MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Callaghan Innovation

BRIEFING

R&D Tax Incentive: Options to expedite transition of Growth Grant recipients

Date:	9 August 2018	**Priority:**	High
Security classification:	In Confidence	**Tracking number:**	MBIE 0512 18-19 CI B-18-027

Action sought		
	Action sought	**Deadline**
Hon Dr Megan Woods **Minister of Research, Science and Innovation**	**Agree** to one of the presented options for the transition period for Growth Grant recipients **Agree** to provide an automatic extension to the end of the transition period Growth Grant contracts expiring from 1 April 2019 **Agree** to one of the presented options for extensions to Growth Grant contracts expiring before 1 April 2019 **Direct** officials to advise on changes to the Ministerial Direction and a transitions communication plan	13 August 2018

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Richard Walley	Policy Director, Science, Innovation and International, Ministry of Business, Innovation and Employment	04 901 4134	s 9(2)(a) [redacted]	✓
Becci Whitton	Manager Stakeholder and Government Engagement, Callaghan Innovation	-		

The following departments/agencies have been consulted
Inland Revenue, Treasury

Minister's office to complete:

☐ Approved ☐ Declined

☐ Noted ☐ Needs change

☐ Seen ☐ Overtaken by Events

☐ See Minister's Notes ☐ Withdrawn

Comment

BRIEFING

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Date:	9 August 2018	**Priority:**	High
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Purpose

To provide advice on options to expedite the transition of Growth Grant recipients onto the R&D Tax Incentive.

Recommended action

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

		Min RS&I
a	**Agree** to	
	1. Provide an optional two-year transition period for all existing Growth Grant recipients without any limitations or changes in terms (Recommended)	*Agree / Disagree*
	OR	
	2. Provide an optional one-year transition period for all existing Growth Grant recipients and a second optional year to businesses with insufficient tax liability to use an R&D Tax Incentive in full (Not recommended)	*Agree / Disagree*
	OR	
	3. Provide an optional two-year transition period for all existing recipients but reduce the rate of the Growth Grant in the second year (Not Recommended)	*Agree / Disagree*
b	**Note** that under current rules Growth Grant recipients with expiring contracts are required to prove they have maintained their R&D expenditure since their last review to obtain an extension	*Noted*
c	**Agree** to provide an automatic extension until the end of the transition period to Growth Grant recipients whose contracts expire on or after 1 April 2019	*Agree / Disagree*
d	**Agree** to	
	A. Provide an automatic extension until the end of the transition period to Growth Grant recipients whose contracts expire before 1 April 2019 (Not recommended)	*Agree / Disagree*
	OR	
	B. Continue the existing contract-renewal process until 31 March 2019 and, for those companies who do not meet the criteria for a renewal, allow a contract extension only to 31 March 2020 (Recommended)	*Agree / Disagree*

e **Direct** officials to	
a) Advise on changes to the R&D Grants Ministerial Direction; and	*Agree / Disagree*
b) Advise on a transitions communication plan	*Agree / Disagree*

s 9(2)(a)

[redacted]

P.P Simon Wakeman

Richard Walley
Manager, Innovation Policy
Labour, Science and Enterprise, MBIE

9 / 8 / 2018

Hon Dr Megan Woods
Minister of Research, Science and Innovation

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s 9(2)(a)

[redacted]

Becci Whitton
Manager, Stakeholder and Government Engagement
Callaghan Innovation

9 / 8 / 2018

Background

1. On 19 July 2018 you agreed to provide limited, end-of-year refunds through the tax system during the first two years of the R&D Tax Incentive (prior to full, in-year refunds becoming available from 1 April 2021). You also agreed to keep Growth Grants available to existing recipients until 31 March 2021 (ie, for one year longer than the period that had been consulted on) to provide a channel for firms with insufficient tax liability to use their tax credits immediately ("firms in loss").

2. At the same time you agreed to discuss the possibility of amending the terms and conditions of the Growth Grant in the transition period, with a view to expediting the transition of Growth Grant recipients onto the R&D Tax Incentive. This paper provides that advice.

3. This paper also provides advice on granting extensions to existing recipients whose Growth Grants expire before the end of the transition period, regardless of whether they would qualify under the current rules.

Options for the second year of the Growth Grants transition period

Allowing a two-year transition period to all Growth Grant recipients is simplest, but may mean few recipients take up the R&D Tax Incentive before 1 April 2021

Option 1: Allow all recipients to remain on Growth Grant for two years, with no changes to terms or conditions

4. Our recommended option is to allow all recipients to remain on the Growth Grant until 31 March 2021, with no changes to terms or conditions. Growth Grant recipients would still have the freedom to move onto the R&D Tax Incentive at any point from 1 April 2019.

5. This option has the advantage of being simple to communicate, easy to understand by businesses, and minimises the administrative costs on Callaghan Innovation. It gives all firms additional time to adapt their internal systems and R&D plans to the new support mechanism. Businesses are also likely to view it as a constructive response to feedback they provided during the consultation period.

6. The main disadvantage is that some Growth Grant recipients are likely to delay their move onto the R&D Tax Incentive, even if they are not disadvantaged by the absence of in-year refundability. It is possible that a large majority of these firms will remain on the Growth Grant until 31 March 2021. This could create a perception that the R&D Tax Incentive is unattractive to the major R&D-performing businesses and thereby undermine confidence in the system during its first two years. This in turn may create uncertainty for businesses around the longevity of the R&D Tax Incentive.

7. Increasing the rate of the R&D Tax Incentive to 15 percent should mitigate this concern to some extent. At this rate, the R&D Tax Incentive will be slightly more generous financially to firms than the effective rate of a Growth Grant, all else being equal.[1] Hence we would expect that some firms with sufficient tax liability will voluntarily shift to the R&D Tax Incentive from 1 April 2020 (if not before).

8. The other disadvantage is that Growth Grant recipients will continue to receive support at the pre-tax rate of 20 percent, which for many firms in loss is – in effect – more generous than the

[1] With 28 percent corporate tax rate, a Growth Grant paid before tax at 20 percent corresponds to an effective (after-tax) rate of 14.4 percent.

15 percent after-tax rate provided under Tax Incentive.[2] It may be perceived that these firms are receiving more favourable treatment for two additional years, relative to competitors that are only able to access the R&D Tax Incentive may perceive.

Two alternative options may expedite the transition of Growth Grant recipients, but will also increase administrative costs and/or uncertainty

9. There are two options for expediting the transition of Growth Grant recipients to the R&D Tax Incentive:

    a. Constrain eligibility during the second year of transition period to firms in loss (Option 2).

    b. Reduce the rate of the Growth Grant to 15 percent in the second year (Option 3).

Option 2: Constrain eligibility in second year to firms in loss

10. One way to reduce the number of firms that remain on the Growth Grant until 31 March 2021 is to allow only firms in loss to remain on the Growth Grant for the second year of the transition period. Based on historical financial data, Callaghan Innovation estimates approximately one third of Growth Grant recipients (or approximately 100 out of over 300) are in profit.

11. Businesses declaring a profit for tax purposes can lower their provisional tax payments immediately in response to the R&D Tax Incentive so should not be affected by the absence of in-year refundability through the tax system. For this reason, you could limit the second year of the transition period to only firms in loss, so that all in-profit Growth Grant recipients move onto the R&D Tax Incentive on 1 April 2020.

12. While administratively achievable, restricting the second year of the transition period would come with increased complexity and uncertainty for firms about their eligibility. The main administrative challenge would be determining whether a business is eligible for a second transition year (ie, whether they are in loss), and when to make that decision.

13. One way to achieve this would be to base eligibility on the tax liability declared in prior tax returns, or in its provisional return for the coming year. This would not be simple, however, and if firms are categorised erroneously as in profit when they depend on in-year cash payments then they may reduce their R&D as a result. Moreover, uncertainty about their eligibility for the second year of the transition period could lead to Growth Grant recipients – in profit or in loss – to delay making commitments to future R&D.

14. Determining eligibility and providing extensions would increase administrative costs for Callaghan Innovation as it would need to build new system processes, assessment mechanisms, and compliance controls. Callaghan Innovation estimates it would require 2-3 additional full-time equivalent employees (FTEs) to manage the process (relative to Option 1). It would also increase compliance costs of Growth Grant recipients as they would need to go through an additional application process.

[2] Rather than paying tax upfront on their Growth Grant, a firm in loss reduces the loss it carries forward to a later date by the size of the Growth Grant. Nominally this puts it in the same position as a firm in profit. However, many firms in loss will not make profit for many years. Moreover, cash-constrained firms will face a much higher cost of obtaining finance, which means they will heavily discount the benefits and costs that occur at a much later date. Hence, for firms in loss that are seriously cash constrained, the effective rate of a Growth Grant at 20 percent is actually close to 20 percent.

Option 3: Reduce rate of Growth Grant in the second year to 15 percent

15. An alternative way to expedite the transition of Growth Grant recipients to the R&D Tax Incentive is to reduce the rate of Growth Grant to 15 percent in the second year beyond 1 April 2020, while leaving open the option to remain on the Growth Grant for the second year to all current recipients.

16. As noted above, at a rate of 15 percent the R&D Tax Incentive is slightly more generous for firms in profit than a Growth Grant at the current rate of 20 percent. Over the long run we would expect firms to choose the option that provides the highest rate of return for their R&D activity. However, these firms may choose to remain on the Growth Grant if given that option to delay incurring the transition costs associated with moving to a new scheme.

17. Reducing the Growth Grant rate to 15 percent in the second year would reduce the effective rate of the subsidy for firms in profit and make it considerably less favourable than the R&D Tax Incentive at 15 percent.[3] This would provide a strong incentive for these businesses to forego their Growth Grant and shift to the R&D Tax Incentive from 1 April 2020.

18. Firms in loss, particularly for those that are cash constrained (and hence rely on the in-year cash payments), would face a different calculus. For these firms the effective rate of a Growth Grant at 15 percent is close to its pre-tax rate.[4] Hence, the effective value they receive is similar to the amount they would have received under the R&D Tax Incentive, so incentive to switch to the Tax Incentive would not be as strong. Moreover, the availability of in-year cash payments means that those firms that depend on them are likely to remain on the Growth Grant until 31 March 2021 (after which in-year refundability would be available).

19. Similar to Option 2, Option 3 has the benefit (relative to Option 1) of encouraging those firms that are not disadvantaged by the absence of in-year refundability to shift to the R&D Tax Incentive in the second year. Moreover, over Option 2 it has the advantage of removing uncertainty for businesses as to whether they are eligible for a Growth Grant in the second year. They will also not have to apply for a one-year extension, and Callaghan Innovation will not have to administer an additional application process. Finally, it means that in the second year the Growth Grant will be no more generous than the R&D Tax Incentive, which evens the playing field relative to potential competitors that only have access to the Tax Incentive.

20. The main disadvantage with Option 3 is that it reduces the level of support to Growth Grant recipients that remain on the Growth Grant in the second year, which may cause them to lower their expenditure on R&D earlier than they would if the Growth Grant remained at the higher rate. Additionally, changing the Growth Grant rate is administratively complex, and will result in increased costs for both businesses and Callaghan Innovation.

21. Furthermore, we cannot be certain whether reducing the rate would be enough to convince sufficient Growth Grant recipients (particularly those in profit) to switch at the start of the second year. This is because these firms may prefer the relative certainty, based on previous experience, of how their claims will be paid under the Growth Grant, to the relatively higher funding under the R&D Tax Incentive.

[3] With 28 percent corporate tax rate, a Growth Grant paid before tax at 15 percent corresponds to an effective (after-tax) rate of 10.8 percent.
[4] For the reasons described in footnote 1, for firms in loss that are seriously cash constrained the effective rate of a Growth Grant at 15 percent is also close to 15 percent.

Recommended option for Growth Grant transition period

22. The key choice is between maintaining incentives for R&D expenditure over the short term and facilitating quicker uptake of the R&D Tax Incentive by Growth Grants recipients in its first two years.

23. The primary justification for allowing a transition period for Growth Grant recipients is to minimise the impact of changing from Growth Grants to the Tax Incentive on business R&D expenditure. For this reason you agreed on 16 April 2018 to consult on the proposal that Growth Grant recipients would be allowed to remain on the Growth Grant until 31 March 2020.

24. The absence of in-year refundability before 1 April 2021 means Growth Grant recipients in loss will not receive the same cash flow support if they move from the Growth Grant onto the R&D Tax Incentive before that date, which may further impact their R&D expenditure. For this reason, on 19 July 2018 you agreed to keep Growth Grants available at least to these firms until 31 March 2021.

25. At the same time, the perceived success of the R&D Tax Incentive in its first two years depends on a sufficient number of R&D-performing firms moving onto the Tax Incentive soon after it is implemented and demonstrating its benefits. You may therefore wish to consider options to encourage Growth Grant recipients to move onto the R&D Tax Incentive before the Growth Grant scheme formally ends on 31 March 2021.

26. Option 1 provides the least risk of disrupting a firm's R&D expenditure by allowing all recipients (regardless of their financial situation) to remain on the Growth Grant until 31 March 2021. However, it means that a large majority of recipients may remain on the Growth Grant until the end of the two-year transition period.

27. The challenge in encouraging firms to move earlier is determining which firms will be most affected by the absence of in-year refundability until 1 April 2021, and therefore would most benefit from the longer transition period. Option 2 does this by restricting eligibility to firms in loss. It is not simple, however, to provide a clear rule based on a firm's financial (or tax) status. Making errors in determining the eligibility of firms, or simply creating uncertainty for firms about whether they will be eligible, may have a negative effect on their R&D expenditure. Moreover, requiring firms to apply for the second year would increase both the compliance costs for business and the administrative costs for Callaghan Innovation.

28. Option 3 instead provides an incentive for firms to move onto the R&D Tax Incentive earlier. Due to differences in the effective rate of the support under Growth Grant for firms in profit versus firms in loss, reducing the rate to 15 percent provides a stronger incentive for firms in profit to make the move. However, this is at the cost of reducing support to those firms that remain on the Growth Grant, which may cause them to reduce their R&D expenditure, at least for the intermediate year. It also involves additional complexity for Callaghan Innovation and for those firms (approximately one third) that have non-standard financial years.

29. On the basis that maintaining stable support for R&D during the transition period is the higher priority, we recommend allowing all recipients to remain on the Growth Grant until 31 March 2021 with no changes to terms or conditions (Option 1).

Extension to expiring Growth Grant contracts

Current rules require Growth Grant recipients to satisfy R&D expenditure and intensity criteria to obtain a contract renewal

30. Regardless of whether you decide to vary the conditions of the Growth Grants in the second year of the transition period, we recommend changing the current rules around the conditions for recipients to obtain a contract extension between now and the end of the Growth Grant scheme.

31. Under the current Growth Grant rules, recipients receive an initial contract of three years and then are eligible for repeated two-year contract extensions if they continue to satisfy the eligibility requirements. In particular, to qualify Growth Grant recipients must have spent at least $300,000 per annum and 1.5% of revenue on eligible R&D in each of the last two years. To remain eligible for extensions they must maintain or increase their eligible R&D expenditure over the two years of the grant period, as compared to the two years prior to the grant period, and maintain a R&D intensity of 1.5 % or higher. Businesses may continue to apply for, and receive, extensions every two years provided they continue to meet the requirements. These requirements were designed to ensure that Growth Grant recipients continue to grow their R&D activity.

Automatically extending Growth Grant contracts that expire <u>from</u> 1 April 2019 will simplify administration without compromising policy objectives

32. In the Growth Grants transition consultation document, the Government proposed that recipients with an active Growth Grant contract on 31 March 2019 would continue to be able to claim Growth Grant funding until 31 March 2020. The consultation document did not explicitly mention the eligibility criteria but it was implied that those firms whose Growth Grant contracts expired between 1 April 2019 and 31 March 2020 would not need to reapply during this period.

33. As the Government is extending the Growth Grant scheme to limit disruption to firms' R&D investment as they transition from one support mechanism to another, we believe that requiring firms to apply for a renewal and prove they satisfy the criteria during this period is not practicable. From a policy perspective, requiring firms to satisfy the criteria will not provide any additional incentive effect as they will not need to meet these under the R&D Tax Incentive. From an administrative perspective, the resources involved in the renewal process would be better spent on supporting firms to make the transition.

34. Moreover, we do not anticipate any additional fiscal costs of providing an automatic extension to these firms. Firms that have qualified for a Growth Grant in the past are likely to qualify for the R&D Tax Incentive, given the lower threshold and lack of intensity criteria in the latter policy. If they were not able to claim the Growth Grant they would instead claim a similar amount under the Tax Incentive.

35. For these reasons we recommend automatically extending grants to those that have an active Growth Grant on 1 April 2019 until the end of the transition period (subject to your decision on Action a of this briefing).

Growth Grant contracts that expire <u>before</u> 1 April 2019 could either be extended automatically or extended only for a limited period if they do not satisfy the criteria

36. There are 75 recipients whose Growth Grants are due to expire between now and 31 March 2019. Callaghan Innovation s 9(2)(g)(i) [redacted] will not satisfy the criteria under the current rules to requalify for the Growth Grant on 30 September 2018 and additional recipients may fail to requalify

when their contracts expire between 31 December 2018 and 31 March 2019. This is because their R&D expenditure has reduced since their last review.[5]

37. The justification for extending the contracts of these firms, even if they do not satisfy the criteria, is that without it they would face a six-month gap in any form of Government support until they are eligible for the R&D Tax Incentive. (We anticipate that all these firms would qualify for the Tax Incentive.) The reduction in support could cause them to reduce their R&D expenditure.

38. On the other hand, these firms were familiar with the Growth Grant criteria and presumably were aware that they may not satisfy them at this point so were in a position to make alternative arrangements. Not extending their contracts provides a reason for them to make the transition to the R&D Tax Incentive from 1 April 2019.

39. We have considered two options for Growth Grants that expire between now and 31 March 2019:

    a. Provide an automatic extension (regardless of whether they satisfy the existing criteria for a renewal) until the end of the transition period to Growth Grant recipients whose contracts expire before 1 April 2019 (Option A).

    b. Continue the existing contract-renewal process until 31 March 2019, and, for those companies who do not meet the criteria for a renewal, allow a contract extension only to 31 March 2020 (Option B).

40. Option A is more in line with the objective of minimising disruption to existing R&D programmes as a result of the transition from one form of Government support to another. It also has the lower administrative costs to businesses and to Callaghan Innovation. However, in effect it would provide an additional two-and-a-half years of support to these firms through the Growth Grant scheme when they would not have otherwise been entitled to it. This could undercut the objective of moving firms to the R&D Tax Incentive as soon as feasible (albeit only a small number of companies would be affected by this provision).

41. Option B would provide an extension of their Growth Grant contract for companies that would otherwise not have been able to renew their contract. This is a transitional measure to avoid a gap in government support until these companies can claim the Tax Incentive. This approach has the benefit of these firms moving to the R&D Tax Incentive more quickly. However, it has higher administrative costs and complexity compared to Option A. It may also be negatively perceived by those among these firms who rely on in-year payments, which will not be available in the R&D Tax Incentive until 1 April 2021.

42. On the basis that expediting the transition of Growth Grants recipients to the Tax Incentive has a higher weighting, we recommend Option B. This option should be positively received as the Government is providing something that – without a rule change – these companies would not have been entitled to.

43. We considered the option of continuing the existing renewals process with no changes, but rejected this because it would create a gap in Government support that could potentially disrupt the R&D programmes s 9(2)(g)(i) [redacted] before they are able

[5] The Growth Grants scheme is now 5 years old. There is a cohort of significant R&D performers who were early adopters of the scheme, who are coming up for their second renewal between now and the end of the year. Some of these companies, despite their significant R&D programmes, may not satisfy the criteria for a second extension as their R&D expenditure has not grown sufficiently. This is an issue with the design of the Growth Grants scheme that, were the Growth Grants scheme continuing, we would have provided you with advice on earlier this year.

to claim the R&D Tax Incentive. It may also be negatively received, with potential negative flow-on effects for the perception of the Tax Incentive.

44. We also considered the option of continuing the existing renewals process and, for firms that did not meet the criteria for a renewal, offering a limited extension only to 31 March 2019. This would provide the quickest transition to the Tax Incentive for these firms while avoiding a gap in Government support. We rejected this option because only limited refundability will be available in the first year of the Tax Incentive. Existing Growth Grant recipients told us during the consultation process that this is very important to maintaining their R&D programmes.

Next steps

45. Implementing any of these options will require changes to the Ministerial Direction. We will provide you with a revised Ministerial Direction the week following receiving your decisions on this briefing.

46. The preferred plan will also need to be supported by effective communication and guidance for businesses to ensure they are aware of their options and have sufficient time to make the required changes.