Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: R&D tax credits: changes to design

Date:	4 April 2007	**Priority:**	Medium
Security Level:		**Report No:**	T2007/496 PAD2007/84

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	5 April 2007
Minister of Revenue	Agree to recommendations	5 April 2007

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
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[information deleted in order to protect the privacy of natural persons, including deceased people]		

4 April 2007

Minister of Finance
Minister of Revenue

R&D tax credits: changes to design

Executive summary

R&D tax credit legislation is currently being drafted. The drafters have identified a number of problems and omissions in the policy as originally developed. We are now recommending a number of minor changes and additions. These changes are consistent with the broad recommendations agreed by Cabinet.

The additions we are recommending are:

- Establishing criteria for the exercise of the ministerial power to waive the internal-use software cap, to reduce the possibility of courts imposing unintended criteria as part of a judicial review. These criteria will be based on the concept of national interest.
- The R&D tax credit will be available for capitalised expenditure incurred in creating depreciable property, where the expenditure would be deductible in the year it is incurred if it were recognised as an expense for financial reporting purposes.
- Any expenditure of an industry research co-operative funded by Crown Research Institutes, tertiary institutions, District Health Boards, associates of those entities, or by entities not in business in New Zealand, will not be eligible for the R&D credit.
- Eligible expenditure of an industry research co-operative must relate to the business of the New Zealand businesses that contribute the funding.

The changes we are recommending are:

- That any associate or controlled subsidiary of a Crown Research Institute, tertiary institution, or District Health Board be ineligible for the credit.

- That there be more comprehensive grouping provisions for the purposes of the internal-use software cap. This is to prevent the splitting of expenditure by the use of subsidiaries or other controlled entities. The grouping provisions will be based on control, and be in line with the consolidation requirements for financial reporting purposes.
- That there be changes to the due dates for filing a detailed tax credit claim. The due date for taxpayers outside an R&D group will be the same as the due date for an income tax return. For taxpayers who are part of an R&D group, the due date should be the last income tax return due date of all the members in the group. This will simplify the legislation, simplify administration and reduce the risk of taxpayers incurring penalties or use-of-money interest.

Recommended action

We recommend that you:

(a) Agree that criteria, based on national interest, be provided for the exercise of the ministerial power to waive the internal-use software R&D expenditure cap.

Agreed / Not agreed Agreed / Not agreed

(b) Agree that the credit apply when R&D capital expenditure incurred in creating depreciable property would be deductible in the year it is incurred if it were recognised as an expense for financial reporting purposes.

Agreed / Not agreed Agreed / Not agreed

(c) Agree that expenditure of an industry research co-operative funded by Crown Research Institutes, tertiary institutions, District Health Boards, associates of those entities, or by entities not in business in New Zealand, will not be eligible for the R&D credit.

Agreed / Not agreed Agreed / Not agreed

(d) Agree that eligible expenditure of an industry research co-operative must relate to the business of the New Zealand businesses that contribute the funding.

Agreed / Not agreed Agreed / Not agreed

(e) Agree that associates and controlled subsidiaries of Crown Research Institutes, tertiary institutions and District Health Boards, rather than just wholly-owned subsidiaries of those entities, be excluded from eligibility for the credit.

Agreed / Not agreed Agreed / Not agreed

(f) Agree that entities under common control be required to group for the purposes of calculating internal-use software R&D expenditure, and that this replace the specific anti-avoidance rule previously recommended.

Agreed / Not agreed Agreed / Not agreed

(g) Agree that due dates for filing a detailed R&D credit document will be aligned with the due date for the claimant's income tax return or, in the case of a group, the last income tax return due date of all the members in the group.

Agreed / Not agreed Agreed / Not agreed

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for Secretary to the Treasury

Keith Taylor
Policy Manager, Inland Revenue

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. A number of problems have been identified following initial drafts of the R&D tax credit legislation. This report contains several changes to recommendations made in previous reports to you (PAD2007/30, PAD2007/31, PAD2007/32, PAD2007/57), and some new recommendations, to resolve these problems. We request that you agree to these changes and new recommendations. This will allow us to finalise drafting of the tax credit rules for the May Bill.

Criteria for Ministerial discretion to waive the software cap

2. The R&D credit rules include a cap on the amount of credit that may be claimed for expenditure on internal-use software R&D that is a core R&D activity. The cap is imposed as a result of negative overseas experience of reclassification of routine back-office software development as R&D, which was unintended by policymakers. In the Cabinet report (CBC 07 35) and the software cap report (PAD2007/57), it was recommended that the Minister of Finance have the power to waive the cap in circumstances in which it is clear that there is genuine R&D.

3. Our drafters have advised that criteria need to be provided in the legislation to allow for the clear exercise of the ministerial power. If criteria are not provided, the courts are likely to impose them in cases of judicial review, and this could lead to unintended consequences. Drafters have also advised that a criterion that an activity is clearly R&D, that it is not a "borderline" case, will not be effective because this will amount to the same thing as saying that the R&D complies with the definition of an eligible activity, which would render the cap useless.

4. We have now provided indicative criteria to our drafters that are based on national interest. These are based on precedents in the Australian R&D tax incentive and export market development grants, and in New Zealand market development grants.

5. The indicative criteria are that:

- the R&D will be exploited mainly for the benefit of the New Zealand economy;
- New Zealand will derive a substantial net benefit from the R&D; and
- the claimant has a commitment to retain the value of their business in New Zealand.

6. Specific tests for the criteria could include the following:

- Whether the profits or gains resulting from the exploitation of a particular result of an R&D activity are commensurate with the amount expended in the carrying on of that activity in New Zealand. This would involve consideration of the value of the result of the activity, the profits or gains to non-residents accruing directly

from the exploitation of the result of the activity, the amounts expended in the carrying on of the activity inside and outside New Zealand respectively, and any other relevant matters.

- Whether the R&D will generate substantial net economic benefits for New Zealand, such as increased Gross Domestic Product, Gross National Product and employment, or substantial positive publicity (such as defining New Zealand as a world-leader in a particular area).
- Whether the entity is majority-owned by New Zealand residents, or whether the entity habitually reinvests a high proportion of earnings in its New Zealand operations.

Changes to the rules to allow the credit for some capitalised expenditure

7. In the R&D credit report (PAD2007/31), we wrote that eligible R&D expenditure must be deductible in the year it is incurred in order to attract the credit.

8. However, this means that R&D expenditure that is capitalised for accounting may not attract the credit whereas R&D that is expensed for accounting will. R&D that is expensed for accounting is immediately deductible for tax. Capitalised R&D expenditure may create depreciable property but the depreciation is unlikely to be eligible for the credit because the property is not used in conducting R&D but is a product of the R&D.

9. We therefore propose that the credit apply when R&D capital expenditure incurred in creating depreciable property would be deductible in the year it is incurred if it were recognised as an expense for financial reporting purposes.

Changes to the rules for industry research co-operatives

10. Industry research co-operatives (IRCs) are not required to meet the "in business" test to be eligible for an R&D tax credit. This exemption recognises the important role that IRCs play in business R&D.

11. However, without adequate safeguards the exemption also creates possibilities for otherwise ineligible entities to claim R&D tax credits for their expenditure. For example, a foreign business could form an IRC in New Zealand in conjunction with any New Zealand business and then receive the benefit of tax credits through the IRC.

12. We recommend two measures to remove such possibilities. Firstly, we propose that any expenditure by an IRC funded by Crown Research Institutes, tertiary institutions, District Health Boards, associates of those entities, or by entities not in business in New Zealand, be ineligible for the credit. And secondly, we propose that the eligible expenditure of IRCs must relate to the businesses of the New Zealand businesses that provide the funding. These

measures will not prevent non-resident businesses from receiving the credit, but the non-resident parent will need to form a New Zealand business to commission the R&D.

Subsidiaries of Crown Research Institutes, tertiary institutions and District Health Boards

13. At the joint-ministers meeting on 20 February, at which the R&D credit was discussed, ministers indicated that they wished to exclude from eligibility for the credit: Crown Research Institutes, tertiary institutions, District Health Boards, and 50%-owned subsidiaries of those entities.

14. In the cabinet paper (CBC 07 35), at paragraph 43, you recommended that Crown Research Institutes, tertiary institutions, District Health Boards and "their associates and controlled subsidiaries" not be eligible for the R&D credit. However, as the result of an oversight, the annex to the paper, which was referred to in the recommendations, referred only to the exclusion of wholly-owned subsidiaries. The body of the report, rather than the annex, reflects our understanding of ministers' earlier decisions.

15. We therefore recommend that Crown Research Institutes, tertiary institutions, District Health Boards, and associates and controlled subsidiaries of those entities, not be eligible for the credit.

Changes to grouping rules for the software cap

16. In the original software cap report (PAD2007/57), we noted that taxpayers would need to be grouped for the purposes of the cap, to prevent taxpayers using multiple subsidiaries to split expenditure into small parcels less than the cap. Originally, we proposed using companies plus their 66%-or-greater subsidiaries, in line with the grouping rules for tax losses, and supplementing this with a specific anti-avoidance provision.

17. Our drafters advised that the specific anti-avoidance provision was unlikely to be any more effective than the existing general anti-avoidance provision. We are not confident that the general anti-avoidance provision is sufficient. In particular, we can construct arrangements with a legitimate business purpose which would be unlikely to trigger the general anti-avoidance provision but would still provide opportunities to split spending to obtain the benefits of credits for expenditure exceeding the cap.

18. We now recommend that a more general grouping rule be used to prevent avoidance. The new rule would see an entity grouped with other entities under common control which also undertake internal-use software R&D. This rule would apply to all types of entity, not just companies. The new rule involves some additional compliance, but mirrors the consolidation rule for financial reporting, so should not involve much additional effort for most entities.

Changes to filing due dates

19. In the original delivery mechanism report, we recommended that the taxpayer have six to eighteen months (depending on balance date) to file a detailed claim document, being the same length of time as a taxpayer with a tax agent and all applicable filing extensions.

20. We now consider that for people who are not grouped for the purposes of R&D credits, and who are not partners in a partnership which elects to file as a group, the due date for the detailed claim document be the same as the due date for the income tax return of the claimant. For people who are grouped or who are partners in a partnership which elects, the due date should be the last income tax return due date of the members of the group. In practice, this means taxpayers will have four to eighteen months to file the document.

21. This change is recommended because it simplifies the legislation and the administration of the credit, and is a safeguard against taxpayers incurring use-of-money interest or penalties because of a claim document being filed after an income tax return due date.