MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

BRIEFING

R&D Tax Incentive – Reducing the impact of Covid-19 on business R&D

Date:	19 March 2020	**Priority:**	Urgent
Security classification:	In Confidence	**Tracking number:**	2778 19-20

Action sought

	Action sought	Deadline
Hon Dr Megan Woods **Minister of Research, Science and Innovation**	**Agree** to bring forward the application date of broader refundability of R&D tax credits to the 2019-20 income year. **Agree** to lodge the attached Cabinet paper on Friday 20 March for consideration by Cabinet on Monday 23 March. **Agree** to refer this briefing to the Minister of Revenue.	20 March 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st contact
Kirsty Hutchison	Manager, Innovation Policy	04 901 4131	[redacted] S 9(2)(a)	✓
Xavier Watts	Senior Policy Advisor, Innovation Policy	[redacted] S 9(2)(a)	[redacted] S 9(2)(a)	

The following departments/agencies have been consulted

The Treasury, Inland Revenue, Callaghan Innovation

Minister's office to complete:

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☐ Withdrawn

Comment

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Purpose

The purpose of this briefing is to seek your agreement to an urgent amendment to the R&D Tax Incentive rules, aimed at encouraging businesses to continue their R&D despite Covid-19.

Recommended action

The Ministry of Business, Innovation and Employment recommends that you:

a **Agree** to bring the application date of broader refundability of R&D tax credits forward to the 2019-20 income year (year 1 of the R&D Tax Incentive scheme).

Agreed/Not agreed

b **Agree** that businesses should be able to choose whether to apply the year 1 or year 2 refundability rules to their year 1 R&D Tax Incentive claims.

Agreed/Not agreed

c **Agree** that the amendment should be introduced via the Urgent Covid-19 Tax Matters Bill.

Agreed/Not agreed

d **Note** the proposal is revenue neutral, and has no effect on our estimate of the fiscal costs of the R&D Tax Incentive. (The fiscal cost model treats tax credits and cash refunds of tax credits as equivalent.)

Noted

e **Note** that Inland Revenue has confirmed it will be capable of implementing and administering this amendment if it goes ahead.

Noted

f **Agree** to lodge the attached Cabinet paper on Friday 20 March 2020 and seek Cabinet approval for the amendment on Monday 23 March 2020.

Agreed/Not agreed

g **Agree** to proactively release this briefing when the Cabinet paper is proactively released.

Agreed/Not agreed

h **Agree** to refer this briefing to the Minister of Revenue.

Agreed/Not agreed

..... / ...... / ......
Hon Dr Megan Woods
Minister of Research, Science and Innovation

[redacted] S9(2)(a)

19/03/2020

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

Problem definition and proposed amendment

1. There is a significant risk that businesses will cut their R&D spending in response to Covid-19. We are particularly concerned about loss-making businesses (and businesses who do not pay enough income tax to fully utilise their R&D tax credits)[1] who cannot benefit from their R&D tax credits this tax year because they do not qualify for refundability under the R&D Tax Incentive's 2019-20 (year 1) income year refundability rules.

2. The year 1 refundability rules restrict refundability to a small subset of eligible entities - New Zealand tax resident R&D-intensive unlisted companies who do not receive tax exempt income (other than from intercompany dividends). In addition, a $255,000 cap applies to refundability in year 1. Loss-making businesses who do not qualify for refundability in year 1 have no choice but to carry their credits forward to year 2 of the regime (the 2020-21 income year), and cash these out in year 2 if they qualify under the proposed new broader refundability rules.

3. It is these loss-making businesses who will need additional support to retain their R&D staff and continue their R&D investments despite Covid-19. One way of providing these businesses with that additional support is by applying the broader refundability rules from the 2019-20 income year.

4. The new refundability rules will replace the existing rules from year 2 of the scheme. The new rules allow businesses to be eligible for refundability provided they are eligible for the R&D Tax Incentive. In addition, the new rules replace the existing $255,000 refundability cap with a labour-related tax cap, which allows firms refunds up to the total amount of labour-related taxes[2] paid in the relevant income year.

Benefits as part of a Covid-19 response package

5. If the application date of the year 2 refundability rules is brought forward as proposed more businesses will be able to access more refundable tax credits sooner.

6. This amendment provides targeted support to innovative businesses, to enable them to retain their R&D programmes and the high-skilled jobs that will be necessary to our future economic recovery. The amendment will provide more support for businesses already intending to claim the R&D Tax Incentive in year 1, and could encourage them to enrol and file their year 1 claims with Inland Revenue sooner (rather than waiting to file closer to their claim due date). If this amendment is not made, businesses are more likely to reduce or stop their R&D, resulting in a deeper and more protracted decline in economic activity. It would also weaken the economy's ability to recover once the global economy has stabilised.

7. A small minority of businesses may be able to access more refunds under the year 1 refundability rules than the proposed year 2 refundability rules. To ensure business certainty in the regime is maintained, and that no business is disadvantaged by the urgent amendment,

[1] In this paper, references to "loss-making businesses" are intended to also include businesses who aren't in a tax loss position in year 1 but don't have enough income tax payable that year to fully utilise their R&D tax credits. This could include, for example, a business who has brought losses forward from a previous year and has used these to reduce its income tax liability in year 1, and as a result has excess R&D tax credits.

[2] The labour-related taxes included in the cap are PAYE (which includes amounts withheld from payments to contractors), fringe benefit tax (FBT), and employer superannuation contribution tax (ESCT).

officials recommend that businesses be allowed to choose which refundability rules they would like to apply to their year 1 R&D Tax Incentive claim. From year 2, all businesses would have to apply the year 2 refundability rules (they would not be able to choose to apply the year 1 rules).

Consultation with selected stakeholders on benefits

8. This proposal was initially suggested by a member of the R&D Advisory Group, who represents a Big 4 accounting firm. This stakeholder suggested the amendment because of their experiences with R&D performing businesses during the 2008/09 Global Financial Crisis (GFC). They saw a significant increase in interest from businesses in the Australian R&D Tax Incentive as the GFC took hold, because businesses needed support to retain their R&D staff during the crisis.

9. Economically, it was key for businesses to retain these staff, because the R&D undertaken during those years would flow through to new products and services in the next two to five years. Without Government support, a lot of R&D labour spend would have been cut. For loss-making businesses, non-refundable credits that can only be carried forward are of little benefit. Refundable credits, on the other hand, can provide these businesses with much needed cash to help support their R&D now, when that support is needed the most.

10. This stakeholder said that providing this support through the R&D Tax Incentive is particularly beneficial because:

    - It targets businesses who are investing in new products, services or processes. This means the support will deliver a longer term benefit to the economy.

    - The greatest R&D expense for most businesses are wages and payments for R&D labour. In addition, R&D expenditure is reasonably discretionary, so is easy to scale back. Providing this additional support through the R&D Tax Incentive will help more New Zealanders keep their jobs.

11. The proposed amendment has been tested with each of the Big 4 accounting firms, which are all members of the R&D Advisory Group. We have also tested the proposal with a representative of the Corporate Taxpayers Group.[3] All stakeholders consulted support this proposal, because it will provide much needed cashflow/timing benefits to businesses.

12. Officials asked all stakeholders consulted to provide an estimate of the amount of cash support this proposal would provide to businesses they are connected with in New Zealand. This sample provides an indication of the likely amount and timing of the cash benefit to firms. Based on the information received we estimate this proposal will provide approximately $50-70 million of cash support to the surveyed businesses. Cash sensitive businesses will be incentivised to file as soon as possible. Businesses that file close to the end of the tax year could expect to receive these refunds within the next few months.

[3] The Corporate Taxpayers Group is an organisation of major New Zealand companies that works with officials to achieve positive changes to tax policy in New Zealand. The Group’s members include Air New Zealand Limited, Airways Corporation of New Zealand, AMP Life Limited, ANZ Bank New Zealand, ASB Bank Limited, Bank of New Zealand, Chorus Limited, Contact Energy Limited, Downer New Zealand Limited, Fisher & Paykel Healthcare Limited, Fletcher Building Limited, Fonterra Cooperative Group Limited, General Electric, Genesis Energy Limited, IAG New Zealand Limited, Infratil Limited, Lion Pty Limited, Meridian Energy, Methanex New Zealand Limited, New Zealand Post Limited, New Zealand Racing Board, New Zealand Steel Limited, New Zealand Superannuation Fund, Opus International Consultants Limited, Origin Energy New Zealand Limited, Pacific Aluminium (New Zealand) Limited, Powerco Limited, Shell New Zealand (2011) Limited, SKYCITY Entertainment Group Limited, Spark New Zealand Limited, T&G Global Limited, The Todd Corporation Limited, TOWER Limited, Vodafone New Zealand Limited, Westpac New Zealand Limited, Z Energy Limited, and ZESPRI International Limited.

Risks

13. There is a risk that bringing forward the application of broader refundability rules could increase the risk of fraudulent claims in year 1 of the scheme. We consider this risk to be small.

14. Year 1 of the scheme ends in less than two weeks, which will provide little opportunity for fraudulent claims to be developed during year 1 in response to the amendment. There are also safeguards built-in to the new broader refundability rules, in the form of a labour-related tax cap, which ensures businesses have a tangible economic presence in New Zealand before refunds will be allowed. The combination of these two factors mean the risk of successful fraudulent claims is very small.

15. Inland Revenue systems are currently set up to apply the year 1 rules to R&D Tax Incentive claims. I have consulted with Inland Revenue, which has confirmed that they will be able to implement and administer the proposal.

Fiscal implications

16. The proposal is revenue neutral, and has no effect on our estimate of the fiscal costs of the R&D Tax Incentive. The model of fiscal costs used treats tax credits and cash payments (in the form of refunds) as equivalent.

17. There will be a one off net debt cash impact. This means that the amount that businesses will benefit from this will be reflected as a net debt impact in the 2019/20 fiscal year. There is no impact on the appropriation or operating balance.

Next steps

18. If you agree to this amendment, it could be included in the Urgent Covid-19 Tax Matters Bill. To enable the legislation to be included in the Bill, you will need to obtain Cabinet approval for the amendment on Monday 23 March 2020. Officials have drafted a Cabinet paper for you (which is included in the Annex), which would need to be lodged by Friday 20 March 2020. The Bill is expected to become law in early April.

19. Inland Revenue has confirmed that it will be capable of implementing and administering this amendment. We will continue to work closely with Inland Revenue and Callaghan Innovation to ensure appropriate communications and guidance is provided to taxpayers if the amendment goes ahead.

Annex: Draft Cabinet paper

In Confidence

Office of the Minister for Research, Science and Innovation

Chair, Cabinet

Reducing the impact of Covid-19 on business R&D

Proposal

1. This paper seeks Cabinet's agreement to changing the application date of the R&D Tax Incentive's broader refundability rules, so that these rules apply one year early (from the 2019-20 income year, rather than the 2020-21 income year).

Relation to Government Priorities

2. This proposal supports the Government's response to Covid-19, by providing additional support to R&D performing businesses.

Background

3. The R&D Tax Incentive was introduced in the 2019/20 income year to replace the existing Callaghan Innovation Growth Grant regime. The aim of the Incentive is to help the Government achieve its goal of increasing R&D spending to 2% of GDP by 2027.

4. Policy development on the R&D Tax Incentive was undertaken in two phases. The first phase came into force on 1 March 2019 for most businesses (the 2019/20 income year, which is referred to as "year 1" in this paper).

5. Phase 1 included a limited form of R&D tax credit refunds for loss-making businesses.[4] The year 1 refundability rules are based on rules used in the R&D Tax Loss Credit,[5] and are fairly restrictive. This means that only a small proportion of R&D Tax Incentive claimants will be able to access refundable credits in year 1 of the scheme. Loss-making businesses who do not qualify for year 1 refundability cannot benefit from their credits in year 1, but can carry their credits forward and potentially get them refunded in a future year if they satisfy certain criteria. These limited refundability rules were used because there was not enough time to develop more comprehensive refundability policy rules as part of the first phase of work.

6. The R&D Tax Incentive provides tangible benefits to profitable businesses, and for those businesses who are eligible for refundability in year 1. It provides no tangible benefit in year 1, however, for loss-making businesses who do are not eligible for refundability under the

[4] In this paper, references to loss-making businesses also includes businesses who are not in a tax loss position but have insufficient income tax liability to offset their R&D tax credits against. This would include, for example, a business who has brought losses forward from a previous year and has used these to reduce its income tax liability in year 1, and as a result has excess R&D tax credits.

[5] An existing tax measure that supports R&D Intensive loss-making businesses.

year 1 rules. There is a risk that these businesses, in particular, will cut their R&D spending in response to Covid-19, unless we make year 1 refundability accessible to more businesses.

7. Phase 2 policy development developed broader refundability rules, which were intended to apply from the 2020-21 income year for most businesses (referred to as "year 2" in this paper). These proposed new refundability rules are contained in the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill, which recently completed its Third Reading.

8. I am proposing that the application date of these new broader refundability rules apply retrospectively from year 1 (rather than year 2), so that more businesses are able to access more R&D tax credit refunds. This will help provide additional cashflow to loss-making R&D performers who might otherwise have to cut their R&D labour and spending in response to disruptions caused by Covid-19.

Problem definition and proposal

9. There is a significant risk that businesses will cut their R&D spending in response to Covid-19, particularly loss-making businesses who cannot benefit from their R&D tax credits this tax year because they do not qualify for refundability under the existing year 1 refundability rules.

The year 1 refundability rules

10. The year 1 refundability rules restrict refundability to a small subset of eligible entities. These rules only allow refunds for New Zealand tax resident R&D-intensive unlisted companies who do not receive tax exempt income (other than from intercompany dividends). In addition, a $255,000 cap applies to limit refundability in year 1. Loss-making businesses who do not qualify for refundability in year 1 currently have no choice but to carry their credits forward to year 2 of the regime (the 2020-21 income year), and cash these credits out in year 2 if they qualify for refundability under the proposed new broader refundability rules.

11. It is these loss-making businesses who need additional support for their R&D now, to encourage them to retain their R&D staff and continue their R&D investments despite Covid-19. One way of providing these businesses with that additional support is by changing the application date of the proposed new broader refundability rules.

The year 2 broader refundability rules

12. The proposed new broader refundability rules will replace the year 1 rules and apply from year 2 of the scheme. The new rules remove the restrictive eligibility criteria referred to above and allow businesses to be eligible for refundability provided they are eligible for the R&D Tax Incentive more generally. In addition, the new rules replace the existing $255,000 refundability cap with a labour-related tax cap, which allows firms refunds up to the total amount of labour-related taxes paid in the relevant income year.

The proposal: bringing the application date forward to year 1

13. If the application date of the year 2 refundability rules is brought forward by a year, so that they apply from year 1 of the scheme, this will provide more businesses with access to R&D tax credit refunds sooner. It will also provide some businesses with larger refunds than they would have obtained under the year 1 refundability rules. By providing more businesses with more cash sooner, this amendment provides important support to businesses, and encourages them to continue doing R&D so that they can continue to receive this support in future.

Giving businesses a choice between year 1 and year 2 rules

14. A small minority of businesses may be able to access more refunds under the year 1 refundability rules than the proposed year 2 refundability rules. To ensure business certainty in the regime is maintained, and that no business is disadvantaged by the urgent amendment, officials recommend that businesses be allowed to choose which refundability rules they would like to apply to their year 1 R&D Tax Incentive claim. From year 2, all businesses would have to apply the year 2 refundability rules (they would not be able to choose to apply the year 1 rules).

New Zealand's future economic recovery

15. This amendment provides targeted support to innovative businesses, to enable them to retain their R&D programmes and the high-skilled jobs that will be necessary to our future economic recovery. The amendment will provide more support for businesses already intending to claim the R&D Tax Incentive in year 1, and could encourage them to enrol and file their year 1 claims with Inland Revenue sooner (rather than waiting to file closer to their claim due date). If this amendment is not made, businesses are more likely to reduce or stop their R&D, resulting in a deeper and more protracted decline in economic activity. It would also weaken the economy's ability to recover once the global economy has stabilised.

Risks

Fraud risks

16. There is a risk that bringing forward the application of broader refundability rules could increase the risk of fraudulent claims in year 1 of the scheme. Year 1 of the scheme ends in less than two weeks, which will provide little opportunity for fraudulent claims to be developed during year 1 in response to the amendment. There are also safeguards built-in to the proposed new broader refundability rules, in the form of a labour-related tax cap, which ensures businesses have a tangible economic presence in New Zealand before refunds will be allowed. The combination of these two factors mean the risk of successful fraudulent claims is very small.

Implementation risks

17. Inland Revenue systems are currently set up to apply the year 1 rules to R&D Tax Incentive claims. I have consulted with Inland Revenue, which has confirmed that they will be able to implement and administer the proposal.

Financial Implications

Fiscal cost

18. The proposal is revenue neutral, and has no effect on our estimate of the fiscal costs of the R&D Tax Incentive. The model of fiscal costs used treats tax credits and cash payments (in the form of refunds) as equivalent.

Cash support for businesses

19. Officials asked all stakeholders consulted to provide an estimate of the amount of cash support this proposal would provide to businesses they are connected with in New Zealand. Based on the sample of businesses who responded to this request we estimate this proposal will provide approximately $50-70 million of cash support to the surveyed businesses. Cash sensitive businesses will be incentivised to file as soon as possible.

Businesses that file close to the end of the tax year could expect to receive these refunds within the next few months.

Legislative Implications

20. Implementing these proposals requires changes to tax legislation (including the Income Tax Act 2007 and potentially also the Tax Administration Act 1994).

21. If approved, I propose including the legislative changes resulting from these recommendations in the Urgent Covid-19 Tax Matters Bill, scheduled for introduction and passage through all stages under urgency on 7 April.

Impact Analysis

Regulatory Impact Assessment

22. A regulatory impact assessment is not required as the broader refundability proposals have already been discussed in the regulatory impact assessment for the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill. Producing a new regulatory impact assessment would substantively duplicate this analysis.

23. While this policy proposal moves the start date for the broader refundability proposals forward, the appropriation for the Tax Incentive in Budget 2018 already allows for the fiscal cost of full refundability, as the existing fiscal cost model assumed no constraint on refundability. There is therefore no change to the analysis already developed in the regulatory impact assessment for the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill as a result of this proposal.

Climate Implications of Policy Assessment

24. Officials do not consider that the policy would have significant implications for the climate. The policy does not aim to reduce greenhouse gas emissions and will not have any notable impact on emissions, waste, or other environmental factors.

Population Implications

25. The proposal will have a positive impact on the population on New Zealand, as it will help encourage businesses to retain their R&D labour and continue purchasing the goods and services necessary to continue performing R&D.

Human Rights

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

Consultation

27. Each of the Big 4 accounting firms (EY, Deloitte, PwC and KPMG), some businesses, and a representative of the Corporate Taxpayers Group[6] have been consulted on the proposal. All stakeholders consulted strongly support the proposal.

[6] The Corporate Taxpayers Group is an organisation of major New Zealand companies that works with officials to achieve positive changes to tax policy in New Zealand. The Group's members include Air New

Communications

28. I will make an announcement on the contents of the Bill, including this proposal, following enactment of the Legislation. A commentary on the Bill will also be released, and Inland Revenue will update its guidance material. Inland Revenue will include details of the new legislation in a *Tax Information Bulletin* after the Bill is enacted. There will also be targeted communication to businesses likely to be affected by the amendment.

Proactive Release

29. I propose to proactively release this Cabinet paper, associated minutes, and key advice papers with any appropriate redactions within 30 working days of Cabinet making final decisions.

Recommendations

The Minister of Revenue recommends that the Committee:

1. **Note** that the new refundability rules that are contained in the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill, which recently completed its Third Reading, are intended to apply from the 2020-21 income year for most businesses (referred to as "year 2" in this paper).

2. **Agree** that the application date of these new broader refundability rules apply retrospectively from year 1 (rather than year 2), so that more businesses are able to access more R&D tax credit refunds.

3. **Note** that this will help provide additional cashflow to loss-making R&D performers who might otherwise have to cut their R&D labour and spending in response to disruptions caused by Covid-19.

4. **Agree** that in year 1 of the scheme, businesses should be able to choose whether to apply the year 1 refundability rules or the year 2 refundability rules.

5. **Invite** the Ministers of Research, Science and Innovation and Revenue to instruct Inland Revenue to draft legislation to give effect to the policy proposal and its intent contained in this paper.

6. **Agree** to introduce legislative provisions to give effect to the proposal in the Urgent Covid-19 Tax Matters Bill.

7. **Agree** to include any consequential legislative amendments necessary to give effect to the proposal in the Urgent Covid-19 Tax Matters Bill.

Zealand Limited, Airways Corporation of New Zealand, AMP Life Limited, ANZ Bank New Zealand, ASB Bank Limited, Bank of New Zealand, Chorus Limited, Contact Energy Limited, Downer New Zealand Limited, Fisher & Paykel Healthcare Limited, Fletcher Building Limited, Fonterra Cooperative Group Limited, General Electric, Genesis Energy Limited, IAG New Zealand Limited, Infratil Limited, Lion Pty Limited, Meridian Energy, Methanex New Zealand Limited, New Zealand Post Limited, New Zealand Racing Board, New Zealand Steel Limited, New Zealand Superannuation Fund, Opus International Consultants Limited, Origin Energy New Zealand Limited, Pacific Aluminium (New Zealand) Limited, Powerco Limited, Shell New Zealand (2011) Limited, SKYCITY Entertainment Group Limited, Spark New Zealand Limited, T&G Global Limited, The Todd Corporation Limited, TOWER Limited, Vodafone New Zealand Limited, Westpac New Zealand Limited, Z Energy Limited, and ZESPRI International Limited.

8. **Note** that the Urgent Covid-19 Tax Matters Bill is scheduled for introduction and passage through all stages under urgency on 7 April, and includes amendments to the Income Tax Act 2007 and the Tax Administration Act 1994.

9. **Note** that this proposal is revenue neutral and has no effect on our estimate of the fiscal costs of the R&D Tax Incentive. The model of fiscal costs used treats tax credits and cash payments (in the form of refunds) as equivalent.

Authorised for lodgement

Hon Dr Megan Woods

Minister of Research, Science and Innovation