The Treasury

Budget 2018 Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) and section 18 of the Official Information Act.

Reference: T2018/666 File no. SH-13-5

THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 16 March 2018

To: Minister of Finance (Hon Grant Robertson)

Deadline: 9:15am on 19 March 2018

Aide Memoire: Research and Development Tax Credit – Briefing for 19 March Ministers meeting

On 26 February 2018, Cabinet agreed in principle to the introduction of an R&D tax credit from 1 April 2019 (CAB-18-MIN-0056 refers). You are meeting the Ministers of Research, Science and Innovation and Revenue at 9:15am on 19 March to discuss progress towards introducing this credit.

This note covers:

- recent design decisions
- fiscal implications, and
- questions you may wish to discuss with Ministers Woods and Nash

Recent design decisions

You have been referred the draft R&D tax credit Discussion Document and associated Cabinet paper[1]. We understand that Ministers Woods and Nash intend to submit the final Discussion Document for consideration by the Cabinet Economic Development Committee (DEV) on 28 March 2018. This follows two joint reports[2] on main and technical design features of the credit, as well as a report on integrity within the tax credit. The attached annex outlines key decisions proposed for Ministers to 1) agree to in principle or 2) seek views on through public consultation.

Overall, the Treasury supports the policy design decisions to date, while noting that future decisions will be key to managing fiscal risks. We consider it is important to monitor how these decisions will impact the cost of the credit and include a robust evaluation plan of the initiative. We also recommend the credit should not be the only form of support for businesses performing R&D.

[1] 2216 17-18/IR2018/113 refers

[2] By the Ministry of Business, Innovation and Employment (MBIE), Inland Revenue (IR) and Callaghan Innovation on 16 February 2018.

Fiscal implications and risks

The release of the upcoming Discussion Document has no fiscal implications, but decisions on the credit's design will affect the final cost of the policy. We consider a key fiscal risk is the potential for businesses to recharacterise expenditure. We note that there are trade-offs around the design of the credit at the margin. In certain cases where the risk of recharacterisation is too high, it may not be appropriate to provide the credit even if it might encourage R&D. Conversely, it may be appropriate to provide a credit in other situations where the benefits of the expenditure outweigh the risk of recharacterisation (for example, where the risk is low and can be mitigated). This risk will be reflected in the Specific Fiscal Risks published as part of the Budget Economic and Fiscal update (BEFU).

You recently received a report on key observations and advice from Australian officials on their experience with an R&D tax credit (T2018/285 refers). [2]

Current estimated cost of the R&D tax credit[3]

Table 1: Estimating the cost of the credit ($m)

	2018/19	2019/20	2020/21	2021/22 & out years	Total
R&D tax credit	70.0	280.0	320.0	350.0	1020.0

Table 1 above assumes all Growth Grant recipients immediately switch to receiving the tax credit, however officials are working on transition options between these two initiatives and will report to Ministers on this shortly. As at MBU 2017/18, the Growth Grants MYA contains $691.111 million across the forecast period. [33]

As the current proposed tax credit and Growth Grant rates are approximately the same, there will be little difference in the cost to government for businesses receiving a tax credit or Growth Grant, however it will determine which appropriation the funding comes out of.

These estimates would not change if the credit included a refundability element from 2020 (New Zealand's Budget accrual accounting means spending is recorded when it is incurred). However, if this policy was introduced, the credit would carry a larger fiscal risk, due to the increased incentive for fraud.

[3] This is the funding requested by MBIE through Budget 2018.

Questions you may wish to discuss with Ministers Woods and Nash

Context	Question
Labour's Fiscal Plan allocated $850 million over the forecast period for an R&D tax credit, on top of funding allocated for Growth Grants. Officials currently estimate the total cost of the tax credit and Growth Grant funding will be $1.02 billion over the forecast period. [2] Final policy decisions post-consultation will impact on the cost of the credit.	• **How can we ensure the credit can be delivered effectively while meeting Budget Responsibility Rules?**
A tax credit can help reach the Government's target of increasing R&D expenditure to 2% of GDP. The Treasury suggests using a combination of policies to increase the effectiveness of the credit and meet the 2% target. These include grants in the innovation system, [33] It is important that Ministers consider what support will continue to be available for businesses alongside the credit well before making final policy decisions. If it is not clear what other support will be available, there will be pressure to 'loosen' the design and implementation of the credit to 'fill the gaps' left by existing R&D measures. This will in turn increase the fiscal risk of the credit.	• **How should the credit work alongside other initiatives in the innovation and taxation systems to support the Government's R&D expenditure target?**
The Treasury considers robust measures should be in place to track both the fiscal cost of the policy and whether the credit is meeting its objectives.	• **How will agencies monitor and evaluate the effectiveness of the R&D tax credit policy?**

Next Steps

We understand that Ministers intend to submit the final Discussion Document for consideration by DEV on 28 March 2018.

We would like to provide you with further advice on how the credit can fit with other policies in the wider tax and innovation systems should you require it.

Hannah Overton, Graduate Analyst, Tax Strategy, [39]
Matt Cowan, Team Leader, Tax Strategy, [39]

Annex: Main and Technical design decisions

The below table outlines main and technical design decisions of the R&D tax credit that officials have proposed for Ministers to 1) agree to in principle or 2) seek views on through public consultation:

Agree in principle:
Available to all businesses, regardless of legal form
Eligible businesses carry out business in New Zealand, own the results, bear the financial risk and have control over the R&D activities
SOEs eligible
All businesses except industry research co-operatives (levy bodies) be required to meet the business test to be eligible for the credit
No more than 10% of the R&D claim by a firm in any year can be for R&D costs incurred overseas, and for the overseas component to be eligible at least 50% of the R&D activities must be performed in New Zealand
Clause included in the legislation enabling changes to the eligible/ineligible activity and expenditure rules to be made by regulations, rather than by primary legislation

For public consultation:
12.5% headline tax credit rate
$120 million maximum expenditure per year for a business
Mitigation measures included if there is a cap
Volume-based scheme – credit based on the total amount of eligible expenditure incurred by a business in a given year
No refundability element in 2019
Support for cash-constrained R&D firms in loss to be included from 2020
Proposed definition and list of excluded activities
Blanket exclusions on some activities under both core and support activity components of the proposed R&D definition
Proposed eligible and ineligible expenditure
Rule/rules to exclude business-as-usual expenditure being claimed as part of R&D expenditure
Whether Crown Research Institutions, District Health Boards and Tertiary Institutions and wholly or partially controlled subsidiaries should be eligible for the credit
Minimum of $100,000 per year of eligible expenditure being required for an entity to be eligible for the credit, except where R&D is performed by approved research providers
Liability and penalty mechanisms to promote accountability
Publishing the names of recipients and the amounts of money they have received with a two-year lag