Tax Tips Alert October 2018

Research & development tax credits: Latest tax bill introduces new regime

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The Taxation (Research and Development Tax Credits) Bill proposes to introduce a research and development tax credit (R&D tax credit) to incentivise businesses to perform research and development (R&D) in New Zealand. The Bill is expected to be enacted mid-2019 with the tax credit applying from the 2019-20 income year.

The draft legislation follows the consultation document Fuelling Innovation to Transform our Economy: A Discussion Paper on a Research and Development Tax Incentive for New Zealand, which was released earlier this year (see our May 2018 issue of Tax Tips for further details).

Key design features of the proposed R&D tax credit

Following consultation, changes have been made to the design of the tax credit to ensure the tax credit is effective in incentivising businesses to undertake more R&D. The key features of the proposed tax credit are:

- credit rate of 15% on eligible expenditure
- $120 million cap on eligible expenditure
- minimum R&D expenditure threshold of $50,000 per year
- limited form of refunds for the first year of the scheme that will mirror the current R&D tax loss cash out scheme (a more comprehensive policy will be in place for the second year of the scheme)
- the definition of R&D is intended to ensure the credit can be accessed more easily across all sectors
- all types of businesses are eligible regardless of legal form (some specific entities are excluded)
- the ownership of any resulting intellectual property does not need to be held in New Zealand if the business can use the results, and
- from the 2020-21 income year, businesses will need to obtain in-year approval from Inland Revenue.

The proposed tax credit presents opportunities for businesses who undertake R&D, especially for those who are more established and engaged in non-software R&D.

However, there are many design features and practical issues that businesses will need to consider when assessing the cash benefit of the tax credit.

R&D definition - still too restrictive

To access the proposed tax credit, a business must be carrying on a "core research and development activity". A core activity is an activity that:

- is conducted using a systematic approach
- has the purpose of creating something new, and
- has the purpose of resolving scientific or technological uncertainty.

The Government and Officials responded to feedback and inserted a requirement to use a "systematic approach" to resolve "scientific or technological uncertainty". This replaces the requirement to use "scientific methods". This is a positive change as many R&D activities do not use "scientific methods".

However, in our view, the definition still remains narrow and could exclude a range of software R&D activities.

The Commentary on the Bill states that "the Government's goal is to increase the amount of business R&D undertaken in New Zealand." The Discussion Document states that software R&D has become increasingly important to the New Zealand economy, accounting for approximately 40-50% of the value of the Callaghan Innovation Growth Grants (Growth Grant) in the last three years.

It would be inconsistent with the Government's stated policy objectives if the definition and practical application of the definition of R&D for the tax credit was too narrow, resulting in the cash benefit of the tax credit being significantly lower than the Growth Grant.

We understand that Officials want to ensure the proposed tax credit is fiscally sustainable. To ensure that the tax credit is only available for firms that are conducting actual R&D, the definition of R&D is therefore not overly broad. However, we question whether the current proposed definition is still too restrictive. In particular, this is evident in the area of software development as it is unclear whether software can fit into the current definition of "R&D activity" e.g. what is considered to be "scientific or technological uncertainty" in the context of software development.

We believe that Officials still have more work to do in this area. Businesses require certainty, especially when planning and budgeting for R&D programmes that can span several years. It is critical that Officials provide more clarity as to what falls within the R&D definition. Businesses need some level of certainty when planning for their R&D spending and when assessing the significant compliance costs associated with applying for the tax credit.

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What is eligible expenditure?

If a business is carrying on a core R&D activity, it can claim a tax credit for eligible expenditure.

Eligible expenditure is generally all expenditure that a business incurs in conducting the R&D activity e.g. employee salaries, expenditure on consumables used, depreciation loss on assets used in R&D.

Certain expenditure is specifically excluded, including internal software development that results in software that performs common internal business functions (such as payroll, HR, or accounting). Other internal software development expenditure (i.e. software developed for in-house use) is only eligible up to a maximum of $3 million.

If a business contracts out the R&D activity to a third party, the expenditure is still eligible but the amount is reduced by 20%.

There is also an apportionment rule on R&D activities that occur in the course of commercial production. In this case, expenditure on the activities is only eligible if it would not have been incurred in the absence of a person's R&D activities - this is a variation of the originally proposed "dual purpose" test (i.e. the expenditure is only eligible if it was incurred "but for" the R&D activity).

R&D tax credits are only available for expenditure on R&D that occurs in New Zealand. However, up to 10% of an R&D claim can be for eligible expenditure incurred on R&D activities that are performed outside of New Zealand.

It will be important for businesses to consider how they are currently capturing R&D expenditure and whether those records reflect the expenditure accurately. Records will be critical in helping a business calculate the amount of tax credit it is entitled to, especially in light of the list of excluded expenditure and the apportionment rule that applies for R&D that is conducted as part of commercial production. This will be especially important for the more established businesses that are likely to undertake continuous R&D on their current products and processes.

Callaghan Growth Grants

The Government has extended the transitional period for businesses that receive Callaghan Growth Grants. Businesses with an active Growth Grant on 1 April 2019 will have an automatic two-year extension allowing them to remain on their Growth Grant up to 31 March 2021 at the latest. Those with expiring contracts can apply for renewal provided they meet the relevant criteria.

Businesses who remain on the Growth Grants will not be eligible for the R&D tax credit. This also captures R&D expenditure for which they have not received a Growth Grant.

Businesses will need to assess which regime is more beneficial to utilise before the Growth Grants are phased out. For loss-making companies, it is probably better to stay on the Growth Grant until March 2021 as:

- The Growth Grant is provided at a rate of 20% on eligible R&D compared to 15% for the tax credit.
- The refundability of the tax credit is limited to $255,000 per annum.
- The Growth Grant funding is provided quarterly.
- At this stage, the definition of R&D for Growth Grants is broader - this is a key issue for software R&D.
- The Growth Grant definition is based on the NZ IAS 38 definitions of "research" and "development", which reduces compliance costs. The tax credit has a different definition of R&D and, therefore, different record-keeping requirements to evidence the link between R&D activities and expenditure.

Refundability

It is great to see the Government recognising the need for refundability. This is particularly important for businesses in the start-up or growth phase as cash flow is critical to the success of those businesses.

Under the proposed rules, a company may receive a maximum of $255,000 refundable R&D tax credits (equivalent of $1.7 million of eligible expenditure) if the company is eligible for the R&D tax loss cash out regime i.e. it needs to meet the wage intensity criteria.

Any tax credits that have not been refunded may be carried forward to the next income year (provided shareholder continuity is met).

A company that cashes out its losses under the R&D tax loss cash out regime is also able to claim R&D tax credits in the same income year.

While this is a positive move, the refundability mechanism is still very limited. The cap of eligible expenditure combined with the general requirement of shareholder continuity could mean that many start-ups may still not benefit from the tax credit. They will be effectively "trapped" as a result of capital raising, causing a breach of shareholder continuity.

We note that deductions for R&D expenditure can be deferred. The tax policy reason for this tax concession for loss-making R&D businesses is that, if R&D expenditure is deducted in the year expenditure is incurred, this would result in a tax loss that could only be utilised if shareholder continuity is maintained. If shareholder continuity is not maintained due to capital raising rounds, tax losses would be forfeited and these R&D costs are effectively non-deductible. In our view, the tax policy reasons for the R&D deferral rules also apply to the tax credit, and therefore the requirement to maintain shareholder continuity to carry forward R&D tax credits needs further assessment.

The Government will undertake further work to harmonise the two regimes, with potential changes effective from 1 April 2020. Refundability is critical in ensuring the tax credit is also effective for growing businesses.

It is also worth noting that there are different definitions of R&D for the R&D tax loss cash out and R&D tax credit rules. In our view, if the R&D tax loss cash out regime remains after 1 April 2020, it is likely that the definition of R&D will be aligned with the R&D tax credit definition of R&D. This would be a negative outcome for businesses undertaking software R&D activities as the definition of R&D would be narrower.

Under the proposed rules, a company may receive a maximum of $255,000 refundable R&D tax credits

Administration of the credits and compliance

Unsurprisingly, there are administrative and compliance requirements for businesses claiming the tax credit. It will be important for businesses to gain an early understanding of the requirements to ensure that appropriate records are kept to support the claim and that the appropriate processes are conducted.

The onus will be on taxpayers to keep sufficient records to support their claim for an R&D tax credit. It is understood that the documentation must be sufficiently detailed, which will result in more compliance costs for taxpayers.

Businesses claiming an R&D tax credit must also file an R&D supplementary return within 30 days of filing their tax return for the relevant income year. The rationale behind this is to provide information to substantiate their claim for an R&D credit. Again, this will result in increased compliance costs for taxpayers. The Bill includes proposals to limit a business's ability to retrospectively claim an R&D tax credit. Once filed, an R&D credit claim can only be amended once and must be made within two years of the date on which a person's income tax return is due for the relevant year.

From the 2020-21 income year onwards, businesses wanting to receive a tax credit will be required to seek approval that their R&D activities meet certain criteria in the year they are undertaking or contracting the R&D activities (in-year approval).

The Bill proposes that the Commissioner can publish the name of each taxpayer, and their eligible R&D expenditure amount in dollar bands, two years after the end of the tax year to which an R&D tax credit claim relates. This is intended to provide transparency as to how the R&D tax credit regime is operating. Callaghan Innovation currently publishes similar information in respect to their Growth Grants.

The compliance costs associated with an R&D tax credit claim can be significant for a business. The additional costs may be felt more acutely by emerging start-up companies that are likely to have limited resources to comply, and also by software developers if it is unclear which activities fall within the definition of R&D.

We are also concerned that a business is potentially required to apply a number of definitions to what is considered to be R&D for different regimes e.g. Callaghan Growth Grants, tax loss cash out regime, research and development deductions. This is inefficient. Each of the definitions will have a slightly different outcome as to what expenditure is considered to be related to R&D. This is confusing and complicated for businesses, which again adds to the compliance costs.

Key differences between the 2008 R&D tax credit and the proposed R&D tax credit

Businesses may be familiar with the 2008 R&D tax credit, which only applied for one year. While the aim of the current proposals is similar in nature (to encourage more R&D spending in New Zealand), there are some key differences between the two regimes such as:

- limited refundability under the proposed tax credit versus full refundability
- definition of "R&D activity" whereby the proposed definition is intended to be more "broad"
- more activities are prevented from being "core R&D activities" as well as the inclusion of a list of activities that are also excluded from being "supporting activities" (including certain internal software development)
- specific apportionment rule for R&D expenditure relating to R&D activities that are undertaken in the course of commercial production
- there is no explicit requirement for the business to bear financial risk associated with the R&D activities
- the ownership and use requirements of the R&D results are more inclusive under the proposed tax credit e.g. results can be owned by another entity in the corporate group
- administration differences including in-year approvals from the 2020-21 income year and deadlines for filing and amending assessments.

Questions for impacted businesses

1. Questions to consider if you are an established business

- Is your business undertaking activities that are looking to solve a scientific or technological uncertainty?
- Do you undertake continuous R&D on your products?
- How is your system currently capturing R&D expenditure?
- Do you undertake internal software development for your business?

2. Questions to consider if you are a business in the growth phase

- Is your business undertaking activities that are looking to solve a scientific or technological uncertainty?
- Should you continue to receive the Growth Grant until it is phased out or elect under the R&D tax credit regime?

General comments

We are pleased to see more support from the Government for R&D in New Zealand. However, we question whether the current definition included in the Bill is still too narrow, with the possibility of leaving a significant portion of software development (which makes up a large portion of R&D) outside the regime. Further work is needed to ensure these innovative businesses are not left out in the cold especially with the Callaghan Growth Grants being phased out.

It is important to note that, while the tax credit is intended to apply to a wider range of businesses, the reality is that there will be winners and losers. As the Bill currently stands, our view is that emerging start-up businesses and those that undertake software development may have difficulty in benefiting from the proposed tax credit.

However, the proposed tax credit does appear to provide wider opportunities for more established businesses, especially those that are engaged in non-software R&D (in light of our question around software generally and the internal software exclusion/cap), as they are more likely to be able to fully utilise the tax credit in reducing taxable income.

We expect the Bill to be referred to the Finance and Expenditure Committee in November 2018. We understand that Officials are working to a tight timetable and therefore we expect that the draft Bill will be referred as soon as possible with submissions likely to be due by mid-December 2018 or late January 2019.

Please contact your usual PwC adviser if you would like to discuss the potential impact of the Bill on your business.

Key dates

- Bill introduced: 25 October 2018
- Submissions to FEC - likely to be due in mid-December or late January
- The Royal assent – mid-2019
- Start date: From the 2019-20 income year

Get in touch

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

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

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

Anna Keogh
Senior Associate
T: +64 4 462 7032
E: anna.b.keogh@nz.pwc.com