Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Market development tax credits

Date:	17 October 2006	**Priority:**	**High**
Security Level:		**Report No:**	T2006/1916 PAD2006/213

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	Thursday 19 October
Minister of Revenue	Agree to recommendations	Thursday 19 October

Contact for telephone discussion (if required)

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17 October 2006

Minister of Finance
Minister of Revenue

Market development tax credits

Executive summary

The Business Tax Review proposed introducing a market development tax credit, which could be modelled on the existing Market Development Assistance Scheme (MDAS) grant, which is administered by New Zealand Trade and Enterprise (NZTE). The overall objective of the tax credit is implied in the Business Tax Review discussion document where the "new markets" objective of MDAS is briefly discussed. However, it could be to increase exports in general, or to assist exporters to enter new markets, or to assist firms to become exporters. The design of the credit will vary depending on its objective.

If the objective of the credit is to support all forms of export market development expenditure, then the credit could simply be provided to all exporters, in respect of a list of specified expenses (option one in the report). This could be delivered as either a volumetric tax credit or one which is incremental over a base year. The volumetric variant would be easier to administer but as it would apply to all export marketing costs it would be the most fiscally expensive option. We will be reporting shortly on the design issues associated with introducing an incremental tax credit.

If the object is to assist exporters in developing new markets, whether for existing or new exporters, then "new market development" would need to be defined (option two in the report). This is complex but officials have identified three possible approaches, namely:

(i) Simple test approach – a bright-line test whereby if an exporter enters a new country or uses a new tariff code or registers a new trademark, then the activity will be eligible for the credit;
(ii) Certification – a separate entity certifies what qualifies as market development;
(iii) Hybrid model – automatic qualification where the simple test is met (per approach (i)) or if the test is not met then use a certification process in order to determine whether the activity constitutes new market development (per approach (ii)).

Each approach has advantages and disadvantages. The simple test is easy to apply, but some exporters undertaking new market development could be inappropriately excluded. The certification process entails a considerable volume of work for an external agency, and in any case, unless there are caps on expenditure and clear rules, the incentive for the certifying body is to always say 'Yes'. The hybrid approach would decrease the volume of work, and allow the

certifying body to concentrate only on difficult cases, but there would still be pressure on the certifying body.

A third option is to provide the credit to new exporters on the basis that there are many barriers to becoming an exporter (financial, skills, time demands) which the credit could reduce. Compared with option two this option would move the focus to helping make more New Zealand businesses internationally focussed rather than helping existing internationally focussed businesses to expand their business. This option would be administratively simpler then option two and less expensive than option one.

No matter which option is chosen, exports to Australia would be excluded under CER rules. The existing MDAS grant and the Austrade grant both exclude trans-Tasman exports due to CER.

There are a number of design decisions which are independent of the options outlined above and which we consider should be tested in the officials' issues paper:

- Firms will need to meet the definition of export to qualify for the credit. Export could be defined as "exporting goods and services to overseas countries where those goods and services are consumed overseas" (the GST definition) which would *exclude* export education and inbound tourism services, or as "the sale of goods and services to overseas consumers" which would *include* export education and inbound tourism services.

- Whether the tax credit would be available for New Zealand produced goods and services, goods substantially of New Zealand origin, or for goods and services produced (either in NZ or overseas) by New Zealand resident firms.

- Which organisations would be eligible for the tax credit.

- The maximum turnover threshold above which a business would not qualify.

- Detailed rules for eligible expenses.

These issues are discussed further in the annex to this report.

Your decisions will be reflected in the officials' issues paper scheduled to be released on 3 November 2006. A draft of that paper will be provided on 26 October 2006 with a cover report requesting further decisions on matters identified as a consequence of the decisions in this report. That further report will also discuss the revenue implications of your preferred option.

Officials proposed that on the introduction of the market development tax credit Ministers announce that the credit will be reviewed after two years to ensure that it is achieving its goals.

Recommendations

It is recommended that Ministers:

(a) **Indicate** whether the export tax credit should support exports in general (option one in report), new market development in general (option two in report), or new exporters (option three in report).

Exports in general	Exports in general
New market development	New market development
New exporters	New exporters

Option one: providing the credit to all export market development expenditure

(b) **Note** that if your preferred approach is providing the credit on all export market development expenditure, we will be reporting further on volumetric and incremental tax credit options.

Noted

Option two: providing the credit to new market development expenditure

(c) **Agree,** if the preferred approach is to provide credit in relation to new market development, to provide the credit to either:

(i) exporters on the simple test approach of market development which provides the subsidy for market development expenditure in relation to exports to a new country, in relation to new products, or new trademarks; **or**

(ii) exporters on the basis of determination of a third party certifying what expenditure qualifies as market development; **or**

(iii) based on a hybrid approach whereby exports would automatically qualify where they meet the new country, new product or new trademark test or if they do not meet these tests a certification process is used to determine whether they meet the other market development characteristics (officials' recommended option if a new market development expenditure credit is preferred).

Agreed (i) (ii) or (iii) /not agreed	Agreed (i) (ii) or (iii) /not agreed

(d) **Agree** that the officials' issues paper discuss whether the current MDAS five-year time period is long enough to enable firms to establish themselves in a new export markets or whether a longer time period is justified.

Agreed/not agreed	Agreed/not agreed

Option three: Apply the credit to new exporters (exporting beyond Australia for the first time)

(e) **Agree,** if the credit is to be available to new exporters, that the credit apply to all export market development expenditure undertaken by a new exporter.

Agreed/not agreed Agreed/not agreed

(f) **Agree,** if the credit is to be available to new exporters, that the time period for which an exporter can qualify for the subsidy is five years or seven years.

Agree – 5 years/Agree – 7 years/Not agreed Agree – 5 years/Agree –7 years/Not agreed

(g) **Agree,** if the credit is to be available to new exporters, that the credit be also available to existing exporters abated at a rate of one year for each year they have been exporting.

Agreed/not agreed Agreed/not agreed

Benedikte Jensen
for Secretary to the Treasury

Keith Taylor
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Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. As part of the Business Tax Review the government has proposed a tax credit for market development expenditure. Currently assistance to export market development is provided through the Market Development component of the Enterprise Development Grants programme (MDAS) administered by New Zealand Trade and Enterprise.

2. This paper discusses the possible features of the market development tax credit which are based on the MDAS scheme, and where appropriate, the Australian export market development grant, administered by Austrade.

3. The features of the current MDAS grant are:

- The scheme provides assistance for new strategic export market activities, such as new market or new product development, but not "business as usual" activities.
- Eligibility is limited to small or medium enterprises (SMEs), defined as firms with less than $50 million turnover or less than 100 full-time-equivalent employees.
- The grant is provided at a rate of up to 50 percent of qualifying expenditure, on a GST inclusive basis.
- Qualifying expenditure includes: in-market visits; overseas representation; bringing overseas buyers to New Zealand; advertising and promotion (excluding sponsorships); marketing material; trade-shows; and certain types of market research. Also, expenditure which is the subject of other government assistance also does not qualify.
- Expenditure relating to activities in the Australian market does not qualify, due to CER rules. (The Australian Austrade grant has a similar restriction in respect of exports to New Zealand.)
- The minimum expenditure a New Zealand firm must undertake to qualify for the grant is $40,000, which provides a grant of up to $20,000 (GST-inclusive).
- The maximum grant that can be claimed by a firm is $100,000 per annum (GST-inclusive), in respect of at least $200,000 of expenditure.
- To reduce compliance costs the grant scheme provides standard costs for airfares and a daily rate for accommodation.
- There is a lifetime cap on the total grant received of $500,000 per firm (GST-inclusive).
- A firm may claim the grant for five years. This means that if a firm does not claim the maximum grant in each year, it will not reach the $500,000 cap.

4. This report outlines the options for a market development tax credit and the areas where decisions are required in order to enable the drafting of an issues paper on the more detailed design parameters of a market development tax credit for release in November.

5. Although the design follows the MDAS model, in some areas, MDAS rules and practices would need to be modified or expanded, due to the differences between a grant and a tax credit. Typically, grants can be rationed and capped, so the supply of the grant is limited, whereas tax credits are available to all who wish to claim them, meaning that supply is unlimited. This creates the possibility of substantial loss of revenue, unless the rules for the credit are tightly specified. In addition, grants are usually within the discretion of some decision making body, and they effectively function as a gift. This means that the level of litigation is low, because it is hard to contest the withholding of a gift. In contrast, because a tax credit is not discretionary, disputes can arise about whether or not a firm or expenditure is eligible for the credit, leading to increased tax litigation. Again, this means that the rules for the credit need to be tightly specified.

6. Treasury and Inland Revenue have been consulted by Ministry of Economic Development (MED) about a paper on the Business Tax Review discussion document. MED is considering a broader range of mechanisms for providing additional assistance for export market development. This report is more narrowly focussed on the options for designing an export market development tax credit. Decisions made in the context of advice from MED may impact on the design of a tax credit for market development.

What is the tax credit trying to achieve?

7. The MDAS grant is justified on the grounds that New Zealand firms face extra costs in developing new markets, but some of the benefits associated with those costs flow to the wider business community, as well as to New Zealand in general. A firm breaking into a new market spreads knowledge of New Zealand as a supplier of goods and services, and acquires knowledge about how to go about supplying that market which can then be used by other firms. The extra costs and the inability to secure all the benefits of incurring the costs can result in an underinvestment in market development, in particular by small and medium sized businesses. Government assistance may encourage firms to enter and develop new export markets, despite these extra costs.

8. The objective of the market development tax credit could be set more broadly or more narrowly than the objective of the MDAS grant. The credit could be targeted to:

- all export market development expenditure (a broader objective); or
- export market development expenditure into new markets (the MDAS objective); or
- new exporters (a narrower objective).

Providing the credit to encourage all forms of export market development expenditure

9. Under this approach the tax credit would be designed to encourage all market development expenditure, subject to limits around eligibility and maximum and minimum spending thresholds. It is not targeted at market development expenditure into new markets but it encourages a general increase in expenditure. Option 1 of this report would support this approach either on a volume-based approach, or through an incremental approach (which would focus more of the tax credit on marginal market development activity).

Providing the credit to new market development expenditure

10. Under this approach only market development expenditure which relates to developing new markets (as defined in some way) qualifies. This approach is aimed at addressing concerns about externalities and consequential under-investment which can occur in relation to new markets. Option 2 of this report would support this approach, using any of the variant means of defining 'new market development expenditure'.

Apply the credit to new exporters

11. Under this approach the main barrier to new market development would be seen as the hurdle businesses face in starting exporting and the credit would be applied to reduce those barriers. Option 3 of this report would support this approach.

12. This report discusses these options and presents the decisions that need to be made depending on which of the approaches you consider better addresses under-investment in export market development. Officials' preference is for the "new markets" objective as this may address market failure, fits with the government's economic transformation objectives, and reflects best practice in overseas countries. However, it may be very difficult to deliver this objective effectively through a tax credit. A narrower subset of new markets - new exporters - may be the better option for effectively and sustainably delivering this objective through the tax system.

Option one: Providing the credit to encourage all forms of export market development expenditure

13. Under this option the objective is to boost all forms of export market development expenditure. The primary benefit of this option is that it reduces the cost of export market development expenditure thereby resulting in some increases in that expenditure. Under this approach the assumption is that it is key for New Zealand's investment in export market development expenditure to be increased. This objective is broader than the objectives of the MDAS grant.

14. The approach would be to provide a tax credit for all export marketing. This would have the benefit of lowering administrative and compliance costs as well as legislative complexity. However, it is not closely targeted, and it would support market development for existing exports in addition to supporting new exports. Thus it would contribute little to the government's economic transformation objectives. It could also create risks with respect to trade policy, and it would have the highest fiscal costs.

15. If the fiscal cost of providing the credit for all export market development is considered excessive there are possibilities to use various incremental approach to reduce this fiscal cost (for example, an approach where all eligible expenditure over a base year level would qualify for the tax credit). The base level of market development expenditure could be set at the level of eligible expenditure incurred in the tax year ending 31 March 2005. Another example would be setting a cap on the maximum amount of expenditure which would qualify for the credit each year.

16. The issues of the various incremental approaches will be discussed in a separate report to Ministers. All of those options in that report will be available to be applied to this option.

17. Although the various incremental approaches may provide a workable solution at lower cost, these approaches also provide the tax credit to market development relating to additional expenditure on current export activities rather than new market development activities (the goal of the credit as outlined in the Business Tax Review discussion document).

18. Overall we do not support the option of providing the credit in relation to all market development expenditure, with or without any adjustment for targetting this option incrementally, because it does not target new market development expenditure, may not support the government's economic transformation objectives, is fiscally costly if not provided incrementally, and is complex if provided incrementally.

Option two: Providing the credit to new market development expenditure

19. Under this approach only that market development expenditure relating to developing new markets, as defined in some way, qualifies.

20. Defining and identifying 'new market development' is complex and it is unlikely that a robust definition could be created. The general practice with this definition is for decisions to be made on judgement rather than interpretation of a clearly stated definition. In administering MDAS grants, New Zealand Trade and Enterprise uses case-by-case judgement to assess whether a proposal represents "new market development". It has not attempted to develop a specific list of criteria for new market development. Austrade, the Australian export market development grant, had a definition of new market development in its legislation for the Australian export market development grant, but that definition has been repealed with increased reliance placed on the judgement of the CEO of Austrade.

21. At a principled level we consider that a definition of "new market development" should be the process of developing a market in order to be in position to provide:

- new products or services to existing markets;
- existing products or services to new markets; or
- new products or services to new markets

22. However, these criteria are very broad. They do not provide sufficient guidance or specific tests that could be used legislatively. Officials have identified three possible ways a new market could be defined legislatively and we consider this definition in the context of the above principles to highlight their strengths and weaknesses. The tests are:

(i) A <u>simple test approach</u> – using simple but arbitrary tests, for example, market development to create a presence in a new country;
(ii) A <u>certification approach</u> – a separate entity certifies what qualifies as market development;
(iii) A <u>hybrid model</u> - automatic qualification where meet new country, new product or new trademark test or if don't meet the test then undergo a certification process in order to determine whether meet the other market development characteristics.

23. All these options are variations of different approaches to defining new market development expenditure.

A simple test

24. The simple approach is to establish a number of arbitrary but clear tests which can be used to determine whether a firm meets the definition of new market development. The tests could be whether:

- The market development expenditure is in relation to a country to which the firm does not currently export.

- The market development expenditure is in relation to a new product which the firm does not currently export. In this context a new product would be identified by comparing the product to other products exported by the firm based on the firm's customs declaration

documentation. Firms exporting goods with a value of more than $1000 have to complete a customs declaration and classify the good using the customs tariff codes. Where a new good's 6 digit tariff code differs from the tariff codes of other goods exported by the firm, then the new good would qualify as a new product for the purposes of the market development tax credit.

- The market development expenditure is in relation to goods and services marketed under a new trademark.

25. In each of these cases, the criteria are simple and it would be comparatively easy to determine whether or not a firm meets them. These definitions would provide certainty for firms and be simple for Inland Revenue to administer. However, these benefits would be at the cost of excluding some firms who undertake new market development who ought to qualify for the tax credit but are excluded because of the arbitrary nature of the proposed criteria. For example, a new product within the same customs tariff code would not qualify.

26. Further, officials consider the tests do not work well for services or software where there is no equivalent to the customs tariff code system and recommend that if this option is pursued, then the proposed issues paper on this credit request submissions on other possible simple tests.

27. There would be pressure from firms to extend the boundaries as the approach is not one of principle and there will be clear cases under this approach of where the credit should be provided and is not being provided. These boundary cases would be hard to defend.

28. While simple we consider the arbitrary nature of this approach a significant concern and therefore it is not recommended.

Separate entity certifies market development

29. A third party with relevant expertise could certify whether a firm is undertaking market development activities into new markets. Once certification has been received by the firm they would qualify for the tax credit, to the extent that their expenditure also fulfils the other eligibility criteria. Expert certification would provide certainty for firms, and it would avoid some of the difficulties of attempting to develop an effective definition of new market development. This is similar to the approach used in Australia of making the key decision a matter of discretion due to the difficulty of establishing a robust non-discretionary definition.

30. This option would differ from the simple test option in that all the characteristics of market development would be taken into account in determining whether a firm's expenditure qualifies as market development, rather than just meeting the new country, new product or new trademark test.

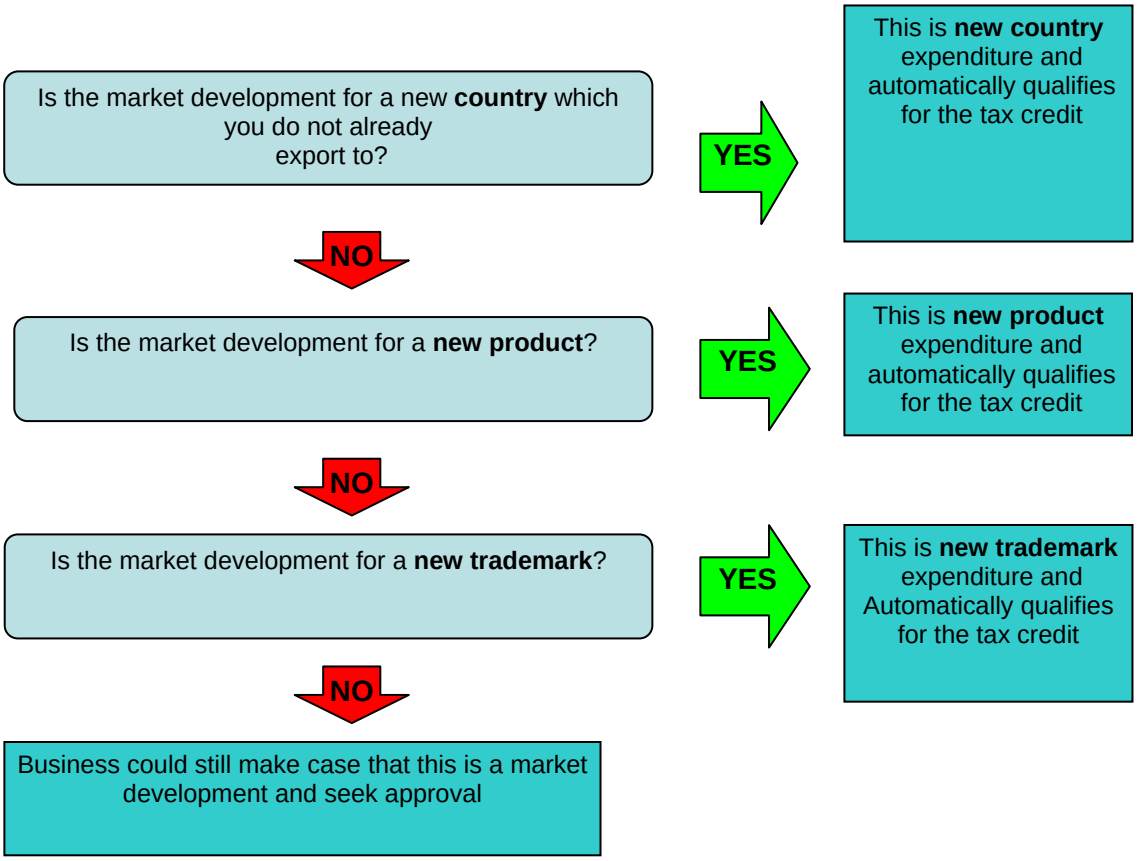
31. The certification process could be performed by a third party such as an existing government agency. An alternative is to set up a board of private sector (and other) experts to perform this function. However, the Australian experience (in the context of their R&D tax credit) has been that the board has an incentive to approve all applications because at the margin it is difficult to determine what is new market development and applications are approved to reduce the risk of decisions being relitigated.

32. While providing a process to get outcomes approximating those established by our principles, this approach requires pre-approval of expenditure. It will have compliance costs associated with the application process and possibly significant costs where there is uncertainty as to the nature of the expenditure. Submissions were opposed to pre-approval processes and emphasised the need for low compliance costs.

33. While providing good outcomes in policy terms we are concerned about the likely complexity of the pre-approval requirements and their associated compliance costs so this option is not recommended.

Hybrid option

34. This option is a combination of the simple test and separate certification options. There would be a number of tests based on the qualifying criteria where if a firm met the tests their activities would automatically qualify as new markets development. The tests could be whether the market development is in relation to exporting to a new country, exporting a new product or new trademark for a product (per the simple test option).



35. A firm whose market development expenditure does not meet the tests but which nonetheless might reasonably be considered to be developing new markets could still qualify and would be required to seek certification that they meet the definition by a certifying body (per separate entity certification option). For example, some new products may not require a new tariff code, so the firm would not meet the new product test. In these cases, firms could apply for certification.

36. The certification functions could be undertaken by a government agency or an external board. The certification process would only deal with the more difficult cases and would provide certainty for both the taxpayer and the government. Providing automatic qualification where at least one of

the new country, product, and trademark tests is met also keeps the administration and compliance impacts of the credit to a minimum.

37. This option more closely targets the credit towards new market development activities and is the option recommended by officials if your policy goal is targeting new market development expenditure.

38. There are risks with this option. If the proposed tests do not filter many cases then many taxpayers will be required to seek expenditure through the certification process with the compliance costs associated with that. Alternatively, if the simple filtering tests we are proposing are too wide then the credit will be applied inappropriately. Finally, to the extent that the proposed tests do not apply in the area of software and services, those sectors will be forced into the certification process automatically if the subsidy is to be claimed.

39. Again we consider the issues paper should request submissions on possible additional tests.

Time limit

40. If the credit is to be for developing new markets, we need to define when markets are no longer new. Following the MDAS model, firms would only be able to claim the tax credit for a certain period of time as the objective of the market development tax credit is to help with developing a sustainable presence in a new market, not to provide long-term funding for marketing activities. Eligibility for the current MDAS scheme is limited to five consecutive years and the Australian export grant limits eligibility to seven consecutive years. By this time, a firm receiving the tax credit should have established a sustainable presence in the market, if they were ever able to do so, and should not need any further government assistance.

41. Limiting the time frame for claiming the credit helps to ensure that the credit does not simply become a subsidy for marketing activity. The time frame for claiming the credit could be linked to new market development projects. However this would be different from the MDAS scheme which allows a maximum of five years for any further grants.

Option three: Apply the credit to new exporters

42. This option focuses the credit on businesses that are new to exporting beyond Australia. There are many barriers to exporting (financial, skills, time demands and so on) which are hurdles and constraints and the credit would act to reduce their burden. The credit would act to encourage export market development for the first time by businesses that would not otherwise have the resources to start exporting.

43. Compared with option two this option would move the focus to helping make more New Zealand businesses internationally focussed rather than existing internationally focussed businesses expand their business. In effect, this approach is predicated on the assumption that the first export decision is the most important and the skills learned from that are more important than the issues associated with moving into further markets. Note however, as discussed above, that exporting to Australia would be excluded from the credit under CER rules.

44. Under this approach, the considerable complexity of the various new market tests is removed because a subsidy would be provided to a new exporter rather than a new export market. (In effect, this option is a subset of the simple test approach to option two, focusing on a relatively narrow test which is feasible to implement and operate.) While the new exporter test is simple it would need bolstering with rules preventing businesses from changing structures in order to continue any subsidy. These rules could be discussed in the proposed issues paper if this option is agreed.

45. An obvious issue with this approach is that existing exporters are excluded, some of whom may be struggling with the barriers that newly commencing exporters will receive the credit to address. We therefore consider that existing exporters should qualify for the subsidy to the extent they commenced export within the past five years. For example, an exporter who has been exporting two years before 1 April 2008 (the start of the grant) would qualify for the grant for the following three years.

Time limit

46. The approach of targeting the business moving into exporting means that any form of time limit on eligibility would need to be based around the business, for example, the credit ceasing after five years of market development expenditure. The longer the credit is available and the more businesses that are entitled to the credit, the more this option moves towards a credit for all export market development expenditure (the volumetric variant of option one in this paper). Limits around eligibility and time are key elements of this proposal.

47. At the point the credit stops the business will either continue exporting as they have been commercially successful, or cease exporting. They may cease either because exporting has only been sustained by the credit or the business still faces significant market development barriers. If this latter case is faced generally by businesses, then the proposed five year period of the credit should be extended. The issue of exceptional cases could be addressed by allowing application for an Export Development grant from NZTE. This issue could be raised in the issues paper for discussion.

Other design decisions

48. There are a number of design decisions which are independent of the options outlined above and which officials consider should be tested in the officials' issues paper.

- The definition of exports;
- The time limit for the tax credit;
- Whether the tax credit should be available for New Zealand or overseas produced goods and services;
- Which organisations would be eligible for the tax credit;
- The maximum turnover threshold above which a business would not qualify;
- Whether standard costs for certain qualifying expenditure should be used to minimise compliance and administration costs;
- The maximum and minimum spending thresholds will need to be determined; and
- Whether the cost of samples should be included as eligible expenditure, and whether or not spouse's expenses should be covered.

49. These issues are outlined in the annex to this report. A number of these issues, while more detailed in nature, are significant and could be contentious. In particular, the definition of exports raises the question of whether market development expenditure around tourism and education should be eligible for the tax credit. In addition, a judgement will need to be made on whether only New Zealand made products should be eligible, or whether a wider "NZ Inc" definition of products should be used.

Review

50. In order to ensure that the scheme is achieving its objectives it could be reviewed after two years of operation. Ministers could announce this review on the introduction of the new market development tax credit.

Next steps

51. Your decisions will be reflected in the officials issue paper scheduled to be released on 3 November 2006. A draft of that paper will be provided on 26 October 2006 with a cover report requesting further decisions on matters identified as a consequence of the decisions in this report. That further report will discuss the revenue implications of your preferred option.

Consultation

52. The Ministry of Economic Development and New Zealand Trade and Enterprise have been consulted in the preparation of this report.

ANNEX Detailed design issues

This section addresses those design issues which do not vary with any specific option and which decisions will need to be made in relation to the issues paper.

Time period

To ensure that firms could not restructure their affairs to avoid any time period restriction, anti-avoidance rules would need to be put in place to avoid asset stripping or setting up a new firm. These would include an associated persons test, a business continuity test and a same assets test.

Definition of export

In order for a firm to qualify for the market development tax credit they would have to meet the definitions of "export" as well as the discussed new market development expenditure test.

Export could be defined as "the exporting of goods and services to overseas countries where those goods and services are consumed overseas". This is the same as the definition of exports used in GST. This definition excludes inbound tourism and educational services provided to foreign students as these services are consumed in New Zealand. These exclusions are consistent with current MDAS practice, although NZTE is reviewing this in respect of some tourism operators. A further reason for exclusion in the case of tourism is that Tourism New Zealand currently undertakes overseas promotion which contributes to the externalities associated with tourism.

A second definition is "the sale of goods and services to foreign consumers". Using this definition would include both tourism and education and therefore extend the scope of those eligible for the credit. However, this definition raises significant boundary issues, including concerns about whether goods and services really are consumed by foreigners. For example, the same service may be advertised and delivered to non-residents on a visiting student's visa, and to students who are able to become residents.

On balance, officials' preference is to proceed with the first definition, "the exporting of goods and services to overseas countries where those goods and services are consumed overseas". This would provide a clear cut test which is less complex to administer and is broadly in line with the current MDAS approach. If once the scheme is implemented there is pressure to extent the definition, Ministers could amend the tax credit scheme. Officials propose to test this definition in an officials' issues paper.

New Zealand or overseas produced goods

The tax credit would be available in respect of developing a new market for sales of goods and services. The MDAS grant is available to firms where the value from the sales in that market is retained in New Zealand. However this is a matter of judgement. If market development assistance is delivered through the tax system, then there need to be more precise rules about which goods and services are eligible.

The credit could be available for:

(1) NZ produced goods only, or
(2) goods substantially of NZ origin, or
(3) overseas produced goods exported by New Zealand resident firms.

Limiting the credit to New Zealand sourced goods and services would require the firm to certify that a good or service is of New Zealand origin. This option may exclude some New Zealand based firms that source some of their products from overseas even if the benefits of developing the new market flow back to New Zealand.

Allowing the credit to be available for goods of substantially New Zealand origin is consistent with the Austrade rules where the grant is limited to goods that have at least 50% Australian content, or if the goods are made outside Australia, then at least 75% of the value of the components that make up the goods are themselves goods with at least 50% Australian content. This approach would require the firm to certify the proportion of the product that is sourced from New Zealand and as certification is not a requirement when exporting to some countries, this would increase the compliance costs for some firms. Again some new market development by New Zealand firms may not qualify if this criterion was adopted.

The third option is to allow the credit to be claimed in respect of both New Zealand produced and overseas produced goods and services of a New Zealand owned firm. This option would benefit the widest group of New Zealand firms.

Limiting the credit to New Zealand owned firms would ensure that the benefits from developing new markets would in the longer term be returned to New Zealand and New Zealanders. However, one common strategy for new/potential exporters is to go into partnership with an overseas firm, either by giving the overseas partner an equity stake in the firm or by setting up a joint venture. This enables the New Zealand firm to access the expertise and distributional networks of the overseas firm. Limiting the tax credit to New Zealand owned firms might discourage firms from allying themselves with overseas partners, thus losing the potential benefits of working with more experienced firms. The more appropriate strategy might be to limit the tax credit to firms that are at least 50% owned by New Zealand tax residents, with ownership traced through companies to natural persons. This would be the easiest test to apply, but it could inappropriately exclude some entities. For example, state-owned enterprises and businesses owned by institutions such as universities where there is no ‘natural person’ owner would be excluded.

This suggests that a two-part test might be needed. If an entity is producing goods that are substantially made in New Zealand (using rules similar to the Austrade rules) then it would be eligible for the tax credit. Alternatively, if the entity was owned by at least 50% New Zealand tax resident natural persons, then it would be eligible for the tax credit. An entity would have to satisfy only one of these tests to be eligible. Although this two-fold test would not be simple, it would nevertheless cover most or all of the entities which ought to be covered by the test. The appropriateness of this two-fold test could be included in an officials’ issues paper.

Who qualifies?

The credit could be available to all taxpayers except entities that have a significant level of government/local authority funding as these entities already benefit from government assistance. Therefore the following entities would not qualify for the credit.

- Government departments
- Government agencies
- Local government
- Council controlled organisations
- Schools, polytechnics, and universities

Although Crown Research Institutes (CRIs) are wholly owned by the government and receive significant government funding, part of their role involves developing and selling research. Export market development they undertake in order to sell research should be eligible for the credit.

Limiting the definition of exports to goods and services provided to overseas consumers where those goods are consumed overseas will exclude schools, polytechnics and universities from claiming the credit in respect of educational services provided to overseas students. However, if the definition of exports is expanded to include the sale of goods and services to foreign consumers, then education services provided to foreign students would qualify. These institutions typically engage in considerable efforts to attract fee-paying foreign students, and they rely on these fees for a large portion of their funding. Because many educational institutions are government funded, they would be excluded from claiming the credit, but private schools and tertiary education providers would not. If the definition of export is expanded to include tourism and education, the appropriateness of excluding government funded schools and tertiary institutions could be reconsidered.

Limitations on the size of firms

The MDAS grant targets firms with less than $50 million turnover and/or less than 100 full time equivalent employees. Austrade uses an even lower threshold, $30 million turnover, but it does not use a full time equivalent employees test. The Australian threshold was lowered to this level after evaluation of the scheme showed that it was most effective at increasing new market development activities in these smaller enterprises.

The threshold constrains the government's fiscal exposure while providing assistance where it is most needed. Given the difficulties with measuring the number of full time employees, it is recommended that eligibility to the tax credit be determined by turnover alone and that the threshold be set at the same level as the MDAS grant, $50 million or less in year of first claiming the tax credit. The threshold limit would also function as a proxy for assisting new exporters, because new exporters are less likely to be larger firms. Whether or not this is an appropriate limitation could be tested in an officials' issues paper.

Expenditure

Qualifying expenditure

The existing market development grant covers the following categories of expenditure:

- in-market visits;
- overseas representation;
- bringing overseas buyers to New Zealand;
- advertising and promotion (excluding sponsorships);
- marketing material;
- trade-shows and events; and
- market research, where the market research is related to refining an approach to a market, rather than establishing an overall strategic direction.

The market development tax credit could include all these types of expenditure, provided that the expense would be ordinarily deductible for tax purposes. It is proposed that the issues paper canvass whether the above classes of expenditure cover market development expenditure or whether other costs should be included. Most of these expense categories could be covered on an 'actual expenditure' basis. However, to provide certainty for firms and to reduce administration and compliance costs associated with making a claim it is proposed that standard costs be set for in-market visits, attendance at trade shows, and bringing overseas buyers to New Zealand.

The existing MDAS grant uses standard costs for market visits, so that any expenditure over that amount is the responsibility of the firms or the individuals involved. The level of the daily allowance varies between countries and is set by external consultants. The Australian export market grant also uses standard costs, of $300 per day. We propose that standard costs also be adopted for the tax credit and would cover the following:

Standard costs	**Expenditure covered**
Daily allowance	accommodation, sustenance, telecommunications, internal travel, and incidentals
Airfares	all international air fares (amount set at return economy airfare to market)

If Ministers consider that a standard-cost approach may result in firms being under-funded for in-market visits, an alternative could be to allow the tax credit to be claimed in relation to actual and reasonable expenditure, up to a specified amount can, that could be set at a reasonably high level. However, this would be more complex to comply with and administer, could require apportionment of expenditure and would attract audit activity and uncertainty around entitlement. The compliance costs involved could significantly outweigh the risk that firms would be 'overpaid' for their actual expenditure on market development related activities. On balance officials' preference is that standard costs be set for market visits, attendance at trade shows and bringing overseas buyers to New Zealand. Officials will separately report to Ministers on the appropriate level to set the standard costs at.

Expenditure that does not qualify

The following expenditure would not qualify for the tax credit:

- Salaries of employees in preparing marketing information or while visiting overseas markets would not be eligible as this is part of business as usual costs.
- Costs of producing samples would not be eligible. Determining the costs of a sample can be difficult as the first sample can include set-up costs, which are then simply part of 'business as usual' production costs. Also, it can be difficult to distinguish between samples and products as samples can often be turned into products later when payment is received, as happens with software. In effect, by allowing samples to be claimed, the credit could be used to underwrite the cost of sales, not the expenses associated with developing an export market. NZTE experience is that samples are problematic and require considerable judgement.
- Expenditure covered by another government grant would be excluded to prevent double-dipping.
- Expenditure that is not ordinarily deductible for tax purposes.

Many small businesses are owned and operated by a husband and wife team. Under the MDAS scheme where an applicant going overseas takes along their spouse the expenditure of the spouse is generally excluded from the grant. However, the applicant can submit a business case justifying why the spouse needs to accompany the applicant on the overseas visit to a market or trade show.

Relatives accompanying business people on overseas market visits was a significant problem with the 1980s export market development tax credit provided through the tax system. The tax credit was available to employees of a business but not the spouses of employees. Inland Revenue's experience was that this was an area of abuse. The tax system does not usually cater for large numbers of case-by-case judgements on whether a spouse's expenditure should qualify.

The introduction of an arbitrary boundary would increase compliance and administration costs and lead to the boundary being challenged. An alternative would be to enable firms to claim the travelling costs of both spouses where the expenditure meets the test of ordinary deductibility for tax purposes. These issues would be canvassed in the officials' issues paper.

Minimum and maximum qualifying expenditure thresholds

There is an opportunity to set maximum and minimum qualifying expenditure thresholds around eligibility for the credit.

Officials' preference is for a minimum expenditure threshold to ensure a sustainable and robust credit achieving the intended policy outcomes. The existing MDAS grant is only available for firms which spend at least $40,000 per annum on eligible market development. The Australian export market grant has a minimum expenditure level of AUD$30,000. Having a minimum level ensures that a firm is serious about developing the new market and reflects what a firm needs to spend in order to make a viable and sustained entry into a new market. Our preference is that the minimum expenditure level in order to qualify for the tax credit be $40,000, the same as the current MDAS grants.

A maximum expenditure threshold could be set to ensuring the cost is within acceptable fiscal parameters. The threshold under the MDAS scheme is $200,000 and the grant is 50 percent of eligible expenditure. As the proposed tax credit percentage is between 7% and 15% consideration could be given to setting the maximum threshold at a higher level partly determined by the percentage value of the tax credit. This would need to be undertaken once this percentage value is decided upon.

However, given the current MDAS grant scheme's 50% subsidy level, the lower the percentage the tax credit the lower the incentive for firms to undertake new market development.