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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MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Inland Revenue
Te Tari Taake

R&D Tax Incentive – refundability and small innovative firms

Date:	27 June 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3584 18-19 IR2019/303

Action sought

	Action sought	Deadline
Hon Dr Megan Woods **Minister of Research, Science and Innovation** Hon Stuart Nash **Minister of Revenue**	**Note** that most loss-making firms will benefit from the refundability proposal but the payroll cap will restrict access to refundable tax credits for some early stage firms with little or no PAYE. **Note** that MBIE will provide further advice on the funding landscape for small innovative firms	4 July 2019

Contact for telephone discussion (if required)

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The following departments/agencies have been consulted

Callaghan Innovation

Minister's office to complete:

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☐ See Minister's Notes ☐ Withdrawn

Comment

BRIEFING

R&D Tax Incentive – refundability and small innovative firms

Date:	27 June 2019	**Priority:**	Medium
Security classification:	In Confidence	**Tracking number:**	3584 18-19 IR2019/303

Purpose

This briefing provides additional information about the impact on small early stage firms of limiting R&D tax credit refunds by the payroll tax cap. It also provides information on other R&D funding instruments that these types of firms can access.

Recommended action

The Ministry of Business, Innovation and Employment (MBIE) and Inland Revenue recommends that you:

		Min. RS&I	**Min. Rev**
a	**Note** that most loss-making firms will benefit from the refundability proposal but the payroll cap will restrict access to refundable tax credits for some early stage firms that have little or no PAYE.	*Noted*	*Noted*
b	**Note** that MBIE intends to review the funding landscape for small innovative firms and will report back with a proposed terms of reference.	*Noted*	*Noted*
c	**Agree** that MBIE can proactively release this briefing (with only information withheld to protect the privacy of natural persons) as part of the proactive release of the Cabinet paper *Extending Refundability for the Research and Development Tax Incentive*.	*Agree / Disagree*	*Agree / Disagree*

Privacy of natural persons

[redacted]

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

27 / 06 / 19

Hon Dr Megan Woods
Minister of Research, Science and Innovation

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Privacy of natural persons

[redacted]

Keith Taylor
Policy Manager
Inland Revenue Department

27 / 06 / 19

Hon Stuart Nash
Minister of Revenue

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Background

1. Minister Woods and Minister Nash met on 6 May 2019 to discuss the draft Cabinet paper, *Extending Refundability for the Research and Development Incentive*. At the meeting officials undertook to:

   - Continue to refine our analysis of the impact a payroll cap will have on small innovative businesses, including through engagement with selected stakeholders who work with startups.

   - Provide you with information on other R&D funding support available for these firms.

The payroll cap addresses the risks that refundability creates for the integrity of the tax system

1. The objectives of the broader refundability proposal are to support as much genuine R&D as possible in a way that is simple to administer and that maintains the integrity of the tax system

2. The refundability proposal agreed by Cabinet is:

   - All firms are 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 (payroll cap).

   - The payroll cap would not limit refundability of tax credits resulting from payments to approved research providers.

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

3. The purpose of the payroll cap is to manage the risks that refundability poses to the integrity of the tax system, thereby supporting the sustainability of the R&D Tax Incentive scheme. The refundability proposal is both generous and broad-based (does not target firms of a particular size) in comparison to other jurisdictions.[1]

4. A payroll cap is simple to administer, ensures firms have tangible economic presence in New Zealand, and is used by some other jurisdictions[2] that provide refundable R&D tax credits. However, a payroll cap may limit refunds for businesses that have little or no PAYE.

Most loss-making firms that qualify for the Tax Incentive will benefit from refundability

5. Our previous analysis on the impact of the payroll cap on small innovative businesses (3372 18-19 IR2019/233 refers) was based on 326 firms in receipt of a Callaghan Innovation Project Grant. Project Grant recipients are a proxy for certain types of firms that are most at risk of not benefiting from the refundability policy (i.e. startups), and we were able to gauge the impact of the refundability policy by using Inland Revenue and Callaghan Innovation data.

[1] 33 out of 46 international schemes do not provide refundability provisions. 12 out of 28 OECD governments currently offer preferential tax treatment to SMEs or young firms.

[2] For example, the UK, Ireland, the Netherlands (2296 18-19; IR2019/005 refers).

6. The initial analysis indicated that 101 of these firms either did not report income, or were in loss and may not receive a refund of their R&D tax credits because they did not pay any payroll taxes. There were a number of significant caveats around the initial analysis, including that it did not take into account the $50,000 minimum expenditure threshold which would have excluded many of these firms from being eligible for the Tax Incentive.

7. We have subsequently updated our analysis using more robust R&D expenditure values[3] and filtering for firms that did not consistently meet the $50,000 R&D expenditure threshold during the project grant period.

8. The revised results indicate that the number of firms whose access to refunds is restricted by the payroll cap is smaller than initially identified.

9. The results show 21 firms with possibly no refund. However, taking into account entities with holding companies (which may give group access to payroll taxes) would leave 12 firms (4% of the sample) with possibly no refund. These firms could still potentially use Approved Research Providers or withholding taxes from voluntary schedular arrangements with contractors to access refundability. More detailed analysis is provided in Annex One.

Stakeholders had mixed views on the impact of the refundability proposal on startups

10. Building on our earlier engagement with stakeholders on the refundability policy, we met with selected stakeholders to test our understanding of the impact a payroll cap will have on small innovative businesses.

11. The discussions with tax advisors (EY, Deloitte, CAANZ, PwC, KPMG) suggest that early stage startups in the software or digital sectors in particular are unlikely to benefit from the refundability proposal due to their reliance on labour from founders or contractors, for which PAYE is not being withheld. To benefit, these firms would need to enter into voluntary withholding arrangements or engage the services of an Approved Research Provider (ARP).

12. Voluntary withholding arrangements are simple to enter into but have only been available from 2017 and have perceived compliance costs, e.g. contractors may have pre-existing arrangements. Some firms may benefit from the ARP expenditure exclusion from the cap, e.g. businesses engaged in scientific-oriented R&D that work with universities or crown research institutes. Firms in the software or digital sectors are less likely to use ARPs. We are unable to estimate the proportion of businesses that may benefit from expenditure with an ARP being excluded from the cap.

13. In contrast, our discussions with other organisations that work with startups on a day to day basis (Astrolab, Level Two and Dotterel) suggest that the refundability proposal will benefit young innovative firms. These organisations observed that contractors are often used for temporary or specialist projects, and that most startups, particularly those building a company around deep technology, need to build a dedicated team of employees.

14. We expect submissions to the Select Committee to reflect the views above. We will report back to Ministers following the submissions process on feedback received and our proposed response.

[3] This now includes additional R&D expenditure reported by firms to Callaghan Innovation. Not all firms choose to record additional data. Officials have used Project Grant R&D values in the absence of self-reported figures.

Stakeholders generally understood that the Tax Incentive is not the only instrument available to support startups

15. The Tax Incentive is the centrepiece of government support for business R&D. However, there are a range of other mechanisms currently available and targeted to small innovative businesses and startups which address the needs of firms that do not qualify for the Tax Incentive (because of the $50,000 threshold or the definition of R&D), or who may be deterred because of compliance costs relative to the benefit they will receive.

16. A brief overview of other funding sources currently available is provided in Annex Two. These measures provide support to early stage innovative businesses to invest in, commercialise and scale up their R&D and to build entrepreneurial capability.

17. For example, firms that just meet the $50,000 R&D expenditure threshold would receive tax credits worth $7,500 (at a 15% tax credit rate). Firms spending less than $50,000 on R&D, may be better off accessing the Getting Started Grant (up to $5,000), the Capability vouchers (up to $5,000) and Project Grants (40% of eligible expenditure). These grants provide a stepping stone to either larger Project Grants or the Tax Incentive.

18. If a firm in a tax loss position qualifies for the Tax Incentive but does not pay any payroll taxes (including at a group level) and does not have any eligible expenditure with an ARP or contractors who agree to voluntary withholding arrangements, then it will be better suited to accessing the other support mechanisms available

19. At the current time, firms that meet the criteria for the R&D Tax Loss Cash Out scheme (generally small R&D-intensive firms) can also receive cash for up to 28% of their tax losses from R&D expenditure, subject to a maximum of $476,000 in the 2019/20 tax year.[4]

We propose to undertake further work on the funding landscape for small innovative firms

20. As noted in some of our earlier briefings on the R&D Tax Incentive, the natural next step following the introduction of the Tax Incentive is to review the wider landscape of support for smaller innovative businesses, including startups. This review will complement the work underway on early stage capital markets (led by the Minister for Economic Development). A focus of this work will be how existing supports other than the R&D tax incentive can be shaped to ensure there is support for firms for whom the tax incentive may not be ideal. We will report back to you on the scope of this project and proposed terms of reference. Our intention is to have initial options explored prior to our response to submissions to Select Committee.

Proactive release

21. We propose to include this briefing (with only information withheld to protect the privacy of natural persons) in the proactive release of the Cabinet paper *Extending Refundability for the Research and Development Tax Incentive* which is currently in process.

Annexes

Annex One: Analysis on the impact of the payroll cap

Annex Two: Other sources of government funding for small innovative businesses

[4] It is proposed to review this scheme now that the R&D Tax Incentive is in place.

Annex One: Analysis on the impact of the payroll cap

1. The table below summarises the results of both our previous analysis and our updated analysis that filters for the impact of the $50,000 threshold and which also benefits from more robust R&D expenditure values.[5]

2. Based on the updated analysis, the number of firms that would not benefit from refundability due to the payroll cap is smaller than under the previous analysis.

Project Grant sample (326 firms)	Results from previous analysis	Results from updated analysis (filtered for firms that consistently meet the $50,000 threshold)
Did not report income or were in loss	260 firms	109 firms
Did not report income or were in loss and paid sufficient payroll taxes	112 firms	45 firms
Did not report income or were in loss and only paid a small amount of payroll taxes (limited refund)	47 firms	43 firms
Did not report income or were in loss and did not pay any payroll taxes (no refund)	101 firms	21 firms

3. Under the updated analysis 21 firms would potentially get no refund. These firms may receive a refund if they have access to withholding taxes through the use of contractors, use an Approved Research Provider, or have a holding company with the potential to pay payroll taxes at the group level.

4. Expenditure on contractors was not available for firms included in the above analysis. However, analysis of data from the R&D Tax Loss Credit scheme (which includes information on R&D contractor spend) shows that withholding taxes from voluntary schedular arrangements with contractors could significantly reduce the number of firms affected by the payroll cap.

5. 9 of the 21 firms have holding companies, so may be able to access payroll taxes at a group level. This would potentially leave 12 firms (4% of the sample) without any refund.

[5] This now includes R&D expenditure reported by firms. Not all firms choose to record this data. Officials have used Project Grant R&D values in the absence of self-reported figures.

Annex Two: Other sources of government funding for small innovative businesses

Measure	Description	Amount
R&D Getting Started Grants *Callaghan Innovation*	Getting Started Grants help a business initiate R&D activity. They can be used for basic prototyping, project planning, technical feasibility studies, developing an IP strategy and accessing technical support.	40% of eligible R&D project costs, up to $5000.
R&D Project Grants *Callaghan Innovation*	Project Grants are designed to help businesses growth their investment in R&D and build R&D expertise.	40% of eligible R&D project costs; reducing to 20% for eligible expenditure over $800,000 or when the business has had multiple grants.
NZTE Capability voucher scheme and Business mentors	Capability vouchers offset the costs of approved training to help grow a business. Business mentor service provides knowledge and skills and expert guidance for a low fee.	The grant covers up to 50% of the cost of training up to a maximum of $5000.
Technology Incubator programme	Technology incubators invest in and help commercialise complex technologies	Incubators have access to pre-incubation grants and repayable loans (up to $750,000) for eligible projects.
Founder incubators	Business support and networks	Incubators may invest in eligible businesses but the equity stake is typically small and not the primary means of funding a business.
Accelerators	Business acceleration programmes focused on rapid and intensive product development to establish an investment ready startup.	Provides access to funding networks and expertise.
R&D Tax Loss Cash Out scheme	Allows business losses from eligible expenditure associated with R&D to be cashed out instead of carried forward.	Up to 28% of a business's tax losses from R&D expenditure, subject to a maximum of $476,000 in the 2019/20 tax year.
Seed Co-investment fund	Equity investment fund aimed at high growth potential, small to medium sized businesses at start-up staged of development.	The fund can invest up to $1.5 million alongside accredited angel and seed co-investment partners.
New Zealand Venture Fund (NZVIF)	NZVIF invests in early stage capital market via a fund of funds approach in privately run venture capital funds	Around $300 million for investment in early stage capital markets.

[6]

[6] In addition Work and Income New Zealand provides a range of grants to help with the costs of starting a business and to pay for business skills training.