BRIEFING

Cabinet paper: R&D tax incentive for implementation

<table>
<thead>
<tr>
<th>Date:</th>
<th>2 August 2018</th>
<th>Priority:</th>
<th>Medium</th>
</tr>
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<tbody>
<tr>
<td>Security classification:</td>
<td>In Confidence</td>
<td>Tracking number:</td>
<td>0189 18-19 IR2018/515</td>
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**Action sought**

<table>
<thead>
<tr>
<th>Hon Dr Megan Woods</th>
<th>Provide feedback to officials on the attached Cabinet paper.</th>
<th>27 August 2018</th>
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<tbody>
<tr>
<td>Minister of Research, Science and Innovation</td>
<td>Forward the attached Cabinet paper to the Minister of Finance.</td>
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<tr>
<th>Hon Stuart Nash</th>
<th>Provide feedback to officials on the attached Cabinet paper.</th>
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<tr>
<td>Minister of Revenue</td>
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**Contact for telephone discussion (if required)**

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Telephone</th>
<th>1st contact</th>
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<tbody>
<tr>
<td>Richard Walley</td>
<td>Manager, Innovation Policy</td>
<td>04 901 4164</td>
<td>✔</td>
</tr>
<tr>
<td>Keith Taylor</td>
<td>Policy Manager, Inland Revenue</td>
<td>04 890 2808</td>
<td></td>
</tr>
<tr>
<td>Becci Whitton</td>
<td>Manager, Stakeholder and Government Engagement, Callaghan Innovation</td>
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**The following departments/agencies have been consulted**

The Treasury

**Minister’s office to complete:**

- [ ] Approved
- [ ] Noted
- [ ] Seen
- [ ] Declined
- [ ] Needs change
- [ ] Overtaken by Events
- [ ] Withdrawn

**Comment**

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Released consistent with the Official Information Act 1982
BRIEFING

Cabinet paper: R&D tax incentive for implementation

Date: 2 August 2018
Priority: Medium
Security classification: In Confidence
Tracking number: 0189 18-19
IR2018/515

Purpose

To provide you with a Cabinet paper to seek Cabinet to approve the design of the Research and Development (R&D) tax incentive to begin drafting legislation. This paper also provides additional advice on:

- Refundability and limitations on its design in year one
- Technical issues that need resolving.

Recommended action

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

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<tr>
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<th>Min. RS&amp;I</th>
<th>Min. Revenue</th>
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<tr>
<td>a</td>
<td>Agree that the design of refundability in year one will follow the constraints of the R&amp;D tax-loss cash-out scheme.</td>
<td>Agree/Disagree</td>
</tr>
<tr>
<td>b</td>
<td>Agree that expenditure should be eligible for the R&amp;D tax incentive if it is incurred on an eligible R&amp;D activity in the relevant income year, subject to the exceptions under the excluded expenditure list.</td>
<td>Agree/Disagree</td>
</tr>
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<td>c</td>
<td>Agree that the tax depreciation loss calculated on depreciable property acquired for use in R&amp;D be eligible for the R&amp;D tax incentive in the relevant income year.</td>
<td>Agree/Disagree</td>
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<td>d</td>
<td>Note officials will continue to work on an appropriate apportionment rule for dual purpose expenditure and report to Ministers on this in due course.</td>
<td>Noted</td>
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<tr>
<td>e</td>
<td>Note officials are finalising the eligible expenditure list, and the activity and expenditure exclusions lists and will report to Ministers on this in due course.</td>
<td>Noted</td>
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<tr>
<td>f</td>
<td>Note that the Cabinet paper seeks Cabinet approval for both Ministers of Research, Science and Innovation and Revenue to make final decisions on: Apportionment rule for dual purpose expenditure</td>
<td>Noted</td>
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- Activity exclusions
- Eligible and ineligible expenditure lists.

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<th>Agree that an R&amp;D tax incentive claim may only be made up until a year after the taxpayer’s return is required to be filed with Inland Revenue.</th>
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<th></th>
<th>Agree to adopt shareholder continuity rules for the R&amp;D tax credit that mirror those with respect to tax losses.</th>
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<td>Agree/Disagree</td>
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<th>Note that the annual administration cost is estimated to be up to $6 million per year and funding is sought for this cost through the reprioritisation of funding from the Growth Grant appropriation and/or the R&amp;D Tax Incentive appropriation.</th>
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<th>Note that we expect to provide you with final advice on transition arrangements for Growth Grant recipients to the R&amp;D tax incentive by 9 August, and will update the Cabinet paper accordingly following your decision.</th>
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<th>Note that officials will use the draft Cabinet paper to undertake inter-departmental consultation.</th>
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<th>Note any feedback on the Cabinet paper will be required by 27 August, or as soon thereafter as possible, to meet the lodgement date for Cabinet Economic Development Committee on 30 August.</th>
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<td>l</td>
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Richard Walley  
Manager, Innovation policy  
Labour, Science and Enterprise, MBIE  
03 / 08 / 18

Keith Taylor  
Policy Manager  
Inland Revenue  
03 / 08 / 18

Becci Whitton  
Manager, Stakeholder and Government Engagement  
Callaghan Innovation  
03 / 08 / 18

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

Hon Stuart Nash  
Minister of Revenue  
..... / ...... / ......
Background

1. Cabinet agreed to implement a non-refundable R&D tax incentive by 1 April 2019 and to consult on the design of the tax incentive [CAB-18-MIN 0056 refers]. Cabinet has also agreed that by April 2020 there will be some form of support for businesses in tax loss, and noted that the R&D tax incentive will replace Callaghan Innovation’s Growth Grants over time [CAB-18-Min 0051 refers].

2. Cabinet invited Ministers of Research, Science and Innovation and Revenue, in consultation with the Minister of Finance, to report back to Economic Development Committee on the outcome of public consultation on the design of an R&D tax incentive, and with advice on the preferred design.

Further advice and the Cabinet paper

3. The Cabinet paper attached at Annex One is drafted based on joint ministerial decisions made on the briefings: R&D tax incentive for implementation (3681 17-18/IR2018/435 refers) and support for loss-making firms and transition arrangements for Growth Grant recipients (3950 17-18/IR2018/499 refers). The Cabinet paper seeks Cabinet agreement to the final policy design of the R&D tax incentive in order to draft legislation for its introduction to Parliament in October 2018.

4. The Cabinet paper also includes additional information on the design of refundability for loss making firms in the first year of the R&D tax incentive. Advice and agreement to this design is sought through this briefing. This briefing also covers advice and agreement to several technical issues that have been included in the Cabinet paper.

5. You have agreed to keep Growth Grants for existing recipients until 31 March 2021. You have also agreed to receive further advice on the possibility of amending the terms and conditions of those grants to expedite the transition of firms from the Growth Grants scheme to the tax incentive.

6. We will provide you with advice on these options by 9 August 2018, and will then amend the Cabinet paper accordingly. If decisions are not able to be made before the Cabinet paper is finalised and lodged, then we recommend asking Cabinet to delegate final decisions on the transition from Growth Grants to the R&D tax incentive to the Minister of Research, Science and Innovation. The attached Cabinet paper includes a place-holder recommendation to this effect.

Refundability

7. Ministers have agreed to provide support to loss-making firms through the introduction of limited tax credit refundability, starting in the 2019/20 tax year. This will be a forerunner to the longer term refundability policy commencing in the 20/21 year (3950 17-18, IR2018/499, CI B-18-024 refers). There are two important constraints on the 2019/20 refundability policy:

   In order to gain Cabinet approval to its inclusion in the legislation planned for introduction in October this year, there is minimal time for its development and no time for broad public consultation.

   • It needs to be consistent with the longer term policy that will apply from 2020/21 in order to reduce transition costs. It is always easier to become more generous over time than to become less generous.

8. These constraints shape the proposal in this paper.
9. Work to determine the refundability policy that will apply from 2020/21, including alignment with the R&D tax loss cash out policy, is not complete. Officials anticipate presenting proposals to Ministers once the legislation providing for the 2019/20 tax incentive has been introduced.

10. Officials recommend using the design features of the tax loss cash out for the refundability policy in 2019/20.

11. We recommend using the tax loss cash out constraints, described below, as the basis for refundability of the R&D tax incentive in 2019/20. This is because of the three benefits that flow from these constraints already being defined in legislation:

- Using something off-the-shelf is consistent with the short timeframe for policy approval and drafting.
- They can be deployed without the fresh consultation that would be required if new constraints were applied.
- We can see what effect they are already having and therefore accurately predict the impact with respect to the tax incentive for the 2019/20 year. Currently 350 firms are participating in the tax loss cash out scheme, with the number growing each year.

12. The main downside to using the tax loss cash out constraints is that they are blunt instruments and set a high hurdle. However, these settings would only apply for the first year of the policy, a point that would be emphasised in any communications about the policy.

The R&D Tax Loss Cash Out Scheme

13. The R&D tax loss cash out scheme is targeted at R&D intensive New Zealand based companies. It was introduced in 2015/16 to recognise that R&D intensive start-ups are likely to need successive financing rounds which might dilute shareholding and lead to tax losses being foregone. There are two main eligibility requirements:

- at least 20% of a firm’s wages are spent on R&D wages
- a cap on the level of eligible R&D expenditure, which in 2019/20 will be $1.8 million.

14. The cap of $1.8m will mean a maximum payout of $270,000 per claimant with the credit rate at 15%.
Technical issues

General expenditure rule

15. You have agreed to a requirement that expenditure be deductible (or an amount of depreciation loss) to be eligible for the R&D tax incentive (3681 17-18/IR2018/435 refers). After further consideration and discussion with key stakeholders on the requirement that expenditure be deductible, we consider this rule would be inconsistent with the policy intent, which is to reward business R&D whether it is successful or not, and that the accounting treatment of R&D expenditure should not influence its eligibility for the R&D tax incentive.

16. Expenditure on unsuccessful R&D is often black hole expenditure, which is non-deductible, and would be excluded from the R&D tax incentive should a deductibility requirement be imposed. To avoid a bias against unsuccessful R&D, we propose that expenditure should be eligible for the R&D tax incentive if it is incurred on an eligible R&D activity in the relevant income year. This would be, subject to specific exceptions under the excluded expenditure list.

17. It is proposed that the tax depreciation loss calculated on depreciable property acquired for use in R&D be eligible for the R&D tax incentive in the relevant income year. Without this exception, the entire cost of the depreciable property used in R&D would be eligible in the year the property is acquired. We also propose that prepayments and other tax adjustments follow their usual tax treatment.

18. Where a business has decided to defer its deductions of R&D expenditure, the deferred expenditure is nevertheless eligible in the year it is actually incurred rather than in the year to which the deduction is deferred.

Apportionment rule for dual purpose expenditure

19. Officials consider an apportionment rule for dual purpose expenditure is necessary to reduce the opportunity for businesses to receive R&D tax credits for business as usual and recharacterisation of other non-R&D expenditure.

20. We consider it helpful to distinguish between R&D that occurs as a discrete activity and R&D that is integral to a commercial process, such as R&D performed while a factory is producing its standard output. In the first instance, we consider a firm should be able to use apportionment rules to allocate a reasonable portion of its overhead and shared costs to its eligible cost of R&D. In the latter instance, we consider a stricter additionality principle is more appropriate. This would mean the firm could only claim as R&D expenditure the additional costs associated with undertaking the R&D. Officials are still testing the practicality of these approaches with key stakeholders. The Cabinet paper seeks approval for Ministers of Research, Science and Innovation and Revenue to make final decisions on this rule.

Finalised activity and expenditure exclusions list

21. Officials are finalising advice on both activity and expenditure exclusions from the R&D tax incentive. Any items added to the activity exclusions list should be based on the following principles:

- To remove uncertainty over whether the activity could be considered R&D.
- To clarify the boundary between R&D and non-R&D activity, such as between development and post-development activity, or innovative and routine work.
- Preventing the R&D tax incentive scheme incentivising particular activities, such as where there are insufficient economic spillovers.

22. The principles that will determine any further items being added to the expenditure exclusions list include:
• The lack of sufficient connection of the expenditure to the R&D activity.
• To reduce compliance and administrative costs.
• To prevent the credit applying to the same expenditure twice (i.e. prevent double dipping).
• To prevent the abuse of the tax incentive and limit fiscal cost.

23. The final lists of activity and expenditure exclusions will be worked through as part of the legislative drafting process and officials will report to Ministers on this at a later date. The Cabinet paper seeks approval for Ministers of Research, Science and Innovation and Revenue to make final decisions on these lists.

Claims filing
24. Officials recommend that an R&D tax incentive claim may only be made up until a year after the taxpayer’s return is required to be filed with Inland Revenue. This is to manage fiscal risk and to ensure we incentivise additional R&D. Claims filed several years after the R&D has been a source of higher expenditure in other jurisdictions. Also, if a claim is filed several years after it is due, it is unlikely the claimant was aware they were doing R&D or that they will be incentivised to do more R&D.

Shareholder continuity with losses and the R&D tax incentive
25. This section provides further information on the relationship between shareholder continuity as applied when carrying forward tax losses and the R&D tax incentive.

26. In general, losses can be retained by a business to offset future earnings for the purposes of calculating tax liability. However, a business ordinarily retain its tax losses while there is a continuous group of shareholders whose combined voting interest in the company is 49% or more. If more than 51% of a company is sold, tax losses cannot be retained.

27. Shareholder continuity requirements are particularly problematic for start-ups. These firms may be in tax loss for a number of years, and may have several capital raising rounds, thereby diluting their ownership. This can result in the shareholder continuity rule being broken, and tax losses incurred early in the business’ life being forgone. This issue has been partially recognised within the tax system for firms undertaking R&D, through the tax loss cash out scheme and through another provision whereby allowing firms to elect the year in which their R&D expenses are recognised. The effect of these is to shield R&D component of a firm’s loss can survive a breach of shareholder continuity, though other parts of the firm’s losses will be forgone.

28. Some other jurisdictions offer a ‘same or similar business’ test, in addition to a shareholder continuity test, allowing losses to be carried forward over significant ownership changes. This policy change, and the wider issue of loss continuity has been raised with government, and is currently being reviewed by the Tax Working Group.

Shareholder Continuity with the tax incentive
29. Shareholder continuity with R&D tax credits is a separate, but related, issue to continuity with losses. Ministers may wish to allow tax credits earned under the incentive to be carried forward despite breaches in shareholder continuity. In the abstract, we think this is a good idea. However, we recommend initially adopting continuity rules that mirror those with respect to losses for three reasons:

• There is a process in train already via the Tax Working Group which may provide recommendations on shareholder continuity. We do not want to undermine that process by moving ahead with a special regime for the tax incentive.
• Separate regimes for R&D and for tax losses are messy and complicated.
• Refundability removes continuity problems. If firms are able to access their R&D credits via a refund, it will be unnecessary to carry them forward and risk losing them through breaches of shareholder continuity.

Administration costs
30. Budget 2018 allocated $4.3 million over four financial years for the administration of the R&D tax incentive through Vote Revenue. This was primarily to cover one-off implementation costs of introducing the policy, based on what was then known. It does not necessarily include additional implementation costs for improvements such as in-year refundability. It contained a small amount for ongoing administration. Experience from overseas has shown that it is important for tax authorities to be appropriately resourced to ensure integrity and sustainability of the scheme.

31. Inland Revenue has now identified that additional FTEs are required to administer the tax incentive. Officials have estimated up to 20 FTEs are required, which would cover advisory, compliance, on-going operational support, technical escalations and management. The full cost of the annual ongoing administration is estimated to be up to $6 million per year. The exact cost will depend on policy settings and the level of uptake of the incentive. Inland Revenue will continue to refine its cost estimates and reconcile these against the current allocation.

32. Officials consider that this cost can be met within baseline funding under the R&D Tax Incentive appropriation combined with the reprioritised funding from the Growth Grant appropriation. The Cabinet paper seeks approval for this reprioritisation.

Regulatory Impact Assessment
33. The regulatory impact assessment (RIA) has not been attached to the Cabinet paper. The RIA is currently being prepared and will be assessed by officials from the Ministry of Business, Innovation and Employment, Inland Revenue and the Treasury.

34. The assessment will be finalised in time for submission of the Cabinet paper to the Economic Development Committee on 30 August. It will be provided to your office by mid-August.

Next Steps
35. We recommend you review the draft Cabinet paper and consult with your colleagues, coalition partner and confidence and supply partner. Note that we will use the draft Cabinet paper to undertake inter-departmental consultation.

36. We recommend you provide feedback to officials on the Cabinet paper by 27 August, or as soon thereafter as possible so that it can be lodged on 30 August 2018, for consideration at Cabinet Economic Development Committee on 5 September 2018.

37. Subject to Cabinet agreement, the expected introduction of the Taxation (Research and Development Tax Credits) Bill is October 2018.

Annexes
Annex One: Cabinet Paper, Research and Development tax incentive for implementation