# The Treasury

## Budget 2014 Information Release

## Release Document

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Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

# Tax policy report: R&D tax losses final policy recommendations and cost update

| | | | |
|---|---|---|---|
| **Date:** | 6 March 2014 | **Priority:** | **High** |
| **Security Level:** | In Confidence | **Report No:** | T2014/359<br>IR2014/102 |

## Action sought

| | Action Sought | Deadline |
|---|---|---|
| Minister of Finance<br>(Hon Bill English) | Agree to the recommendations.<br>Note the contents of the report. | 11 March 2014 |
| Minister of Science and Innovation<br>(Hon Steven Joyce) | Agree to the recommendations.<br>Note the contents of the report. | 11 March 2014 |
| Minister of Revenue<br>(Hon Todd McClay) | Agree to the recommendations.<br>Note the contents of the report. | 11 March 2014 |

## Contact for telephone discussion (if required)

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[7]

6 March 2014

Minister of Finance
Minister of Science and Innovation
Minister of Revenue

# R&D tax losses final policy recommendations and cost update

## Executive summary

This report seeks your approval to the final policy design relating to the cashing out of losses of R&D-intensive start-up companies. It also provides an updated administration cost to bid for funding at Budget 2014. Should you agree to the design and be comfortable with the administration cost, we will then prepare a paper for you to take to Cabinet to confirm these decisions.

An officials' issues paper, *R&D tax losses*, was released in July 2013 for public consultation. It proposed allowing R&D-intensive start-up companies to "cash out" (refund) their tax losses arising from qualifying R&D expenditure. This was followed by a report in December 2013 (T2013-3146/PAS2013-264 refers) which proposed policy changes arising from the consultation process [7]

### Proposed policy changes

[7]

Officials are now in a position to seek your approval to the full and final proposed policy settings, including some of the modifications put forward in the December report. The key proposals are:

- Shareholder-employee salaries, contracted labour, and 66% of expenditure on contracted R&D should be included within the R&D wage intensity measure, but sweat equity should be excluded.
- The list of excluded activities should be based on the list of excluded activities from Callaghan Innovation's Growth grant (see Annex 2), with the exception of operating leases.

In addition, officials have also settled their views on the proposed rules to recover the value of the cashed-out loss from successful R&D start-ups. In response to concerns from submitters about compliance and administration costs, we are now proposing that any recovery of cashed-out losses should be the liability of the company rather than the shareholder. In addition, we are proposing that this recovery should be triggered when 90% of the shares in the company are sold.

The remaining policy settings are summarised in Annex 1.

**Administration costs**

[7]

**Fiscal cost**

In the December report, officials estimated that the average annual fiscal cost of the policy will be in the region of $14-16 million, based on key assumptions about the scale and scope of the proposal. Officials are satisfied that none of the modifications proposed in this report will alter these assumptions, and so our central estimate of the annual fiscal cost of the proposal is $15 million.

### Next steps

Inland Revenue is currently preparing a Business Case which examines the range of administration options for this policy, [7]

Should you agree with the proposed final design, officials will prepare a Cabinet paper and accompanying Regulatory Impact Statement. This will enable a bid for funding at Budget 2014 for implementation costs [7]
It is intended that the policy will be legislated for in the proposed August 2014 taxation bill with the policy to be implemented for the 2015-16 income year.

## Recommended action

### Final policy settings

a) **Agree** to a final policy design for the R&D tax losses policy with the following features:

   a. [7]

   b. Shareholder-employee salaries, contracted labour, and 66% of expenditure on contracted R&D should be included within the R&D wage intensity measure, but sweat equity should be excluded.
   c. The list of excluded activities should be based on the list of specific exclusions from Callaghan Innovation's Growth grant (see Annex 2), with the exception of operating leases.
   d. Recovery of the value of the cashed-out loss from successful R&D start-ups should be the liability of the company rather than the shareholder, and should be triggered when 90% of the shares in the company are sold.

| | | |
|---|---|---|
| Agree/disagree | Agree/disagree | Agree/disagree |
| Minister of Finance | Minister of Science and Innovation | Minister of Revenue |

### Administration cost

b) [7]

c) **Note** that these estimated implementation and ongoing costs will be refined further in the Business Case for administration options.

| | | |
|---|---|---|
| Noted | Noted | Noted |
| Minister of Finance | Minister of Science and Innovation | Minister of Revenue |

d) [7]

e)

**Fiscal cost**

f) The average annual fiscal costs are expected to be $15 million per year.

| | | |
|---|---|---|
| Noted | Noted | Noted |
| Minister of Finance | Minister of Science and Innovation | Minister of Revenue |

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[7]

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**Hon Bill English**
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**Hon Steven Joyce**
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**Hon Todd McClay**
Minister of Revenue

## Introduction

1. The Minister of Revenue announced at Budget 2013 that an officials' issues paper, *R&D tax losses*, would be released for public consultation. It was subsequently released on 23 July 2013. The issues paper proposed allowing R&D-intensive start-up companies 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 of the tax losses carried forward being wasted.

2. R&D start-ups also typically face cash-flow and capital constraints. Allowing R&D start-ups to cash out qualifying R&D tax losses could assist in alleviating both issues.

3. Officials have since reported to Ministers on the proposed changes to the policy settings and administration in late 2013 (PAS 2013-226 and T2013-3146/PAS2013-264 refer). These changes have arisen chiefly to reduce compliance costs for the targeted group of R&D start-ups, who are not equipped to handle a high compliance burden. [7]

4. In order to secure funding for the implementation and administration costs for the 2014-15 fiscal year, this report provides an updated, but not final, estimate of these costs to Ministers. [7]

This report also provides final policy recommendations on the aspects of the design that were not settled in the December 2013 policy report (T2013-3146/PAS2013-264 refers).

[7]

## Final policy settings

6. This section sets out officials' final policy recommendations for the R&D tax losses policy. It builds upon the policy settings proposed in the officials' issues paper and the modifications proposed in the December 2013 report as a result of consultation submissions. Policy settings not previously raised with Ministers are discussed in this section with the rest of the policy design summarised in a table in Annex 1.

[7]

[7]

[7]

## Excluded activities

19. Officials propose using Callaghan Innovation's list of specific exclusions from their Growth grant to provide additional guidance to potential applicants. This is similar to the list of excluded activities already proposed by officials that was used for the R&D tax credit.
[7]
It is also noteworthy that the Callaghan Innovation list is not exhaustive and activities not listed must still meet the definition. The previously proposed excluded activities and Callaghan Innovation's Growth grant specific exclusions are listed in Annex 2.

20. Officials will make one change to Callaghan Innovation's list of specific exclusions to ensure that expenditure on operating leases remains eligible. Expenditure on lease payments is currently excluded on Callaghan Innovation's list. Operating leases are relatively short-term leases and are used to lease equipment by R&D start-ups when it is not appropriate to purchase the item, and should be eligible R&D expenditure.

[7]

## Neutrality and integrity measures

22. The proposed measures are intended to ensure that a cashed-out loss is viewed as an interest-free loan, rather than a grant.[1] The appropriate time to recover the value of the cashed-out loss is when investors, or the R&D start-up, make a return on their investment. At this point the R&D start-up is no longer constrained by a cash-flow constraint or disadvantaged by the tax treatment of losses.

### *Events which would cause recovery of cashed-out losses*

23. The events at which the cashed-out loss should be recovered are largely unchanged from those suggested in the December report. Loss recovery should take place when:

- the company sells intellectual property;
- some form of ownership change occurs; or
- the company migrates overseas for tax purposes.

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[1] Although if the R&D is ultimately unsuccessful the cashed out loss will in substance become a grant.

24. In the issues paper, officials proposed that loss recovery should arise when a 5% shareholding was sold and that loss recovery income should arise to the shareholder involved. As discussed in the December report, submitters were concerned that such an approach would involve significant compliance and administration concerns. In particular, it required the shareholder to know the level of cashed-out loss the company held.

25. Officials have reconsidered this option. We continue to be comfortable with new share issues being outside the scope of any loss recovery rule. We also continue to be of the view that there should be some form of loss recovery when the shares of the company are sold. This is because selling the shares in the company rather than the intellectual property is also a mechanism for unlocking the value created from the R&D. However, we agree that any recovery should be a liability of the company rather than the shareholder.

26. We, therefore, propose that when 90% of the shares in the company are sold, loss recovery is triggered for the company. Officials recommend 90% rather than 100% as the threshold for selling the company as it is not uncommon for private equity-owned companies to have 5-10% management shares which are not sold when private equity extracts value through sale.

27. We expect that shareholders will indirectly bear this liability as any buyer knowing of the loss recovery liability should pay less for the shares than they would otherwise.

28. For this proposal and also the proposal to recover the cashed-out loss if the company changes its tax residence or on liquidation, officials recommend that there be a deemed sale of intellectual property and that losses be recovered to the extent that a profit is made. This is consistent with the core rule that losses are recovered to the extent a profit is made on the sale of the intellectual property.

***Mechanism to recover losses***

29. The officials' issues paper had 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, upon further reflection officials are now aware that as not all losses are available to be cashed out, R&D start-ups with cashed-out losses could be able to apply these losses brought forward against any potential loss recovery income effectively making the cashed-out loss a grant for any R&D start-up with a stock of losses.

30. Officials' alternative proposal is to require R&D start-ups to reinstate their tax losses if a loss recovery event takes place, subject only to the restrictions imposed under existing provisions that allow for the deferment of losses arising from R&D expenditure. This involves the taxpayer making a payment to the extent a loss recovery is required, but in turn they can have their cashed-out losses reinstated as tax losses arising from R&D expenditure to be allocated to a future income year under existing provisions. The payment to reinstate losses will not be deemed income for tax purposes, but represents the loan repayment required to

convert their cashed-out losses back into losses arising from R&D expenditure to carry forward, thus reinforcing that cashed-out losses are in the nature of a loan and not a grant.

### Other policy settings

31. The remaining policy settings as outlined in the officials' issues paper have been adjusted in response to submitters' concerns. These are summarised in Annex 1. These remaining details will be discussed alongside the issues outlined in this paper in the upcoming Cabinet paper seeking approval of the final policy design.

## Administration costs

[7]

[7]

## Fiscal costs

38. In the December report, officials estimated that the average annual fiscal cost of the policy will be in the region of $14-16 million, based on key assumptions about the scale and scope of the proposal. Officials are satisfied that none of the modifications proposed in this report will alter these assumptions, and so our central estimate of the annual fiscal cost of the proposal is $15 million.

## Next steps

39. Should you agree to these proposals, we will prepare a Cabinet paper and Regulatory Impact Statement that will detail the full and final policy settings, and bid for funding at Budget 2014. [7]

40. The current timeline would suggest that this initiative could be legislated for in the proposed August taxation bill with an implementation date of income years starting on or after 1 April 2015.

# Annex 1: Summary of other final policy settings

## R&D wage intensity

41. R&D start-ups must spend at least 20 percent of their total wage and salary expenditure on R&D to be eligible for a cashed-out loss. This measure includes shareholder salaries, contracted labour, and 66% of expenditure on contracted R&D.

## Company restriction

42. The restriction of the policy to certain companies ensures the policy remains targeted. Companies listed on a recognised stock exchange are ineligible because they are not cash-flow and capital-constrained to the same degree as R&D start-up companies. Also, companies that have flow-through treatment of tax losses, such as look-through companies, are excluded. Any developments in this area, such as the establishment of a stock exchange that targets high-growth and innovative firms, will be followed closely by officials.

## Other eligibility requirements

43. R&D-intensive start-up companies must be in a tax loss position for the applicable income year and resident in New Zealand for tax purposes. All eligibility requirements must also be met on a group basis, if the company is part of a group.

## Grouping rules

44. Officials currently propose applying a grouping threshold of 66% of commonality for this policy. This is consistent with how taxpayers are grouped for tax purposes under current tax legislation and officials judge this threshold should be sufficient to ensure taxpayers from outside the target group are not able to access a cashed out loss. Only companies with complex corporate structures will face compliance costs arising from the grouping rules; as most R&D start-ups have a simple corporate structure, few companies in the targeted group should be affected.

## Excluded expenditure

45. The current proposed exclusions are:

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

46. Officials propose allowing expenditure on operating leases to be included as eligible expenditure. Operating leases are typically shorter-term leases that are not substitutes for financing a purchase with debt (these are finance leases and will remain excluded).

### Amount of R&D tax losses to be cashed out

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

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

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.

### De minimis threshold

48. Officials do not propose a de minimis threshold. 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

49. Officials are confident that the neutrality and integrity measures can be made to work effectively, and that an absolute cap on total losses able to be cashed out is not necessary.

## Annex 2: Excluded activities

***Excluded activities proposed after the analysing submissions on the officials' issues paper:***

- Prospecting for, exploring for or drilling for minerals, petroleum, natural gas or geothermal energy.
- Research in social sciences, arts or humanities.
- Market research, market testing, market development or sales promotion including consumer surveys.
- Quality control or routine testing of materials, products, devices, processes or services.
- Making cosmetic or stylistic changes to materials, products, devices, processes or services.
- Routine collection of information.
- Commercial, legal and administrative aspects of patenting, licensing or other activities.
- Activities involved in complying with statutory requirements or standards.
- Management studies or efficiency surveys.
- The 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.
- Pre-production activities such as a demonstration of commercial viability, tooling-up and trial runs.

***Specific exclusions from Callaghan Innovation's Growth grant:***

- Prospecting or exploring for minerals, petroleum, natural gas or geothermal energy.
- Research in the social sciences, arts or humanities.
- Market research or surveys, market testing, market development or sales promotion, management studies, efficiency surveys or the routine collection of information.
- Activities involved in ensuring that existing products or processes comply with statutory requirements or standards, and quality control, routine testing or trouble-shooting during commercial production. However, testing in search of significant product or process improvements is eligible.
- Routine, on-going efforts to refine, enrich, or otherwise improve on the qualities of an existing product or process, or to make cosmetic or stylistic changes to it.
- Any costs involved in protecting, licensing, selling or defending intellectual property or of acquiring or using external intangible assets (for example, patent licences).
- Adapting an existing product or process to a particular customer's need or site.
- Routine design of tools, jigs, moulds and dies, or seasonal or other periodic design changes to existing products. However, expensed design activities involved in developing a new product or process are eligible.
- Supporting, de-bugging or making minor improvements to existing computer software.
- Engineering follow-through in an early phase of commercial production.

- Activities related to the construction, relocation, rearrangement or start-up of facilities or equipment other than facilities or equipment solely used for the businesses' R&D (which may be included).
- Interest expenses or lease payments of any kind, and any overheads that are not closely linked to R&D activities. Eligible overheads include finance, personnel, training, travel, administration and library activities associated with R&D, and reasonable R&D-related transportation, storage, cleaning, repair, maintenance and security activities.

[7]