Tax Tips Alert
May 2019

R&D tax credit bill enacted

pwc

pwc.co.nz

The Taxation (Research and Development Tax Credits) Act 2019 received the Royal assent on 7 May and is now in force.

In this special edition of Tax Tips, we provide guidance on how to transition to the new R&D tax credit regime, and we highlight some key issues you need to watch out for. We also look ahead to examine how further upcoming changes to New Zealand's R&D ecosystem may affect your business. Finally, while not a tax case, we explore the implications of the *Trends v Callaghan Innovation* decision for taxpayers making claims under the R&D tax credit regime.

For more background and detail on the Bill as it was introduced, please refer to Tax Tips, October 2018. For a summary of changes that were made to the Bill during the consultation process, please see Tax Tips, April 2019.

The R&D tax credit: What you need to know

- Applies from the 2019/20 income year
- 15% tax credit applied against income tax liability
- Minimum spend: $50,000 capped at $120 million
- 10% of your overall eligible R&D expenditure can be conducted overseas
- Limited cash refundability for certain loss making entities
- New definition of R&D with exclusions for specific activities and costs
- Eligible internal software expenditure capped at $25 million
- Current Callaghan Innovation Growth Grant recipients and associated entities are ineligible to claim the R&D tax credit in the same income year

01

Eligible entities

Most businesses, regardless of legal structure, will be eligible to transition into the new regime at the start of their 2019/20 income year (1 April 2019 for standard balance dates), provided:

1. They have a fixed establishment in New Zealand
2. They or their associates do not receive a Growth Grant in the same income year

02

Eligible R&D activities

A "core R&D activity" is one that:

1. Is conducted using a systematic approach; and
2. Has a material purpose of creating new knowledge, or new or improved processes, services, or goods; and
3. Has a material purpose of resolving scientific or technological uncertainty

03

Eligible R&D expenditure

The following expenditure may be eligible if incurred for the purpose of undertaking an eligible R&D activity:

1. Wages and salaries
2. Depreciation loss on assets
3. Direct expenditure on consumables and other materials
4. Apportioned overheads

04

Compliance requirements

Compliance in Year 1 operates slightly differently. The supplementary R&D tax return is due 30 days after income tax return is due. There is a maximum 2-year period to amend (increase) a tax credit claim after filing due date.

From Year 2 (FY21) of the regime and beyond, they must obtain pre-approval for their R&D activities (in-year approval). Businesses spending >$2 million in eligible R&D may opt out and instead will need to acquire certification from an approved R&D certifier stating their R&D activities and expenditure meets the requirements of the R&D tax incentive.

What you need to consider

Documentation requirements

Businesses that claim R&D tax credits must keep records that demonstrate the activities undertaken met the definition of an R&D activity. The documentation will be relied upon during the claim approval and review processes to determine whether eligible R&D is being undertaken. These records should be kept contemporaneously. Records created retrospectively may not satisfy the documentation requirements and may risk a claim being pared back or rejected.

The records required to support a claim for an R&D tax credit will go beyond the financial records normally required to be kept for tax purposes. However, as far as possible, these should be based on the documentation you keep to manage your R&D already and should include:

- documenting entity eligibility (normal business records will often be enough to confirm the taxpayer is undertaking a business in New Zealand and that the taxpayer has controlling rights over the R&D)
- the purpose of the R&D and what new knowledge, process, product, or service is sought
- the scientific or technological uncertainty that the systematic approach is intended to resolve
- why the uncertainty could not be resolved by information in the public domain or deduced by a competent professional when the R&D activity was undertaken
- outlining the systematic approach that guided the R&D activities, and
- evidencing the nature of any supporting activity integral to the core R&D activity.

Software

The eligible expenditure cap for internal software development has been increased to $25 million per year. Nevertheless, the application of the tax definition of R&D to software development remains restrictive for two key reasons. Firstly, the legislation explicitly excludes several activities that are integral to the software development life cycle, such as testing, from being eligible core R&D activities. Secondly, there remains some uncertainty as to the threshold for satisfying the scientific or technological uncertainty requirements in the context of software development.

The policy rationale behind the restrictions placed on software is primarily driven by doubts about whether there is sufficient technological or scientific uncertainty in software development. Furthermore, the Government aims to incentivise businesses to undertake more “risky” R&D activities, while simultaneously discouraging improving the return on investment for projects that would have been undertaken regardless of the tax incentive. Hence, software development for internal administration (accounting, HR, inventory, etc) are fully excluded, even in the presence of scientific or technological uncertainty, as the Government sees this as low risk and having limited beneficial spill-overs for the wider economy.

What will be considered eligible internal software development?

Any software development where the main purpose is to enhance an internal non-administrative operation, or enables the provision of a service to customers, and which is not explicitly sold or licensed to a customer, is likely to be eligible. Activities undertaken in this area of software development must nevertheless meet all the requirements of a “core R&D activity” to be eligible.

Example: A bank is trying to develop a customer-facing mobile app that enables the bank to provide financial services to its customers. The scientific or technological uncertainty in this case is whether the bank can provide financial statements to customers in real time, which currently no software engineer knows how to develop, so novel methods will have to be used. In this example, the software development is likely to be eligible R&D.

What will be considered eligible external software development?

The test for determining external software development which is not subject to the $25 million cap is whether the main purpose at the time of development was to sell or licence the resulting software to a non-associated customer.

This definition includes firmware and other software that is integral to the operation of a good that is subsequently sold. For example, software developed specifically for, and embedded into a product (e.g. a new washing machine).

Example: A home appliances manufacturer developed software that resolved the technological uncertainty of whether lint can be filtered out of a washing machine automatically. The software was subsequently embedded as firmware and integral to the operation of a new washing machine. In this case, the software development resolved a technological uncertainty, and was intended to be sold along with the hardware. Therefore, it is likely to be eligible R&D.

Partial refundability available in 2019/20 income year

Businesses in a tax loss position for the 2019/20 income year may be eligible to cash out the R&D incentive up to a maximum of $255,000 ($1.7 million in eligible R&D expenditure), subject to meeting the following requirements:

- must be a company
- minimum of 20% of personnel costs must be related to R&D (wage intensity test)
- not listed on a recognised exchange

This refundability can be accessed alongside the R&D tax loss credit scheme, and unlike the latter, the refund does not need to be repaid if a trigger event occurs. Additional tax credits not cashed out or offset against other tax liabilities may be carried forward, subject to shareholder continuity requirements.

Contracted R&D

The new R&D incentives regime recognises that, for some businesses, it is more economical to outsource R&D to a third party. As a result, the legislation has been amended to allow contracted R&D expenditure to be fully claimable to the extent that it relates to eligible R&D activities and expenditure.

Contracted R&D activity and expenditure follows the same requirements as those of core R&D activities and expenditure. The new regime imposes a responsibility on the contracting party to ensure the R&D claim only includes expenditure on eligible activities, and excludes any ineligible expenditure. If using an R&D contractor, you need to consider the information required to identify total eligible expenditure for each eligible project and whether the contract terms specify the information to be provided by the contractor.

Additionally, the regime has been designed to ensure multiple taxpayers do not claim for the same R&D expenditure. Partnerships and joint ventures seeking to claim the incentive will be treated as a collective for tax purposes, and the parties to such arrangements will claim a tax credit in proportion to their interest in the collective R&D.

Hence, for businesses either working together to conduct R&D or contracting R&D activities to a third party, it is important to consider the contractual arrangements to ensure clarity around who will be responsible for collecting relevant data to support an R&D credit claim and who is eligible to claim the tax incentive (and in what proportions). Uncertainty or ambiguity over both data and claimant(s) may result in no one being eligible to claim the tax incentive.

In-year approval pilot programme

Inland Revenue will be seeking participants to undertake a trial application of both the standard in-year and significant performer approval processes during the second half of 2019. The pilot programme will allow Inland Revenue to gather feedback, and subsequently improve the in-year approval process prior to opening access to all claimants from the 2020/21 income year. Participants in the pilot programme can expect to gain certainty around what activities will be eligible under the new regime. It will also provide an opportunity to implement any changes to their internal R&D systems prior to the general roll-out of the approval regime.

Further changes to the R&D incentives ecosystem

Phase 2 of refundability policy design

The Government recognises that the R&D tax credit incentives are not well suited for loss-making entities, such as cash-constrained startups with a big idea, who would see the most value from a refundable R&D tax incentive.

Phase 2 of the policy process on refundability has begun to address this misalignment. From our discussions with policy officials, we are expecting draft legislation later this year that will address refundability more broadly. We understand any resulting change will apply from the 2020 income year.

We also understand that draft legislation will consider the interaction of the various R&D-related regimes within the tax rules, including the potential scope and design of the R&D loss cash out regime.

Callaghan Innovation grants

The R&D tax credit is replacing the Callaghan Innovation Growth Grants. As such, Growth Grant applications are no longer being accepted. All Growth Grants will end by 31 March 2021. Current Growth Grant recipients with a 31 March year end are ineligible to claim the R&D tax credit in the same income year.

Growth Grant recipients on a non-standard balance date (i.e. not on a March balance date) will be able to transition into the R&D tax credit regime on 1 April 2021 and will be able to claim a part-year tax credit for any eligible R&D expenditure incurred during the remainder of their particular income year.

Growth Grant recipients may choose to transition into the new R&D tax credit at an earlier date. We advise businesses to carefully consider which scheme will best meet their funding objectives. PwC can assist with this process by developing a transition plan to manage the different application processes and compliance obligations.

Recipients of other Callaghan Innovation administered funding, such as Project Grants, will still be eligible to claim the R&D tax credit. Grant recipients will be able to claim the R&D tax credit on any remaining balance of eligible R&D activity that is not funded by the grant. If your business will receive both an eligible R&D grant and the R&D tax credit, care must be taken to ensure that expenditure claimed under one scheme is not subsequently claimed again under the other.

Case study: Trends Publishing

This recent case concerning a Callaghan Growth Grant recipient provides some useful insights into the record-keeping requirements for any business seeking to claim R&D incentives, whether a grant or a tax credit. The five-year dispute between Growth Grant recipient, Trends Publishing (Trends) and Callaghan Innovation (Callaghan) was settled in the High Court at the end of April 2019. While the crux of the case revolved around whether Trends intentionally misled Callaghan to obtain funds to keep the business afloat financially, the case also provides commentary on the importance of documenting R&D contemporaneously within the New Zealand R&D incentives regime.

Background

Trends is a marketing and publishing company that experienced declining advertising revenues due to the changing technology environment. In response, they sought to develop their digital business as an avenue to create new revenue streams. By December 2013, Trends had successfully completed and launched an engagement platform that was generating revenues from clients. Trends applied for a Growth Grant in December 2013. Their application recapped their successes over the past 18 months and identified eight areas of research that would offer the most significant growth for the business over the next three years.

It was made clear to Callaghan that Trends' R&D was largely non-technical in nature. Rather, it was aimed at optimising the commercial viability of the existing platform by using existing technologies to develop subscription and pricing models. Despite the non-scientific nature of Trends' proposed R&D, Callaghan nonetheless approved their grant.

When Trends sought reimbursement for their expenditure on R&D as per the terms of the Growth Grant funding agreement, Callaghan sought further information from Trends with regard to the amounts claimed. Trends complied, but Callaghan still required further information and appointed an external auditor to undertake an investigation of Trends' compliance with the funding agreement.

The auditor's report advised Callaghan that *"Trends may have intentionally set out to mislead Callaghan to obtain funds to keep its business afloat financially"*. Specific concerns included:

- R&D labour expenses were overstated by approximately 76%
- inaccurate recording of other expenses claimed as R&D, and
- lack of appropriate accounting and documentation to support their claim.

For these reasons, Callaghan terminated Trends' Growth Grant in April 2015. The issue before the Court was whether Callaghan Innovation was within their rights to terminate the funding agreement.

The High Court found Callaghan's assessment of Trends' application to be too narrow. Callaghan only considered the business eligibility requirements and ignored their duty to assess applicants against the definition of eligible R&D activities. Nevertheless, the High Court ultimately found that Callaghan had acted in accordance with their statutory obligations as Trends had breached their obligation to keep sufficient records.

Implications for record-keeping

The Court noted the following concerns around documentation:

- The Court gave no weight to, and discredited, Trends' R&D cost allocation spreadsheet, as it had been created **retrospectively** and its provenance was unexplained. The Court ruled, in the absence of any contemporaneous source documents to support apportionments, later reconciliations cannot be relied upon.
- Trends claimed other expenses directly in proportion to the labour claimed as eligible R&D without any contemporaneous records detailing either the project or the expenses incurred. The Court agreed with the auditor's opinion, finding that this claim was simply "unbelievable".
- The Court noted "[Trends] *were simply carrying on their normal tasks as there was otherwise no contemporaneous evidence to suggest they were carrying out eligible R&D*".

A key outcome from the Trends case is that the burden of proof will lie with the applicant to separate R&D from business-as-usual expenditure adequately. Under the new R&D tax credit regime, businesses must be able to contemporaneously document that their R&D activities were conducted through a systematic approach that resolves scientific or technological uncertainty, with the material purpose of creating something new.

Practical tips and your next steps

Due to the new regime's tax-specific definition of R&D and contemporaneous documentation requirements, it is critical to be prepared well in advance of submitting your claim. Closer collaboration between technical and finance teams will be required to effectively transition into the new regime. Teams should start collaborating on the following:

- understanding how the new definition of R&D affects the eligibility of existing R&D activities
- reviewing existing documentation processes to see whether adequate information is being captured to evidence eligible R&D activities, and expenditure.

Businesses should consider the following summary for a smoother transition into the new R&D tax incentives:

1. Some of the documents needed will exist outside the business' current accounting systems. Hence, a starting point for many businesses is ensuring a level of integration across their accounting and knowledge management systems. This would allow expenditure on R&D activities to be linked with the purpose of the R&D in a timely manner, rather than having it apportioned retrospectively.
2. For software developers, as technology can advance so rapidly, it is particularly important that you keep contemporaneous records demonstrating your investigation of the state of knowledge at the time you undertook the activities for which you are claiming the R&D tax credit.
3. If your business contracts out R&D to a third party, you want to consider amending or inserting contractual requirements to ensure total eligible expenditure for each eligible project is documented and identified and to ensure that you are the principal and have the sole control with respect to the core R&D activity.
4. For joint ventures and partnerships, it is important to clarify the rights and obligations of all parties to the resulting R&D. Failure to do so may mean no party is eligible to claim.
5. A tax loss entity that is eligible for the R&D tax loss credit (cash out) will also be eligible to claim limited refundability under the R&D tax credit concurrently in the same 2019/20 income year. What will be claimable as eligible R&D under each scheme will differ somewhat as there are differing definitions of R&D.

Please contact our specialist R&D incentives team if you need help understanding the new rules or if you have any queries about transitioning into the new regime.

Get in touch

Anand Reddy
Partner
T: +64 9 355 8371
E: anand.s.reddy@pwc.com

Jill Somerfield
Partner
T: +64 9 355 8463
E: jill.l.somerfield@pwc.com

Nadine Williams
Director
T: +64 21 846 464
E: nadine.williams@pwc.com

Sandy Lau
Director
T: +64 4 462 7523
E: sandy.m.lau@pwc.com

© 2019 PricewaterhouseCoopers New Zealand. All rights reserved. 'PwC' and 'PricewaterhouseCoopers' refer to the New Zealand member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.