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### POLICY AND STRATEGY

Tax policy report: Introducing a Research and Development Tax Credit

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| **Date:** | 17 November 2017 | **Priority:** | Medium |
| **Security level:** | In Confidence | **Report no:** | IR2017/596 |

Action sought

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|  | **Action sought** | **Deadline** |
| Minister of Revenue | Agree to forward this Report to Ministers of Finance and Research, Science and InnovationAgree to convene a meeting of your Ministerial colleagues | As your timetable permits |

Contact for telephone discussion (if required)

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| **Name** | **Position** | **Telephone** |
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**POLICY AND STRATEGY**

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17 November 2017

Minister of Revenue

Introducing a Research and Development Tax Credit

Executive summary

 Introducing a Research and Development (R&D) tax credit is one of the government’s priorities.

 All OECD countries provide support to business R&D, usually through some combination of tax credits and grants. Tax credits should be considered as a complement to grants rather than as an alternative. Tax credits and grants have different strengths and weaknesses. Having both enables each to be directed at their particular strengths.

 A tax credit’s strengths are likely to be greatest where it operates as neutrally as possible as per types of firms and levels of assistance and where there are boundary-type judgements, these are made in as explicit and rigid way as possible. Grants we would suggest are a better mechanism for targeting particular types of firms if that is a goal for developing the New Zealand R&D ecosystem.

 There is an opportunity as part of the design of the R&D tax credit to learn from the experiences of other countries and from New Zealand’s own previous experience to ensure the Government gets the best value from the policy while ensuring as far as possible risks are managed. Key risks to be managed are around the integrity of the tax system and protection of the revenue base.

 Choices in the design and implementation of the credit will reduce but not eliminate these risks.

 There will be trade-offs between policies that might maximise support for business R&D and measures that might undermine other parts of the tax system.

 One way to manage the risks is a thorough policy and implementation design process. We consider 1 April 2019 is a feasible implementation date for an R&D tax credit, though there are some risks associated with this timeframe.

Recommended action

 It is recommended that you:

* Forward this report to the Ministers of Finance and Research, Science and Innovation
* Convene a Ministerial sub-committee consisting of you and the Ministers of Finance and Research, Science and Innovation.

**Richard Braae**

Senior Policy Advisor

Policy and Strategy

**Hon Stuart Nash**

Minister of Revenue

\_\_\_\_\_ / \_\_\_\_\_ / 2017

Background

 The previous Labour Government introduced an R&D tax credit in 2008. This was repealed by the National Government in 2009.

 Introducing a 12.5% R&D tax credit was a policy your Party campaigned on during the election.

 Though it has not been recognised as an immediate priority in terms of being on the 100-day Plan, we understand implementing this policy is a Government priority.

 There are three Ministers who will have responsibilities relating to introducing the R&D tax credit. These are you, as Minister of Revenue, the Minister of Finance and the Minister of Research, Science and Innovation.

 The purpose of this Report is to assist in your engagement with your Ministerial colleagues.

Ways of supporting business R&D

 Governments have different ways of supporting business R&D, broadly divided into tax credits and grants.

 Grants and tax credits are not interchangeable. Grants usually involve an application and pre-approval process. Tax credits are more non-discretionary – once eligibility has been defined, firms self-assess their eligibility and submit their claim for the credit without further bureaucratic intervention.

 However, these distinctions are not hard and fast and some countries’ grant schemes have features that bring them closer to tax credits and vice versa.

 Their different characteristics mean that grants are perceived to work best for targeted interventions to grow particular types of R&D whereas tax credits, being non-discretionary, are more suited to providing broad support for all business R&D.

 In New Zealand, R&D is currently supported via grants[[1]](#footnote-1) provided by Callaghan Innovation and a tax loss cash-out scheme administered by Inland Revenue. The cash-out scheme is targeted to start-ups because these firms are more likely to face cash flow constraints, but eligibility extends to other companies. Projected expenditure on grants for 2017/18 is $171 million and for the tax loss cash-out $13 million.

 We consider any consideration of an R&D tax credit should not happen in isolation but involve consideration of all of Government’s objectives in this space and a matching of instruments (tax credits, grants, loans, tax-loss cash-outs) to where they can best advance government objectives.

Perspectives on support for R&D

 The New Zealand tax system operates within a broad-base low-rate framework. The essence of this framework is that tax operates neutrally and as much in the background as possible.

 One implication of this framework is that the tax system is generally not used to address externalities[[2]](#footnote-2) – either positively or negatively. Inland Revenue’s position is that there should be a high burden of proof before moving away from broad-base low-rate principles to using the tax system to address externalities. This is because there are many activities that proponents could support on the basis of a possible positive externality. Allowing concessions can quickly lead to a demand for further exceptions and an undermining of the coherence of the tax system. Inland Revenue’s approach has been supported by successive tax reviews.

 Nonetheless, all OECD countries provide some tax or non-tax incentives for business R&D. This is on the basis of the positive externalities that arise from R&D.

 R&D is beneficial in terms of promoting productivity and economic growth but firms underinvest in R&D because they cannot capture all the benefits flowing from it for themselves. Government support is justified in terms of raising the amount of R&D from what it otherwise would have been so as to get more of the social benefits.

 A majority of OECD countries provide tax credits as part of a programme of supporting R&D. Within the OECD, New Zealand is something of an outlier in not having an R&D tax credit.

 Even though R&D is one of the activities for which there is the strongest empirical evidence for positive externalities, in the past we have argued against R&D credits on the grounds that the likely benefits of such a tax are likely to be outweighed by its costs. Costs include a reduction in the consistency and coherence of the tax system and a potential for considerable accounting activity being devoted to recharacterising expenses to benefit from tax credits. This continues to be our first-best advice. At the same time some of our concerns may be moderated by a well-designed R&D tax credit that draws on international best practice.

 In introducing an R&D tax credit, we consider there needs to be attention to protecting the integrity of the tax system and protecting the fiscal base. Within the design of the tax credit, we anticipate there will need to be trade-offs between policies that might maximise support for R&D and measures that might undermine other parts of the tax system.

Risks to be managed with an R&D tax credit

 The global history of R&D tax incentives is one of expenditure blow outs, followed by reviews, followed by tightening up. This is not conducive to scheme stability, which is important for growing business R&D.

 We suggest there are two particular risks to be aware of. The first is recharacterisation of business activity as R&D. This means the Government spends money without gaining any of the externalities that it expects from subsidising R&D. It also weakens the tax system because if firms perceive they can exploit weaknesses in one part of the system this weakens the voluntary compliance framework on which our tax system is built.

 Relatedly, there is a risk of unanticipated fiscal costs. In part, this is likely to reflect recharacterisation. But it appears, from overseas experience, that there are particular features of tax credit schemes that are more likely to lead to aggressive claiming by firms, or promotion of such by tax advisors.

 Consequently, we think there are some features of the tax credit that will be important for minimising these risks, even though they cannot be avoided completely:

* introducing an R&D tax credit should be more than re-implementing the 2008 policy. Though the previous policy provides a good starting point, there is an opportunity to learn about what has changed since then in the way businesses operate and from other jurisdictions about what works well and to adjust our scheme accordingly;
* tax credits should be considered as a complement to grants rather than as an alternative. Tax credits and grants have different strengths and weaknesses. Having both enables each to be directed at their particular strengths;
* a tax credit’s strengths are likely to be greatest if it operates as neutrally as possible as per types of firms and levels of assistance and where there are boundary-type judgements, these are made in as explicit and rigid way as possible. Grants we would suggest are a better mechanism for targeting particular types of firms if that is a goal for developing the New Zealand R&D ecosystem;
* the way R&D is defined and potentially excluding certain sectors or activities from the scheme are also ways of managing risk. This will include careful assessment of how to treat R&D expenditure on software and mining, and whether to extend the credit to R&D that is undertaken overseas. Importantly, our initial exploration of these issues suggests that the previous revenue protection measures in the 2008 rules may no longer be sufficient;
* clarifying our expectations of tax advisors and introducing an accountability framework for them will minimise risks around their adopting an aggressive tax-planning oriented approach;
* early and significant engagement, jointly with Callaghan Innovation, with firms undertaking R&D, will help us better understand these issues and also shape business expectations about how the tax credit is likely to work.
* we consider the cost of an R&D tax credit should be charged against the Vote: Business, Science and Innovation appropriation rather than being recorded as a reduction in company tax receipts, as this is more likely to focus attention on expenditure growing more rapidly than anticipated.

 We note that New Zealand has some strengths that can assist in the development of a stable R&D tax credit regime:

* New Zealand’s small size makes it easier to achieve good coverage of those firms likely to be interested in an R&D tax credit;
* Callaghan Innovation and MBIE know the sector;
* Inland Revenue has close working relationships with the accounting and tax advisory professions.

 Because we anticipate introducing the R&D tax credit will involve more than re-implementing the 2008 policy, we have indicated to MBIE that 1 April 2019 is the earliest feasible commencement date for a new scheme. In doing so we have pointed out that we see three sets of risks associated with this timeframe:

* The capacity of applicant firms to be ready;
* The willingness of accounting software developers to provide systems that will support firms being able to integrate their R&D tax credit application with their normal business operations;
* Inland Revenue’s operational capacity given Business Transformation and 100-day Plan projects.

 The likelihood and scale of these risks will become clearer as the design of the R&D tax credit progresses.

 MBIE has conveyed this advice to the Minister for Research, Science and Innovation.

 Allowing time for policy and implementation design will allow good participation with the R&D sector in designing the rules, identification and mitigation of fiscal risks reducing policy instability, and engagement with other countries to ensure we are adopting current best practice.

Next steps

 As previously stated, there are three Ministers with an interest in this policy, with each of you having particular areas of focus. MBIE has provided advice to its Minister (Briefing number 0890 17-18) and this has been forwarded to you. MBIE has also suggested there be a Ministerial sub-committee consisting of you, the Minister of Finance and the Minister of Research, Science and Innovation. We endorse this suggestion.

 We therefore recommend you forward this report to your Ministerial colleagues and convene a meeting of these colleagues.

Consultation

 In developing this report we have consulted with officials from MBIE, Treasury and Callaghan Innovation.

 DPMC has been informed.

1. There are three Grant schemes: Growth Grants, Project Grants and Student Grants. [↑](#footnote-ref-1)
2. An externality, sometimes referred to as a spillover, arises where there are costs or benefits that affect a party that did not choose to incur that cost or benefit. [↑](#footnote-ref-2)