



BRIEFING

Research & Development Tax Incentive Early Implementation Review

Date:	20 November 2020	Priority:	High
Security classification:	In Confidence	Tracking number:	MBIE: 2021-1234 IR2020/479

Action sought		
	Action sought	Deadline
Hon Dr Megan Woods Minister of Research, Science and Innovation	Agree to discuss actions to improve the implementation of the RDTI with the Minister of Revenue and officials.	23 November 2020
Hon David Parker Minister of Revenue	Agree to discuss actions to improve the implementation of the RDTI with the Minister of Research, Science and Innovation and officials.	23 November 2020
Hon Dr Ayesha Verrall Associate Minister of Research, Science and Innovation	Note the contents of this briefing.	23 November 2020

Contact for telephone discussion (if required)			
Name	Position	Telephone	1st contact
Richard Walley	Policy Director, Science, Innovation and International	Privacy of natural persons	✓
Mary Mulholland	Principal Policy Advisor, Innovation Policy		
Kerryn McIntosh-Watt	Policy Director (acting), Inland Revenue		
Chris Gillion	Policy Lead, Inland Revenue		
Esther Livingston	Chief Operations Officer, Callaghan Innovation		
Danielle Hannan	Manager Partnerships & Design, Callaghan Innovation		

The following departments/agencies have been consulted

Minister's office to complete:

Approved

Declined

Noted

Needs change

Seen

Overtaken by Events

See Minister's Notes

Withdrawn

Comments

BRIEFING

Research & Development Tax Incentive Early Implementation Review

Date:	20 November 2020	Priority:	High
Security classification:	In Confidence	Tracking number:	MBIE: 2021-1234 IR2020/479

Purpose

This briefing provides an update on the implementation of the R&D Tax Incentive (RDTI), drawing on the findings of a recent review commissioned by MBIE and feedback from businesses and advisors.

Executive summary

The RDTI is intended to support a wide range of R&D performing businesses to increase their investment in R&D. 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.

Successful administration of the RDTI is essential to establish a world-class, accessible and efficient scheme that will achieve the Government's objectives. Good progress has been achieved with comprehensive guidelines developed in parallel to the legislation and engagement with stakeholders through the policy, legislation and implementation process. However, there are early indications that the take-up of the RDTI is lower than expected and that some businesses are finding the application of the scheme challenging.

R&D Tax Incentives are difficult policies to administer. Recognising this, MBIE commissioned PwC to undertake an early implementation review. The review identified that good progress was made in setting up the scheme, but that urgent measures are needed to:

- **Strengthen the partnership approach to the RDTI.** While there is an existing Memorandum of Understanding (MoU) in place between Callaghan Innovation and Inland Revenue, there is an opportunity to strengthen expectations of working across all three agencies. An additional tripartite MoU between MBIE, Inland Revenue and Callaghan Innovation will establish governance and information sharing arrangements.
- **Expand and improve engagement with businesses.** Engagement is necessary to assist businesses to understand the requirements of the scheme. A priority group for targeted engagement are businesses that are about to transition from Growth Grants to the RDTI.
- **Address uncertainty around the eligibility requirements and that they are potentially being applied too narrowly.** The review highlights that applicants consider the legislative tests for eligible R&D are being applied too narrowly and, consequently, that the compliance costs of applying outweigh the benefits.

The findings are consistent with what officials have heard directly from a number of businesses, advisors and industry organisations Commercial Information. The concerns are not restricted to one sector, although it appears that technology businesses are more likely to be told that they do not qualify.

Information on actual uptake should be interpreted cautiously as the majority of claims for the 2019/20 tax year will be not submitted until 7 May 2021, accordingly data on the first full year of applications is not yet available. COVID-19 may also have had an impact. At this stage, only a small

number of applications have been received. Of the 144 Supplementary Returns received, 43 have been processed and 19 have been approved (44% pass rate) equivalent to \$950,000 of RDTI support. Of the 103 General Approvals received for Year Two, 44 have been processed and 9 have been approved (20% pass rate). The figures do not include businesses seeking Criteria and Methodologies approval, which is intended to be a streamlined process for significant R&D performers.

Innovation will be a critical part of the economic recovery from COVID-19 so these early results indicate that change is needed. To address this, we have identified a hierarchy of actions to streamline the RDTI decision process and improve the user experience.

Actions with immediate effect to respond to the PwC Implementation Review including:

- strengthening the partnership approach as set out in the tripartite MoU;
- establishing shared performance measures for the programme including governance and accountabilities;
- stepping up engagement and education, including visits, with businesses in advance of the approvals process and ensuring there is a plan around each applicant as to how they will be managed;
- improving the RDTI guidelines and the issuing of sector specific guidelines; and
- reviewing declined applications to understand the drivers for these decisions and using this to inform a review of the definition of eligible R&D.

We think that the above actions will have a significant impact on customers' experience with the scheme, but it may take some time for this impact to be visible. There are other options which could be considered in addition to the above if these do not bring about the desired results. A number of these additional options are outlined below.

Actions that could be progressed in the next 3 to 6 months subject to Ministerial approval (these options require further policy work and legislative change). Our priority actions are:

Confidential advice to Government

Recommended action

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

- a **Note** that a review into the early implementation of the RDTI has highlighted that measures are required to address the following areas to ensure that the administration of the scheme meets the Government's expectations:
- Strengthen the partnership approach to the RDTI;
 - Expand and improve engagement with businesses including a plan for this work; and
 - Address concerns that R&D eligibility requirements are being applied too narrowly.

Noted

- b **Note** that, to date, the number of businesses who are successfully meeting the RDTI requirements are low (the pass rate is 44% for supplementary returns and 20% General Approvals), however, businesses have until 7 May 2021 to file claims for year one.

Noted

- c **Agree** to discuss options to address these findings with officials.

Agree/Disagree

Richard Walley
Policy Director
Labour, Science and Enterprise, MBIE

20 / 11 / 2020

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

..... / /

Kerryn McIntosh-Watt
Policy Director (acting)
Inland Revenue

20 / 11 / 2020

Hon David Parker
Minister of Revenue

..... / /

Esther Livingston
COO Internal Partnering
Callaghan Innovation

20 / 11 / 2020

Continued investment in business R&D is critical to our ability to build a more resilient, prosperous and sustainable economy post COVID-19

1. Innovation will be at the heart of the economic recovery from COVID-19. Research and Development (R&D), especially that performed by businesses, is recognised as a main driver of technological innovation. It creates new knowledge that not only enables the business to produce new and improved products, but also provide benefits to others in the economy (such as competitors) that are not captured by the business itself. Encouraging these spill overs is a primary motivation for governments to subsidise business R&D through mechanisms such as R&D tax incentives.
2. Continued investment in innovation, including through the RDTI, is a Government priority. According to Statistics New Zealand's R&D survey, there are approximately 1,500 to 2,000 businesses in New Zealand that report undertaking R&D.¹ A key goal of the programme is to broaden the base of R&D performing businesses by delivering support for R&D through a rules-based programme delivered through the tax system.
3. The RDTI is the government's largest investment in business R&D with a budgeted allowance of around \$1.02 billion dollars over the next four years.

Successful administration of the RDTI is essential to achieving the Government's objectives

4. The administration of the RDTI was designed to balance two goals:
 - Education and engagement: provision of accessible support to a wide range of businesses; and
 - Integrity and compliance: maintaining trust and confidence in the tax system through effective use of government funding, which in turn would support a sustainable scheme.
5. Experience from other jurisdictions showed that building awareness and understanding of the programme through an education and information programme would be important to support uptake and to improve the quality of claims. For example, Canada runs engagement pre-claim to support the receipt of the best possible claims and post-claim for those who were unsuccessful to improve any subsequent claim. Callaghan Innovation was tasked with leading this due to its extensive networks with businesses and knowledge of business R&D. Sufficient resourcing was approved for the implementation of the scheme so that staff would be able to proactively engage with applicants, including site visits, where necessary.

MBIE commissioned a review of the early implementation of the RDTI

6. Evidence from the implementation of R&D tax incentives around the world show they are difficult to implement. Given this, in July 2020, MBIE commissioned PwC to conduct a review of the early implementation of the RDTI. The purpose of the review was to check whether the programme was being implemented in line with the policy objectives of delivering a world-class, accessible and efficient programme.
7. A key focus for the review was the user experience of the scheme to date. The review team interviewed and/or surveyed all major groups of stakeholders in the scheme. A copy of the final report is attached as Annex Two.

¹ The R&D Survey uses a different definition of R&D than the RDTI.

The foundations of the scheme are in place but key areas need to be developed further

8. The review found that good progress has been made in setting up the scheme. The review noted that “overall reasonably good progress has been made with implementing the scheme” including the establishment of the core team. They also note the working relationship is improving considerably. The review then notes that it is a new scheme and further progress is needed in the following areas:
 - **Further strengthen the partnership approach to the RDTI.** Agencies are working together and progress is being made, a tripartite MoU between MBIE, Inland Revenue and Callaghan Innovation is being signed to support both governance and information sharing. This is a key foundation for the three-way partnership that is intended to underpin policy and programme delivery.
 - **Expand, and improve the quality of, engagement with businesses.** While the marketing and communication strategy has been fully deployed, there is a need to now focus on direct engagement with businesses, including site visits. This is necessary to improve businesses’ understanding of the requirements and to assist them into the scheme. Engagement will help improve the quality of applications. Continued improvements to the guidance, including more case studies, will be an area of significant resource investment in the near future. This will include issuing guidance for particular sectors such as software and horticulture.
 - **Address uncertainty around the eligibility requirements and that they are potentially being applied too narrowly.** A theme in the feedback from businesses and their advisors is that the legislative tests for eligible R&D are restrictive and the approach taken to eligibility assessments is adding compliance costs.
9. The review also noted that businesses had raised that software R&D and its treatment under the scheme as an area of concern.

These findings are consistent with feedback officials have heard from stakeholders

10. These findings are consistent with what officials are hearing directly from businesses, their advisors and industry bodies Commercial Information
11. Concerns about eligibility are not restricted to one sector, although it appears that technology businesses are finding the RDTI more difficult to access than the previous R&D Growth Grants scheme. Some businesses, in particular those who are or were until recently receiving Growth Grants, have told officials that they expect to get significantly less support under the RDTI.
12. Commercial Information
13. The tax system is largely based on the customers providing self-assessments that Inland Revenue are able to take at face value.² However, for the RDTI, the legislation requires that the Commissioner of Inland Revenue must be ‘satisfied’ as to the eligibility of an applicant. As a result, the operational team must assess the applicant’s eligibility in a more considered and robust manner than the other parts of the tax system. This aspect of the

² This is supported by a risk based audit and investigation approach.

system appears to be a source of frustration for businesses. The pre-approval process was designed to provide certainty to businesses about their eligibility for the RDTI. Feedback suggests this feature of the regime may not be working as intended. A suggestion for recalibrating this is included in the options set out below.

The difference between the Growth Grants and the RDTI is a source of tension

14. The business concerns outlined above should be considered alongside the difference in policy settings between the two regimes. One aspect often overlooked is that R&D Growth Grants were not intended to provide enduring support for individual businesses in the way that the RDTI does. A number of Growth Grant recipients would have no longer been eligible for R&D support through this scheme because they did not meet the requirements e.g. to continue to grow their R&D expenditure or meet the R&D intensity thresholds. Affected businesses performing eligible R&D may be better off under the RDTI.

Information from Inland Revenue on approvals is consistent with PwC’s assessment

15. PwC did not have access to hard data on the number of RDTI claims being processed and on approvals. Figures provided to MBIE by Inland Revenue on 6 November 2020 to support this briefing appear to confirm that only a small proportion of businesses are making it through the assessment process.

	Filed	Processed	Approved (Pass rate)	Declined	Withdrawn
Year One (Supplementary returns)³	144 ⁴	43	19 (44%)	14	10
Year Two (General Approvals)	103	44	9 (20%)	26	9

16. The General Approval is the binding pre-approval for R&D activity and is the key metric for uptake. General Approval is required for the current (2021) and later tax years (each one can cover up to three years) so that relevant expenditure can be included in that year’s Supplementary return. In year one (2020), General Approval was not available so taxpayers only filed Supplementary returns. From 2021, this is based directly on the General Approval (no 2021 supplementary returns have yet been received).
17. The nineteen approved supplementary returns sought the RDTI for a total of around \$6.3 million of gross R&D expenditure. This equates to approximately \$950,000⁵ of RDTI support approved (15% of 6.3 million).⁶ The figures are in contrast to the temporary R&D loan scheme which has supported 369 businesses with a total loan value to date of \$109 million.
18. The figures above do not capture businesses seeking Criteria and Methodologies approval (CAM). The CAM is intended to be a streamlined process for significant R&D performers (spending more than \$ 2million on R&D per year). There will be a small number of these applications, but they will likely form a significant proportion of the credits paid out.
Commercial Information

³ Note that there was no general approval process for Year One of the scheme.

⁴ The total stated R&D expenditure for all filed supplementary returns is \$45 million.

⁵ Inland Revenue are yet to assess the eligible expenditure so the final RDTI support figures may change.

⁶ The 2020 Estimates of Appropriations allocated \$225 million for 2019/20.

19. At this early stage it is uncertain how many claims are in preparation. However, a concern is that some businesses are self-selecting out of the scheme.
20. We expect that increased engagement will help improve businesses understanding of the requirements and should have an impact on approval rates over time. Business site visits are proposed as part of the engagement process (COVID-19 permitting). Both Callaghan Innovation and Inland Revenue can apply currently allocated and unspent RDTI administration funds for this.

Actions are needed to enable the scheme to meet the Government's objectives

21. These early numbers along with the feedback indicate further work is required to ensure the Government's objectives are met. We have identified a hierarchy of actions to streamline engagement, improve governance, the claims process and improve the user experience.

Actions with immediate effect to respond to the PwC Implementation Review

22. MBIE, Callaghan Innovation and Inland Revenue have jointly developed an Action Plan to address the findings of the review and are implementing these actions with immediate effect. Key actions in the plan include:
 - Embedding the partnership approach set out in the tri-partite MoU to strengthen governance and oversight. This will establish clear joint governance and appropriate accountabilities to ensure whole agency focus on delivery at all levels;
 - Establishing a set of performance measures for the programme with shared accountability for success;
 - Stepping up engagement with businesses – as we have heard from other jurisdictions, pre and post engagement with businesses is key to a successful scheme. Officials are making further improvements to our engagement programme including developing pre and post engagement plans for customers and jointly working through applications with businesses and their tax agents to build their capability to present high quality and informed applications;
 - Continuing engagement with Growth Grant recipients transitioning to the RDTI;
 - Improving the RDTI guidelines and supporting industry sector materials; and
 - Reviewing declined applications to check that the policy design and process outcomes meet the Government's objectives. We will use this process to inform a review of the definition of eligible R&D. This may identify a need for improvements to policy or legislation.
23. The previous Minister of Revenue established a private sector committee (R&D Advisory Group or RDAG) to contribute their expertise to the policy development and its legislative implementation. There may be merit in formalising this committee to now provide expert input on the implementation going forward.
24. We consider that the above actions will support the scheme and user experience by actively supporting businesses to understand and access the scheme. The operational team's preliminary view is that many of the applicants are not engaging with the definition. Improved engagement with businesses should support them to demonstrate their claim.
25. As part of improving support to businesses and other stakeholders such as tax agents, Inland Revenue has also been improving its legal guidance as its understanding of the legislation becomes better informed by applicants and the R&D environment it is seeing. This has meant on-going refinement and improvement in its practice and in the guidance for applicants. Inland Revenue is supporting Callaghan Innovation in giving effect to these

on-going enhancements. We expect that this work will improve applicants' experience and perceptions of the General Approval process.

26. At the same time, the review of declined applications will surface any underlying policy issues that may need to be considered as well as identifying if there are particular areas where business and stakeholder understanding need to be further developed.

Options that could be progressed in the next 3 to 6 months

27. We think that the above actions will have a significant impact on the customer experience of the scheme, but it may take some time for this impact to be visible. Ministers may also wish to consider other additional options to further strengthen the user experience and the decision process of the scheme if the above options do not bring about the desired results.
28. We have identified the following priority options to streamline the decision-making process and provide certainty for key R&D performing businesses, both of which require further policy work and legislative change:
 - *Transition Growth Grant recipients directly into the RDTI* - This will cushion the transition from Growth Grants to the RDTI while encouraging these businesses to engage with the RDTI.

Confidential advice to Government

29. These priority options could be further supported by measures to address upfront compliance costs and challenges for businesses seeking to access the scheme. These options also require legislative change:

Confidential advice to Government

- *Progress in-year refundability of the RDTI* – this would provide businesses with greater choice about when they access the financial support provided through the RDTI to manage their cash flow and may be of particular interest to loss-making businesses and pre-revenue start-ups who face greater cash flow challenges.

Further actions

30. Support for software development was identified as an area of concern during the policy consultation. Accordingly, Inland Revenue has progressed a review on the treatment of software in tax incentive regimes as part of its tax policy work programme. Inland Revenue has been consulting with policy and operational people from other countries (Singapore and Canada) for critique and comment on the New Zealand rules. Inland Revenue will report back to Ministers on this review.
31. Beyond the RDTI, the digital sector is an MBIE priority. Industry policy is working closely with the sector on a Digital Industry Transformation Plan which could be a mechanism to address any gaps in government support for the sector. MBIE will provide further advice

to Ministers on innovation funding mechanisms to complement the tax incentive including whether there is a case for a software-specific mechanism in this area.

We expect that you will be contacted by businesses and their representatives about the RDTI and alternative support for technology businesses

32. Businesses and industry organisations, Commercial Information [REDACTED] have informed us that they intend to raise their concerns about the RDTI with Ministers. Businesses are also asking whether the Government is intending to provide alternative support for the tech-sector.
33. We will work with your office on communications material to support engagement with businesses on these issues.

Annexes

Annex One: RDTI policy and design features

Annex Two: PwC report on the implementation of the RDTI

Annex One: RDTI policy and design features

The R&D Tax Incentive seeks to increase investment in R&D by lowering the cost to businesses of performing R&D

Innovation and the creation of new knowledge through investment in research and development (business R&D) underpins a sustainable and productive economy.

Business expenditure on R&D is the major proxy for levels of innovation in New Zealand. Expenditure increased by 121 per cent between 2010 and 2018.

However, business expenditure on R&D is low relative to other countries; 0.74 per cent of New Zealand's GDP in 2018 compared to the average for other small advanced economies (1.88 per cent), and the overall OECD average (1.70 per cent).

There is strong international evidence that R&D tax credits are effective at incentivising increased business investment in R&D. In 2020, 32 out of 37 OECD countries offered some form of R&D tax incentive for business R&D.

The advantage of a Tax Credit as a vehicle for supporting business R&D is that all businesses interact with the tax system thereby enabling a much broader base of businesses to access government support than through mechanisms such as an R&D grant scheme.

The RDTI replaces the R&D Growth Grants scheme as the Government's main form of support for business R&D. The Growth Grant scheme will completely cease at the end of March 2021.

New Zealand's R&D Tax Incentive, including the definition of R&D, is consistent with international best practice

The RDTI seeks to support as much genuine R&D as possible whilst maintaining the integrity of the tax system. Additionally the RDTI is intended to:

- provide easily accessible support to a broad range of R&D performing businesses;
- provide certainty for businesses;
- be sustainable and stable;
- maintain trust and confidence in the tax system; and
- complement and strengthen the Government's package of support for research, science and innovation.

The key design features of the RDTI are:

- a 15% tax credit on eligible R&D expenditure between \$50,000 and \$120 million;
- businesses that spend less than \$50,000 a year on R&D can still access the RDTI if their R&D is contracted to an approved research provider;
- Businesses can exceed the \$120 million expenditure cap by seeking approval for a new expenditure cap with the Commissioner of Inland Revenue, who must make the decision in consultation with the Chief Executive of MBIE; and
- A definition of R&D based on the OECD Frascati manual, and is consistent with international best practice.

RDTI definition of Research & Development*

R&D means an activity that -

- is conducted using a systematic approach; and
- has a material purpose of creating new knowledge, or new or improved processes, services, or goods; and
- has a material purpose of resolving scientific or technological uncertainty; but

It does not include an activity, if knowledge required to resolve the uncertainty is -

- publicly available;
- deducible by a competent professional in the relevant scientific or technological field...

*Income Tax Act 2007, Section LY 2 (1).

- The definition of R&D is deliberately broad in order to support as much R&D as possible, and it is also neutral with respect to sector or firm size. The definition was amended during consultation on the draft legislation in response to feedback from businesses that the definition would not support software R&D.
- The schedules to the Act contain provisions to exclude particular activities from accessing the Tax Incentive (e.g. routine de-bugging of existing software) and to cap particular types of expenditure that are likely to create fiscal risks (e.g. purchasing bespoke software solutions).

Businesses that are in a tax loss position are eligible to receive their tax credit in cash (refundable tax credits) instead of carrying the credit forward. This is particularly important for early stage businesses including pre-revenue start-up firms.

A limited form of refundable tax credits was introduced in 2019 to apply in year one. In 2020, the scheme was amended to broaden access to refundable tax credits and, in response to COVID-19, access to the broader form of refundable tax credits was brought forward to apply to the first year of the scheme.

The refundable tax credit is capped by the total amount of labour related taxes paid by the business to minimise the increased risk of fraud that occurs when cash is paid out via the tax system. R&D performed by an approved research provider is excluded from the cap.

In year one of the scheme, all businesses can access the RDTI through their supplementary return. In year two of the scheme, businesses are required to seek General Approval for their intended R&D activities at the start of the tax year. Businesses that spend more than \$2 million a year on R&D can opt into the Significant Performer Regime and apply for a Criteria and Methodology Approval.

Annex Two: PwC Implementation Review

Provided as an attachment.