



BRIEFING

R&D tax incentive for implementation

Date:	12 July 2018	Priority:	Medium
Security classification:	In Confidence	Tracking numbers:	3681 17-18 IR2018/435 CI B-18-023

Action sought		
	Action sought	Deadline
Hon Dr Megan Woods Minister of Research, Science and Innovation	Discuss and/or Agree to the main design features and issues for consideration Forward the attached paper to the Minister of Finance for signing	24 July 2018
Hon Stuart Nash Minister of Revenue	Discuss and/or Agree to the main design features and issues for consideration Forward the attached paper to the Minister of Finance for signing	24 July 2018

Contact for telephone discussion (if required)				
Name	Position	Telephone		1st contact
Richard Walley	Policy Director, Science, Innovation and International	04 901 4164	s 9(2)(a)	✓
Keith Taylor	Policy Manager, Inland Revenue	04 890 2808		
Becci Whitton	Manager, Stakeholder and Government Engagement, Callaghan Innovation			

The following departments/agencies have been consulted
The Treasury and the Department of Prime Minister and Cabinet

Minister's office to complete:

- | | |
|---|--|
| <input type="checkbox"/> Approved | <input type="checkbox"/> Declined |
| <input type="checkbox"/> Noted | <input type="checkbox"/> Needs change |
| <input type="checkbox"/> Seen | <input type="checkbox"/> Overtaken by Events |
| <input type="checkbox"/> See Minister's Notes | <input type="checkbox"/> Withdrawn |

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Purpose

This paper seeks agreement on key design features to include in the Research and Development (R&D) tax incentive for implementation in 2019. The design features selected will be reflected in a Cabinet Paper for discussion at the Economic Development Committee (DEC) on 5 September where final decisions on the design of R&D tax incentive will be made.

Executive summary

The Government has set itself a target to increase R&D expenditure to 2 per cent of GDP. A large amount of this growth is expected to come from increased business expenditure on research and development (BERD). Internationally, it is common for governments to use R&D tax incentive schemes to stimulate BERD. Cabinet has agreed to the implementation of an R&D tax incentive from 1 April 2019.

The key decisions sought in this paper are:

- The **selection of key design features**, including: a user-friendly R&D definition, a credit rate of 15 per cent, a \$120 million cap, and a minimum expenditure threshold of either \$100,000 or \$50,000 per year.
- The **adjustment of design features** which have the potential to reduce the amount of R&D activity in New Zealand, including: a now broader set of business eligibility criteria, the recommended inclusion of State Owned Enterprises and minority-owned subsidiaries of Crown Research Institutes, Tertiary Education Organisations and District Health Boards and a dual purpose expenditure exclusion.
- The **inclusion of technical design features** which ensure the robustness and sustainability of the scheme over the long-term, including: activity exclusions, eligible expenditure exclusions, overseas expenditure rules and business continuity rules.
- The selection of **a range of administration features** that will help streamline the administrative process, including: the claims process, the inclusion of provisional tax liability, the use of determinations, binding rules and Order In Council, transparency, evaluation and penalty measures.

Alongside, the key decisions sought in this paper are an outline of the additional workstreams being undertaken to ensure the successful implementation and uptake of the scheme over the next two years.

The overall timeframes are very short. The timetable for achieving commencement in April 2019 requires legislation to be introduced to Parliament in October. It is therefore important to resolve policy issues expediently. We will provide the following to your offices:


- A draft Cabinet paper with policy recommendations on the design of the R&D tax incentive by the end of July for consideration at Cabinet on 5 September.
- An accompanying paper with advice on design features that are still a work progress, by the end of August.
- Dependent on agreement by Cabinet in September draft legislation for the R&D tax incentive will be ready for consideration by mid-October, with the intention of introducing it to Parliament by late-October.

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Recommended action

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

	Min RS&I	Min Revenue
a Agree to include a single revised R&D definition (which incorporates a materiality threshold) in the legislation.	Agree/ Disagree	Agree/ Disagree
b Agree to a headline tax credit rate of 15 per cent for implementation in 2019.	Agree/ Disagree	Agree/ Disagree
c Agree to retain a \$100,000 per year minimum eligible R&D expenditure threshold to qualify for the R&D tax incentive. (officials preferred option)	Agree/ Disagree	Agree/ Disagree
Should Ministers consider an alternative threshold:		
d Agree to retain a minimum expenditure threshold but reduce it to \$50,000 per year.	Agree/ Disagree	Agree/ Disagree
e Agree to include a \$120 million R&D expenditure cap with the discretion to exceed it through a pre-registration process.	Agree/ Disagree	Agree/ Disagree
<i>Business eligibility criteria</i>		
f Agree that the in-house R&D business eligibility criteria be included in the legislation, enabling subsidiaries of multinational corporates to qualify for the R&D tax incentive.	Agree/ Disagree	Agree/ Disagree
g Agree that the eligibility of partnerships is assessed at the partnership level rather than the individual partner-level.	Agree/ Disagree	Agree/ Disagree
h Agree that the contracted R&D business eligibility criteria be included in the legislation.	Agree/ Disagree	Agree/ Disagree
i Agree that the eligibility criteria include the requirement that the results of the R&D activity are freely available to be used by the R&D performer at no extra cost above the business' eligible R&D expenditure for the activity.	Agree/ Disagree	Agree/ Disagree
<i>Entity inclusions and exclusions</i>		
j Agree that industry research cooperatives be eligible for the R&D tax incentive under a special rule in the legislation.	Agree/ Disagree	Agree/ Disagree
k Agree to allow mixed ownership models, businesses with a minority Crown shareholding and Air New Zealand to be eligible the R&D tax incentive as long as they meet the proposed business eligibility criteria.	Agree/ Disagree	Agree/ Disagree
l Agree to include State Owned Enterprises in the R&D tax incentive as long as they met the proposed business eligibility criteria.	Agree/ Disagree	Agree/ Disagree

m	Agree to exclude Crown Research Institutes (CRIs), District Health Boards (DHBs) and Tertiary Education Organisations (TEOs) from the R&D tax incentive.	Agree/ Disagree	Agree/ Disagree
n	Agree to include minority owned subsidiaries of CRIs, DHBs and TEOs (i.e. the CRI, DHB or TEO has a share-holding up to 49 percent) in the R&D tax incentive.	Agree/ Disagree	Agree/ Disagree
o	Agree to a rule that prevents businesses from claiming R&D tax credits if they are already receiving Growth Grant funding.	Agree/ Disagree	Agree/ Disagree
p	Agree to replace the dual purpose activity test with an alternative test at the expenditure level. The final test selected will be included in the legislation.	Agree/ Disagree	Agree/ Disagree
<i>Activity and expenditure</i>			
q	Agree to include in legislation two lists of R&D activity exclusions, one that covers exclusions under core R&D activity and another that covers exclusions for both core and support R&D activities.	Agree/ Disagree	Agree/ Disagree
r	Agree that social science research is excluded under core activities but be eligible under support activities.	Agree/ Disagree	Agree/ Disagree
s	Agree that eligible expenditure be based on a broad range of actual R&D costs.	Agree/ Disagree	Agree/ Disagree
t	s 9(2)(f)(iv) 	Noted	Noted
u	Agree that a R&D expenditure exclusion list is included in legislation.	Agree/ Disagree	Agree/ Disagree
v	Agree to a requirement that expenditure be deductible (or an amount of depreciation/loss) to be eligible for the R&D tax incentive.	Agree/ Disagree	Agree/ Disagree
w	Agree to include a rule that allows up to 10 per cent of an annual R&D claim to be overseas expenditure.	Agree/ Disagree	Agree/ Disagree
x	Agree to impose business continuity rules on R&D tax credits carried forward in 2019 with the intention to review the rules in light of any recommendations from the Tax Working Group.	Agree/ Disagree	Agree/ Disagree
<i>Additional technical design features</i>			
y	Agree that the feedstock rule is extended to apply to inputs that are used, destroyed, or subject to a process or transformation in the R&D process.	Agree/ Disagree	Agree/ Disagree
z	Agree that companies are issued an imputation credit equal to the R&D tax credit they are entitled to.	Agree/ Disagree	Agree/ Disagree
aa	Agree that R&D tax credits should be applied to a tax liability after non-refundable tax credits and credits for	Agree/ Disagree	Agree/ Disagree

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supplementary dividends, but before imputation credits.		
<i>Administration</i>		
bb Agree that the R&D tax incentive apply from the 31 March 2020 income tax year.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
cc Agree to include a pre-approval mechanism in the legislation with a separate ability to turn this mechanism on.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
dd Agree that R&D tax credits be included in taxpayers' residual income tax calculations.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
ee Agree that the legislation expressly allow for Orders in Council to be used to amend schedules, and to legislate for the use of approved software at a future date.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
<i>Transparency, evaluation and penalties</i>		
ff Agree that the names and funding bands of successful claimants of R&D tax incentives be published with a two year lag.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
gg Agree that Inland Revenue have the ability to share taxpayer-specific information regarding R&D tax incentive claims with MBIE, Treasury, and Callaghan Innovation officials.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
hh Agree that claim information be integrated into Statistics New Zealand Longitudinal Business Database (LBD) and the National Research Information System (NRIS).	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
ii Agree to include a legislative requirement that Government commissions an evaluation of the R&D tax incentive every five years from the commencement of the scheme.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
jj Agree that standard penalty provisions in the Tax Administration Act 1994 apply to R&D tax incentive claims, and that the promoter penalty rules be extended to include R&D advisers.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>
<i>Cabinet paper and legislation</i>		
kk Note that a Cabinet paper on R&D tax incentive policy recommendations will be prepared based on decisions made on this paper and provided to you by the end of July.	<i>Noted</i>	<i>Noted</i>
ll Note before Cabinet consideration, officials will provide you with final advice on design features that are still being developed such as the commercial consideration rule and the dual purpose activity test.	<i>Noted</i>	<i>Noted</i>
mm Agree for draft legislation to be prepared reflecting policy decisions agreed by Cabinet.	<i>Agree/ Disagree</i>	<i>Agree/ Disagree</i>

s 9(2)(a)



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

12 / 07 / 18

s 9(2)(a)



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12 / 07 / 18

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

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Hon Stuart Nash
Minister of Revenue

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Hon Grant Robinson
Minister of Finance

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Background

1. Cabinet has agreed to implement a non-refundable R&D tax incentive by 1 April 2019 [CAB-18-Min 0056 refers]. Cabinet has also agreed that by April 2020 there will be some form of support for businesses in tax loss, and noted that the R&D tax incentive will replace Callaghan Innovation's Growth Grants over time [CAB-18-Min 0051 refers].
2. Government published a discussion document seeking feedback on various design features proposed for the R&D tax incentive. A brief, summarising the public submissions, was sent to your offices on 29 June (3679 17-18/IR2018/380 refers).
3. This brief recommends the key R&D tax incentive design features to include in draft legislation. It draws on the submissions to the discussion document, international experience and further analysis and modelling by officials.
4. A parallel paper provides advice on options for providing support for loss-making firms in 2019-20 and the transition arrangements for Growth Grant recipients (3950 17-18 refers). A draft Cabinet paper will be prepared based on decisions from the two papers and provided to you by the end of July.

Design of the R&D tax incentive

5. The design objectives of the R&D tax incentive are to provide easily accessible support to a broad range of R&D businesses within fiscal constraints, while maintaining trust and confidence in the tax system.
6. The tax incentive design proposed in the discussion document largely followed the R&D tax credit available for the 2008/09 income year with modifications to reflect changes in international best practice and New Zealand's current R&D grants programme. However, the international business environment has changed since 2008. Commercial interactions have become increasingly globalised, technology driven, with commercial inputs being sourced across multiple jurisdictions. Business structures and practices have changed to reflect this new environment. These additional factors have been given greater consideration in the recommended selection of design features.
7. Given the challenging timings of implementation for this policy it was agreed that an abbreviated version of the R&D tax incentive would be implemented by 2019. The following additional features will be developed for implementation in 2020 and 2021:
 - Refundability of R&D tax credits and other mechanisms to provide claimants with additional certainty around their claim. Officials will brief you on this work separately.
 - Third party approved software, to allow in-year refundability for some claimants. Officials will consult with software developers, and will continue to consider in-year refundability. It is expected that the software could be available by 1 April 2021.
8. In terms of the Government's goals around growing an innovative economy, it is also important that broader tax policy settings are correct. Addressing technical issues such as black hole feasibility and loss continuity in the tax system may help stimulate business innovation in addition to the R&D Tax Incentive. It is likely the Tax Working Group will consider black hole expenditure and continuity rules at a future date.

Critical R&D tax incentive design features

Definition of R&D

9. The R&D definition ensures the activities that should be incentivised are captured and those that should not be excluded. The discussion document proposed a definition of R&D as:

Core activities:

(a) activities conducted using scientific methods that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes, or services; and that are intended to advance science or technology through the resolution of scientific and technological uncertainty.

Support activities:

(b) other activities that are wholly or mainly for the purpose of, required for, and integral to, the performing of the activities referred to as core activities.

10. To ensure government funding targets difficult R&D the discussion document proposed a materiality test. The intent of the test was to gauge if a business's R&D was intended to address a difficult problem and significantly advance science or technology.
11. The discussion document highlighted the possibility of a separate R&D definition for software to reflect the unique circumstances of this sector.
12. Businesses and intermediaries expressed concern throughout the consultation process that the proposed definition was too narrow. They advised that its retention would exclude a lot of business R&D or incentivise firms to creatively describe their R&D activities to satisfy the definition. The software industry strongly supported this view.
13. Businesses and intermediaries submitted that the materiality test was set too high, in particular with the inclusion of 'significant' as part of resolving scientific or technological uncertainty. Intermediaries and other industry groups acknowledged that it would be difficult to administer two different R&D definitions. Having more than one definition could reduce taxpayer certainty, increase compliance costs, and would be unfair if industry-specific definitions were not available for all industry groups potentially excluded by the proposed definition.
14. Officials agree that it is important to have a single, rigorous R&D definition that describes the R&D processes of most businesses. While officials acknowledge business concerns regarding the materiality test, officials consider a materiality threshold necessary to ensure that trivial or incremental R&D is not subsidised.
15. Officials have developed a new core R&D activity definition following consultation with businesses and intermediaries. This definition has been favourably received by stakeholders, including the software industry, and is described below.

A core activity is:

(a) conducted using a systematic approach; and has a purpose of creating new knowledge or new or improved processes, services, or goods; and has a purpose of resolving scientific or technological uncertainty.

(a)(i) An activity is not a core activity if knowledge required to resolve the uncertainty is: publicly available; or deducible by a competent professional working in the relevant scientific or technological field.

A support activity:

(b) has the sole or predominant purpose of, is required for, and integral to, conducting a core activity.

16. The main difference between the two definitions is the approach used to undertake R&D. The recommended definition is no longer limited to R&D being conducted using a scientific method but instead allows a broad range of systematic approaches to be used in the R&D process for example, engineering, design and software methods. A materiality threshold has been included through the uncertainty test described in part (a)(i) of the core activity definition.
17. Though the recommended definition could be interpreted as being slightly more liberal than that in the discussion document, officials do not consider it will add to the scheme's cost. This is because the proposed definition is likely to align with how businesses define R&D for the Statistics New Zealand survey which is the basis of the cost estimate.
18. **Officials recommend including a single revised R&D definition (which incorporates a materiality threshold) in the legislation.**

The credit rate

19. The discussion document signalled an approximate tax credit rate of 12.5 per cent to enable meaningful consultation, while deferring final decision on the rate until after consultation [1714 17-18/IR2018/083 refers].
20. A key theme throughout the consultation process and in submissions was the perception that the 12.5 per cent credit rate was low compared to Growth Grants or other schemes overseas, and would be unlikely to induce additional R&D. It was also noted by businesses that the credit rate in 2008 was 15 per cent and the proposal to reduce it to 12.5 per cent seemed like a backward step.
21. Officials have produced forecasts of eligible R&D expenditure over a four-year period based on growth rates of BERD and a range of other behavioural assumptions¹ and used this to calculate the likely cost of the scheme under different credit rates (ranging from 12.5 per cent to 20 per cent). We have compared the forecasts to total funding available, including R&D tax incentive budget allocation and baseline funding for Growth Grants.²

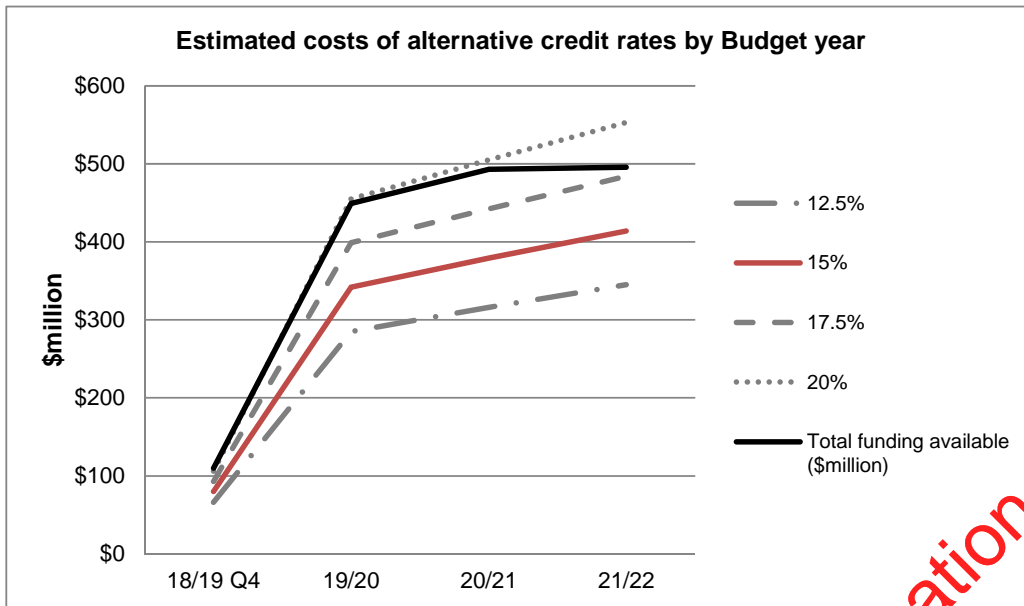
Budget Year	18/19 Q4**	19/20	20/21	21/22
R&D tax incentive budget allocation (\$million)	\$70	\$280	\$320	\$350
Growth Grant baseline funding (\$million)*	\$40	\$169	\$173	\$146
Total funding available (\$million)	\$110	\$449	\$493	\$496
Cost with 12.5% credit rate (\$million)	\$66	\$285	\$316	\$345
Cost with 15% credit rate (\$million)	\$80	\$342	\$379	\$414
Cost with 17.5% credit rate (\$million)	\$93	\$399	\$442	\$484
Cost with 20% credit rate (\$million)	\$106	\$455	\$505	\$553

*MYA as per Budget 17

** last 3 months of 2018/19 year only

¹ The forecasts are based on R&D expenditure estimates in the 2016 R&D Survey, extrapolated forward in line with GDP growth forecasts. They also incorporate an anticipated response to the R&D tax incentive, based on evidence of the response found by studies of overseas schemes.

² The model used to generate the forecasts assumes that all Growth Grant recipients switch the R&D tax incentive from 1 April 2019, so the cost of providing an R&D subsidy to these firms is therefore counted in the estimates. However, if these firms remain on the Growth Grant until a later date and the amount they receive under the Growth Grant is higher than they would have under the R&D tax incentive then the cost will be higher.



22. The short and long-term impacts and costs associated with the R&D tax incentive are uncertain. The short-term cost to government is uncertain as we do not know how much R&D reported in the R&D Survey will meet the proposed definition of eligible R&D under the tax incentive or how many additional businesses will be eligible. In the longer term, we can expect the R&D tax incentive to lead to greater growth of BERD, both through more firms undertaking R&D and an increased R&D from those already engaging in R&D. Because of the time lag associated with filing tax returns, actual evidence of the scheme's uptake and the associated R&D expenditure involved will not be available until 2021/22.
23. Based on the information available, officials consider that a 15 per cent credit rate starting in 2019 is feasible. There is enough funding available to meet the forecast cost of the scheme through to the 2021/22 year. Assuming a similar level of funding is be available in 2022/23 as the year prior, there should also be enough funding to meet the cost of the scheme in 2022/23. If growth in BERD continues on the trajectory shown new money will likely be required for allocation from 2023/24 onwards.
24. Officials consider starting at a 15 per cent rate as the best option given fiscal constraints because:
- A 15 percent credit rate is likely to induce a greater amount of additional R&D than a lower rate.
 - The rate is more favourable compared to Growth Grants (taking into account the lack of R&D intensity threshold, increased cap, and corporate tax rate), meaning R&D support to businesses switching from the R&D tax incentive will not decrease.³
 - The business community is likely to perceive it as internationally competitive, particularly against Australia. This could help prevent businesses relocating overseas to take advantage of more favourable R&D schemes.
 - At the same time, a higher credit rate combined with a mechanism to exceed the cap could induce more international companies to relocate their R&D activity to New Zealand than would have otherwise.

³ Growth Grant recipients that do not pay tax (i.e., are in loss) will still receive less under the Tax Incentive with a rate of 15 per cent than they do under a Growth Grant. However, they will be able to carry forward a greater loss that they can apply against their tax liability in a future period.

25. **Officials recommend a headline tax credit rate of 15 per cent for implementation in 2019.**

Comment

The Treasury has been consulted on this report and broadly agrees with the recommendations. However, the Treasury does not agree with the recommendation to increase the credit rate from 12.5 per cent to 15 per cent because:

- The Treasury does not consider that an adequate value-for-money case has been presented for the additional approximate \$60 million per annum. This additional funding has not been assessed against the Government's other priorities;
- the Government has not made a decision regarding how any Growth Grant funding which may become available should be reprioritised; and
- this would increase the fiscal uncertainty of the package and the higher rate may increase integrity risks.

If Ministers are interested in raising the credit rate, The Treasury recommends that this is considered after the R&D tax incentive's first evaluation in 2024.

The minimum threshold

26. The discussion document proposed that all businesses that meet the agreed criteria and undertake eligible R&D could have access to the R&D tax incentive if they choose. For businesses who undertake less than \$100,000 R&D expenditure a year access to the tax incentive would come through their use of an Approved Research Provider. Submitters were generally against the minimum threshold, considering it too high and disadvantaged start-ups.
27. Analysis from the 2016 Statistics NZ R&D Survey shows that around 700 businesses per year will not be eligible for the R&D tax incentive if there is a minimum threshold of \$100,000. Around 450 of these businesses undertake \$50,000 or less R&D spending a year.
28. Officials believe it is important to keep the minimum threshold at \$100,000 because:
- Advice from Her Majesty's Revenue and Customs (HMRC) (IR2018/455/18-19 0061 refers) supports a minimum threshold. The combination of compliance costs for applicants and administrative costs for government could outweigh the value of the credit. Removal of the minimum threshold in the United Kingdom led to a large increase in small claims (an increase of 33 per cent).^{s 9(2)(g)(i)}
 - The minimum threshold for Growth Grants is \$300,000. Many small businesses that do not satisfy the Growth Grants threshold will be able to access the R&D tax incentive.
 - Start-ups and small businesses will still have access to Project Grants, which do not have a minimum expenditure threshold. Currently, there are 263 businesses that are in receipt of Callaghan Innovation grant funding for R&D projects under \$100,000.
 - Businesses that contract out their R&D to Approved Research Providers will be able to access the R&D tax incentive even if they do not satisfy the \$100,000 threshold.

- The \$100,000 minimum threshold roughly equates to the cost of one full-time employee working on R&D. It is unlikely that businesses with less than one full-time employee will be able to generate a significant amount of spill-over benefits from that R&D activity.
29. Officials consider that \$100,000 minimum expenditure threshold is a critical design feature to include in the scheme to ensure its long-term viability.
 30. If Ministers wish to consider lowering the minimum threshold then officials suggest reducing it to \$50,000 on the basis it would include a further 250 businesses into the scheme and the combined compliance costs for applicants and the administrative costs for government will not outweigh the benefit of the tax credit received. For example, a business undertaking \$50,000 of R&D would receive a \$6,250 tax credit (at a 12.5 per cent credit rate) or \$7,500 tax credit (at a 15 per cent credit rate). The average administrative cost for government is likely to be at least \$2,000 per claim and the cost to business will be a similar amount or higher, leaving around \$2,000 benefit.
 31. **Officials recommend retaining a \$100,000 per year minimum eligible R&D expenditure threshold to qualify for the R&D tax incentive, or if Ministers prefer, retain a minimum expenditure threshold but reduce it to \$50,000 per year.**

Cap on R&D expenditure

32. The discussion document proposed that businesses would be able to claim up to \$120million of eligible R&D expenditure each year, which equates to a credit of \$18 million based on a 15 per cent credit rate (or \$15 million based on a 12.5 per cent credit rate). The discussion document proposed either a Ministerial discretion to exceed the cap or a pre-registration requirement for large claims.
33. Submissions generally supported the \$120 million cap. Some submitters said the cap would incentivise them to increase their R&D expenditure to reach the cap. The majority of submitters preferred the pre-registration option to exceed the cap.
34. Officials consider the \$120 million cap is at the right level and agree it is important to have discretion to exceed the cap because larger firms considering whether to conduct their R&D in New Zealand may be marginally more attracted to a discretionary scheme.
35. **Officials recommend including a \$120 million cap with the discretion to exceed it through a pre-registration process.**

Design features limiting the policy intent

36. Consultation to date has indicated that certain design features proposed in the discussion document have potential to decrease the level of R&D activity in New Zealand. These features include; business eligibility criteria, proposed exclusions to the criteria and the dual purpose activity rule.

Business eligibility criteria

37. The policy intent is for all businesses to be eligible for the R&D tax incentive regardless of legal structure, so that the incentive is accessible, inclusive, and does not distort business structuring decisions. To this end, the discussion document carried forward the 2008 business eligibility criteria.
38. Businesses expressed concern that the proposed criteria around the control, financial risk, and effective ownership requirements could exclude international subsidiaries undertaking R&D in New Zealand for their parent company. § 9(2)(b)(ii)

in New Zealand.

39. Officials agree that the business eligibility criteria carried forward from 2008 could exclude valid R&D activity, so would be contrary to the policy intent. As a result, officials propose two separate sets of eligibility criteria, distinguishing between business that perform R&D in-house and businesses that contract out their R&D activities.

In-house R&D: business eligibility criteria

40. To satisfy the in-house R&D business eligibility criteria, officials propose that a business undertaking R&D be required to:

- carry on business in New Zealand through a fixed establishment;
- perform a core activity in New Zealand;
- conduct day-to-day management of the core activity in New Zealand;
- the results of the R&D activity are freely available to use for the business at no extra cost above the business's eligible R&D expenditure for the activity;
- have R&D controlling rights⁴ in relation to the core activity, or ensure these rights are held by a company in the same group of companies as the business; and
- not contract out the R&D activity to an R&D contractor.

41. Subsidiary companies directly performing R&D in New Zealand for foreign parents would need to satisfy the in-house eligibility criteria to be eligible for the R&D tax incentive. The proposed new criteria are more inclusive of subsidiaries, because it does not require subsidiaries to bear the financial risk, and have any control over R&D activities beyond day-to-day management.

42. Consultation has also identified the need to assess business partnerships as a whole, rather than at individual partner level. Officials agree that individuals in partnership should be assessed at the partnership level.

43. **Officials recommend that the in-house R&D business eligibility criteria be included in the legislation, enabling subsidiaries of multinational corporates are able to qualify for the R&D tax incentive.**

44. **Officials recommend that the eligibility of partnerships is assessed at the partnership level rather than the individual partner-level.**

Contracted R&D: business eligibility criteria

45. In 2008, there was only one set of eligibility criteria, with various rules intended to ensure that the business contracting out the R&D (the principal) would be eligible for the R&D tax credit. Despite these rules, a number of claims were successfully made by R&D contractors for activities they had been paid to do by other businesses.

46. The separate contracted R&D business eligibility criteria, in conjunction with other targeted rules, are intended to ensure that R&D tax credits are only paid to the business commissioning the R&D, and that credits are not paid out twice in relation to the same R&D activity.

47. To satisfy the contracted R&D business eligibility criteria, the following criteria should be met:

⁴ Officials propose that R&D controlling rights be legislatively defined as meaning the rights to start, stop, and change the direction of an activity, and the right to choose whether results are followed up on.

- the principal carries on a business in New Zealand through a fixed establishment;
- the principal contracts with a contractor that the contractor will perform a core activity on the principal's behalf;
- the contractor performs the core activity in New Zealand as part of a business carried on by the contractor in New Zealand through a fixed establishment;
- the core activity is performed in New Zealand;
- the day-to-day management of the core activity is conducted in New Zealand;
- the results of the R&D activity are freely available to use for the business at no extra cost above the business's eligible R&D expenditure for the activity;
- R&D controlling rights⁵ in relation to the core activity are held by the principal, or a company within the principal's corporate group; and
- the contractor receives market value consideration for performing the R&D activity from the principal, or from a company within the principal's corporate group.

48. **Officials recommend that the contracted R&D business eligibility criteria be included in the legislation.**

Ownership of R&D results

49. The revised business eligibility criteria are primarily concerned with where R&D occurs. Claimants are not required to own the results of the R&D. However, we propose keeping one feature of the 2008 regime, namely that claimants have access to the results of the R&D at no extra cost.
50. This is likely to be a contentious issue. Some subsidiaries of multinationals have indicated this requirement would not be problematic. Other advisors have indicated it could pose transfer pricing issues⁶ or make some R&D performers ineligible for the tax credit.
51. However, the alternative, that the firm undertaking the R&D does not have access to the results of the R&D at no extra cost is also problematic. It could mean that government will fund R&D in New Zealand via the tax incentive and New Zealand firms will subsequently pay to access the intellectual property generated by that R&D.
52. **Officials recommend that the eligibility criteria include the requirement that the results of the R&D activity are freely available to be used by the R&D performer at no extra cost above the business' eligible R&D expenditure for the activity**

Specific inclusion of industry research cooperatives

53. At this stage, and in line with the proposal in the discussion document, officials consider that industry research cooperatives, including levy bodies⁷ should be eligible for the R&D tax incentive regardless of not meeting the business test.⁸ R&D funded through industry research cooperatives is fundamentally business R&D and may result in benefits that are not fully captured by the industry.

⁵ Officials propose that R&D controlling rights be legislatively defined as meaning the rights to start, stop, and change the direction of an activity, and the right to choose whether results lead to further work.

⁶ Transfer pricing occurs when different divisions of a multi-entity company are in charge of their own profits. When divisions are required to transact with each other, a transfer price is used to determine costs.

⁷ This includes businesses controlled by one or more of these entities.

⁸ The "in business" test is based on case law, requiring a person to intend to make a profit, and to carry on a profession, trade, manufacturing or undertaking.

54. **Officials recommend that industry research cooperatives be eligible for the R&D tax incentive under a special rule in the legislation.**

Potential exclusions to business eligibility tests

55. The discussion document proposed that State Owned Enterprises (SOEs), Crown Research Institutes (CRIs), District Health Boards (DHBs), Tertiary Education Organisations (TEOs) and their subsidiaries could be potentially excluded from the scheme. The rationale for the proposed exclusion was their ability to access alternative sources of public funding thereby not making them a true private business which is the main focus of the scheme. The discussion document was silent on mixed ownership model companies and other types of businesses the Crown has shares in.

Mixed ownership models and other types of businesses the Crown owns shares in

56. Currently mixed-ownership companies (where the Crown must own up to 51 per cent) and Air New Zealand (in which the Crown has a 52.1 per cent shareholding but is a publicly listed company) would meet the business eligibility criteria making them eligible for the R&D tax incentive. The discussion document did not propose excluding these types of entities from the scheme. Officials consider them to be important players in New Zealand's innovation system and to exclude them would be anti-competitive.
57. **Officials recommend continuing to allow mixed ownership models and Air New Zealand to be eligible for the R&D tax incentive as long as they meet the proposed business eligibility criteria.**

SOEs

58. A strongly voiced concern from SOEs throughout the submission process was that the proposal to exclude them from the scheme would be anti-competitive. The State-Owned Enterprises Act 1986 requires SOEs to be 'as profitable and efficient as comparable businesses that are not owned by the Crown'. This objective cannot be achieved if SOEs are not entitled to incentives that are available to comparable private sector businesses.
59. Many SOEs are established R&D performers and anticipate the R&D tax incentive would incentivise them to undertake additional R&D. SOEs undertake business based on operating revenue, with a focus on cash flows, as opposed to raising capital. If SOEs have access to the R&D tax incentive, then it will increase SOEs operating cash-flow and allow them to reinvest in additional R&D activity. This view was generally supported from wider submissions.
60. Officials agree with the competitive neutrality concerns and that access to the R&D tax incentive will allow SOEs to undertake additional R&D activity. On these grounds officials consider SOEs should be included. SOEs are some of New Zealand's larger businesses. Attracting, incentivising and supporting large R&D performers will build scale in our economy and stimulate greater R&D. To exclude SOEs could be seen as contrary to achieving this goal.
61. Based on the submissions received and further analysis undertaken, the inclusion of SOEs into the scheme would increase its cost by a small margin (between \$1.6 million to \$2.6 million per year⁹). **Annex 1** lists the type of R&D conducted by SOEs and their actual and estimated R&D spending.
62. An alternative suggestion was made that SOEs could be directed to undertake additional R&D through a letter of expectation or something similar. However, additional R&D cannot

⁹ The additional cost of including SOEs in the scheme based on a combination of reported R&D spending included in SOE submissions and where no information was supplied, the 2008 median claim reduced in line with the 12.5 percent credit rate was applied.

§ 9(2)(b) per year (based on a 12.5 per cent credit rate) but this number is highly uncertain.

73. **Officials recommend including minority owned subsidiaries of CRIs, DHBs and TEOs (i.e. the CRI, DHB or TEO has a share-holding up to 49 percent) in the R&D tax incentive.**

Other excluded entities: businesses in receipt of Growth Grants

74. **Officials recommend a rule that prevents businesses from claiming R&D tax credits if they are receiving Growth Grant funding.**

Dual purpose activities

75. Dual purpose activities were identified as a risk area when officials reviewed the 2008 R&D tax credit. Some businesses claimed a large part of their day-to-day manufacturing costs on the grounds that these were part of their R&D. The discussion document proposed a dual purpose activity exclusion, where an activity carried out for both an R&D purpose and a non-R&D purpose should not qualify as R&D.
76. Most submissions said the dual purpose exclusion would prevent any of their R&D activities from qualifying for the R&D tax incentive, because all businesses undertake R&D with an intention to derive commercial benefit from the R&D at a future date. Officials agree that the dual purpose activity rule could prevent businesses from claiming genuine R&D.
77. In 2008, there was no general apportionment rule, although a 'to the extent' rule applied to some items of eligible expenditure. R&D tax incentives in other jurisdictions often have a general apportionment rule for dual purpose expenditure of some kind. Officials consider a general apportionment rule is necessary to prevent businesses from receiving R&D tax credits for business as usual and other non-R&D expenditure.
78. Officials have considered a number of tests, including a 'to the extent' test, a 'but for' test, and a 'wholly or mainly' test. Officials propose a 'but for' test, so that expenditure on dual purpose activities would be eligible if it were incurred only as a result of the R&D. Officials will continue to consider this issue, so that the general apportionment rule selected best suits the policy intent of the R&D tax incentive but also ensures the long-term fiscal sustainability of the regime.
79. **Officials recommend replacing the dual purpose activity test with an alternative test at the expenditure level. The final test selected will be included in the legislation.**

Other technical design features in the discussion document

80. The remaining technical design features included in the discussion document cover the more mechanical aspects of the R&D tax incentive.

Activity exclusions

81. The discussion document proposed certain activity exclusions. Internationally, most R&D tax incentives routinely exclude certain activities, for example activities where the boundary between experimental development and pre and post-development activity are blurred. Businesses were in favour of clear distinctions being made between those included as support activities and those excluded from core activities.
82. The discussion document also proposed blanket exclusions to certain activities under both the core and support limbs of the R&D definition. The majority of submitters on this point

were concerned that the blanket exclusions would lead to activities critical to the R&D process being excluded altogether.

83. Officials agree that blanket exclusions of certain activities from both core and support activities would be unduly harsh and exclude activities critical to the R&D process. Officials recommend having two lists of activity exclusions (refer **Annex 2** for a draft set of exclusions):
- one which excludes specific activities from core R&D and,
 - one which excludes specific activities from both core and support R&D.
84. The list of proposed activity exclusions is similar to that of the 2008 R&D tax credit with some additional exclusions. The exclusion lists are considered necessary to ensure that only R&D activities critical to the R&D process qualify for the R&D Tax Incentive. The final items included in each list will be worked through as part of the legislative drafting process and officials will report to Ministers on this at a later date.
85. **Officials recommend including two lists of R&D activity exclusions in legislation, one that covers exclusions under core R&D activity and another that covers exclusions for both core and support R&D activities.**

Social science research exclusions

86. Research in social science tends to be excluded from R&D incentives internationally. The discussion document proposed that either social science research should be eligible under support activities but not core activities or that there should be a blanket exclusion for social science research altogether.
87. Submissions highlighted the growing importance of social science research in R&D; this was particularly pertinent to the software industry. There was concern that blanket exclusion would mean less R&D was undertaken, although this concern lessened if it was eligible as a support activity.
88. While, there are some grounds for allowing research in social science to be included as a core R&D activity, the fiscal consequence of doing so are unknown. Officials recommend that social science research continue to be excluded as a core R&D activity but be eligible as an R&D support activity. Officials will undertake further work to better understand the implication of allowing social science research as a core activity s 9(2)(f)(iv)
89. **Officials recommend social science research should be excluded under core activities but be eligible under support activities.**

Eligible expenditure

90. The discussion document suggested two proposals for determining eligible expenditure. The first was eligible expenditure based on direct R&D labour costs only, but with a higher credit rate to compensate. The second option was based on a range of direct and indirect costs, with overhead costs calculated as a proportion of labour.

Eligible expenditure based on direct R&D labour costs only

91. While some submitters liked the simplicity of determining eligible expenditure through R&D labour costs only, the majority did not favour it as an approach as it was seen as not accurately capturing the full extent of business expenditure on R&D.
92. Submitters saw the approach potentially leading to industry distortions (ie labour-intensive industries such as software are favoured over capital intensive industries like manufacturing). The approach would also go against the overall policy intent of the scheme which seeks to

treat all industries equally and provide the same type of support to wide range of businesses across all industries.

93. International literature also indicates that R&D tax incentives have the potential to be absorbed by higher wages paid to R&D workers, instead of an increase in worker numbers. This effect can be exacerbated when labour is the only eligible R&D cost component of the scheme¹³.
94. While the first option is simple and easy to apply officials consider that the majority of businesses would not support this approach due to the complex nature of R&D spending. Officials are also concerned by the industry distorting and labour cost distorting nature of the approach and consider eligible expenditure should be based on a broad range of R&D costs.

Eligible expenditure based on a broad range of R&D costs with overheads calculated as a proportion of labour

95. A modest number of submitters felt that this approach would favour labour-intensive industries but were still in favour of the approach as it was a simple way to calculate overheads. Some businesses and intermediaries thought it would be difficult to reflect the nuance of company size and industry with a 'one-size-fits-all' formula. R&D Growth Grant recipients currently use this type of method to calculate their overheads.
96. Officials agree that this method of calculating overheads is a useful mechanism for SMEs to use to simplify their claims process. § 9(2)(f)(iv)
However, for year one it is proposed that R&D expenditure will be calculated on actual overhead costs.

97. **Officials recommend that eligible expenditure be based on a broad range of actual R&D costs.** § 9(2)(f)(iv)

Expenditure exclusions

98. The discussion document proposed the exclusion of some R&D expenditure. The rationales for the exclusions were insufficient connection to the R&D activity and reducing the compliance and administration costs for businesses.
99. A list of draft expenditure exclusions are provided in **Annex 3**. There are some changes to the proposed exclusions list from 2008, mainly around software expenditure but also in relation to contractor expenditure – where only up to 80 per cent of the contractor cost can be claimed. The rationale is to exclude the profit component from the contractor's charge for the R&D, as the tax incentive does not cover this for in-house R&D. The final list of exclusions will be worked through as part of the legislative drafting process.
100. **Officials recommend that a R&D expenditure exclusion list is included in draft legislation.**

Expenditure must be deductible for tax purposes

101. The discussion document proposed that expenditure must be deductible or amortisable by businesses under the *Income Tax Act 2007* to be eligible for the R&D tax incentive.
102. Officials consider that expenditure must be deductible (which includes an amount of tax depreciation loss) to be eligible for the R&D tax incentive. It is proposed that prepayments and other tax adjustments generally follow their usual tax treatment. Where a business has decided to defer its deductions of R&D expenditure, the deferred expenditure is nevertheless

¹³ Appelt, S. *et al.* (2016), "R&D Tax Incentives: Evidence on design, incidence and impacts", *OECD Science, Technology and Industry Policy Papers*, No. 32, OECD Publishing, Paris. <http://dx.doi.org/10.1787/5jlr8fldqk7j-en>

eligible in the year it is actually incurred rather than in the year to which the deduction is deferred.

103. **Officials recommend a requirement that expenditure be deductible (or an amount of depreciation loss) to be eligible for the R&D tax incentive.**

Overseas R&D expenditure

104. Because the aim of R&D tax incentive is to primarily incentivise R&D activity taking place in New Zealand, the discussion document proposed only a small proportion of overseas R&D expenditure be eligible. The technical requirement outlined in the discussion document allowed businesses to claim up to a 10 per cent portion of overseas R&D expenditure, when less than half of the R&D expenditure for a project occurs overseas.
105. Only a small number of submitters commented on this aspect, of which mentioned that overseas research was integral to their New Zealand research. This applied equally across the start-up space as well as to large companies. Clinical trials were mentioned specifically in this context - often clinic trials are required to be run off-shore because of New Zealand's small population. Clinical trials by their nature can be one of the largest expenditure items in an R&D project. Complying with statutory requirements in other jurisdictions was also mentioned.
106. Internationally, there is no clear consensus on the ideal threshold to apply and officials see this as an expenditure risk area. Australia allows up to 50 per cent on overseas expenditure but the expenditure requires separate approval. The United Kingdom is generally relaxed about any level of overseas expenditure, which is mainly due to EU requirements. Canada limits overseas expenditure to 10 per cent of eligible expenditure.
107. While recognising some businesses will be at a disadvantage with a 10 per cent expenditure threshold, on balance officials consider it should remain in place on the basis it is more advantageous than under the current Growth Grant scheme, and that there will be potential to increase the level in the future if required.
108. However, officials consider the 2008 rule as proposed in the discussion document to be overly complex. For the sake of clarity and ease of administration a simple rule is likely to work better. Officials recommend including a rule that states in any year, no more than 10 per cent of an R&D claim can be for overseas expenditure. This would eliminate the need for 50 per cent of the cost of the project being tied to New Zealand. Overseas expenditure will need to be defined, which will be reflected in the draft legislation. Currently, officials consider including imported materials as domestic expenditure but non-resident taxpayer's labour costs as overseas expenditure. Officials will report back to you on this at a later date.
109. **Officials recommend including a rule that allows up to 10 per cent of an annual R&D claim to be overseas expenditure. A definition of eligible overseas expenditure will be included in the draft legislation.**

Commercial consideration

110. The discussion document proposed excluding expenditure from eligibility if it related to activities which the entity conducting the activity received or could reasonably expect to receive consideration. In general submitters were not in favour of this rule, considering it unduly harsh.
111. Officials are proposing to extend the feedstock rule, as well a proposed tightening of the principal/contractor rules. This may remove the need for a separate commercial consideration rule.
112. **Officials consider a separate commercial consideration rule may not be necessary, but will consider this further and report to you in due course.**

Business continuity rules

113. The discussion document suggested that continuity rules could be imposed on the R&D tax credits. This rule would prevent future investors in businesses, which have not incurred the cost of the R&D, from getting the benefit of tax credits that have had to be carried forward.
114. Submissions were concerned about the effect this rule would have on start-ups, which by their nature often undertake shareholding changes as they seek additional equity. It was also suggested that receiving the credit should be an incentive for investors, not a disincentive.
115. Officials have sympathy with these arguments but consider this issue should be considered as part of the more general issue of business continuity rules, which are being reviewed by the Tax Working Group.
116. **Officials recommend imposing continuity rules on R&D tax credits carried forward in 2019, with the intention to review the rule in light of any recommendations from the Tax Working Group.**

Inclusion of additional technical design features

117. A range of additional technical design features not included in the discussion document have been raised throughout the consultation process and need to be addressed in the legislation.

Feedstock rule

118. The feedstock rule in the 2008 scheme meant that only the net cost of an item subject to a process or transformation would receive the tax credit. In other words, a person was allowed a credit to the extent the cost of the input exceeded the value of the output. Officials have analysed 2008 claims and consider the feedstock rule was difficult to enforce and allowed recharacterisation of expenditure.
119. Officials propose that this rule is strengthened by extending it to inputs that are used or destroyed in the R&D process, in addition to those that are subject to a process or transformation.
120. **Officials recommend that the feedstock rule should be extended to apply to inputs that are used, destroyed, or subject to a process or transformation in the R&D process.**

Imputation credits

121. Officials propose that companies are given an imputation credit equal to their R&D tax credit. The purpose of this is to prevent 'claw back' of the R&D tax credit in the form of tax at the shareholder level when the benefit of the credit is distributed to shareholders via a dividend.
122. **Officials recommend companies are issued an imputation credit equal to the R&D tax credit they are entitled to.**

Ordering rules

123. **Officials recommend that R&D tax credits should be applied to a tax liability after non-refundable tax credits and credits for supplementary dividends, but before imputation credits.**

Administration of the R&D tax incentive

Claims process

For the policy to be successful it will need to be effectively administered

124. In terms of the claim process most submissions requested that compliance burdens be kept light and that the process to claim be streamlined, clear and low cost. Feedback also highlighted the need for clear guidance and education material to support firms in making claims. Most submitters were also keen on the idea of being able to submit claims via third party software providers provided they would minimise compliance cost and increase the overall efficiency of the scheme.
125. Inland Revenue has made the following administrative decisions. In terms of year one of the R&D tax incentive, firms will be required to register their interest in applying for the incentive and to file their claims online through Inland Revenue's e-service (MYIR) at the end of the tax year. As part of the online claim process firms will be required to submit and upload supporting information that details the R&D activity and expenditure. By year three the intention is to only allow R&D returns from approved accounting software packages.

Application start date

126. Officials propose that the technical description for the first year of the tax incentive is that it is the 31 March 2020 income tax year. This means early balance date taxpayers will be eligible for the R&D tax incentive from as early as October 2018. Most claimants are expected to have standard balance dates, however, and will only be eligible for the R&D tax incentive from 1 April 2019.
127. **Officials recommend that the R&D tax incentive apply from the 31 March 2020 income tax year.**

Pre-approval

128. While the discussion document did not directly address the possibility of a pre-approval being included in the administrative process, it was spontaneously raised as an option throughout the consultation process and in submissions. Businesses were generally supportive of a pre-approval process on the basis it would give them increased certainty that they were complying with the legislation and would therefore be eligible to receive the tax incentive when they submit their tax return.
129. Officials consider pre-approval is a useful mechanism. In addition to providing certainty for claimants, it is a useful screening mechanism that can give confidence that expenditure claims are for valid R&D. It is an important feature of the Norwegian R&D tax credit (see 18-19 0061, IR2018/455), where it is supported by both public sector officials and private sector representatives. Despite requiring firms to go through two steps (approval of the R&D activity, then approval of the R&D expenditure), it has not deterred uptake of the scheme.
130. Ideally, this feature would be part of the tax incentive scheme from day one. However, Inland Revenue faces constraints associated with its Business Transformation process and may not be able to accept applications for approval of the R&D activity in year one.
131. Therefore, officials propose that the pre-approval mechanism is included in the legislation with the ability to turn this on once there is the capacity to process applications.
132. **Officials recommend including a pre-approval mechanism in the legislation with a separate ability to turn this mechanism on.**

Provisional tax

133. It is proposed that any R&D tax credits received by a business be taken into consideration when calculating the business's residual income tax. This would have the effect of reducing business' provisional tax liability, and would improve administrative efficiency because it enables business' provisional tax payable to reflect their expected income tax liability.
134. **Officials recommend that R&D tax credits be included in taxpayers' residual income tax calculations.**

Orders In Council

135. It is important the R&D tax incentive remains flexible enough to be adjusted when serious issues occur. Officials consider a variety of second and third order regulatory mechanisms could be used to this effect.
136. The legislation will allow for schedules containing specific R&D activity and expenditure exclusions to be amended via Order in Council. The ability to make changes to the schedules outside of primary legislation is necessary so that the Government can quickly close off problem areas identified that could impact on the fiscal sustainability of the R&D Tax Incentive.
137. It is also proposed that Orders in Council be available to enable the use of approved third party software by claimants once this software is available.
138. **Officials recommend that the legislation expressly allow for Orders in Council to be used to amend schedules, and to legislate for the use of approved software at a future date.**

Transparency, evaluation and penalties

Transparency

139. The discussion document proposed that the names of successful claimants of R&D tax incentives be published, with a two year lag. Funding bands indicating the approximate amount of credits paid out would be published alongside the names of claimants. The purpose of this transparency measure is to deter taxpayers from making inappropriate claims that would attract negative media scrutiny.
140. The discussion document also proposed that Inland Revenue have the ability to make taxpayer-specific information in relation to R&D Tax Incentive claims available to MBIE, Treasury and Callaghan Innovation officials to support evaluation and policy development. It was also proposed that claim information be integrated into Statistics New Zealand Longitudinal Business Database (LBD) and the National Research Information System (NRIS).
141. Consultation with businesses and tax advisers to date has indicated that these proposed transparency measures would be acceptable. The publication of names and R&D tax credit bands was generally viewed as acceptable, as similar information is currently published by Callaghan Innovation in respect of Growth Grant recipients.
142. **Officials recommend that the names and funding bands of successful claimants of R&D tax incentives be published with a two year lag; that Inland Revenue have the ability to share taxpayer-specific information regarding R&D tax incentive claims with MBIE, Treasury, and Callaghan Innovation officials; and that claim information be considered for integration into Statistics New Zealand Longitudinal Business Database (LBD) and the National Research Information System (NRIS).**

Evaluation

143. The discussion document proposed the R&D tax incentive be evaluated following the transition from Growth Grants, and within four years of commencement. Monitoring in the shorter term is important to speedily identify and remedy issues that could compromise the integrity of the incentive.
144. Tax legislation generally does not require evaluation because there are effective informal mechanisms allowing problems and issues with tax legislation to be raised and addressed. However, officials consider there is merit in making an exception to this for the R&D tax incentive because it is giving money out rather than raising revenue.
145. Submissions generally supported the proposed evaluation measures. s 6(b) [REDACTED] Officials propose that an evaluation of the R&D tax incentive every five years be required by legislation.
146. **Officials recommend including a legislative requirement that government commission an evaluation on the R&D tax incentive every five years from the commencement of the scheme.**

Penalties

147. The discussion document proposed that the standard penalties provisions in the *Tax Administration Act 1994* should apply to R&D tax incentive claims. It also asked whether the promoter penalty rules should be extended so that the joint and several liability provisions apply where advice is provided on a contingency fee basis. International experience suggests that the risks around R&D tax credits may be greater when advisors are paid on a contingency basis, as they too gain an incentive to inflate the claim.
148. Consultation with businesses and tax advisers to date has been largely supportive of the proposed penalty measures.
149. **Officials recommend that standard penalty provisions in the *Tax Administration Act 1994* apply to R&D tax incentive claims, and that the promoter penalty rules be extended to include R&D advisers paid on a contingency fee basis.**

Additional work-streams

Refundability

150. Businesses in a tax loss position, particularly start-ups, will not benefit from R&D tax credits in the first year of the scheme. The Government recognises that it is important to support these types of businesses as often R&D intensive firms spend their early years in a tax loss position, and have a lower probability of becoming profitable than other types of businesses. These firms are considered important participants within the innovation system both as a source of value-add employment and with the development of a more productive and diversified economy.
151. Officials are also considering an opportunity to introduce a measure that supports businesses with insufficient tax liability, mirroring the R&D tax incentive, for the 2019 tax year. This would provide a positive response to the strong feedback received through consultation and would acknowledge the considerable proportion of eligible R&D businesses that have insufficient tax liability to take full advantage of the R&D tax incentive in its first year.
152. As part of the ongoing policy work on refundability, consideration will be given to the treatment of atypical businesses. Currently, the R&D tax incentive is available to a range of

entity structures including charitable businesses, levy bodies, other industry research co-operatives, co-operatives and some Maori businesses. Often these businesses will be structured to never incur tax liability, so while eligible for the R&D tax incentive they will be unable to benefit from it. In theory, refundability mechanisms could be used to support these types of entities, unless the chosen parameters of the scheme exclude them entirely eg refundability may be designed to target high-growth start-ups or specific industries.

153. Possible refundability options for atypical businesses could include passing tax credits back through their membership base or allowing some exceptions to the refundability rules eg certain types of businesses are refunded regardless of their structure. For the latter option some consideration would need to be given to how much R&D these businesses undertake and the overall cost their inclusion is likely to incur. For example, some levy bodies such as DairyNZ undertake around \$20 million on R&D a year and Fonterra, a non-profit cooperative, is one of New Zealand's largest R&D performers and likely to undertake R&D at a level close to the cap.
154. Officials also need to consider the impact refundability might have on entity behaviour. Currently, many industry research co-operatives enter into collaborative research projects with CRIs as part of the science investment funding process. If refundability was available to them, they may choose to subcontract their research to CRIs instead, thereby getting cash back on their R&D investment.

Certainty package

155. An issue raised by stakeholders during consultation was a desire for greater certainty within the process of applying for and receiving the R&D tax incentive. As part of its commitment to take a customer-oriented approach to the administration of the tax incentive, officials are considering a range of measures to be introduced by 2020. As well as reducing uncertainty and compliance costs for applicants. These measures could also provide greater assurance around integrity of payments for government thereby reducing risk around refundability for firms in loss. Issues that will be examined in this tranche of work include:

- Establishing a pre-approval process for R&D activities. As noted above, it is proposed that this be included in the legislation, but it is likely that the administrative systems to put this into effect will only be available from year two.
- Establishing the concept of a research and development department/centre for large R&D performers. There could be a global pre-approval that the activity within this centre constituted eligible R&D and therefore avoid such a centre having to undertake detailed project by project claims.
- Simplified processes for SMEs. An important goal in administering the tax incentive is that the compliance costs for applicants are commensurate with the benefits they receive. For SMEs, whose claims are likely to be smaller in monetary terms and who are less likely to have dedicated administrative staff, this is particularly important. Officials consider there could be ways of designing the tax credit that will make compliance simpler for SMEs. An example would be allowing firms to use a 'labour cost plus mark-up' approach to establishing their eligible expenditure.

Successful uptake of the R&D Tax Incentive

156. To ensure the successful implementation of the R&D tax incentive there needs to be strong uptake of it by R&D performing businesses. However, the submission process has shown that there is a lack of awareness of the benefits of the scheme and some of the design features within it. Specifically, there was confusion about the credit in comparison with the Growth Grants, concern about the lack of support for start-ups and businesses in tax loss, and concern that software businesses may be excluded from the scheme.

157. To address these issues officials from MBIE, Inland Revenue and Callaghan Innovation are developing an implementation strategy to ensure there is widespread awareness and understanding of the R&D tax incentive before its implementation date in April 2019. Part of this process will be the development of guidelines which will sit alongside the tax legislation to inform businesses of the detailed parameters of scheme.

Next Steps

158. A draft Cabinet paper will be sent to your offices based on decisions made on this paper by the end of July.

159. Before the paper is considered at Cabinet, officials will provide you with final advice on design features that are in work progress such as the commercial consideration rule, activity exclusions, ineligible expenditure and the dual purpose activity test. This paper will be available by the end of August.

160. Dependent on agreement by Cabinet draft legislation will be ready for consideration by mid-October, with the intention of introducing it to Parliament in late-October.

Annexes

Annex 1: SOE R&D expenditure and types of R&D undertaken

Annex 2: Draft activity exclusions under core and support activities


Annex 3: Draft list of ineligible expenditure

Released consistent with the Official Information Act 1982

Annex 1: SOEs actual and estimated R&D expenditure and types of R&D conducted

State Owned Enterprises		
Company name	R&D spend per year *based on a 12.5 per cent credit rate	Type of R&D undertaken
Airways Corporation of New Zealand Ltd	s 9(2)(b)(ii)	
Kordia Group Ltd		
Meteorological Service of New Zealand Ltd		
Transpower New Zealand Ltd		
AsureQuality Ltd		

Released consistent with the Official Information Act 1982

Kiwirail Ltd	<p>s 9(2)(b)(ii)</p> 
Electricity Corporation of New Zealand Ltd (Residual)	
Orillion Previously known as: Animal Control Products limited	
Landcorp Farming Ltd	
New Zealand Post Ltd	
Quotable Value Limited	
New Zealand Railways Corporation	

Released consistent with the Official Information Act 1982

Annex 2: draft activity exclusions under core and support activities

Activity exclusion	Core	Supporting
Research in social sciences, arts, or humanities	Excluded	Included
Quality control or routine testing of processes, services, or goods	Excluded	Included
Routine collection of information	Excluded	Included
Preproduction activities, such as a demonstration of commercial viability, tooling up, and trial runs	Excluded	Included
Testing	Excluded	Included
Supporting, de-bugging, or making minor improvements to existing computer software, using known methods	Excluded	
Routine software and computer maintenance	Excluded	
Converting existing systems to new software platforms	Excluded	Included
Creating products using tools designed for that purpose	Excluded	Included
Prospecting for, exploring for, or drilling for, minerals, petroleum, natural gas, or geothermal energy	Excluded	
Market research, market testing, market development, or sales promotion, including consumer surveys ¹⁴	Excluded	
Making cosmetic or stylistic changes to processes, services, or goods	Excluded	
Commercial, legal, or administrative aspects of patenting, licensing, or other activities	Excluded	
Activities involved in complying with statutory requirements or standards ¹⁵	Excluded	
Management studies, efficiency surveys, or organisational design	Excluded	
Reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications, or publicly available information	Excluded	
Software development undertaken for the dominant purpose of internal administration	Excluded	
Development of data entry procedures and user interfaces	Excluded	Included

¹⁴ Only market development, sales promotion and consumer surveys are excluded from the support activity definition.

¹⁵ The support activity exclusion relates to existing products only. Complying with statutory requirements for new products may qualify as a support activity.

Annex 3: draft list of ineligible expenditure

- Payments of salary or wages to a non-resident.
- Payments for services performed by a non-resident.
- Expenditure on employee share schemes.
- Expenditure on employee recruitment and relocation.
- Payments of bonuses to employees.
- Expenditure under a financial arrangement.
- A deduction under sections DB 5 to DB 15 (which relate to financing and financial arrangement adjustments).
- Professional fees incurred in determining a person's entitlement or lack of entitlement to a research and development tax credit.
- Expenditure or loss in relation to a right to use intangible property other than software.
- Expenditure or loss in relation to software that is bespoke or customised, or is not widely commercially available.
- Gifts.
- Expenditure or loss in relation to core technology.
- Expenditure or loss for plant, machinery, or materials to commercialise R and D activities' results, including pre-production expenditure or loss.
- Expenditure or loss that is a pre-condition to, subject to the terms of, required by, or otherwise related to a grant made by the Crown or a local authority.

Released consistent with the Official Information Act 1982