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In confidence

Office of the Minister of Science and Innovation
Office of the Minister of Revenue

Chair
Cabinet Business Committee

Cashing-out research and development tax losses

Proposal

1. This paper seeks the agreement of the Cabinet Business Committee to amendments to the Income Tax Act 2007 and Tax Administration Act 1994 to be included in the next available omnibus tax bill.

2. It proposes a policy regime that will allow R&D-intensive start-up companies to "cash out" (refund) their tax losses arising from qualifying R&D expenditure, rather than carrying these losses forward. This policy should help to reduce cash-flow and capital constraints, as well as biases against R&D arising from the current tax treatment of losses.

3. Inland Revenue is seeking tagged contingency funding through Budget 2014 for implementation and ongoing operational costs. Estimates have been provided with a contingency to reflect uncertainties and risks associated with the project. These estimates will be refined in a Business Case scheduled for Cabinet consideration shortly after Budget 2014,
[7]

4. The funding will allow for the implementation of the preferred option outlined in the forthcoming Business Case. The recommended policy settings are not substantively dependent on the outcome of the Business Case.

5. The proposal has an estimated fiscal cost of $15 million per annum that should be included as a reduction in tax revenue.

Executive summary

6. This paper seeks Cabinet approval of the final policy design relating to the cashing out of losses of R&D-intensive start-up companies (R&D start-ups). It also provides the estimated implementation and ongoing operational costs to bid for a tagged contingency in Budget 2014.

7. R&D start-ups are often unable to use their tax losses in a timely fashion, or at all. This is because they have no source of income during the R&D phase to offset their losses against, and the high-risk nature of R&D means that successful innovation is not guaranteed. They also suffer from cash-flow and capital constraints. This is likely to have the overall

effect of less R&D being undertaken by existing R&D start-ups than is efficient, and a lower likelihood of successful innovation.

8. An officials' issues paper, *R&D tax losses*, was released in July 2013 for public consultation. The issues paper proposed allowing R&D start-ups to "cash out" (refund) their tax losses arising from qualifying R&D expenditure, rather than carrying the loss forward to apply against future income. The overall policy intent is to provide a temporary cash-flow benefit, resembling an interest-free loan, for R&D start-ups that will be repaid out of their future taxable income, or through the proposed loss recovery rules. Qualification rules apply to ensure that the rules are appropriately targeted at R&D start-ups. The key settings of the policy are outlined in the comment section.

[7]

12. The average annual fiscal cost of the proposal is $15 million, which should be included as a reduction in tax revenue. However, it is based on some key assumptions. If these were to change, both the average fiscal cost and year-to-year variation in fiscal cost could change.

13. The policy settings proposed in this paper do not largely depend on the administration option that results from the Business Case. [7]

We propose that

the necessary legislative changes be included in the next omnibus tax bill following the 2014 general election with the policy to be implemented for income years beginning on or after 1 April 2015.

Background

14. Cabinet agreed to the release of an officials' issues paper, *R&D tax losses*, for public consultation in April 2013 (CAB Min (13) 14/4 refers). The consultation paper was announced as part of Budget 2013 and subsequently released on 23 July 2013. A total of 24 submissions were received from a range of submitters, including professional services firms, industry and other professional bodies, R&D companies and individuals.

15. The issues paper proposed allowing R&D start-ups to "cash out" their tax losses arising from qualifying R&D expenditure, rather than carrying the loss forward to deduct against future income. The current tax treatment of losses can create a bias against investment in R&D start-ups because:

- R&D start-ups expect to be in an ongoing tax-loss position through the research and development phases, without other sources of income to apply the losses against; and
- R&D is high-risk, which increases the chance that the tax losses carried forward will not be able to be used because no profit is derived.

16. R&D start-ups also typically face cash-flow and capital constraints, which could be alleviated by allowing them to cash out qualifying R&D tax losses. These constraints arise for the following reasons:

- Information asymmetries – These arise when potential lenders have less information about the value of an R&D project than the company itself has, which can lead to a break-down in the provision of financing that would be worthwhile if both parties were equally well informed. This is especially prevalent for R&D-intensive start-up companies, given the novel and/or experimental nature of R&D, the lack of proven commercial experience and the lack of a proven market for the final product.
- High sunk costs – R&D expenditures often have a low or zero resale value in the event of failure. This means that R&D-intensive start-ups often have little in the way of collateral that can be used to secure debt-financing.
- High up-front costs – The natural profit cycle for innovative projects tends to involve high up-front costs and, consequently, longer periods in tax loss. This implies that the problem faced by R&D start-ups is not just their overall ability to access capital, but also timely access to capital.

Allowing R&D start-ups to cash out qualifying R&D tax losses could assist in alleviating both issues.

17. As a result of public consultation, changes to the proposals in the issues paper have arisen chiefly to reduce compliance costs for the targeted group of R&D start-ups, which are not equipped to handle a high compliance burden. [7]

[7]

This paper does not address detailed issues relating to the administration of the policy; these will be covered by the Business Case.

19. The proposed initiative is part of the Building Innovation work stream of the Government's Business Growth Agenda. The *Building Innovation* progress report released in August 2012 noted that a wider review to investigate whether the tax treatment of R&D expenditure was discouraging firm R&D was to take place. This initiative is an outcome of that review and ensures the business environment is set to give businesses confidence to innovate through removing barriers to investment in R&D start-ups that arise from tax settings.

Comment

20. This section details the final recommended policy settings, including the eligibility criteria, other restrictions aimed at ensuring the policy is appropriately targeted and rules to ensure that the cashed-out loss is recovered when the taxpayer makes a return. For each relevant policy feature, the proposed setting and policy intent is outlined. Where this setting has changed from that set out in the issues paper, this is also explained. The full policy is described below.

R&D wage intensity

21. The issues paper proposed that companies must spend at least 20 percent of their total PAYE wage and salary expenditure on R&D to be eligible for a cashed-out loss. This approach was intended to reduce potential abuse of the policy and ease administrative and compliance costs, as the measure would be based on existing information available to the company and Inland Revenue. Submitters raised concerns that using a R&D wage intensity measure based only on PAYE wages and salary expenditure would severely curtail access to the policy because R&D start-ups often use alternatives to PAYE wages and salaries for their greater flexibility.

22. We now propose including shareholder salaries, contracted labour and contracted R&D within the measure, in addition to PAYE wage and salary expenditure. For contracted R&D, this would be achieved by deeming 66% of contracted R&D expenditure as wage and salary expenditure on R&D; this is consistent with the "1.5 times multiplier" method used to determine an amount of other R&D expenditure for calculating the amount of tax losses that can be cashed out. Sweat equity, where equity replaces salary compensation for employment, remains excluded from the R&D wage intensity measure, as the equity provided cannot be valued objectively or accurately.

Company restriction

23. We currently propose excluding listed companies from the policy. A company that is able to list on a stock exchange is less likely to have difficulty accessing its tax losses and

does not face the cash-flow and capital constraints that R&D start-ups do. However, this exclusion should be reconsidered and reported on by Inland Revenue officials following the announcement by the New Zealand Stock Exchange of the establishment of a new market. Officials will need to assess whether the target group of R&D start-ups may look to list on the new market. Other types of companies that can access the benefits of their tax losses with flow-through treatment will also be excluded.

Grouping rules

24. We propose applying a grouping threshold of 66% of shareholder commonality for this policy, which is consistent with the general grouping rules. This means that companies that meet this level of common ownership will have to satisfy the eligibility criteria on a group basis, as well as the relevant single entity. We consider this threshold should be sufficient to ensure taxpayers from outside of the target group are not able to access a cashed-out loss. It should also ensure "angel" investors with shareholdings in multiple R&D start-ups are not grouped together.

[7]

Excluded activities

29. We propose using Callaghan Innovation's list of specific exclusions from their Growth grant, which lists excluded activities (and expenditure) that will not be considered R&D, to provide additional guidance to potential applicants. This is similar to the list of excluded activities already proposed in the issues paper, which was used for the R&D tax credit. [7]

The issues paper also proposed excluding clinical trials and late-stage software development. However, these will no longer be explicitly excluded.

[7]

Excluded expenditure

31. The issues paper proposed excluding a number of expenses on the basis that they could distort economic decisions, endanger the integrity of the policy, or create inequity between taxpayers in a similar position. The exclusions from the issues paper were:

- interest expenses on R&D;
- the purchase of existing R&D assets;
- R&D undertaken offshore; and
- lease payments for R&D equipment.

32. We propose retaining these exclusions. However, based on concerns raised by submitters, we propose one amendment to Callaghan Innovation's list of specific exclusions to ensure that expenditure on operating leases, as defined in the Income Tax Act, remains eligible. Expenditure on lease payments is currently excluded from the Callaghan Innovation list. Operating leases are relatively short-term leases and are used by R&D start-ups to lease equipment when it is not appropriate to purchase the item. These leases should be considered eligible R&D expenditure.

Amount of R&D tax losses to be cashed out

33. Qualifying taxpayers will be able to cash out, for the relevant year, the lesser of:

- 1.5 times their eligible R&D salary and wages expenditure;
- total tax losses;
- total qualifying R&D expenditure;
- the overall cap on eligible R&D tax losses.

34. The 1.5 times multiplier applied to the R&D salary and wages expenditure is intended to help companies cash out losses that are incurred as a result of other non-salary and wage R&D expenditure. The different ways of calculating the amount of the cashed-out loss is necessary to ensure R&D start-ups with and without a large proportion of salary and wage

expenditure to total expenditure (subject to meeting the wage intensity threshold) have similar access to the policy.

35. The initial cap is to be set at $500,000 of losses, which amounts to a cashed-out loss of $140,000. This will rise eventually to $2 million, equivalent to a cashed-out loss of $560,000. The rise will take place in increments of $300,000 per annum over five years. This cap reduces its fiscal risk, especially in the early years of the new rules when there will be uncertainty over the response of R&D start-ups to the changes. Gradually increasing the cap will help ensure that the benefits of the cashed-out loss will not be reduced by an increase in demand for R&D inputs that will result in an increase in the cost of carrying out R&D, rather than an increase in R&D itself.

Neutrality and integrity measures

36. The overall policy intent is to provide a temporary cash-flow benefit for R&D start-ups that will be repaid out of their future taxable income. However, of the R&D start-ups that derive a return from the investment, not all derive a return that is taxable. Often the return is not realised until the intellectual property is sold. If the value of the cashed-out loss is not recovered from the sale proceeds, the interest-free loan becomes a grant, and the fiscal risk of the policy is much greater.[1] The issues paper proposed a series of measures to recover the value of the cashed-out loss when investors or the R&D start-up makes a capital return.

<u>Events triggering loss recovery</u>

37. As an integrity measure, we propose that loss recovery should take place for the company when a taxpayer with a cashed-out loss or investor makes a capital return, but only to the extent of the cashed-out loss. We propose that "loss recovery events" would be when:

- the company sells intellectual property;
- some form of ownership change occurs;
- the company becomes non-resident (for tax purposes); or
- the company is liquidated.

38. The issues paper proposed that loss recovery should take place when a 5% shareholding was sold and that loss recovery income should arise to the shareholder involved. Submitters were concerned that such an approach would involve significant compliance and administration concerns around knowledge of the level of cashed-out loss the company held.

39. To address these concerns, we propose that such an approach is replaced by a rule that applies to the company only and applies when 90 percent of the shares in the company are sold. With the change to make the liability the company's rather than the shareholder's, we feel that a high threshold is necessary to ensure the company is not adversely affected by changes in shareholding. We have chosen a threshold of 90 percent, rather than 100 percent, to account for management interests being retained in situations when private equity sells out. Although the liability is on the company, we expect that shareholders will indirectly bear this liability, as any buyer knowing of the loss recovery rules should pay less for the shares than they would otherwise.

[1] We note however that to the extent that the R&D is not ultimately successful, the cashed-out loss will become a grant.

40. If the company changes its tax residence or liquidates, we recommend that there be a deemed sale of intellectual property at its market value and that losses be recovered to the extent that a profit is made on that deemed sale.

Mechanism to recover losses

41. The officials' issues paper described the recovery of the value of the cashed-out loss as "loss recovery income", which would claw-back the value of the cashed-out loss as income if one of the events that triggered the claw-back took place. This had the advantage of administrative simplicity, as such income could be simply added to a company's tax return for a year. However, R&D start-ups with other losses that were not able to be cashed out could apply these against the loss recovery income, effectively making the cashed-out loss a grant.

42. To avoid this outcome, we propose to require R&D start-ups to reinstate their tax losses through a cash payment if a loss recovery event takes place. The payment to reinstate losses will not be deemed income for tax purposes, but represents the loan repayment necessary to convert their cashed-out losses back into losses arising from R&D expenditure to carry forward to apply against future income. This also reinforces that cashed-out losses are in the nature of a loan and not a grant.

43. To illustrate how this would work in practice, a taxpayer eligible for a cashed-out loss has in year 1 a $100 cashed-out loss (equivalent to $28) and $100 of losses being carried forward. In year 2, the taxpayer sells intellectual property, receiving a capital return of $500. This is a loss recovery event, and the taxpayer is required to return the value of the cashed out loss ($28) to Inland Revenue, and will have their loss of $100 reinstated. Consequently, the loss is reinstated, and the taxpayer will now have $200 of losses being carried forward to apply against future taxable income.

De minimis threshold

44. Some submitters on the issues paper raised the idea of a de minimis threshold for R&D expenditure to prevent trivial claims, but this is not proposed. As this policy targets small R&D start-ups, it would be inconsistent with the policy intent to prevent very small companies from accessing the policy based on their size.[7]

Cap on losses

45. At this stage, our view is that that the neutrality and integrity measures should be able to work effectively, and that an absolute cap on total losses able to be cashed out is not necessary.

Consultation

46. In addition to the public consultation mentioned above, the Ministry of Business, Innovation and Employment (MBIE) has been consulted on the recommendations proposed in this paper. This paper has been prepared with the assistance of officials from the Treasury
[7]

Financial implications

47. The recommendations in this report are expected to have an average fiscal cost of $15 million per annum, to be recorded as a reduction in tax revenue.

48. We have explored the sensitivity of the costs to changes in key assumptions. In particular, this includes the overall repayment rate of the cashed out loss (which depends on both the firm survival rate, and the ability to recover losses from firms that sell intellectual property, undergo a change in ownership or migrate), and the timeframe for repayment. This additional sensitivity analysis indicates that if the repayment rate is higher or lower than expected, both the average fiscal cost and year-to-year variation could change.

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18 & out-years**
Tax Revenue	-	-	(15.000)	(15.000)	(15.000)

[7]

[7]

Human rights

52. The proposals are not inconsistent with the Human Rights Act 1993 or the New Zealand Bill of Rights Act 1990.

Legislative implications

53. The proposals will require changes to the Income Tax Act 2007 and the Tax Administration Act 1994. The proposed regime should apply from income years starting on or after 1 April 2015.

54. These proposals should be included in the next available omnibus tax bill scheduled for later this year, which in turn means that the legislation will not be passed ahead of the 1 April 2015 start date. Even with the original assumption of introduction around August this year, it was always anticipated that there would be a degree of retrospectivity compared to the start date. [7]

We note that even with legislative introduction in early 2015, it would be passed by the time that taxpayers' losses crystallise for the first year of the policy on 31 March 2016.

Regulatory impact analysis

55. The Regulatory Impact Analysis requirements apply to the proposal. A Regulatory Impact Statement (RIS) is attached.

56. The Quality Assurance reviewer at Inland Revenue has reviewed the *Cashing-out research and development tax losses* RIS and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.

57. The administrative details of the proposal, and therefore the nature and extent of potential implementation risks, are not known at this time and are therefore not analysed in the RIS. However, as these matters will be the subject of a Business Case, we are satisfied that the analysis will be undertaken and presented to Cabinet before the proposal is included in legislation.

Publicity

58. On the assumption that the Committee agrees with the proposed policy, the final policy settings could be announced at Budget 2014.

59. As the administrative regime for the policy will be determined in the Business Case, it may need to be communicated that the administrative regime for the policy is still under development.

Recommendations

60. We recommend that the Cabinet Business Committee:

Background and policy

1. **Note** the decision to release for public consultation the officials' issues paper, *R&D tax losses*, in July 2013.

2. **Note** that 24 submissions were received and considered, with proposed policy settings revised to improve the targeting of the policy towards R&D-intensive start-up companies, and reduce their compliance costs.

3. **Agree** to legislative amendments that will introduce new rules to allow R&D-intensive start-up companies to "cash out" their tax losses arising from qualifying R&D expenditure, with the following features, subject to the corresponding budget bid being approved by Cabinet:

    3.1 To be eligible for the policy, applicants should meet the following criteria must be satisfied:

    i. Company expenditure (and group expenditure) on R&D wages and salaries must be at least 20 percent of their total wage and salary expenditure.
    ii. The company (and group) must be in a tax-loss position for the applicable income year.
    iii. The company must be resident in New Zealand for tax purposes and cannot be a look-through company, listed company, qualifying company or special corporate entity.
    iv. The company must be able to satisfy the Commissioner of Inland Revenue that they are carrying out eligible R&D.

    3.2 [7]

    3.3

    3.4 The following expenditure should not be eligible as R&D expenditure:

    i. Interest expenses.
    ii. The purchase of existing R&D assets.
    iii. R&D undertaken offshore.
    iv. Financial lease payments for R&D equipment.

3.5 Qualifying taxpayers will be able to cash out, for the relevant year, the lesser of:
   i. 1.5 times their eligible R&D salary and wage expenditure.
   ii. Total qualifying R&D expenditure.
   iii. Total tax losses.
   iv. The overall cap on eligible R&D tax losses.

3.6 The initial cap is to be set at $500,000 of losses per year, which amounts to a cashed out loss of $140,000 under the current corporate income tax rate of 28 percent.

3.7 Losses should be recovered through requiring taxpayers to return the value of the cashed-out loss and reinstating the losses of the taxpayer if a "loss recovery event" occurs.

3.8 The "loss recovery events" are:
   i. The company sells intellectual property.
   ii. 90 percent of the company's shares are sold.
   iii. The company migrates overseas for tax purposes.
   iv. The liquidation of the company.

4. **Agree** that the changes in recommendation 3 be included in the next available omnibus tax bill.

5. **Agree** that the changes in recommendation 3 be effective for income years beginning on or after 1 April 2015.

6. **Delegate** authority to the Minister of Finance, Minister of Science and Innovation and Minister of Revenue to make any minor or consequential amendments to the rules necessary to ensure their effective implementation, including any changes to the listed companies exclusion resulting from the announcement by the New Zealand Stock Exchange of a new market.

7. [7]

Fiscal and administration costs

8. **Note** that the estimated average fiscal cost of $15 million per year from the 2015/16 fiscal year will be included as a reduction in tax revenue:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19 & out-years**
Tax Revenue	0.000	(15.000)	(15.000)	(15.000)	(15.000)

[7]

12. **Note** that funding for the costs in recommendations 9 and 10 is being sought as a tagged contingency through the Budget 2014 Package Cabinet paper on 14 April, [7]

13. **Note** that the implementation and operational costs will be refined further for the administrative options presented in the Business Case, which will likely lead to the contingency factor being adjusted and the overall project cost being revised.

Hon Steven Joyce
Minister of Science and Innovation

____ / ____/ ____
Date

Hon Todd McClay
Minister of Revenue

____ / ___ / ____
Date