MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

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

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

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

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AIDE MEMOIRE

Talking points for the DEV Cabinet paper: Extending Refundability for the R&D Tax Incentive

Date:	17 May 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3482 18-19

Information for Minister(s)
Hon Dr Megan Woods **Minister of Research, Science and Innovation**

Contact for telephone discussion (if required)

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The following departments/agencies have been consulted
Inland Revenue

Minister's office to complete:

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- ☐ Withdrawn

Comments

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Date:	17 May 2019	**Priority:**	Medium
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Purpose

This aide memoire provides talking points for the Cabinet paper on *Extending Refundability for the Research and Development Tax Incentive*. The paper has been lodged for discussion at the Economic Development Committee (DEV) on Wednesday 22 May 2019

Kirsty Hutchinson
Manager, Innovation Policy
Labour, Science and Enterprise, MBIE

17 / 05 / 2019

Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive

1. The Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive has been lodged for discussion at the Economic Development Committee (DEV) on 22 May. The paper seeks DEV's agreement to the design of the refundability policy of the R&D Tax Incentive from year 2 of the scheme so that legislation can be drafted for introduction to Parliament in June 2019.

2. The paper reflects decisions made by you and the Minister of Revenue based on advice informed by stakeholder engagement, and further analysis by officials. The paper also incorporates feedback from other government departments, and lessons from other jurisdictions.

3. Talking points for the Cabinet paper are provided at Annex One. Possible questions and proposed answers are provided at Annex Two.

4. Subject to Cabinet approval, the next step will be to draft legislation. We plan to provide you and the Minister of Revenue with draft legislation by early June. This R&D legislation will be part of the next Tax Omnibus Bill.

Annexes

Annex One: Talking points on the Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive

Annex Two: Q&As

Annex One: Talking points on the Cabinet Paper – Extending Refundability for the Research and Development Tax Incentive

Background

- The R&D Tax Incentive is now live. Legislation has been enacted.
- The current legislation only allows for limited refundability. The Government has committed to a more comprehensive policy on refundability from year 2 of the Incentive.
- The R&D Tax Incentive has been designed to be a broad based scheme, providing easily accessible R&D support for eligible businesses regardless of their size, revenue or profit or loss position.
- Delivering a broader refundability policy is important, or the Incentive will not be as effective as intended.

Refundability proposal

- The core proposal is that firms in loss can have all their tax credits refunded for expenditure with an Approved Research Provider, and all other tax credits can be refunded subject to a cap based on the amount of payroll taxes paid by a firm. Payroll taxes will primarily comprise PAYE (which includes withholding taxes on schedular payments to contractors), but will also include payments for Fringe Benefit Tax and Employer Superannuation Contribution Tax.
- All businesses will be eligible for refundability, consistent with eligibility for the Incentive. Levy bodies are included as the R&D they perform is fundamentally business R&D.
- Charities and other tax-exempt organisations will be excluded from the Tax Incentive. These organisations are outside the tax system so they should not benefit from incentives provided from within it. In particular, charities already receive several tax concessions so it is not appropriate to extend further benefits to them.
- Because these rules would not apply a broad association test, businesses that are partially owned by a charity, such as a post-settlement iwi organisation, would not be excluded.

Payroll cap

- A payroll cap will help ensure the integrity of the Incentive through reducing the risk of fraudulent claims which have been problematic (along with an associated fiscal risk) in other jurisdictions with refundable R&D tax credits.
- A payroll cap means firms do not get more from the tax system than they put in, which combats the use of shell companies.
- The UK had this policy in place for SMEs but removed it in 2011. The consequence was a sharp increase in the incidence of fraud. The UK Government has recently announced its intention to reinstate the policy.[1]

Next steps

- Subject to Cabinet approval to the proposed refundability design, legislation will be introduced to Parliament in June 2019.

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

Annex Two: Q&As

Does the refundability proposal increase the fiscal cost of the Incentive?

- No. The Incentive's fiscal cost model assumes that firms in loss will claim the full tax credit. Treasury have confirmed that they are comfortable that allowing refundability as proposed will have no further impact on the appropriation.
- The 2018 R&D survey results show higher growth in R&D than previously forecast. However, the updated fiscal cost estimates still fall within the existing appropriation.

What impact will the payroll cap have on small companies?

- A small proportion of companies, most often smaller ones, quite legitimately pay little or no PAYE. They may employ staff on contract rather than as employees or owners may take drawings rather than a salary. On the surface, these firms may receive little initial benefit from the proposed refundability policy.
- However, the impact on small companies should be manageable:
    - Some of the firms that do not pay PAYE appear to do limited amounts of R&D so would not meet the $50,000 threshold.
    - Where a firm's R&D is via a contract with an Approved Research Provider, all its tax credit will be refunded.
    - Because the cap is based on all payroll taxes, there will be scope for firms to enter into an agreement with contractors and deduct withholding tax. Such payments would increase the amount of tax credit that would be refunded.
    - There is, and will continue to be, other support that such firms could potentially access rather than the Tax Incentive. Possibilities include project grants, the R&D tax loss cash out, the Technology Incubator Programme, and the New Zealand Venture Capital Fund.
- Officials are continuing to investigate the impact this policy may have on smaller R&D intensive firms and will provide further advice prior to the policy being considered at Select Committee if it seems necessary.

Why are large companies eligible for refundability?

- Larger firms are less likely than smaller firms to be cash constrained so their need for refunds may be less. However, the following reasons support refunding the tax credit for all firms (subject to the payroll cap):
    - The policy provides for even handed treatment of firms in profit and loss, thereby incentivising all of them to undertake additional R&D.
    - Meeting the government's target of growing R&D to 2% of GDP requires growth in R&D from large as well as small firms.
    - Some larger firms that are major R&D performers are in a tax loss position. These firms would get no benefit from credits carried forward; the only way they will benefit from credits is if they are refunded.
    - In addition to performing R&D in New Zealand, these large companies would still have to be contributing to the New Zealand economy through payments to employees or contractors, as the payroll cap prevents them from taking more out of the New Zealand tax system than they put in.

- If the Committee is unwilling to support full refunds for large companies, officials would recommend a cap on the amount that is refunded rather than any targeting to SMEs.
- There is a default cap of $18 million (being 15% of the maximum eligible expenditure of $120m per year).
- We would suggest a cap should be at least $5 million if the Tax Incentive is to be perceived at least as favourably as the Growth Grant.

Why are tax exempt organisations not eligible for refundability?

- This position is based on these organisations being outside the tax system so they should not benefit from incentives provided from within it. In particular, charities already receive several tax concessions so it is not appropriate to extend further benefits to them.
- Because these rules would not apply a broad association test, businesses that are partially owned by a charity, such as a post-settlement iwi organisation, would not be excluded.

Are local authorities eligible for refundability?

- Local authorities would be ineligible for the R&D Tax Incentive. However, council controlled organisations would be eligible.

Why are levy bodies and payments to Approved Research Providers not subject to the cap?

- Payments to Approved Research Providers will be easy to verify, posing a lower fraud risk.
- Levy bodies are empowered to collect levies by statute, definitely have an economic presence in New Zealand, and consequently pose a reduced risk that refunded R&D tax credits will be unrecoverable.

What other forms of R&D support does the government provide?

- Over time we intend to have a full package of support for New Zealand's innovation system. The R&D Tax Incentive will be one support amongst many.
- Other forms of current government support for business R&D include: R&D Project and Student grants, advice, and support in kind; and a limited R&D tax loss cash out.
- Officials are reviewing the R&D tax loss cash out and project grants to ensure R&D intensive start-ups have adequate R&D support. There is 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.

How does the refundability proposal compare internationally?

- Most overseas R&D tax credit schemes with refundability have some constraints. A system with no restrictions on refundability would be an outlier amongst OECD countries.
- The different ways in which refundability is limited often reflect differences in the underlying tax incentive scheme. Some countries limit refundability to SMEs and start-ups.
- It is relatively common to limit refunds to the amount paid in other taxes such as PAYE. This ensures a firm has a tangible economic presence in the country where the claim is being made, the amount refunded is commensurate to activity in the jurisdiction and it reduces the risk that the claim is made by a non-existent entity.

What are stakeholders' views on the proposal?

- This proposal has been informed by input from a wide array of organisations.
- Many submissions on the Tax Incentive legislation were in favour of broader refundability.
- Further engagement undertaken specifically with smaller R&D performers indicated that a PAYE cap could restrict the tax credit refunds available to these firms. The proposed cap now brings in FBT and ESCT in addition to PAYE, as well as expenditure on Approved Research Providers.
- These changes to the cap will reduce its impact for some of these firms. In addition, the current ecosystem of support (which includes project grants and the R&D tax loss cash out) for these smaller R&D performers will continue.
- MBIE, Inland Revenue and Callaghan have discussed 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 use non-refundable R&D tax credits; levy bodies; charities; and Māori business representatives.
- These discussions have helped shape the broader refundability proposals, and have highlighted the desirability of broad eligibility and an accessible process.