy design changes as needed, in consultation with the Minister of Revenue and in line with the objectives of the policy

7.3 carry out minor legislative amendments in the next tax omnibus bill.

8 I plan to announce the support as soon as possible to give businesses certainty around budgeting and planning for the 2021/22 financial year.

Background

The R&D Tax Incentive will help achieve the Government's goal of 2 per cent R&D expenditure by 2027

9 The Government has announced the ambitious 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 businesses. Business R&D creates new knowledge that enables businesses to produce new and improved products and services, and is a key driver of innovation that benefits the economy and society.

10 The Research and Development Tax Incentive (RDTI) came into effect in April 2019 and is a broad-based mechanism to support and incentivise R&D across the economy. Successful implementation of the RDTI is essential to establish a world-class, accessible and efficient scheme that will achieve the Government's objectives.

11 The RDTI is intended to replace the Growth Grants scheme. To ease the transition between these two schemes, existing Growth Grants recipients were granted an additional two years to transition to the RDTI (financial years 2019/20 and 2020/21). This was meant to provide sufficient time for government agencies to fully implement the scheme and for Growth Grant recipients to understand its implications for their R&D support. All remaining Growth Grant contracts ended in March 2021.

While implementation of the RDTI has been progressing well, some businesses are finding the transition challenging

12 The implementation of the RDTI scheme has largely progressed as intended since it came into effect in 2019. Comprehensive guidelines have been developed and there has been good engagement with stakeholders through the policy, legislation and implementation processes.

13 However, there are indications that the take-up of the RDTI is lower than expected and that some businesses are finding aspects of the scheme challenging. I have received feedback that a number of Growth Grant recipients are having issues meeting the definition of eligible R&D activity under the RDTI. This is creating uncertainty about whether they will be able to receive the same level of support under the RDTI and may raise compliance costs. This feedback was also reflected in an early implementation review conducted by PwC and commissioned by MBIE last year.

14 The RDTI and Growth Grant schemes use different definitions of R&D. This was a deliberate policy choice to target support towards activities that provide the Government with the greatest return on investment. It was expected that the profile of government support for R&D activity would change between the two regimes and some businesses would receive increased support, but others would receive less or be ineligible for the RDTI. However, it was anticipated that most Growth Grant recipients would generally be eligible for some level of support from the RDTI.

15 At the present point in the income-tax cycle, officials do not yet have a full view of the difference between the support available to businesses under the Growth Grants and the RDTI. This will vary between businesses, but feedback so far indicates a bigger gap than initially anticipated. It is possible that this may negatively impact business expenditure on R&D, compounding the effects of COVID-19 and a challenging economic climate, as some businesses cut back on their R&D activities due to financial constraints or move their R&D overseas.

Analysis

Agencies have been working to ensure implementation is aligned with the policy intent.

16 I have directed officials to undertake work to resolve the issues surrounding the transition. Since then, officials have worked to calibrate the R&D eligibility criteria so that it is consistent with the policy intent for the RDTI. This will be reflected in refreshed, detailed guidance which will be published imminently. This guidance is intended to clarify eligible R&D activity which will help businesses understand how the criteria apply to their situation.

17 Notwithstanding this progress, we do not yet know if the work on clarifying the eligibility criteria will have the desired effect of aligning with the original policy intent. Officials will monitor business response to the new calibration to assess its effectiveness. This type of continuous improvement and refinement of criteria to better reflect policy intent is an expected part of implementing any new initiative.

Additional support for Growth Grant businesses is needed as new guidance is embedded

18 As businesses are now beginning to make decisions about their R&D programmes for the coming financial year, I consider that providing greater certainty to businesses through additional, assured support is warranted. Certainty around government R&D support will give businesses confidence to continue to invest in R&D and contribute towards achieving the 2 per cent R&D goal.

19 Accordingly, I propose providing temporary, additional support to ensure these businesses maintain their expenditure on their R&D programmes during this period.

20 Other R&D-performing businesses who are not Growth Grant recipients are also likely to face challenges due to COVID-19. The Government has implemented a number of support mechanisms for these businesses, both through generic support mechanisms such as the wage subsidy and targeted R&D support through the R&D loan scheme.

Policy objectives and options

21 I consider the following policy objectives key to ensuring an effective support mechanism without compromising the successful implementation of the RDTI:

21.1 Maintaining business investment in R&D by providing continuity of the level of government support, while the outstanding issues in the implementation the RDTI are resolved.

21.2 Maintaining business engagement with the RDTI as the primary form of business R&D support.

21.3 Minimising disruption to the implementation of the RDTI and incentivise businesses to take up the RDTI as soon as it is feasible.

22 Against these policy objectives I have considered the following options:

22.1 Create a transitional support mechanism for ex-Growth Grant recipients within the RDTI. This option would use the RDTI as to deliver funding support. The support would take the form of a one-off adjustment to a business's entitlement under the RDTI, up to the amount they would have expected to receive under the Growth Grant scheme.

22.2 Extend the Growth Grant for another year: this option retains Growth Grant settings as a mechanism for providing support.

22.3 Provide an alternative temporary support mechanism, e.g., a temporary concessionary loan scheme.

23 I seek Cabinet's agreement to the first option, an adjustment to a business's RDTI entitlement, as it best achieves all three objectives of maintaining support for business R&D, maintaining business engagement with the RDTI, and minimising disruption to its implementation. It is important to note that the number of businesses needing the support may be low, to the extent that the recalibrated R&D eligibility criteria aligns with the policy intent. It is important that the RDTI implementation proceed on the existing timetable to embed the new scheme and allow agencies to focus on its administration. Extending the Growth Grant scheme for another year would slow the transition to the new scheme and, in particular, mean businesses would delay engaging with the RDTI.

24 It was always understood the end of the Growth Grant scheme would disappoint some businesses that would have received more support under that scheme; however,

continuing with the existing transition timetable will help us move businesses past this pain point more quickly than options that extend the transition period or create an entirely new support scheme for R&D.

Key design features of an adjustment

Eligibility and Duration

25 The adjustment would only be available only to existing Growth Grant recipients and those who exited the Growth Grant scheme during the two-year transition period (i.e., on or after 31 March 2019). The inclusion of businesses that have already exited the Growth Grant scheme is intended to capture those who exited the scheme early to take part in the RDTI pilot.

26 To be eligible for the adjustment a business must complete a RDTI application. It is possible that a small number of former Growth Grant businesses will have no eligible expenditure under the RDTI and therefore cannot participate in the RDTI. In this case the adjustment would be for the full amount under the Growth Grant and would not be offset by any RDTI entitlement. These businesses would still be required to apply for the RDTI to ensure continued engagement with the RDTI and increase familiarity with its requirements for future years.

27 The business must continue to perform R&D. A light-touch method would be used to determine that the business has undertaken R&D (against the Growth Grant definition). This process will be designed to minimise additional administrative costs for businesses applying for the adjustment and the Government in implementing the adjustment.

28 The adjustment would be available to businesses for expenditure in the current 2021/22 financial year. I propose that the adjustment also be made available for the 2019/20 and 2020/21 years to avoid disadvantaging those businesses who left the Growth Grant scheme early during the transition to the RDTI. The cohort of businesses claiming adjustments for previous years is likely to be small (approximately 40 businesses).

29 At this stage I do not plan to extend the adjustment beyond the 2021/22 financial year. This should provide sufficient time to ensure that the RDTI is operating as intended. The short timeframe will help signal the temporary nature of the scheme and better incentivise business engagement with the RDTI.

Timing

30 A business will submit an application for the adjustment at the same time it files its RDTI claim. Most businesses have until 31 March 2023 to file their tax return for the 2021/22 year, and 30 April 2023 for their RDTI supplementary return. As it usually takes around 10 weeks to process a supplementary return, most adjustment applications may not be received and paid out until July 2023. However, businesses can choose to submit their returns earlier if they wish. If a business wished to take advantage of the tax credit and the adjustment sooner, it could submit their return as soon as they wish after the end of the 2021/22 year (i.e., 31 March 2022).

31 A business will receive its adjustment as soon as practicable after it receives a decision on its RDTI claim. Inland Revenue will need to confirm the businesses gross RDTI entitlement to inform the adjustment calculation.

Determining the size of an adjustment

32 The size of the adjustment is intended to approximate what a business would have received if the Growth Grant scheme had continued, offset by their actual entitlement under the RDTI.

33 The maximum that a business is entitled to under the adjustment will be the lower of:

33.1 the average of its Growth Grant payments in the last 3 years before it entered the RDTI; and

33.2 the amount it would have been entitled to in the current year under the Growth Grant scheme.

34 I consider that this formula best balances the policy objectives of maintaining support for business R&D while encouraging business to engage with the RDTI as the primary form of business support. Using an average of the past years (rather than what the business received in the last year or it would have received in the year if the Growth Grant scheme had continued) will maintain a stable level of funding for businesses that have been engaged in R&D – and relying on the Growth Grant – for a long time, while giving businesses that do not have a history on the Growth Grant an incentive to take advantage of the RDTI sooner.

35 The second leg of the formula – reducing the adjustment if a business's current R&D expenditure has fallen below the average of its last 3 years – will avoid creating a windfall for a business that has not maintained its level of R&D. This will protect against the allegation that the adjustment provides an unfair benefit to ex-Growth Grant recipients.

Assurance process

36 To incentivise businesses to engage in the RDTI and continue their investment in R&D, it is important that the assurance burden and cost for businesses to receive the adjustment are low. I propose a light touch, high trust approach to assurance. This could include, for example, asking company directors to provide an attestation that they are performing eligible R&D and establishing a risk-based audit programme for recipients of the adjustment.

Implementation

37 I consider that Callaghan Innovation is best placed to administer the adjustment. Callaghan Innovation has existing systems and expertise to administer similar funding mechanisms. They also have existing relationships with these businesses. However, there is risk that this may create some confusion for businesses or a perception that it is a continuation of the Growth Grant scheme. This risk can be mitigated through clear communications and engagement with these businesses.

Financial Implications

38 Introducing the additional R&D support mechanism would be fiscally neutral. This is because the forecast for the RDTI was set on the assumption that businesses would claim the same amount of R&D expenditure under the RDTI as they were reporting while they were under the Growth Grant regime. Therefore, the funding delivered to businesses with this mechanism will be no more – and potentially less – than we had budgeted to deliver if all businesses were claiming their full entitlement under the RDTI.

39 The current RDTI appropriation is a Benefit and Related Expense appropriation. However, as this appropriation is not a pure forecast appropriation, based on how the forecasts are set, officials have recommended this be changed to a Non-Departmental Other Expense appropriation.

40 As the support provided under the proposed mechanism will ensure that businesses receive support for all of their R&D expenditure, and the rates for RDTI and Growth Grant are approximately the same after tax, this alternative mechanism for calculating that entitlement will not change the cost. Officials estimate the maximum cost at $190 million for 2021/22. As not all businesses will require an adjustment, and few adjustments (if any) will be for the full entitlement, officials estimate the proportion of that cost to be paid out as adjustments to be significantly less than the maximum amount.

41 However, it is necessary to do a fiscally neutral adjustment (FNA) from the RDTI appropriation to a new appropriation created for this purpose. I therefore propose that Cabinet agree to the creation of a new appropriation for purpose of funding the adjustment. I further propose the transfer of $95 million from the RDTI appropriation for the purpose of providing the transitional support adjustment. Given the uncertainty of the estimates underpinning the amount required for this appropriation, I am seeking authorisation for myself and the Minister of Finance to jointly approve further transfers between these two appropriations to ensure that neither is exceeded.

42 Implementing this option will require additional operating funding to cover the cost of administration over the period of the adjustment (businesses will have until 30 April 2023 to file their supplementary return). Callaghan Innovation estimate that a further $6,148,000 will be required. These costs will be covered by a reprioritisation of funds within Vote Business, Science and Innovation.

Legislative Implications

43 Implementing the additional support will require some small changes to the RDTI legislation. The RDTI rules exclude R&D activity supported by a government grant to avoid double dipping. To overcome this, it will be necessary to make a minor amendment to ensure that businesses that receive the additional support still receive their full entitlement under the RDTI. This is similar to the change made for R&D loans. Further technical amendments may be required to the Income Tax Act 2007 and Tax Administration Act 1994 to ensure that there are no unintended tax consequences in relation to the additional support.

44 Any legislative amendments would be agreed with the Minister of Revenue who has been consulted on this paper. Changes would be included in the next tax omnibus bill by the start of the 2021/22 income year.

Impact Analysis

Regulatory Impact Statement

45 The Regulatory Impact Analysis Team at the Treasury has determined that the proposal to provide transitional support to R&D performing businesses is exempt from the requirement to provide a Regulatory Impact Statement on the grounds that it has no or only minor impacts on businesses, individuals, and not-for-profit entities.

Climate Impacts

46 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

Human Rights

47 The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Consultation

48 The following government agencies have been consulted: Inland Revenue, The Treasury and Callaghan Innovation.

Communications

49 I plan to announce the support as soon as possible to give businesses certainty around budgeting and planning for the 2021/22 financial year.

Proactive Release

50 I propose to proactively release this Cabinet paper with any appropriate redactions within 30 working days of the proposed support being announced.

Recommendations

Policy settings

1 **Note** that while the implementation of the RDTI scheme has largely progressed as intended, some businesses have found aspects of the transition challenging.

2 **Note** there are larger than expected differences in the eligibility of R&D between the Growth Grant and Research and Development Tax Incentive (RDTI) regimes, which may result in a steep funding cliff for some companies.

3 **Note** that the uncertainty generated by differences in regimes may negatively impact business expenditure on R&D and the Government's goal of raising R&D expenditure to 2 per cent of GDP by 2027.

4 **Agree** that the Ministry of Business, Innovation and Employment, Callaghan Innovation and Inland Revenue put in place a temporary transitional support mechanism in the form an adjustment to businesses' entitlement under the RDTI.

5 **Authorise** the Minister of Research, Science and Innovation, in consultation with the Minister of Revenue, to make operational and detailed policy design changes in line with the policy objectives set out in this paper.

Financial implications

6 **Note** that the RDTI is a forecast appropriation and is heavily undersubscribed compared to current forecast, due to the eligibility criteria of the RDTI scheme not aligning with the original policy intent.

7 **Agree** that the temporary transitional support mechanism and the RDTI should be funded from the one forecast, currently only available through the RDTI appropriation.

8 **Agree** that, as neither the transitional support mechanism nor the RDTI are pure forecast appropriations, both appropriations should be Non-Departmental Other Expenses appropriations.

9 **Agree** to change the appropriation *Research, Science and Innovation: R&D Tax Incentive* in Vote Revenue from a Benefits or Related Expenses appropriation to a Non-Departmental Other Expenses appropriation.

10 **Agree** to the establishment of the new Non-Departmental Other Expenses appropriation *Research, Science and Innovation: Transitional Support to R&D Performing Businesses* in Vote Business, Science and Innovation, as follows:

Vote	Appropriation Minister	Title	Type	Scope
Vote Business, Science and Innovation	Minister of Research, Science and Innovation	Research, Science and Innovation: Transitional Support to R&D Performing Businesses	Non-Departmental Other Expense	This appropriation is limited to providing a temporary transitional support payment to former recipients of the Research and Development Growth Grant to support them to transition to the Research & Development Tax Incentive

11 **Approve** the following fiscally neutral adjustment to give effect to the policy decision in recommendation (4) above, with no impact on the operating balance and net core Crown debt:

	$m – increase/(decrease)				
	2020/21	**2021/22**	**2022/23**	**2023/24**	**2024/25 & Outyears**
Vote Revenue **Minister of Research, Science and Innovation** Benefits or Related Expense: Research, Science and Innovation: R&D Tax Incentive	-	(9.500)	(28.500)	(57.000)	-
Vote Business, Science and Innovation **Minister of Research, Science and Innovation** Non-departmental Other Expense: Research, Science and Innovation: Transitional Support to R&D Performing Businesses	-	9.500	28.500	57.000	-

12 **Note** that the operating costs for administration of the adjustment will be funded through a reprioritisation within Vote Business, Science and Innovation.

13 **Approve** the reprioritisation of funding, as set out below, to enable Callaghan Innovation to administer the adjustment, with no impact on the operating balance and net core Crown debt:

	$m – increase/(decrease)				
Vote Business, Science and Innovation **Minister of Research, Science and Innovation**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25 & Outyears**
Non-departmental output expense Research, Science and Innovation: Repayable Grants for Start-Ups	(6.150)	-	-	-	-
Multi-Category Expenses and Capital Expenditure: Research, Science and Innovation: Callaghan Innovation - Operations MCA Non-departmental Output Expense: Building Business innovation	1.563	0.809	1.889	1.889	-

14 **Agree** that the proposed changes to appropriations for 2020/21 in the recommendations above be included in the 2020/21 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply.

15 **Authorise** the Minister of Research, Science and Innovation and the Minister of Finance to jointly make decisions to transfer further funding between the *Research, Science and Innovation: Transitional Support to R&D Performing Businesses* appropriation and the *Research, Science and Innovation: R&D Tax Incentive* appropriation to support the administration of this transitional support mechanism as required.

Legislative changes

16 **Agree** that any legislative measures giving effect to the policy decisions on the transitional support measure be included in the next omnibus tax bill by the Minister of Revenue.

Authorised for lodgement

Hon Dr Megan Woods

Minister of Research, Science and Innovation