April 2018

FUELLING INNOVATION TO TRANSFORM OUR ECONOMY

A discussion paper on a Research and Development Tax Incentive for New Zealand

New Zealand Government

For more details see **mbie.govt.nz**

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MINISTERS' FOREWORD

April 2018

This Government's vision is to build a better New Zealand for all our people and we see an incredible opportunity ahead of us to do this.

That means a country with affordable, healthy homes; an environment we can be proud to leave to future generations; and a diverse, sustainable, and productive economy that delivers for our people.

This vision can't be delivered with the same old approaches. We need new ideas, new innovations, and new ways of looking at the world.

And that is where science, innovation and research can play an important role. That is where we see our innovators, our scientists, our entrepreneurs and our visionaries building a better New Zealand.

Currently New Zealand's gross expenditure on research and development is 1.28 per cent of GDP – compared to an OECD average of 2.38 per cent. Business expenditure on R&D has been steadily rising, but at 0.64 per cent of GDP it is low – too low – when compared to other small advanced economies, and is well below the OECD average of 1.65 per cent.

We have committed to increasing R&D expenditure to two per cent of GDP over 10 years.

Growing R&D expenditure has benefits for us all. For businesses, R&D is recognised as a key indicator of innovation, which enhances their ability to be successful in changing markets.

More broadly, R&D provides for the diversification of the economy by encouraging new industries and companies, new jobs and new ways of doing business. Some of these industries will build on our traditional strengths; others in new areas.

Increasing R&D support is part of how we'll help Kiwi firms to move further up the value chain and deliver higher wages. More R&D will ensure we are living up to New Zealand's international reputation as a place of daring and innovation.

Achieving this ambitious R&D target will mean a step change in New Zealand's approach to innovation.

Sustained increases in government investment are important, so we are committed to playing an active role in investing in research, science and innovation and in a way that can make a real and noticeable difference.

We will also need to see an increasing contribution from the private sector, specifically in businesses undertaking R&D.

That's why we are introducing an R&D tax incentive as a further addition to the system of government support for New Zealand's innovation framework. Over time we intend to grow this package, including targeted support for R&D performers, start-ups and innovative firms. The R&D tax incentive will be one lever amongst many.

The R&D tax incentive will have a broad reach across our economy. A wider and more diverse range of firms will be able to access the tax incentive which will assist and encourage businesses of all sizes and scales to undertake R&D.

Tax incentives allow firms to decide what R&D they should do, and offer a greater element of certainty to businesses. It will be a simpler process, opening access to those that have either struggled to access support or have been shut out of the process in the past. We want to establish a system of support that will stand the test of time and give businesses the consistency and confidence they need to succeed.

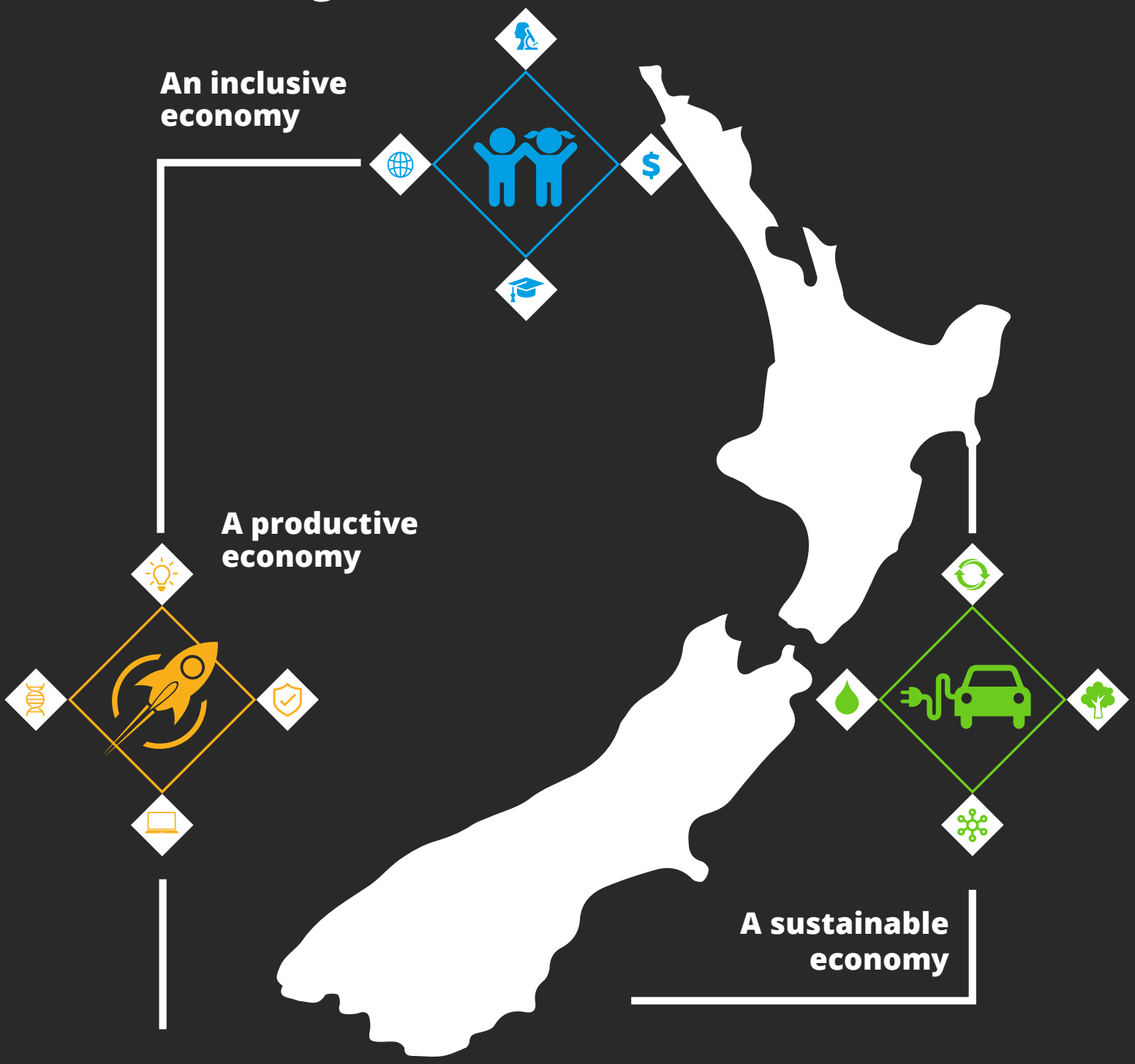
Obviously, there needs to be a careful approach to distributing tax incentives. This discussion document sets out the main and technical design features government is proposing to introduce in an R&D tax incentive. We have learned from what happens overseas and from what we've experienced in New Zealand to ensure there remains a high level of trust and confidence in New Zealand's tax system and the credit is used to support genuine R&D.

Over the next six weeks, the Ministry of Business, Innovation and Employment, Inland Revenue, and Callaghan Innovation will be actively seeking your feedback on specific aspects of this proposal through a variety of channels. We encourage you to engage and provide your feedback on the proposals in this document to ensure we create a mechanism that will support New Zealand business to innovate and be the step change we are challenging you to take.

Minister of Research, Science and Innovation, Hon Dr Megan Woods

Minister of Revenue, Hon Stuart Nash

Transforming New Zealand



Challenges facing NZ

- High carbon economy & climate change
- Changing demographic
- Data & security
- Illness & disease
- Low value economy

How to address these challenges

- Skills
- Education institutions
- Human & physical capital
- Collaboration
- R&D
- Regulations & intellectual property settings
- International connections

Section 1

A RESEARCH AND DEVELOPMENT TAX INCENTIVE FOR NEW ZEALAND

Why we need to be more ambitious

Introducing a Research and Development Tax Incentive will:

- drive faster growth of business research and development (R&D), and help New Zealand reach our goal of increasing R&D expenditure to 2 per cent of Gross Domestic Product (GDP) by 2027
- offer greater certainty to businesses
- be accessible to a diverse range of businesses
- complement and strengthen the Government's coordinated package of support for research, science and innovation.
- lead to greater innovative business activity, thus increasing employment, industry diversity, international engagement, profitability and overall sustainability.

VISION

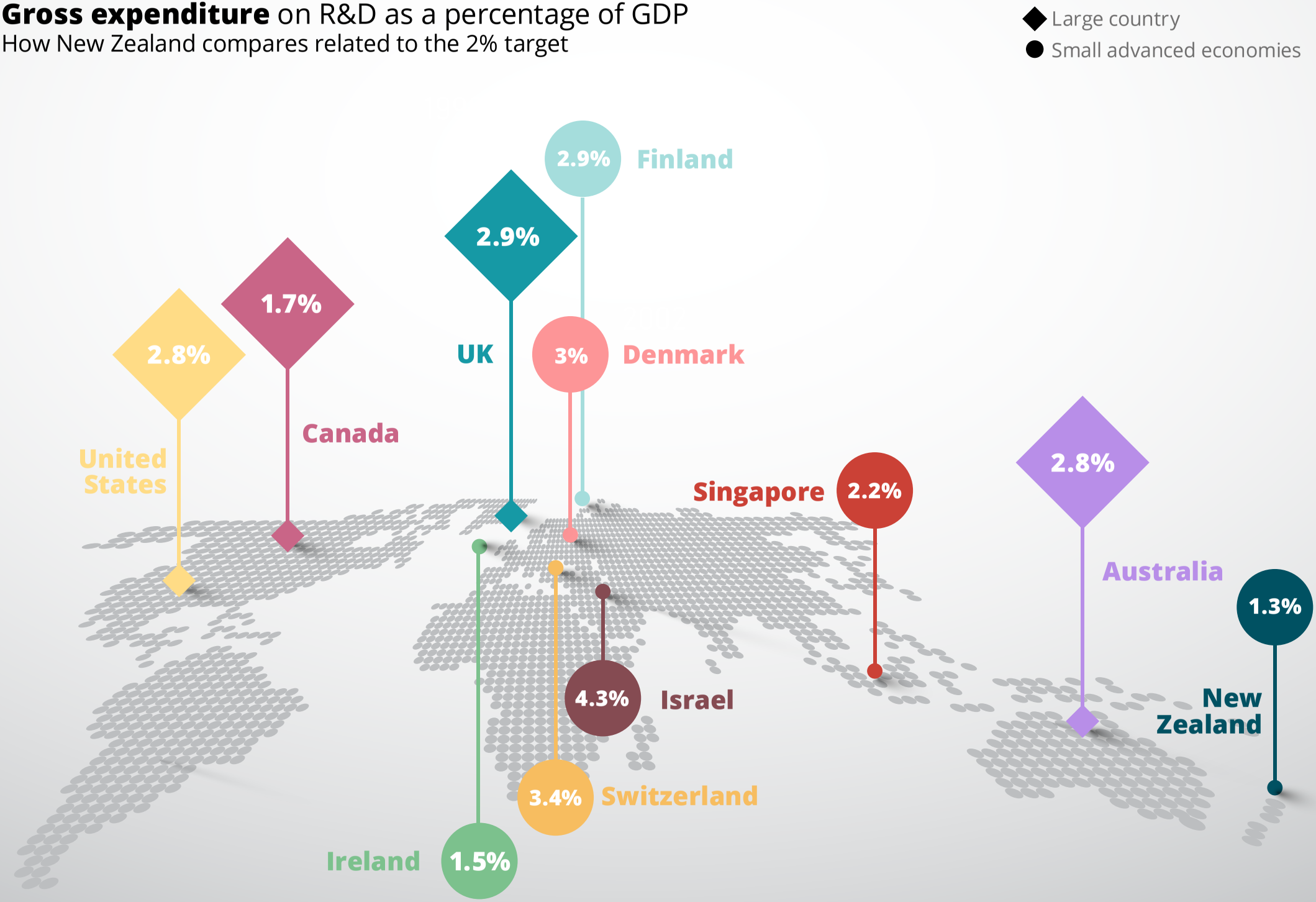
More research and development powered by business helping to create a diverse, sustainable and productive economy.

Our expectation is that:

- taxpayers will meet their responsibilities and obligations
- the Tax Incentive will be managed prudently
- taxpayers will have clarity about eligibility; and
- processes will be streamlined.

Gross expenditure on R&D as a percentage of GDP

How New Zealand compares related to the 2% target



The introduction of a Research and Development Tax Incentive is part of the Government's economic strategy to help improve the well-being and living standards of New Zealanders through better productivity, sustainability and inclusive growth.

New Zealand needs more private sector investment in research and development. One factor limiting investment is uncertainty that business will secure the benefits of that R&D, even if it proves to be successful.

That's why the government is introducing an R&D Tax Incentive: lowering the cost of research and development reduces the risk for businesses and gives them an incentive to do more. A tax incentive will give businesses better access to support, greater predictability and consistency. This is expected to increase growth in business R&D in New Zealand over the medium to long term, encouraging innovation and moving New Zealand towards the type of economy needed to better support our well-being objectives. These include increasing employment, productivity, industry diversity, international engagement, profitability and overall sustainability.

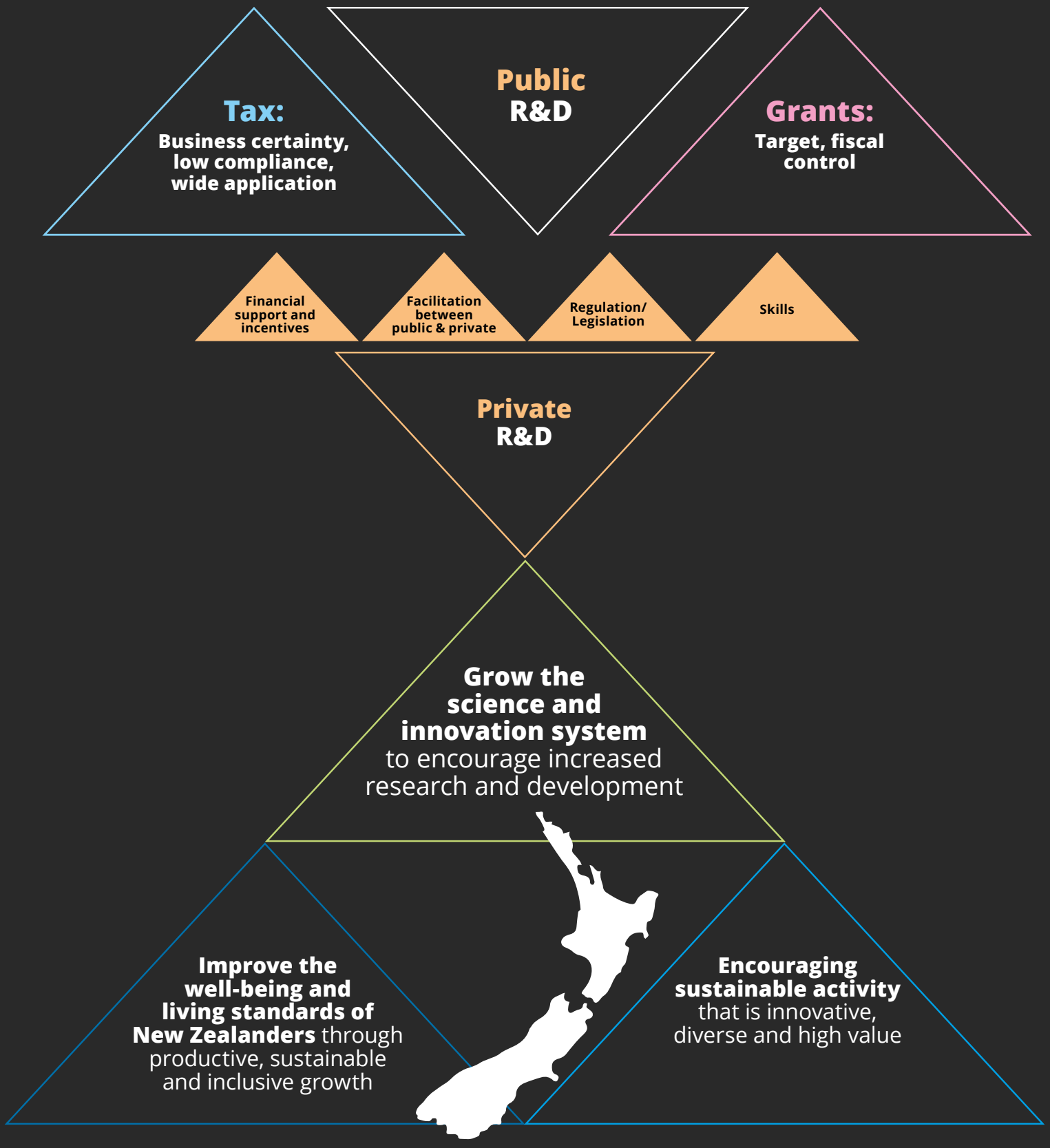
Across the OECD, almost all countries have a tax credit as part of their support for R&D.

The R&D Tax Incentive will not stand alone. It is part of a system of wider government support for New Zealand research, science and innovation.

This includes Government support for business R&D continuing to be delivered through the tax system and grants.

The R&D Tax Incentive is not the only way the Government is ensuring its policies are fit for purpose. For instance, we have also established the Tax Working Group to examine further improvements to the structure, fairness and balance of the tax system.

How the new R&D Tax Incentive helps achieve the Government's economic strategy.



The R&D Tax Incentive will apply from 1 April 2019.

Expected: Key dates

April 2018 (we are here)	Public consultation on proposals
May-June 2018	Post-consultation policy development
Mid 2018 – mid 2019	Policy work on support for businesses in tax loss
September 2018	Legislation is introduced to Parliament
Late 2018	Parliamentary Select Committee - further opportunity for public consultation
April 2019	Date for R&D Tax Incentive to take effect
Early 2019	Legislation enacted Guidance materials published
April 2020	Support for businesses in loss is introduced

The following section sets out the main features of the R&D Tax Incentive and asks a number of questions that we would like to get your responses to, including questions on: eligibility, the definition of R&D, eligible expenditure, business in tax loss and administration. We would be grateful to receive your views on these matters via the submission process.

Section 3 explains how you can provide feedback on these specific proposals via a submission and other ways you can have your say during public consultation on the R&D Tax Incentive.

You will find a summary of the discussion questions in the Appendix.

For more information visit **www.MBIE.govt.nz/rdincentive**

Section 2

DESIGN, DISCUSSION AND QUESTIONS

The proposed R&D Tax Incentive has been designed to provide easily accessible support to a broad range of businesses in a fiscally responsible way, while also maintaining trust and confidence in the tax system.

To make good R&D investment decisions, it is important that businesses can plan for government support over time and for that support to be easily understood and accessible.

The sustainability of the scheme is critical to business certainty – and achieving good value for taxpayers' money is the key to sustainability. An efficient scheme will be very clear about what expenditure will, or will not, attract an incentive and will prevent claims for expenditure that are unrelated to R&D.

It is anticipated that the detailed rules of the Tax Incentive will change over time. This is important to reflect the changing nature of R&D in New Zealand and to respond to potential abuse or misuse of the incentive. Potential changes will be balanced against the need to maintain stability so that businesses can plan their R&D activities with confidence.

The proposed design has evolved from that used in the 2008 tax credit. We have incorporated lessons learned from that time, as well as from international experience and the existing R&D grants scheme.

The rest of this section outlines the main design settings and proposals. Questions are asked throughout the document and we would like to receive your responses to these questions via the submission process. Please note the settings may change as a result of feedback from consultation, either at this stage or during the Select Committee stage of the Bill, or from further policy development work.

Rate

The mechanism for providing the R&D Tax Incentive is a tax credit.

A 12.5% tax credit on eligible expenditure will be available to business doing R&D in New Zealand. The credit will be available for eligible expenditure incurred from 1 April 2019.

This rate is similar to the median tax credit available across the Organisation for Economic Co-operation and Development (OECD).[1]

The government considers that the Tax Incentive should apply to all eligible R&D expenditure and will not be restricted to incremental spending. A Tax Incentive requiring increasing investment in R&D expenditure is not favoured because of its inherent complexity.

Imputation

A business' imputation credit account will be credited by an amount equal to the tax credit so that shareholders receive a benefit from the tax credit when dividends are distributed. This approach replicates that of the 2008 tax credit.

Will I be eligible?

All businesses, regardless of legal structure, will be eligible to claim the Tax Incentive. We consider that it should be accessible and as inclusive as possible. It should also avoid distorting the way businesses structure themselves.

New Zealand R&D businesses have a range of entity structures. Māori businesses, in particular, are more likely to have varying entity structures.[2]

You will be eligible if you:

- **are located in New Zealand and carrying out R&D in New Zealand[3]**
- **satisfy the tax test of being in business (the nature of your activities must amount to a profession, trade, manufacturing or undertaking and there must be an intention to make a profit)**
- **are claiming for R&D expenditure that relates to your business or intended business**
- **have control over the R&D activities**
- **bear the financial risk of the R&D activities**
- **effectively own the results of the R&D.**

1 International comparisons of tax credit rates need to take into account that countries define their tax incentives in different ways. For instance, Australia's incentive is a tax offset (incorporating the value of income tax deductions) making it appear much higher in value than the tax credit proposed for New Zealand.
2 These structures can be created under legislation, collective land titles and treaty settlements and can involve a large number of owners and complex governance arrangements. This can make it difficult to transfer business operations into a company structure.
3 A business must meet the tax test of having a fixed establishment in New Zealand.

The above requirements mean that the Tax Incentive goes to the business making the decision to invest in R&D. It also prevents two businesses claiming the Incentive for the same expenditure. For example, if the R&D activity is sub-contracted, the Incentive should go to the business commissioning the R&D and not the business that is getting paid for doing the work.

Government entities

The focus of the Incentive is on private businesses. The place for entities funded by government needs to be considered. State Owned Enterprises are not eligible for Growth Grants and Crown Research Institutes, District Health Boards, Tertiary Education Organisations, and subsidiaries under their control were not eligible for the 2008 tax credits.

Q1

If SOEs, Crown Research Institutes, District Health Boards, Tertiary Education Organisations, and their subsidiaries are excluded from the tax incentive, what will the likely impact be on business R&D in New Zealand?

Industry research cooperatives undertaking or commissioning R&D will be eligible

Industry research cooperatives (including levy bodies) that receive contributions or levy payments for the purpose of R&D will be eligible for the Tax Incentive. R&D funded through levy bodies is fundamentally business R&D and may result in benefits that are not fully captured by the industry. Industry research cooperatives will need to show that they meet all the requirements to claim the credit, except the requirement to be a business.

What qualifies as an R&D activity

The scheme's definition of R&D must be clear and robust and as practical as possible. There should be very little ambiguity regarding what R&D activities are eligible. This may be challenging because "R&D" is not generally defined precisely. Businesses may consider they are doing R&D because a project is innovative and challenging. However, the intention of the scheme is to give incentives for activities which resolve scientific or technological uncertainty.

R&D would be defined as:

(a) Core activities: those conducted using scientific methods that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes, or services; and that are intended to advance science or technology through the resolution of scientific or technological uncertainty.

OR

(b) Support activities: those that are wholly or mainly for the purpose of, required for, and integral to, the performing of the activities referred to in paragraph (a).

Where the final definition includes technical terms (e.g. scientific method), these would be defined in legislation, with illustrative examples in the accompanying R&D tax incentive guidelines.

Q2 How well does this definition apply to business R&D carried out in New Zealand?

Q3 Does this definition exclude R&D that you think should be eligible, please illustrate with examples.

The proposed definition of R&D is based on international best practice, guided by the OECD's Frascati Manual[4] and, like other design settings, adjusted for lessons learned from overseas, the previous R&D tax credit and from the administration of R&D grants.

The definition recognises a spectrum of R&D activity from basic research, to experimental development work to create new or improved materials, products, devices, processes, or services.

The current definition used in the R&D grant system and for income tax deductibility, which is based on the New Zealand equivalent to International Accounting Standard 38 (NZ IAS 38), is not considered suitable. The proposed definition puts a greater emphasis on resolving scientific and technological uncertainty by applying processes that rely on the scientific method.

Q4 Does the scientific method requirement exclude valid R&D in some sectors, please illustrate with examples?

To ensure government funding is well targeted, the incentive is intended to support R&D that addresses a material problem and anticipates a material advance in science or technology. This is reflected in the requirement that activities are intended to "advance science or technology through the resolution of scientific or technological uncertainty", which ensures that the credit is only available for solving problems that have not already been solved, and which will expand the existing knowledge base.[5] A change from the 2008 Tax Credit is the removal of "novelty" as a separate limb for eligibility.

Q5 What would the impact be on business R&D in New Zealand if a materiality test was applied to **both** the problem the R&D seeks to resolve and the intended advancement of science or technology?

4 The OECD Frascati Manual is regarded internationally as setting the benchmark for defining and identifying R&D activities.
5 R&D will qualify for the tax credit where it is done by two firms simultaneously but independently or where the work has already been done but it is not public knowledge because it is a trade secret.

R&D need not be successful to qualify

The outcome of R&D is inherently uncertain; it is not necessary that the R&D activity be successful to be eligible for the tax incentive.

Support activities

Supporting activities (covered by paragraph b of the proposed definition) are activities that are part of the R&D project but are not conducted using a scientific method or do not advance science or technology themselves, for example, literature searches.

Q6 How well does this definition apply to business R&D carried out in New Zealand?

Some activities are excluded from the tax incentive

Certain activities are routinely excluded from R&D tax incentives. They may be excluded because governments do not wish to incentivise a particular activity through the tax system. Other exclusions remove uncertainty over whether a particular activity could be considered R&D or to clarify the boundary between experimental development and pre and post-development activity, or innovative and routine work.

The following activities should be excluded from paragraph (a) of the definition, but could qualify as support activities under paragraph (b):

- prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal reserves
- research in social sciences, arts or humanities
- market research, market testing, market development or sales promotion (including consumer surveys)
- quality control or routine testing of materials, products, devices, processes or services
- the making of cosmetic or stylistic changes to materials, products, devices, processes or services
- routine collection of information
- commercial, legal and administrative aspects of patenting, licensing or other activities
- activities involved in complying with statutory requirements or standards
- management studies or efficiency surveys
- the reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information
- pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs
- dual purpose activities.

The proposed excluded activities are broadly consistent with those in comparable jurisdictions and reflect the exclusions in the 2008 tax credit. The Growth Grant has a similar exclusion list, also intended to remove uncertainty and clarify boundaries around what activities count as R&D.

Blanket exclusions for these activities are also being considered to make them ineligible under both core and support activities. This would reduce the risk of expenditure being recharacterised to be eligible as supporting activities.

Q7 Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe.

Research in social sciences tends to be excluded in other jurisdictions. However, the assumption that this type of research is not a focus of business R&D may no longer be valid because it is becoming more embedded in digital R&D.

Q8 Please provide any examples where social science research is/has been a core part of business R&D in New Zealand?

Dual purpose activities

A risk identified from claims for the 2008 tax credit was that businesses carried out R&D as part of a broader activity and included business as usual expenses from those activities in their claims. The R&D incentive may be better targeted if it applies to an activity conducted solely for an R&D purpose. If an activity was carried out for a R&D purpose and a non-R&D purpose, the entire activity would not qualify as a R&D activity. This type of test is consistent with brightline (a clear boundary) tests used in income tax rules and is similar to those adopted in other jurisdictions.[6]

Q9 What is the likely impact on business R&D in New Zealand if dual purpose activities are ineligible for the R&D Tax Incentive?

Some R&D carried out overseas will be eligible

The aim of the Tax Incentive is to encourage business to conduct R&D in New Zealand because of the wider social and economic benefits that accrue throughout the country. For that reason the Incentive will primarily be for R&D carried out domestically.

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

However, some businesses may not be able to conduct their entire R&D in New Zealand. Examples include the need to meet foreign regulatory requirements when a product is being developed for an overseas market or when access to specialised capability, a special environment or technology is needed but not available in New Zealand.

Up to 10 percent of the eligible expenditure on an R&D project can be for overseas R&D costs if:

- **the overseas work is part of an R&D project based in New Zealand; and**
- **at least half the R&D expenditure within a project is for activities carried out in New Zealand.**

If more than half of the R&D expenditure within a project is for activities carried out off-shore, the overseas expenditure will be ineligible for a tax credit. But the R&D expenditure incurred on activities carried out in New Zealand will be eligible.

Eligible expenditure on R&D

Eligible expenditure for the Tax Incentive will need to have a direct link to R&D activities. The credit will apply only to expenditure that is deductible, or amortisable, under the Income Tax Act (or, in relation in those with tax-exempt income, that would be deductible, or amortisable, if the income were not exempt).[7]

Two possible approaches for determining eligible expenditure are outlined below. Eligible expenditure can either be based:

1. solely on direct R&D labour costs, or
2. on a broader range of direct and indirect costs (including options for determining appropriate overhead expenditure)

Direct R&D labour as the only eligible expenditure

The first approach is to limit eligible expenditure to solely direct labour costs[8]. This approach is potentially the simplest and would focus the incentive to employment of staff performing R&D which is where, arguably, spillovers are likely to be greatest.

Q10 **What are the advantages and/or disadvantages of limiting eligible expenditure to R&D labour cost?**

Direct and indirect costs as eligible expenditure

The second approach matches that used in the 2008 tax credits and what is used in the Australian tax incentive.

7 This requirement will exclude depreciation on intangibles not listed in Schedule 17 of the Income Tax Act.
8 If such an approach were adopted, the rate of the credit would be higher reflecting the smaller base of eligible expenditure.

Eligible expenditure would include:

- **Salary and wages** of employees and payments to independent contractors directly and actively engaged in core R&D activity (scientists, engineers) and R&D support activity
- The annual **depreciation on tangible property** used in conducting R&D[9]
- The cost of **employee training, recruitment, relocation and travel** when it is incurred directly as a result of R&D activities
- **Materials incorporated into prototype products and plant**
- **Overhead costs** (see below for discussion of two options)
- **Items consumed in the R&D process**
- **Net cost of items processed or transformed in R&D process**
- **Payments to a person for R&D services** when part or all of an R&D project is outsourced.

Treatment of overhead costs (for the second approach to eligible expenditure)

Two options are being considered for allocating overhead costs:

1. include apportioned overhead costs when they are incurred partly for R&D activities
2. calculate overhead costs as a set percentage of the direct labour costs for the R&D activity.

A number of other jurisdictions use the second method.[10] The main advantage of it is its simplicity, but it can create a bias against capital intensive R&D activities.

Q11 What are the advantages and/or disadvantages of setting overhead costs as a percentage of R&D labour costs?

Excluded expenditure (for second approach to eligible expenditure)

Some expenditure would be excluded to:

- make it clear that such expenditure does not have a sufficient connection with the R&D activity
- reduce compliance and administrative costs
- prevent double dipping
- prevent abuse of the credit (e.g. subsidising excessive input costs for marginal R&D or excessive inputs paid to associates)
- limit fiscal risk
- ensure that the expenditure is at risk to the claimant.

9 The credit should not apply to assets in a tax depreciation pool unless the pool consisted solely of R&D assets used wholly in conducting R&D. Similarly, credits would not be affected by losses or gains on disposal of capital assets.
10 Canada, Portugal and Chile base their eligible expenditure largely on labour costs.

Ineligible expenditure is:

- Interest expenditure
- Loss on sale or write-off of depreciable assets (with one exception)
- Profits on R&D services and property provided by an associate
- Amounts in excess of market value for leasing property of an associate
- Depreciation attributable to the time an asset is not used in R&D
- Certain depreciation deductions on assets acquired from an associate
- The cost of feedstock other than the net cost (e.g. in relation to the cost of items transformed in the R&D process, only net expenditure would attract the credit– that is the additional cost of the materials which are the subject of processing or transformation of the value of the output)
- The cost of acquiring technology used as a basis for further R&D[11]
- Expenditure funded by a government grant or any required co-funding
- Donations
- Professional fees in determining whether the person, activities or expenditure are eligible
- The cost of acquiring intangible assets
- Expenditure of an industry research co-operative funded by an ineligible person
- Expenditure that relates to R&D activities for which the entity conducting the activity, had received or could reasonably be expected to receive consideration for the activity (see discussion below on commercial consideration).

Regardless of which of the two approaches to eligible expenditure is adopted the following general issues need to be addressed.

Commercial consideration

We propose to strengthen the "at risk rule"[12] that applied to the 2008 tax credit by adopting the Australian rule that excludes expenditure that relates to R&D activities for which the entity conducting the activity has received or could reasonably be expected to receive consideration.

Q12 Are there any reasons why expenditure related to R&D activities for which commercial consideration is received should be eligible for a tax incentive? Please describe.

11 Examples of technology that can be purchased and used as a basis for further R&D could include intellectual property or a tangible asset such as a prototype. The definition is similar to that used in Australia.
12 The eligibility requirement that claimants must bear the financial risk of the R&D activity.

Software R&D

Software R&D has become increasingly important in our economy – accounting for approximately 40-50 percent of the value of grants in the last three years. We anticipate there may need to be a variation to the standard definition to ensure it adequately captures R&D software activity. Officials are doing additional work in this area by talking to firms undertaking software R&D and other key stakeholders on how the R&D definition should apply to software. Special treatment for some activities, such as testing and internal software development, is also being considered.

Q13 What variations or extensions to the definition of core activities are required to ensure it adequately captures R&D software activities?

Timing of expenditure

Tax Incentives are available in the year in which the R&D expenditure is recognised as a deduction for income tax purposes. That recognition can be moved forward to prevent losses from being extinguished when shareholder continuity is lost as a result of additional equity investors being brought on board.

There is a question about whether continuity should be imposed on tax credits that are carried forward. This would prevent subsequent investors in a business, who have not incurred the cost of the R&D expenditure, from getting the benefit of unallocated tax credits. However, it would remove the R&D incentive for the initial investors who undertook the R&D, and is arguably inconsistent with the growth cycle of R&D start-ups – these companies are typically loss making until the initial development work is successful, at which point additional equity investors are usually brought on board.

Q14 Are there reasons why continuity rules should not apply to tax credits? Please describe.

Minimum threshold

A business will need to spend a minimum of $100,000 on eligible expenditure, within one year, to qualify for the Tax Incentive.

The minimum threshold will not apply to R&D activities outsourced to an Approved Research Provider.

Approved Research Provider – **including public and private entities**

For a person to become a listed research provider they would have to apply to the Commissioner of Inland Revenue and meet the following requirements:

- capability **(including appropriate qualifications and certifications)** to perform R&D activities on behalf of other persons
- has in New Zealand the facilities needed to perform the R&D activities
- charges market prices for performing the R&D activities
- available to perform R&D activities on behalf of persons not associated with them.

The names of listed research providers would be published so businesses can see who they are.

The rationale for having a minimum threshold is to avoid disproportionate administration and compliance costs.

The rationale for setting the threshold at $100,000 of eligible expenditure is to filter out claims that are not likely to be genuine R&D. $100,000 of expenditure is roughly the cost of one full time employee's salary and related overhead costs.

Q15 Is the minimum threshold set at the right level? If 'no', please provide further details.

Businesses in tax loss

The Government recognises that it is important to support R&D businesses that are in tax loss or which have insufficient taxable income to use their tax credits. R&D intensive firms, in particular, typically spend their early years in a tax loss position. They also have a lower probability than other businesses of becoming profitable, so may never be able to use their R&D tax credits to improve their cash position.

The Government is committed to providing a better policy option to support these businesses. However, the policy issues are complex and will not be resolved in time for the introduction of the Tax Incentive in April 2019.

Officials are undertaking further work to consider support for R&D businesses in tax loss and will consult with stakeholders as policy positions are developed. From April 2020, an appropriate policy incorporating additional features supporting businesses in tax loss will be introduced.

The Tax Incentive to be introduced from 1 April 2019 will be "non-refundable." Businesses in loss, or whose tax credit is greater than their tax liability, will be able to carry forward their tax credit to a future tax year.

The existing R&D tax loss cash out scheme may be reviewed as part of any further policy work but no changes will be made to it for the 2019-2020 income year.

Will there be a maximum?

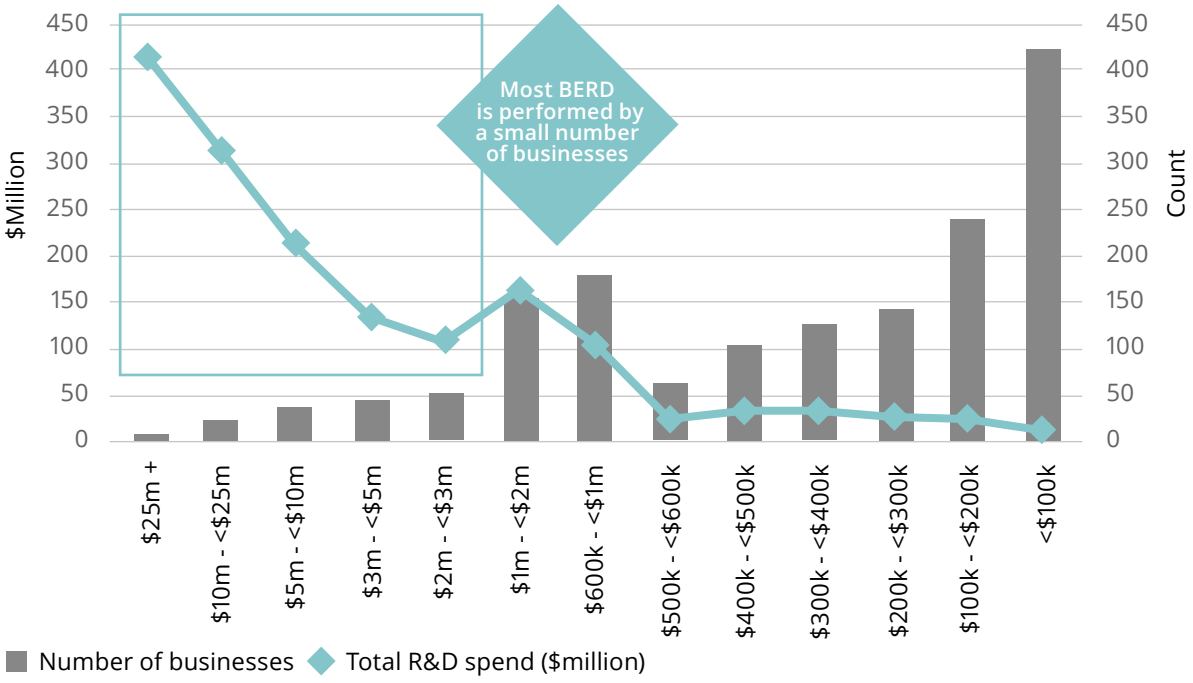
A business will be able to claim a tax credit for up to $120 million of R&D expenditure each year. This equates to a tax credit of $15 million each year, based on a 12.5% rate.

A limit on the amount a business can claim each year helps protect against loopholes being exploited that would otherwise create shocks to the cost of the scheme and reduce its sustainability.

However, caps reduce genuine large claims, and large claims for genuine R&D carried out in New Zealand will be a measure of the success of the scheme.

It is therefore important to create an incentive for our largest R&D performers to increase the amount of R&D they continue to do. We also want to attract large international R&D intensive firms to New Zealand.

Distribution of BERD across firms



A Tax Incentive alone will not achieve these two things, but it may have an important part to play.

Two possible ways to incentivise spending on R&D above the level of the cap are to either:

1. have a Ministerial discretion to waive the cap for genuine claims, or
2. to require pre-registration for large claims.

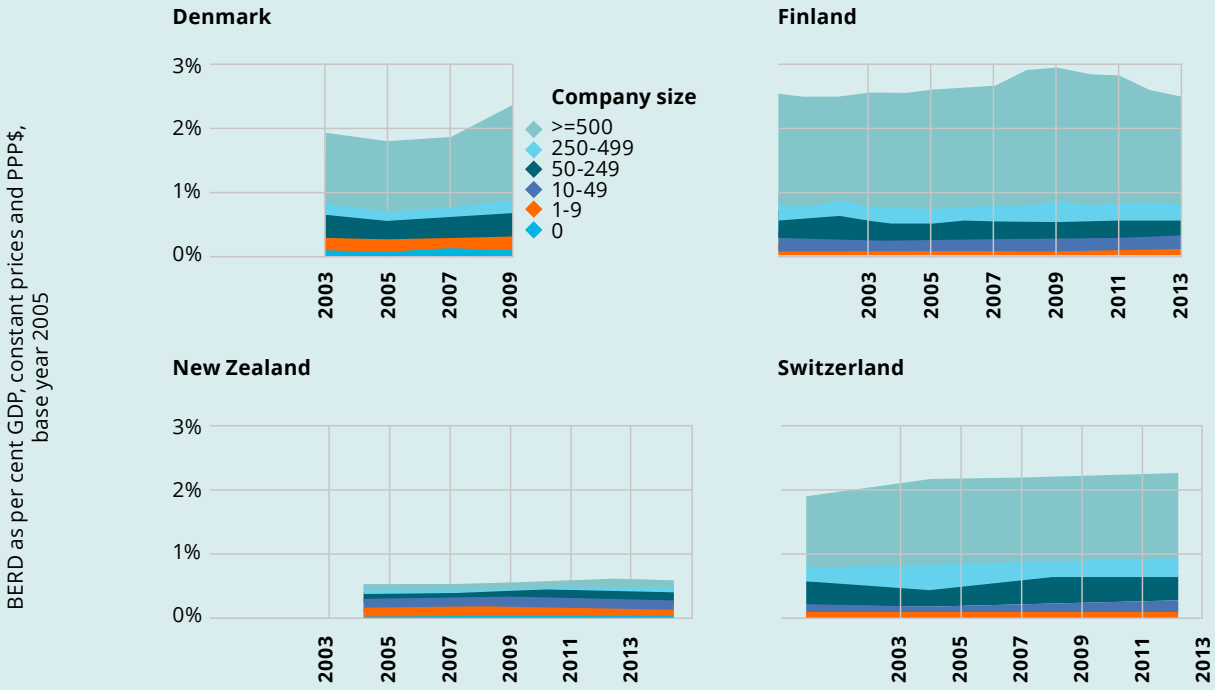
Pre-registration could include outlining the R&D activities and expected expenditure that would be the subject of a claim in the following year. The criteria for the application of a Ministerial discretion generally requires the likelihood of additional benefits (as well as meeting the general requirements of the incentive).

Both these options have benefits and drawbacks. Ministerial discretion to waive the cap would address loopholes but would unavoidably reduce certainty for businesses and be at odds with the non-targeted nature of tax incentives. A system of pre-registration for claims would create more certainty for businesses and reduce, but not eliminate, the exposure to loopholes. Substantial changes to the direction of planned R&D activities could also create complications.

Q16 How important is a cap or a mechanism to go beyond the cap? Please provide further details.

Q17 What features of a Ministerial discretion or pre-registration would make them most effective?

New Zealand's distribution of R&D by business size is dramatically different to other small advanced economies. Companies with more than 500 staff perform 50 per cent or more of the total Business Expenditure on Research and Development (BERD) in Denmark, Finland and Switzerland but only 18 per cent in New Zealand. It is the lack of R&D carried out by large companies which is driving New Zealand's low overall BERD rates.



New Zealand has a similar number of large companies (ie. with greater than 1,000 employees) to Denmark and Finland. However, New Zealand lacks the very large, multinational companies which tend to drive R&D expenditure in other countries.

Growing or attracting large R&D performing firms is essential to the New Zealand economy.

Large firms bring resources to the economy that small firms struggle to provide:

- high quality managers and entrepeneurs
- knowledge of international markets
- large capital budgets
- corporate finance
- a customer base for smaller high-growth firms.

Innovative partnerships

The innovative partnerships programme aims to attract large international R&D intensive firms to New Zealand. The programme maximises global reach by actively promoting New Zealand's strengths to international companies and attracting them to undertake research and develop their products in New Zealand.

There are numerous factors that might affect the location choice of R&D investment by large international firm including support for business R&D. An R&D tax incentive can support these decisions.

Evaluation

The R&D Tax Incentive will be the largest component of government support for encouraging business' R&D. Reviewing the scheme for its effectiveness and identifying opportunities to improve its efficacy and integrity are important to ensuring on-going value and long-term sustainability.

It is proposed that the scheme be evaluated following the transition from Growth Grants and within four years of commencement. Monitoring in the shorter-term is also important to speedily identify and remedy issues that could compromise the integrity of the Incentive. The Government is committed, through regulatory changes, to maintain a Tax Incentive that benefits New Zealand. It will adjust the Incentive, potentially through changes to the definitions of eligible activity and expenditure, if this goal is not being met.

Transparency

The standard approach to taxpayer specific information is for secrecy provisions to apply. However, in the case of the Tax Incentive, where substantial government funds are being allocated, the Government considers an alternative approach is justified because transparency will assist in maintaining the integrity of the scheme.

Transparency and evaluation would be enhanced by:

- **publishing the names of recipients and the amounts of R&D support (expressed in bands rather than the exact amount) they have received. It is proposed this data would be published with a two-year lag to protect commercially sensitive information**
- **making taxpayer-specific information in relation to R&D Tax Incentive claims available to Treasury, Callaghan Innovation and MBIE officials to support evaluation and policy development**
- **integrating claim information into Stats NZ's Longitudinal Business Database (LBD). The data would also be integrated with the National Research Information System (NRIS).**

Q18 What are your views on the proposed mechanisms to promote transparency and enhance evaluation?

Q19 Are there any other risks that need to be managed? Please descibe.

Penalties

The standard penalties provisions in the Tax Administration Act 1994 would apply to R&D Tax Incentive claims. International experience suggests that the risks around R&D tax credits may be greater when advisors are paid on a contingency basis, as they too gain an incentive to inflate the claim.

Officials are considering whether penalties should be extended where a tax advisor has, or would have, received a direct financial benefit from the claim (in the form of a fee contingent on the R&D Tax Incentive) and the R&D Tax Credit application demonstrates a serious offense. An option being considered is to refine the promoter penalty rules so that the joint and several liability provisions can apply in the circumstances described above.

Q20 Are there risks with extending penalties to external advisors in this way?

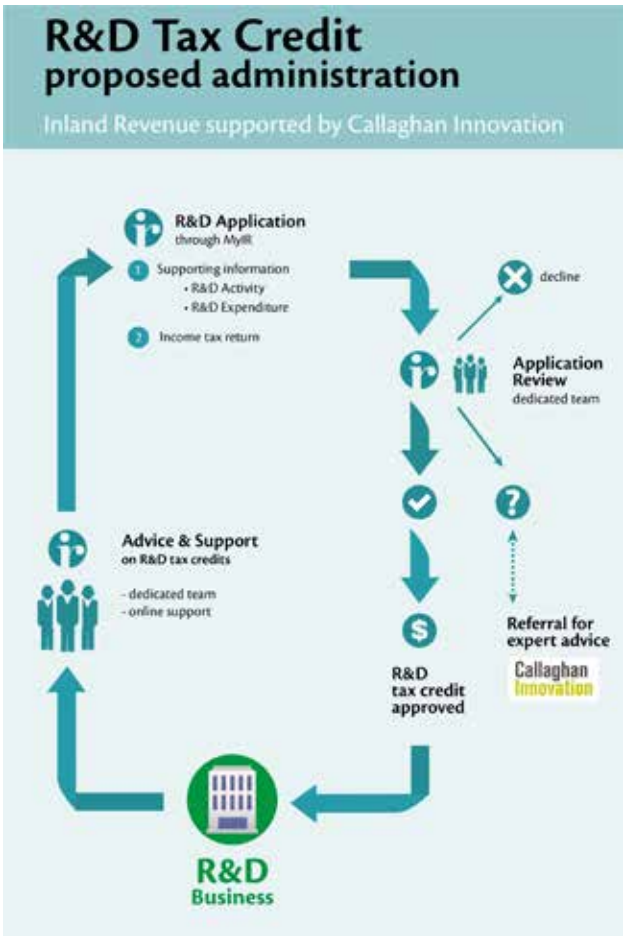
Administration

Inland Revenue will administer the R&D Tax Incentive, supported by Callaghan Innovation. The design of the administration will have a customer focus to provide certainty for claimants.

To ensure the best customer experience Inland Revenue will be accountable for providing education, advice, determinations, and compliance activity in relation to claims.

Callaghan Innovation brings existing knowledge, networks and on R&D activities and expenditure. They will use that capability to support Inland Revenue administer the tax credit and provide certainty to businesses.

The R&D Tax Incentive will be administered separately to the R&D tax loss cash out scheme. But this will be reviewed to ensure a seamless process in the future.



Return process for R&D Tax Incentive

Inland Revenue aims to provide a seamless process for businesses wanting to claim the Tax Incentive, which will be linked to the income tax return. Customers will also need to submit supporting R&D activity and expenditure information through the MyIR portal.

In future Inland Revenue anticipates customers being able to make claims through third party software. This would also make it easier for business to keep records and ensure R&D expenditure is correctly characterised.

Initial features of the claim process being considered include:

- Applications will only be made through Inland Revenue's e-services (MyIR) – there will be no paper application process
- Customers being set up within MyIR as a R&D business
- A range of guidance and education material (including online tools) to assist claimants
- Submitting supporting information that details the R&D activity and expenditure, including the ability to upload attachments. This is required to determine that the R&D activity is eligible, including information on the hypothesis the business is seeking to address through the R&D.
- Submitting other information such as whether the business has used an external advisor and any contingency fees.

Claim period

Businesses will have one year after the end of the income year to submit their claim.

Record keeping

Businesses will be required to keep sufficient records to support claiming the Tax Incentive. This includes R&D project information and eligible expenditure (i.e. core vs support expenses) and any funding sources. The legislation for the Tax Incentive will outline record keeping requirements needed to support an R&D Tax Incentive claim.

Compliance

Inland Revenue will employ a range of integrity measures to ensure that claims are correct, initially relying on manual checks. Inland Revenue plans to create an environment that supports customers and provides greater certainty on claims prior to submission. It is anticipated that future use of approved third party software will reduce the need for post-application compliance checks.

Certainty for taxpayers

Inland Revenue is considering how the rulings and determinations processes could be extended to include the proposed R&D Incentive.

Q21 What is the right level of information required to support a claim?

Q22 What opportunities are there for customers to submit R&D Tax Incentive claims via third party software?

Q23 What integrity measures do you think Inland Revenue should use?

Transition from Growth Grants

The Growth Grant administered by Callaghan Innovation will be phased out with the introduction of the Tax Incentive, but will continue as normal until final decisions are made by the Government. The work on the detail of the transition arrangements will be guided by the following principles:

- Maintain business confidence in government support for R&D
- Provide certainty and predictability of funding for businesses carrying out R&D
- Support the successful implementation of the R&D Tax Incentive
- Avoid a fall in business expenditure on R&D caused specifically by the transition arrangements
- Provide for a simple and efficient transition for existing Growth Grant recipients
- Avoid fiscal risk to Government accounts
- Respond to the needs of various business types while ensuring no firms are specifically favoured or disadvantaged by the transition process.

In parallel with the public consultation on the proposals in this discussion document we will consult on the process for transition to the Tax Incentive with existing recipients of Growth Grants and businesses with Project Grants who were on a trajectory to apply for Growth Grants.

As outlined on page 23 additional features of the scheme for businesses in loss will be developed for implementation from the 2020-2021 income year.

Section 3

HOW TO HAVE YOUR SAY

Submissions

Section 2 of this document discusses design settings and proposals for the R&D Tax Incentive. We are interested in your views on the questions in this part (collected together in Appendix 1).

See **MBIE's website** to make a submission online.

You can also email your submission to: **RDincentive@MBIE.govt.nz**

Or post your submission to:

'R&D tax incentive team'
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

Please send your submission by 5:00pm on Friday 1 June.

For more information visit **www.mbie.govt.nz/RDincentive**

Next steps

Your views will help us to develop policy options for the design of the R&D Tax Incentive. After the consultation period closes, MBIE, Inland Revenue, the Treasury and Callaghan Innovation will provide to the Government policy options, which will take into account your views, for inclusion in legislation to implement the Tax Incentive.

When that Bill is introduced to Parliament, you will also have an opportunity to submit in writing or verbally to a parliamentary Select Committee.

Personal information and confidentiality

Your submission will be shared with officials from Inland Revenue, Treasury and Callaghan Innovation. Any personal information in your submission will be held in accordance with the Privacy Act 1993. MBIE may publish the submissions and provide a summary on the website www.mbie.govt.nz. Please let us know if you do not want your name to be included in any submissions or summary of submissions that MBIE may publish. We will not publish your contact details (eg, email address, phone number or postal address).

MBIE may be asked to release submissions under the Official Information Act 1982. This Act has provisions to protect sensitive information given in confidence but MBIE can't guarantee the information can be withheld. If you do not want any information contained in your submission to be released, you need to tell us which information in your submission you consider should be withheld and explain why. For example, you might want some information to remain confidential because it is commercially sensitive or personal.

Appendix 1

Summary of discussion questions

Question 1: If SOEs, Crown Research Institutes, District Health Boards, Tertiary Institutions, and their subsidiaries are excluded from the tax incentive, what will the likely impact be on business R&D in New Zealand?

Question 2: How well does this definition apply to business R&D carried out in New Zealand?

Question 3: Does this definition exclude R&D that you think should be eligible, please illustrate with examples.

Question 4: Does the scientific method requirement exclude valid R&D in some sectors, please illustrate with examples?

Question 5: What would the impact be on business R&D in New Zealand if a materiality test was applied to both the problem the R&D seeks to resolve and the intended advancement of science or technology?

Question 6: How well does this definition apply to business R&D carried out in New Zealand?

Question 7: Are there any reasons why the exclusions should not apply to support as well as core activities? Please describe.

Question 8: Please provide any examples where social science research is/has been a core part of business R&D in New Zealand?

Question 9: What is the likely impact on business R&D in New Zealand if dual purpose activities are ineligible for the R&D Tax Incentive?

Question 10: What are the advantages and/or disadvantages of limiting eligible expenditure to R&D labour cost?

Question 11: What are the advantages and/or disadvantages of setting overhead costs as a percentage of R&D labour costs? What would the appropriate percentage be?

Question 12: Are there any reasons why expenditure related to R&D activities for which commercial consideration is received should be eligible for a tax incentive? Please describe.

Question 13: What variations or extensions to the definition of core activities are required to ensure it adequately captures R&D software activities?

Question 14: Are there reasons why continuity rules should not apply to tax credits? Please describe.

Question 15: Is the minimum threshold set at the right level? If 'no', please provide further details.

Question 16: How important is a cap or a mechanism to go beyond the cap? Please provide further details.

Question 17: What features of a Ministerial discretion or pre-registration would make them most effective?

Question 18: What are your views on the proposed mechanisms to promote transparency and enhance evaluation?

Question 19: Are there any other risks that need to be managed? Please describe.

Question 20: What are the risks with making external advisors liable in this way?

Question 21: What is the right level of information required to support a claim?

Question 22: What opportunities are there for customers to submit R&D Tax Incentive claims via third party software?

Question 23: What integrity measures do you think Inland Revenue should use?

New Zealand Government