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COVERSHEET

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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

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Office of the Minister of Research, Science and Innovation

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

EXTENDING REFUNDABILITY FOR THE RESEARCH AND DEVELOPMENT TAX INCENTIVE

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to proposals to extend refundability of the Research and Development (R&D) Tax Incentive so that legislation can be drafted for introduction to Parliament in June 2019.

Executive summary

2. The R&D Tax Incentive has come into effect from the start of the 2019/20 income year.

3. This scheme provides for limited refundability of R&D tax credits for firms in tax loss or with limited income tax liability. We have consistently signalled extending the refundability provisions once further policy work had been completed.

4. This paper seeks agreement to draft legislation that will broaden the refundability provisions. We propose that from the 2020/21 income year, refundability is broadly available. This broader refundability would be subject to a cap based on the amount of 'payroll'[1] taxes paid by a firm in each year (proposed cap). The proposed cap would not apply to tax credits resulting from payments to approved research providers, and would not apply to R&D tax credits refunded to levy bodies.

5. We have considered whether tax exempt organisations should be eligible for refundability. We believe that **all tax exempt organisations, except organisations receiving tax exempt income under section CW 9 and 10**[2] **of the Income Tax Act, should be ineligible for the R&D Tax Incentive.**

Background

6. The R&D Tax Incentive provides tax credits to firms undertaking R&D. Reducing the amount of income tax paid by these firms lowers the cost of their R&D, thereby incentivising firms to undertake more R&D. This is a key policy to support the

[1] Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).

[2] CW 9 applies to dividends derived from foreign companies and CW 10 applies to dividends within New Zealand wholly-owned groups.

Government's goal of raising the amount of R&D undertaken and grow a more innovative economy.

7. The Taxation (Research and Development Tax Credits) Bill has been enacted and the R&D Tax Incentive scheme has commenced from 1 April 2019 for most businesses[3].

8. The R&D Tax Incentive was developed under tight timeframes. Consequently, there was insufficient time to resolve some complex issues before the legislation was drafted. The major issue requiring further consideration was refundability of tax credits.

9. Refundability refers to paying out R&D tax credits if a business has insufficient income tax liability. That is, if a business has made a tax loss or its income tax liability is less than the R&D tax credits it has earned. An alternative to refunding the credit is to allow firms to carry their surplus credits forward and use them when they move into a tax paying position.

10. Cabinet agreed to a limited approach to refundability for the first year of the R&D Tax Incentive. We committed to review the policy that would apply from the second year.

11. This paper seeks agreement to a proposal for broader availability of refundability of tax credits that will apply from the 2020/21 income year.

12. This proposal also addresses the position of organisations that receive tax exempt income (tax exempt organisations). Because these organisations generally do not have an income tax liability, the only way they will benefit from the R&D Tax Incentive is if their credits are refunded. In general, we propose that tax exempt organisations should not be eligible for the R&D Tax Incentive, but we consider an exception should be made for levy bodies.

Refundability is an important feature in the R&D Tax Incentive

13. Providing a refund ensures that all firms doing R&D are able to immediately benefit from the tax credits they are eligible for under the R&D Tax Incentive. For instance, an established business can apply its tax credits to offset tax it would pay on profits generated in other parts of the business. Similarly, a large conglomerate can support a loss-making R&D division through profits from other parts of a business. By contrast, an early stage R&D intensive firm may not be able to benefit from the tax credit until a much later date, if at all if it never attains profitability or experiences a breach in shareholder continuity.

14. Refundability provides the financial incentive for R&D when it is most needed. In most cases, a firm will incur R&D expenditure prior to receiving revenue from commercialising its product. Therefore, not only are early stage R&D-intensive firms more likely to be in loss, they are also more likely to be cash constrained. For these firms, cash today will be much more valuable than a credit that is carried forward,

[3] The R&D Tax Incentive applies from the beginning of the 2019/20 income year, which means the date from which it applies depends on the balance date of each individual claimant. For most standard balance date (31 March) claimants, the R&D Tax Incentive will apply from 1 April 2019.

especially as they risk losing their credits if they breach the R&D tax credit shareholder continuity rules[4].

15. Enabling firms in tax loss to have their credits refunded provides a more powerful incentive for them to undertake R&D.

16. However, paying out to businesses, rather than reducing the amount of tax they pay, increases the risk of fraud. This could destabilise the R&D Tax Incentive and has been an issue in other jurisdictions[5]. The risk is not particular to R&D tax credits and arises in other parts of the tax system such as donor tax credits and GST refunds.

17. Refundability also increases the likelihood that firms will claim the R&D Tax Incentive, which will result in a higher fiscal cost. In countries where credits are refunded, growth in the amount of R&D claimed, and hence fiscal cost growth, is faster amongst those firms getting refunds. Discussions with officials in Australia and the UK suggest that some of this increased R&D is of marginal quality. Cash payments for small, start-up firms are highly attractive for some firms so encourage reclassifying other expenditure as R&D or claiming for activity that is not R&D.

18. These conflicting drivers are reflected in how refundability is treated in other countries. Across the OECD, though most countries have an R&D tax credit, only half provide refundability. Of those that do, almost all apply further constraints. Australia, for instance, only has refundability for small to medium sized firms and has introduced legislation to cap the amount that is refunded. The UK is also consulting on a proposal to cap the refund for small and medium sized firms.

19. We note that New Zealand's R&D Tax Incentive contains features to promote integrity of the scheme and ensure its sustainability over the long term. These include the requirement for R&D activity to primarily occur in New Zealand, the system of in-year approval (starting in 2020/21), and the exclusion of claims if a firm's R&D expenditure is below a $50,000 threshold. Nonetheless, we consider it sensible to be aware of how risks have emerged in other countries and therefore how we can build safeguards into the New Zealand scheme.

Proposals for refundability for firms in loss

20. Our starting point is that refundability is a desirable policy because it will encourage more firms to undertake R&D. However, to ensure the scheme's long-term sustainability, we consider it prudent to constrain how much can be refunded.

21. The principles we have applied in developing the proposals in this paper are:

    21.1 The policy should be simple for firms to understand and comply with.

[4] The R&D tax credit shareholder continuity rules are very similar to the tax loss shareholder continuity rules. They require businesses to maintain shareholder continuity of 49% or more to carry forward their R&D tax credits from one period to the next.

[5] For instance the UK Treasury and HMRC have released a consultation document 'Preventing abuse of the R&D Tax Relief for SMEs'.

21.2 Consistent with the underlying approach to the R&D tax incentive, refundability should be broadly available rather than applying selectively to particular types of firms.

21.3 We have avoided situations where a change in a firm's circumstances alters its eligibility for refundable tax credits. In Australia, if a firm's turnover grows to exceed $20 million per year, it is no longer eligible to have its credits refunded.

22. The recommended proposal on refundability for firms is:

22.1 All firms should be entitled to a refund of their R&D tax credits, to the extent their R&D tax credits are equal to or less than the amount of 'payroll' taxes paid by a firm in the relevant income year (proposed cap)[6].

22.2 The proposed cap would not apply to limit refundability of tax credits resulting from payments to approved research providers.

22.3 The proposed cap would not apply to R&D tax credits refunded to levy bodies.

23. The proposed cap is designed to prevent refundable tax credits being paid out to firms who are fraudulently claiming the tax credit. Some overseas jurisdictions counter this risk by limiting R&D tax credit refunds to the amount of PAYE paid by the firm. This is a simple and unobtrusive test but overlooks that some firms may legitimately pay little PAYE[7]. Consequently, we propose that additional payroll-related taxes paid and payments to approved research providers be included to reduce the impact of this constraint.

24. Nonetheless, we anticipate that some firms may not be able to receive a full refund of their tax credits in the year in which they are earned as a result of this policy.

25. We note that the R&D Tax Incentive is not the only instrument that can assist the early stage firms that may be affected by this policy. MBIE, in conjunction with Inland Revenue and Callaghan Innovation, is leading a programme of work to review our interventions for R&D intensive start-ups in light of the shifting R&D funding environment. This includes: a review of Callaghan Innovation's R&D Project Grants; reviewing the R&D tax loss cash out scheme; and a commitment to a refreshed and more ambitious Technology Incubator Programme. MBIE is also leading work, through the New Zealand Venture Capital Fund, to deepen capital markets to support high-growth/scale-up firms involved in disruptive technology.

Tax exempt organisations

26. There are different types of tax exempt organisations, including charities, some levy bodies, public authorities and local authorities, sports promoting bodies, and science

[6] Payroll taxes would include PAYE, FBT, employer superannuation contribution tax (ESCT) and withholding tax on schedular payments (WT).

[7] For instance, many start-up firms will limit their financial risk by employing staff on contract rather than recruiting them as permanent members of staff. These staff employed on contract may choose to have withholding tax (WT) paid by the firm on their behalf.

and industrial research promoting bodies. A common feature is that they do not pay income tax, so have no income tax liability against which to offset their R&D tax credits. Therefore, these organisations will only benefit from the R&D Tax Incentive if their credits are refunded.

27. There are arguments for and against these types of organisations having their tax credits refunded. In general, the argument for is that the R&D they undertake is potentially valuable and enabling them to benefit from the tax credit could stimulate them to do more R&D.

28. The argument against is that these organisations are outside the tax system so should not benefit from incentives provided from within the tax system.

29. However, the specifics of these arguments vary with the type of tax exempt organisation, so it is useful to consider each type separately.

Levy bodies

30. Levy bodies receive levy payments from their members, which are generally taxable businesses. These payments are then used to fund levy bodies' R&D activities, which are performed for the benefit of levy body members. The R&D performed by and funded through levy bodies is fundamentally business R&D.

31. Levy bodies are not by definition tax exempt organisations, but some may receive tax exempt income. A carve-in is proposed for them, as these entities do not receive the same tax concessions as charities (such as donee tax credit status, GST and FBT concessions).

32. We propose that levy bodies would have fully refundable R&D tax credits[8].

Charities

33. Charities also undertake valuable R&D. However, we propose that charitable organisations be ineligible for refundable tax credits, even though they are not currently excluded from receiving the Growth Grant.

34. Charities do not pay income tax, they receive GST concessions[9], and are exempt from FBT. Also, they benefit from the donor tax credit regime (which provides tax credits to those who donate to charities), as these credits incentivise individuals and businesses to donate to charities. In short, charities receive Government support. These benefits mean that charities' cash flow is enhanced by provisions in the tax system, and they do not have their profits top-sliced as a tax paying organisation does. Therefore, we do not consider it appropriate to extend further benefits to charities through the tax system.

35. Charities are currently treated as carrying on a business in New Zealand for the purposes of determining eligibility for the R&D Tax Incentive. We propose removing

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[8] Levy bodies that receive other Government funding for some of their R&D activities would only be eligible for R&D tax credits to the extent their R&D activities are not already subsidised by the Government.

[9] The current GST treatment of charities is concessionary, relative to other organisations, because it allows charities almost full input tax deductibility even if very few taxable supplies are made.

this rule for consistency and excluding them from being eligible for the R&D Tax Incentive.

36. Excluding charities means that businesses wholly-owned by charities are excluded, because these are also considered charities. However, we are not proposing to include broader association rules. This means if a tax paying business donates to a charity, even a business controlled by that charity, this would not invalidate the business's access to the R&D Tax Incentive. It would also mean that a charity could set up a partially controlled business entity, subject to the rules within the constitution of the charity, that could be eligible for the R&D Tax Incentive.

Māori businesses

37. Māori businesses may structure their affairs differently from non-Māori businesses for a variety of reasons. The R&D Tax Incentive has broader eligibility for different forms of business entities than the Callaghan Innovation Growth Grant regime, which required specific entity eligibility rules to allow some Māori businesses to qualify.

38. Māori authorities are not tax exempt - they pay tax at 17.5% rather than at the company rate of 28%. Māori organisations that carry out R&D activities should be eligible for the R&D Tax Incentive. A small number of post-settlement governance entities have registered as charities, but businesses that are partially controlled by these entities would not be charities so would be eligible for the R&D Tax Incentive.

Other tax exempt organisations

39. For the avoidance of doubt, we propose that other tax exempt organisations including local authorities be ineligible for the R&D Tax Incentive. This was the original policy intent, established as part of the initial policy development of the Incentive, but this exclusion was not included in the Taxation (Research and Development Tax Credits) Bill. Local authorities have the ability to raise the revenue required to perform R&D activities through rates. The R&D tax incentive should not be required to incentivise R&D activities by local authorities.

40. Within the Income Tax Act, there is provision for income from dividends in certain circumstances (CW 9 and CW 10) to be tax exempt. In the original legislation we provided for receipt of such income to not affect eligibility for the tax incentive or refunds. We propose this should continue to be the case.

Anticipated further work

41. Establishing a robust policy on refundability rounds out the work programme for establishing the R&D Tax Incentive, but we anticipate other refinements and developments in the years ahead. These include, but may not be limited to:

    41.1 Changes to make the R&D Tax Incentive more attractive for recipients. An important issue for many firms is when they will receive R&D tax credit payments. Growth Grant recipients receive payments quarterly, and during stakeholder engagement, firms raised the lack of quarterly payments as a negative aspect of transitioning from Growth Grants to the R&D Tax Incentive. At present, Inland Revenue systems only allow for end of year payments but, once Inland Revenue's Business

Transformation is more advanced, a system of in-year refundability may be possible[10].

41.2 There is also a commitment for further policy work to be undertaken as part of the Tax Incentive to simplify administrative processes for small to medium enterprises. This work will ensure that the compliance costs for applicants are commensurate with the benefits they receive. Examples of this could be allowing small firms to use a 'labour cost plus mark-up' approach to establishing their eligible expenditure.

41.3 A review of complementary policies, including the R&D tax loss cash out and Callaghan Innovation Project Grants. With the R&D Tax Incentive in place, the Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation will undertake further work to ensure other instruments in the system of government support for R&D are complementary to the R&D Tax Incentive.

41.4 There will be ongoing monitoring of the R&D Tax Incentive, plus a formal review once it has been in place for five years. We anticipate these processes will identify areas for improvement.

Stakeholder engagement

42. This refundability policy has benefited from input from a wide array of organisations.

43. The importance of broad refundability in incentivising business investment in R&D was a strong theme from the consultation conducted by the Ministry of Business, Innovation and Employment, Inland Revenue, and Callaghan Innovation following the release of the Government Discussion Document on the R&D Tax Incentive in mid-2018. The need for broad refundability was also emphasized in submissions received by the Finance and Expenditure Select Committee on the Taxation (Research and Development Tax Credits) Bill, and through additional stakeholder meetings.

44. The Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation have discussed the refundability proposals with the Corporate Taxpayers' Group; Chartered Accountants Australia and New Zealand; representatives from PwC, KPMG, Deloitte and EY; approximately 25 representatives from R&D performing businesses in tax loss or with insufficient taxable income to fully utilise non-refundable R&D tax credits; some large established R&D performers; levy bodies; charities; cooperatives; Federation of Maori Authorities; and Māori business representatives. These discussions have helped shape the refundability proposals and have highlighted the desirability of broad eligibility and an accessible process.

45. As part of the broader refundability discussions, stakeholders were asked to consider the impact of a PAYE cap. A PAYE cap, which would limit the amount of R&D tax credits refunded to a firm to the amount of PAYE paid by the firm in the relevant year, was seen as problematic.

[10] Though other pre-conditions are likely before in-year refundability can be offered..

46. Stakeholders advised that a PAYE cap could constrain the benefit loss-making early stage R&D intensive firms would derive from the credit. Many of these firms use contractors over employees because of the flexibility afforded by contracting arrangements. R&D intensive start-ups may have fewer non-R&D employees (compared with larger firms), and may also have a higher proportion of non-employee R&D expenditure (such as expenditure on capital assets or consumables).

47. As a result of this stakeholder engagement, a broader range of taxes paid by firms have been included in the proposed cap, along with any tax credits resulting from payments to approved research providers.

Consultation

48. The Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation prepared this Cabinet paper.

49. The following agencies have been consulted during the development of this paper: Treasury, Te Puni Kōkiri, Department of Internal Affairs and Ministry of Primary Industries.

50. The Department of the Prime Minister and Cabinet was informed.

Financial implications

51. Broadening the policy on refundability will make the policy more attractive and therefore incentivise firms to undertake and claim more R&D under the Tax Incentive. A consequence is that the cost of the R&D Tax Incentive will be higher than what it otherwise would be under the limited refundability that will apply in the first year.

52. However, this does not require any additional appropriation from that which Cabinet approved for the R&D Tax Incentive in September 2018.

53. In the paper that approved the appropriation, Cabinet agreed to limited support for businesses in tax loss starting April 2019 and noted that the design features for refundability would be broadened in subsequent years (DEV-18-MIN-0174). Therefore, the broader refundability policy proposals fall within the scope of what Cabinet has already agreed.

54. The fiscal cost estimates that were used to justify that appropriation were based on the assumption that from the Incentive's inception all firms, including those in loss, would claim and receive the full amount of the tax credits in the year in which they are earned, even without full refundability. Therefore, the appropriation has already allowed for the costs associated with the policies we are proposing.

55. As a sensitivity test, officials have also considered the possibility that the broader approach to refundability will drive faster growth in R&D and therefore higher costs of the Incentive than is predicted on the standard assumptions. There is a large degree of uncertainty around these estimates but they nonetheless suggest that even with this additional cost, the estimated cost of the R&D Tax Incentive would still fall within the current appropriation.

Legislative implications

56. Implementing these proposals requires changes to the Income Tax Act 2007 and the Tax Administration Act 1994.

57. If approved, we propose developing draft legislation for changes resulting from these recommendations in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill, scheduled for introduction in June 2019. We also anticipate this drafting will include some minor remedial matters relating to the Tax Incentive legislation already enacted.

Impact Analysis

58. MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Regulatory Impact Statement prepared by MBIE. The Panel considers that the information and analysis summarised in the Regulatory Impact Statement meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.

Human Rights

59. There are no human rights implications arising from the proposals in this paper.

Gender Implications

60. There are no gender implications arising from the proposals in this paper.

Disability Perspective

61. There are no specific disability considerations arising from the proposals in this paper.

Publicity

62. We will make an announcement on this policy once Cabinet decisions have been made. We will also make an announcement when the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill is introduced. A commentary on the Bill will be released at this time. Details will be posted on the Ministry of Business, Innovation and Employment, Inland Revenue and Callaghan Innovation websites.

Proactive release

63. We propose to proactively release this Cabinet paper, associated minutes, and key advice papers in whole within 30 working days of Cabinet making final decisions.

Recommendations

We recommend that the Cabinet Economic Development Committee:

1. **Note** legislation introducing an R&D tax credit has been enacted;

2. **Note** that this provides limited refundability of the tax credit for firms in loss or with insufficient tax liability to offset the tax credit;

3. **Note** we have previously signalled our intention to review the policy applying to the refundability of the tax credit;

4. **Agree** that R&D tax credits will be refundable for firms in loss or with insufficient tax liability to offset their tax credits, subject to a maximum equal to the amount of payroll taxes paid by a firm in each year plus any tax credits resulting from payments to approved research providers;

5. **Agree** that levy bodies are eligible for a refund of their tax credits and their refunds are not limited by the cap proposed at 4 above;

6. **Agree** that all tax exempt organisations, except organisations receiving tax exempt income under section CW 9 and 10 of the Income Tax Act 2007, be ineligible for the R&D Tax Incentive;

7. **Note** that local authorities would be ineligible for the R&D Tax Incentive.

8. **Agree** to delegate authority to the Ministers of Research, Science and Innovation and Revenue to make any adjustments of a minor and technical nature to the policy on refunding R&D tax credits as necessary, to achieve its policy intent;

9. **Agree** to delegate authority to the Ministers of Research, Science and Innovation and Revenue to make any adjustments of a minor or technical nature or as required to achieve the intent of the R&D Tax Incentive policy, and where the adjustments can be funded from within the existing appropriation;

10. **Invite** the Ministers of Research, Science and Innovation and Revenue to instruct Inland Revenue to draft legislation to give effect to the policy proposals and their intent contained in this paper;

11. **Approve** the inclusion of legislation to implement recommendations 1 to 10 above in the Taxation (1st 2019 Omnibus Issues, and Remedial Matters) Bill;

12. **Note** that it is expected the Bill will be introduced no later than 26 June 2019;

13. **Note** that this Cabinet paper, the associated Cabinet minute, and key advice papers will be released on the Ministry of Business, Innovation and Employment's, Inland Revenue's and Callaghan Innovation's websites.

Authorised for lodgement

Hon Dr Megan Woods
Minister Research, Science and Innovation

Hon Stuart Nash
Minister of Revenue