MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

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

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

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

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MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Inland Revenue
Te Tari Taake

BRIEFING

R&D Tax Incentive: Phase 2

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

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

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Richard Walley	Policy Director, MBIE	04 901 4134	Privacy of natural persons	✓
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The following departments/agencies have been consulted
The Treasury, Callaghan Innovation

Minister's office to complete:

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

Comments

R&D Tax Incentive: Phase 2

Purpose

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

Recommended action

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

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

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

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

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

Agree / Disagree

Privacy of natural persons

[redacted]

Richard Walley
Policy Director
Labour, Science and Enterprise, MBIE

13 / 11 / 2018

Privacy of natural persons

[redacted]

Keith Taylor
Policy Manager
Inland Revenue

13 / 11 / 2018

Hon Dr Megan Woods
Minister of Research, Science and Innovation

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Hon Stuart Nash
Minister for Revenue

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Background

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

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

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

Supporting businesses in loss

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

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

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

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

Refundability in Year One will be limited

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

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

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

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

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

Parameters for Phase 2

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

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

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

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

Issues for further examination

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

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

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

   b. ***What can be learnt from international comparisons:***

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

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

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

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

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

Other issues to consider within Phase 2

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

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

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

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

Potential Phase 3 issues

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

Timelines and next steps

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

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

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

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

Suggested timetable

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