21 December 2007

Special report from the
Policy Advice Division of Inland Revenue

Research and development tax credit legislation

Legislation introducing a tax credit for eligible research and development activities has been enacted. The R&D legislation appears only in the Income Tax Act 2007 (as it comes into effect from the 2008-09 income year) and the Tax Administration Act 1994. As the R&D provisions in the Taxation (Business Taxation and Remedial Matters) Act 2007 have been rewritten and restructured, this report is intended to provide assistance to potential claimants and their advisors in understanding the scheme of the new legislation. A more detailed account will be released in a *Taxation Information Bulletin* to be published in 2008.

Draft guidelines on the R&D tax credit have also been released by Inland Revenue for consultation. These can be found at http://www.ird.govt.nz/public-consultation/.

Introduction

New tax rules provide a tax credit for New Zealand businesses that perform R&D on their own behalf, or that commission others to perform R&D for them, provided the R&D is performed predominantly in New Zealand. The definition of R&D is in line with that in comparable jurisdictions where it has proved to be sustainable. It applies not just to white-coat research but to the development of new or improved products or processes in a variety of industries.

R&D expenditure that is eligible for the credit includes the cost of employee remuneration, training and travel of employees conducting R&D, depreciation of tangible property, consumables, certain overheads and payments to entities conducting R&D on behalf of the claimant.

The credit applies at the rate of 15 percent of eligible expenditure in a year. It is claimed in the annual income tax return, offsetting the tax liability of the claimant. Surplus credits are refundable. This means that businesses that have a tax loss or have only tax-exempt income receive the credits in cash.

Background

The government first raised the option of introducing an R&D tax credit in the Business Tax Review discussion document, released in July 2006. This was followed by an issues paper in November 2006 which proposed general eligibility criteria, a definition of R&D and a list of eligible expenditure. The government announced the introduction of the credit as part of the Business Tax Reform package in Budget 2007.

R&D tax incentives are common overseas. The rationale for them is that there is under-investment by businesses in R&D because the investing firm does not capture all of the benefits of the investment. There are likely to be spill-over benefits to New Zealand when businesses invest in R&D and providing an R&D tax credit will encourage firms to invest more in R&D. There is a body of international evidence that suggests that tax incentives have been effective at encouraging business R&D.

Key features

Eligibility for the credit (sections LH 1 to LH 3 and LH 7 of the Income Tax Act 2007)

To be eligible, a claimant must be in business in New Zealand. Non-residents must be in business in New Zealand through a fixed establishment in New Zealand. The expenditure for which a claim is made must relate to that business or an intended business of the claimant. An exception to the requirement to be in business exists for industry research co-operatives which have special rules.

Crown Research Institutes, tertiary institutions, and District Health Boards, their associates and entities under the control of any combination of them, are not eligible for the credit. R&D performed by a business in partnership with such an entity is also not eligible.

Claimants must bear the financial risk associated with the R&D project, have control over the work and effectively own the project results. When R&D is outsourced, this distinguishes the person who commissions the R&D (who is eligible for the credit) from the person who merely performs the R&D on behalf of someone else. The performer is not eligible for the credit, and the incentive is provided to the party making R&D investment decisions.

The claimant must also spend at least $20,000 of eligible expenditure in the year a claim is made unless the R&D services are purchased from an unassociated listed research provider. These are entities that perform research for others on a commercial basis.

The business must conduct R&D activities as these are defined in section LH 7. They must be systematic, investigative and experimental activities that either seek to advance science or technology through the resolution of scientific or technological uncertainty or that involve an appreciable element of novelty. In either case the activities must be directed at acquiring new knowledge or creating new or improved products or processes. These are "SIE" R&D activities. Certain activities are excluded, as they are in other jurisdictions, generally to delineate more clearly the boundary between innovative and routine activity.

Activities that support SIE activities, but that are not systematic, investigative and experimental in themselves, are eligible if they are wholly or mainly for the purpose of the SIE activities, and are required for, and integral to, them.

Rate of credit (section LH 4)

The credit applies at the rate of 15 percent of eligible expenditure.

Eligible expenditure (section LH 3(1)(e), LH 5, LH 6, LH 8, Schedule 21)

Expenditure is eligible only if it is of a type listed in Schedule 21 Part A and not listed in Part B. The expenditure must also generally be deductible in the year it is incurred, although there are exceptions from this requirement for certain expenditure.

Eligible expenditure includes the cost of employee remuneration, training and travel; depreciation of tangible assets used in conducting R&D; certain overhead costs; consumables and payments to third parties for R&D performed on behalf of the claimant.

Ineligible expenditure is listed in Schedule 21 Part B. The main items are interest; loss on sale or write-off of depreciable property; the cost of acquiring core technology (technology used as a basis for further R&D); expenditure funded from a government grant or the required co-funding; expenditure on intangible assets and professional fees in determining eligibility.

Expenditure on R&D done overseas is not eligible unless it part of a project based in New Zealand and is 10 percent or less of the eligible expenditure incurred on the project in New Zealand.

Cap on internal software development (sections LH 9 to LH 13, LH 17)

There is a cap of $3 million on eligible expenditure where the R&D activity is "internal software development". Internal software development includes the development of software without the main purpose of sale to non-associates, as well as the development of software which is used in administration of the claimant's business or to provide its customers with services other than the use of its computer technology or software. The cap applies whether the activity is an "SIE" activity or a support activity. The level of the cap can be increased by the Minister of Finance when it is in the national interest. Claimants under common control that undertake internal software development will be required to calculate their expenditure as a group and to allocate the cap between members.

Administrative procedures (sections OB 4(3)(eb), OB 7C, OK 2(3)(cb), OK 4B, OP 5(2)(bb), OP 7(3)(fb), OP 11B Income Tax Act 2007; sections 3(1), 22(2) and (7), 33A(2), 43A(2), 68D and 68E, 91AAP, 91C(4), 108(1B), 108B(3)(d), 113(1), 113D, 141(7C) and (7D) Tax Administration Act 1994)

Businesses will claim the tax credit in an income tax return. They will work out their liability for tax in the normal way, and then subtract the amount of the credit. Where the amount of the credit exceeds the tax liability, the balance is used to reduce other tax liabilities, or is refundable in cash.

The credit will reduce residual income tax, which will reduce provisional tax liability, allowing businesses that pay provisional tax to receive the benefit of the credit closer to the time they incur R&D expenditure. This reduction will be immediate for people who estimate provisional tax, but delayed for people who use the "uplift" method for calculating provisional tax.

Companies and Māori authorities will receive a credit in their imputation credit accounts for an income tax liability that is satisfied by way of the credit.

To be eligible for the credit, a business must provide – in addition to the income tax return – a detailed statement of R&D activities and expenditure. This is collected for administrative, including evaluation, purposes.

From a date to be appointed by the Governor-General by Order in Council (but no later than 1 April 2010), a potential claimant will be able to apply to the Commissioner to determine whether an activity is R&D, whether a person is eligible for the credit, and whether expenditure is eligible for the credit. Binding rulings are not available on these matters.

There are a number of other minor and consequential amendments to the Tax Administration Act 1994 relating to the new tax credit.

Application date

The credit will apply from the 2008–09 income year.

Detailed analysis

Unless otherwise indicated, examples assume a standard income year and section references are to the Income Tax Act 2007.

Who can claim the credit (section LH 1)

In business in New Zealand (subsection (1))

To be eligible, a claimant must carry on business in New Zealand. Non-residents must carry on business in New Zealand through a fixed establishment.

This requires activities to be a profession, trade, manufacture or undertaking with an intention to make a pecuniary profit. All types of New Zealand businesses are eligible, whether incorporated or not, including businesses that earn only exempt income.

In the case of partnerships, the business test is applied at the partnership level, rather than to individual partners. (See discussion below on section LH 3(3)(a)).

An exception exists for industry research co-operatives which do not need to be in business. However, there is a requirement that the members of the co-operative be in business. That requirement is discussed further below in relation to section LH 3 and other requirements in relation to the co-operatives are discussed below in relation to section LH 16.

Crown Research Institutes, tertiary institutions and District Health Boards (subsection (2))

Crown Research Institutes, tertiary institutions, and District Health Boards and their associates, and entities controlled by any combination of those entities, are not eligible for the credit. These entities are defined in section YA 1 through cross-references to their enabling Acts. Crown Research Institutes are defined in section 12 of the Crown Research Institutes Act 1992. A tertiary institution is a body established under section 162 of the Education Act 1989. A District Health Board is a board established under section 19 of the New Zealand Public Health and Disability Act 2000.

Association is determined using the 1988 version provisions (section YB 20(2)(ob)). However, the tripartite test does not apply for the purpose of determining who is associated under section LH 1(2) (section YB 4(3B)). R&D performed by a person in partnership with one of these entities is also not eligible, see discussion below on section LH 3(2).

Example

ACo is 25 percent owned by a Crown Research Institute, 26 percent owned by a trust whose beneficiary is a tertiary institution, and 49 percent is owned by a private firm BCo. ACo is not an eligible person.

BCo purchases 5 percent of the shares from the trust and thereby takes a controlling share in ACo which it later sells to a tertiary institution. ACo is an eligible person for the period that BCo has a controlling interest.

Entitlement to the credit (section LH 2)

Section LH 2(2) provides for the tax credit and section LH 2(1) sets out the broad requirements for entitlement to the credit.

To claim the credit, a claimant must, for a year or part-year:

- be an eligible person under section LH 1(1) – that is, carry on business in New Zealand;
- meet the requirements in section LH 3 – in essence, do R&D related to the business, have the requisite control of the R&D project and effective ownership of the results and incur eligible expenditure or depreciation on the R&D that is tax deductible in the year;
- perform the R&D activities on its own behalf and not on behalf of another person;
- incur $20,000 or more (or a pro-rated amount) of eligible expenditure or depreciation unless the R&D is outsourced to an unassociated listed research provider;
- file a detailed R&D statement in relation to that year by a due date (new section 68D or 68E of the Tax Administration Act 1994).

The amount of the credit is set out in section LH 4 at 15 percent of "eligible expenditure".

Minimum expenditure threshold (subsections (3) and (4))

A claimant must have eligible expenditure (as calculated under section LH 4) of at least $20,000 to qualify for the credit. This is pro-rated when a person is eligible under section LH 1(1) for part of a year only (for example, when the person carries on business for part of a year only).

An exception to the minimum threshold exists if the R&D services are outsourced to an unassociated listed research provider.

If a provider is delisted, payments under an arrangement entered into when the provider was still listed are not subject to the minimum threshold. The claimant and the provider must not have been associated at the time the arrangement was entered into. This is to ensure that the claimant will not be subject to the minimum threshold if the provider is delisted subsequent to the parties agreeing on the arrangement for services.

The requirements to be a listed research provider are set out in section LH 15.

Example

In 2010, ACo incurs $10,000 of eligible expenditure on R&D performed inhouse. This is not eligible for the credit.

In 2010, BCo spends $10,000 contracting an unassociated listed research provider to do its R&D. The part of the $10,000 that is eligible expenditure will not be subject to the minimum threshold.

In 2010, CCo spends $100,000 on eligible expenditure undertaking its own R&D. This expenditure exceeds the minimum threshold.

Expenditure treated as incurred in a year (subsection (5))

Expenditure that is deductible in a year but added back as income under the timing rules in Part CH at the end of the year is not eligible for the credit in that year. It becomes eligible for the credit in a subsequent year when it ceases to be added back. Because the expenditure is not actually incurred in that subsequent year, it needs to be treated as incurred in that year to satisfy the provisions listed. This applies to the opening value of trading stock, unexpired amounts of expenditure under section DB 50 and unpaid employment income under section DB 51.

It applies also to overseas eligible expenditure that is incurred in one year and is eligible for the credit in a subsequent year (subsection (5)(d)).

Treatment of credits (subsection (6))

The credit is applied to satisfy a claimant's tax liability for as far as the credit extends. Surplus credits are applied, in turn, to satisfy an income tax or provisional tax liability that is payable in relation to other years, or any amount due and payable under an Inland Revenue Act (such as GST, or PAYE). Any excess credits are refunded.

Eligibility requirements (section LH 3)

In order to claim the credit, the claimant must satisfy the following requirements which are listed in subsection (1).

R&D must be related to the business of the claimant (paragraph (a))

A claimant must perform on its own behalf, or have another person perform on its behalf, R&D related to the business of the claimant or an intended business of the claimant.

This means that there must be a connection or link between the R&D activity and the general area of the claimant's business. This requirement will generally be satisfied when the results of the activity (if successful) would have a direct and beneficial application in the claimant's business. Similarly, the requirement would be satisfied if the activity results in an extension of that business.

To show that the R&D relates to an intended business of the claimant, the claimant must have a reasonable expectation, at the time that the activity is carried out, to exploit the results commercially in an extension of its business or in a new business if the R&D is successful.

In the case of industry research co-operatives the R&D must be related to the business of an industry member. The requirements on industry research co-operatives and industry members are discussed below in relation to section LH 16.

Claimants must bear the risk, have control over the project and effectively own the results (paragraph (b) to (d))

Claimants must be able to show that they control the research and development activities, bear the financial risk associated with the project, and effectively own the project results.

The tests in section LH 3(1)(b) to (d) are intended to ensure that the tax credit goes to the party making R&D investment decisions – that is, the party deciding what R&D should be undertaken to enhance its business activity.

If R&D activities are subcontracted, the rules act to prevent double dipping. The credit goes to the party commissioning the R&D, and someone who performs the R&D on behalf of the other person is not eligible.

In some cases, no one will be eligible to claim a tax credit for the R&D activity, even when it is carried out in New Zealand, because it is being carried out on behalf of an ineligible person.

Parties to an unincorporated joint venture, or partners of a partnership (if the partnership consists of only eligible partners), can apply these tests as though the joint venture or partnership performed the R&D activity as an entity in its own right. See the discussion below on sections LH 3(3) and (4).

Controlling the R&D activity

Claimants must have control of the R&D activity. This means that they have the ability to:

- determine the R&D activities to be undertaken;
- decide on major changes of direction;
- stop an unproductive line of research;
- follow up on an unexpected result; and
- terminate the activities or project.

The control requirements can still be met if the R&D activity is contracted out to a provider who is responsible for the day-to-day management of the work. The commissioner of the research will be eligible for the credit as long as it meets the control requirements above.

This may mean that the claimant exercises that control at the beginning of an arrangement and is bound by it for the duration of the work. For example, a provider may only undertake a programme of work if the party commissioning it agrees to bind itself to finance the whole programme. In these situations the claimant is not considered to have given away control, but made choices in the contract in advance. Even then, the claimant should be entitled to check that the programme is being carried out and require the researcher to act according to the arrangement.

If a business contracts another entity to carry out the R&D activity on its behalf, and that entity subcontracts that work to a third party, the R&D activity is still done on behalf of the original commissioning business, not on behalf of the intermediary contractor.

It is possible to exercise control decisions before a project begins. For example, parties could agree what R&D will be undertaken before the work begins and what criteria should be used to determine whether a line of research is unproductive and should be terminated.

Where a major researcher determines a programme of research and actively seeks industry participants to fund the work, it may still be possible for the industry participants to meet the control requirements.

While the researcher may have independently formulated the R&D programme and control day-to-day management, it is subject to the agreement between the industry participants and the researcher. Essentially, the industry participants exercise joint control when they choose to participate and enter into the arrangement to fund the work programme.

A business's owners have the ultimate ability to control the activity by exercising their proprietary rights, but this does not undermine the demonstration of control of the activities by the business.

Financial risk

The claimant must bear the financial risk of the R&D activity.

If the R&D activity is outsourced, the claimant can be taken to be bearing the financial risk if it is required to pay for the activity to be carried out, regardless of the outcome of the activity. On the other hand, if a party receives payment for carrying out R&D regardless of the outcome of the activity, then it is unlikely to be bearing the financial risk in relation to those funds.

"At risk" contracting is where the contractor works on the basis that its fee is not payable unless it succeeds. In this situation, the party contracting out the work would not be eligible for the tax credit. The contractor may be eligible for the tax credit if it meets the eligibility requirements in its own right.

Businesses may want to reduce the financial risk of undertaking the R&D by finding another party to contribute to financing of the work. If they enter into an agreement to fund eligible R&D activity with another person, they may be eligible for the tax credit for their share of the expenditure. They are required to bear the financial risk in relation to their expenditure, not for all of the expenditure on the work.

The application of funds from donations to carry out R&D activities does not in itself mean that the claimant is not bearing the financial risk of carrying out the R&D activity. An expectation that the funds be applied for a particular purpose is not in itself fatal to the claim by the recipient that it bears the financial risk of doing the R&D.

Effective ownership of results

Effective ownership of the results of the R&D activity means that the claimant must have the ability to exploit the results for gain without further fee or payment. That is, the claimant must have gained the right to use the results of the activity in its business without incurring further costs. It does not require the claimant to formally own the intellectual property or results arising out of the project.

While ownership can be shared, the claimant must retain sufficient rights to have reasonable commercial use of the results, commensurate with its contribution to the work.

Effectively owning the results does not require the claimant to own the intellectual property. Intellectual property such as copyright, a patent, or a registered design, may not be available to protect the results.

It is also possible to have all the advantages of ownership without actually owning the intellectual property. The claimant may have the right to use a patent, to require the patent to be licensed, to restrict or direct further development based on the patent, all without further fee or payment, and not be the formal holder of the patent.

Some rights of ownership may be given to others without denying the effective ownership of the results. For example, a business having R&D carried out on its behalf might completely control commercial use of the results of that R&D (including further development of those results for commercial purposes), but allow the researcher exclusive scientific publication rights.

Similarly, actual use of particular results may only be possible in limited ways or for limited purposes, which means limited rights can amount to full effective ownership. For example, exclusive rights of commercial use and development for only a few years might amount to full ownership in a particularly fast-changing area.

A share in ownership of overall results may also amount to acceptable ownership. For example, if a business does R&D that builds on existing research results belonging to another person, the business may take a share of the overall results. The interest must match its contribution to the overall research.

If the R&D activity does not result in a product or patent, but results in new knowledge (perhaps published in a scientific paper), one way this requirement could be satisfied is if the business has been granted a preferential right to use the results of the activity. A preferential right could be access to unpublished results, or early access to results.

Subsequent sale of the results does not change the effective ownership of the results at the time the eligible R&D was conducted. However, R&D carried out under an agreement that required the disposal of results or commercial rights for inadequate return will suggest less than effective ownership of the results.

It is possible that the R&D activity is unsuccessful and there are no exploitable results from it. This does not mean that the claimant does not effectively own the results of the activity.

Deductible expenditure or depreciation loss (paragraph (e))

The claimant must incur expenditure or depreciation that is of a type listed in Schedule 21 Part A and not of a type listed in Part B. It must also be deductible in the year in which it is incurred. There are exceptions to the deductibility requirement for expenditure in deriving tax-exempt income, certain capital expenditure referred to in section LH 5(4) and deferred expenditure referred to in section LH 5(5).

For tax-exempt income, the requirement is that the expenditure or depreciation *would be* deductible if the person derived income other than tax-exempt income.

Partnership with entities excluded under section LH 1(2) (subsection 2)

R&D activities done in partnership with an entity referred to in section LH 1(2) are not eligible for a tax credit. Section LH 1(2) excludes anyone who is:

- a Crown Research Institute, a tertiary institution, or a district health board;
- associated with a Crown Research Institute, a tertiary institution, or a district health board; or
- controlled by one or more of the entities referred to above.

This is to prevent partnership structures being used to circumvent the requirements for eligibility.

Partnerships (subsection 3)

Paragraph (a) makes it possible for the business tests and the minimum threshold to be applied at the partnership level even though individual partners will be claiming the tax credit in relation to R&D activities carried out on behalf of the partners.

The requirements for claimants to be in business in New Zealand (section LH 1(1)(a)), for their R&D activity to be related to either that business or an intended new business (subsection (1)(a)(i)), and the minimum threshold for eligible expenditure can be applied at a partnership level, with the partnership treated as the entity performing the R&D activities.

Partners in a partnership will be taken to have met these requirements if the partnership (treated as the entity carrying out the R&D activities) would meet those requirements.

Paragraph (b) allows partnerships consisting of only eligible partners to apply the requirements to control the R&D activity, bear the financial risk of undertaking the work, and effectively own the results of the activity at the partnership level.

If the partnership, treated as an entity performing the R&D activities, would meet those requirements, the partners in the partnership will be treated as meeting those requirements.

Partners in partnership with ineligible partners (such as those excluded under section LH 1(2)) must meet the control, risk, and ownership requirements in their own right. This is also to prevent partnership structures being used to circumvent the requirements for eligibility.

The government will review these rules once the Limited Partnership Bill is enacted.

Joint ventures (subsection 4)

Subsection 4 allows parties performing R&D as part of an unincorporated joint venture to apply the requirements to control the R&D activity, bear the financial risk of undertaking the work, and effectively own the results of the activity at the joint venture level.

If the joint venture, treated as an entity performing the R&D activities, would meet those requirements, then the parties to the joint venture will be treated as meeting those requirements. While the financial risk can be shared between the parties, each party can only claim the tax credit in relation to their share of the expenditure for which they bear the financial risk.

Parties may establish a company in which they are shareholders to carry out R&D activities (incorporated joint venture). For the company to claim the credit it will need to show the R&D activities have been carried out on its own behalf and not on behalf of its shareholders. The company will be required to meet the requirements to control the activity, bear the financial risk of doing the work, and own the results. The fact that the shareholders may expect an indirect benefit through dividends does not mean the company is carrying out R&D activities on their behalf.

Amount of tax credit (section LH 4)

The amount of the tax credit is 15 percent of "eligible expenditure". This is the amount of expenditure or depreciation that is listed in Schedule 21 Part A, not excluded under Part B, and deductible in the year after making adjustments as required under sections LH 5 and LH 6.

Adjustments in calculating "eligible expenditure" (section LH 5)

Expenditure added back under timing rules (subsection (2))

Expenditure that is added back as income under subpart CH for tax purposes generally is also added back for the purpose of calculating the credit. This applies also to expenditure that would be added back under that subpart if the R&D expenditure was not deferred under section EJ 23 or if the claimant did not derive only exempt income.

Example 1

In March 2009, ACo incurs $100,000 of eligible expenditure on R&D services to be provided by a Crown Research Institute. The services have not been performed by the end of ACo's income year. The amount of the unexpired portion calculated under section EA 3 is therefore $100,000, which is income of ACo in the 2008-09 year under section CH 2. The amount that is eligible for the credit in that year is therefore $0 ($100,000 deductible eligible expenditure less $100,000 added back as income). The $100,000 becomes deductible in the 2009-10 income year. The services are provided in May 2009 so there is no unexpired portion added back as income. The $100,000 is therefore eligible for the credit in the 2009-10 income year.

Example 2

BCo is owned by B, who is a shareholder/employee of the company. B is engaged as an employee in conducting R&D. In March 2009, BCo accrues a liability for B's salary but has not paid it out by the last date for filing its return of income as provided in section EA 4(3). The salary is therefore added back as income under section CH 3(2) and is not eligible for the credit in the 2008-09 year. The salary is paid out in the 2009-10 year and therefore becomes eligible for the credit in that year.

Under section LH 3(3), there is an exception to the requirement to add back certain expenditure for the purposes of calculating the amount eligible for the credit. This is for stock to which CH 1 applies if it is feedstock under clause 8 of Schedule 21 Part A that has been processed or transformed in the R&D. If expenditure on stock has been incurred but the stock has not yet been processed or transformed in the R&D activities, the adjustment applies.

Example

In February 2009, ACo buys or manufactures $100,000 of trading stock which it intends to process or transform in R&D. It is still on hand and has not been processed or transformed in the R&D activity at March 31 2009. The value of the closing stock is therefore added back as income in the 2008-09 year. This add back also applies for the purpose of calculating the credit. The opening value of the stock ($100,000) is then deducted in the 2009-10 year. In April 2009 the trading stock is processed or transformed in the R&D activity. The stock is still on hand at 31 March 2010 but there is no add back of the value of the stock for the purposes of the credit.

Under clause 8 Schedule 21 Part A, if the market value of the stock is $30,000 only $70,000 will be eligible for the credit and it will be eligible in the 2009-10 year.

Certain capital expenditure (subsection (4))

An exception to the rule that expenditure be deductible in the year it is incurred is provided for certain capital expenditure that is not deductible under section DB 34. The intention is that the rule applies to expenditure that would be deductible but for the capital limitation.

Eligible capital expenditure incurred in seeking to create or improve a **depreciable *intangible*** asset that is developed as the object of the R&D activities attracts the credit when it is incurred.

Example 1

ACo has $100,000 R&D salary expenditure in developing software which is intangible depreciable property. The expenditure falls into three categories. Some is revenue expenditure and some is expenditure that is expensed for accounting and is immediately deductible for tax under section DB 34. Both those categories of expenditure therefore satisfy section LH 3(1)(e) and the credit applies in the year the expenditure is incurred. The third category is development expenditure that is capitalised for tax and accounting. Section LH 5(4) applies to this and it attracts the credit in the year in which it is incurred.

Capital expenditure incurred in seeking to construct or improve a **depreciable *tangible*** asset that is developed as the object of the R&D activities (such as a trial model or preliminary version) attracts the credit when it is incurred only when its sole intended use is in the R&D process of that business.

Example

In the 2008-09 year, ACo incurs eligible salary and materials costs in constructing a preliminary version of a product that it intends to add to its range of trading stock. The sole purpose of the prototype is its use in the R&D process in developing a model for the trading stock. It treats these costs as capital costs for accounting and tax. The expenditure attracts the credit in that year. Depreciation on facilitative assets used in the construction of the prototype also attract the credit in that year.

Capital expenditure in seeking to construct or improve a trial model or prototype that is not solely to be used in the R&D process does not attract the credit as it is incurred and is discussed in the section on depreciation of assets used in R&D (Schedule 21 Part A clause 2).

Deduction deferred under section EJ 23 (subsection (5))

Eligible expenditure is calculated as if deferral of a deduction under section EJ 23 were not allowed. If a business elects to defer a deduction for R&D expenditure under section EJ 23, the expenditure is therefore eligible for the credit in the year in which the expenditure is incurred, and not the year in which the deduction is taken. For the purposes of calculating the credit, the expenditure is still subject to the add-back rules in subpart CH (by virtue of the words "or would apply" in section LH 5(2)).

Example 1

ACo is owned by A, who is a shareholder/employee of the company. A is engaged as an employee in conducting R&D. In March 2009, ACo pays a salary to A but elects to defer a deduction for this expenditure under section EJ 23. The expenditure is eligible for the credit in the 2008-09 year.

Example 2

BCo is owned by B, who is a shareholder/employee of the company. B is engaged as an employee in conducting R&D. In March 2009, BCo accrues a liability for B's salary but has not paid it out by the last date for filing its return of income as provided in section EA 4(3). BCo elects to defer a deduction for the expenditure under section EJ 23. For the purposes of calculating the credit only, there is an assumed add-back of the salary under section CH 3(2) and the salary is not eligible for the credit in the 2008-09 year.

Expenditure on overseas R&D (section LH 6)

Expenditure on R&D activities carried out overseas is not eligible for the tax credit unless it is part of a project based in New Zealand and meets the definition of overseas eligible expenditure.

Subsection (1) excludes expenditure or an amount of depreciation loss on R&D performed overseas unless it is part of a research and development project. "Research and development project" is defined in subsection 4, see discussion below.

Subsection (2) excludes expenditure or an amount of depreciation loss on R&D performed outside New Zealand as part of a research and development project, unless it is overseas eligible expenditure.

A "research and development project" is defined in subsection (4) and means a process;

(a) consisting of co-ordinated research and development activities controlled by the business; and

(b) having start and finish dates; and

(c) undertaken collectively to achieve a specified objective within constraints of time, cost and other resources; and

(d) for which the business bears the financial risk and effectively owns the results, if any; and

(e) for which the business incurs on research and development activities performed in New Zealand more than half of the total amount of expenditure and depreciation loss that would be eligible expenditure under section LH 4 in the absence of subsection (2).

For an R&D project to exist more than half of the expenditure that would be eligible under section LH 4 must be incurred on R&D activities performed in New Zealand. If that is not the case, then the expenditure incurred on activities performed outside New Zealand will not be eligible for the credit. However, the expenditure incurred in New Zealand will still be eligible.

"Overseas eligible expenditure" is defined in subsection (5). The expenditure must be:

- expenditure that would be eligible under section LH 4 (in the absence of a restriction on overseas R&D); and
- incurred on R&D performed outside New Zealand in or after the 2008-09 income year; and
- limited to 10 percent of the total eligible expenditure incurred in New Zealand in or after the 2008-09 year as part of the same research and development project.

The 10 percent rule applies over the life of the project. Therefore eligible expenditure incurred on R&D activities performed overseas can be carried forward until sufficient local eligible expenditure is incurred on the same project. Similarly, the eligible overseas expenditure can be incurred in years subsequent to years in which the eligible local expenditure is incurred.

"New Zealand" is defined in section YA 1.

Example 1

Company A performs eligible R&D activities. The activities are carried out over three years, starting in the 2008-09 income year. Some of the activity is carried out in New Zealand, and some is done in Australia.

In the first year, the company spends $100,000 on eligible expenditure in New Zealand and $15,000 on eligible expenditure in Australia. The company is entitled to claim the tax credit in relation to $110,000 of expenditure. This is made up of $100,000 of local expenditure + $10,000 Australian expenditure. The remaining $5,000 of Australian expenditure has to be carried forward until there is sufficient eligible local expenditure to claim the credit.

In the second year of the project the company spends $100,000 on eligible expenditure in New Zealand and $2,000 on eligible expenditure in Australia. The company is entitled to claim the tax credit in relation to $107,000 of expenditure, made up of $100,000 local expenditure + $5,000 Australian expenditure carried forward from the previous year + $2,000 Australian expenditure from the current year.

In the third year, the company has no eligible expenditure in New Zealand and $40,000 of eligible expenditure in Australia. The company is entitled to claim the tax credit in relation to $3,000 of expenditure, made up of $3,000 of Australian expenditure, for which sufficient local expenditure was incurred in the prior year and the resulting entitlement carried over to this year.

Example 2

Company B performs R&D activities which are carried out over three years, starting in the 2007-08 income year. Some of the activity is carried out in New Zealand, and some is done in Brazil.

In the 2007-08 year, the company spends $100,000 in New Zealand and $15,000 in Brazil. The company is not entitled to claim the tax credit in relation to any of expenditure because the R&D is done before the credit is in effect.

In the second year the company spends $100,000 on eligible expenditure in New Zealand and $15,000 on eligible expenditure in Brazil on the same R&D project. The company is entitled to claim the tax credit for $110,000 of expenditure, made up of $100,000 local expenditure + $10,000 Brazilian expenditure.

In the third year, the company spends $20,000 on eligible expenditure in New Zealand and $200,000 (unexpectedly) on eligible expenditure on the same project in Brazil. The company is entitled to claim the tax credit in relation to the $20,000 of New Zealand expenditure for that year. However, the project no longer comes within the definition of an R&D project (because more eligible expenditure has being incurred in Brazil than in New Zealand in or after the 2008-09 income year) and therefore the company must revise its tax credit claim for the previous year and pay back the credit for the Brazilian expenditure incurred in that year.

Definition of R&D activities (section LH 7)

Only research and development activities as defined in section LH 7 are eligible for the tax credit.

The definitions of "research" and "development" in section DB 35, which apply to allow tax deductibility to follow accounting treatment, remain and are updated. As the tax treatment is so closely linked to accounting, the accounting definitions have been retained for that purpose only and are not relevant for the credit.

Research and development activities are:

(a) systematic, investigative and experimental activities that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes or services and that

- are intended to advance science or technology through the resolution of scientific or technological uncertainty, or
- involve an appreciable element of novelty;

(b) other activities that are wholly or mainly for the purpose of, required for, and integral to, the carrying on of the activities in paragraph (a).

The definition is not limited to basic research and is expected to apply to a wide range of development activities in a variety of industries. However, routine business activities directed at improving efficiency that do not seek to advance science or technology, or that do not involve an appreciable element of novelty, are not eligible.

The definition draws on elements of the R&D definitions in the United Kingdom, Ireland, Canada and Australia. It is most similar to the Australian definition, which has advantages for businesses operating on both sides of the Tasman and also for Inland Revenue, which will be required to implement the credit within a short timeframe. In particular, it is expected that application of the "appreciable element of novelty" limb would draw on Australian experience.

Activities described in paragraph (a) are "SIE" activities and activities in paragraph (b) are support activities. This is relevant in relation to the excluded activities in Schedule 21 Part C.

The creation of new or improved production equipment and machinery would be included in paragraph (a) as new or improved products.

R&D need not be successful to qualify for the credit.

There is legislative clarification of the meaning of some of the terms used in the definition. Further elaboration on the definition will be in guidelines. There will be consultation in developing guidelines.

Systematic, investigative and experimental activities (subsection (2))

Claimants will need to demonstrate that the R&D process followed a planned, logical progression of work involving hypothesis, experiment, observation and evaluation.

Scientific or technological uncertainty (subsection (3))

This exists when knowledge of whether something is scientifically or technologically possible, or how to achieve it in practice, is not publicly available or deducible by a competent professional working in the field. This definition, and the definition of "technology", are derived from the United Kingdom R&D definition.

Novelty (subsection (4))

For activities to be "novel" there needs to be some development of the technology or a new use of existing technology. To establish whether something is new, it should be compared with what is already available in the public arena on a reasonably accessible world-wide basis at the time in that technology.

The "appreciable element of novelty" limb is drawn from the Australian R&D definition and the statutory clarification discussed in the paragraph above is based on the explanation of that term in the Australian *R&D Guide* (Part B page 16). The provisions should be very similar in scope. In particular, "appreciable" means meaningful or significant in the context of the activities undertaken.

Technology (subsection (5))

For the purposes of the R&D definition, technology is the practical application of scientific principles and knowledge.

Simultaneous R&D

Under the definition, R&D can be done:

- by two firms simultaneously and independently doing the same innovative work;
- when work has already been done but this is not public knowledge because it is a trade secret, and another firm repeats the work.

Improvements to existing products/processes

Incremental development and improvements to existing products or processes can qualify as R&D. However, the improvement that is sought would have to be one that involved an appreciable element of novelty or attempted to advance science or technology. It therefore should be more than routine upgrading.

Support activities (paragraph (b) of R&D definition)

Supporting activities that are wholly or mainly for the purpose of, required for, and integral to the carrying on of SIE activities referred to in paragraph (a), but which in themselves are not systematic, investigative and experimental, are eligible R&D. Support activities are eligible only if there is an SIE activity, though the support activities need not occur in the same income year as the SIE activity.

The requirement that activities be wholly or mainly for the purpose of SIE R&D is intended to exclude the following types of activity:

- Construction of an asset with an innovative component when the main purpose of construction is sale of the asset or use of the asset for commercial purposes.
- Activities carried out simultaneously for routine business purposes and R&D where R&D is not the main purpose. So, for example, if a business collects data mainly for its routine business operations but also uses it as an input to R&D it is not an eligible support activity.

Example 1

ACo is a boat building company that designs innovative components for its boats. It develops a new type of keel which advances boat building technology and is R&D. The keel is to be tested on a boat it is building for a customer. Construction of the boat is not a qualifying support activity as the boat is not built mainly for R&D. It is built mainly for sale to a customer. This means that none of the construction costs are eligible for the credit.

Example 2

BCo is a developer constructing an apartment complex on reclaimed land. It has commissioned an engineering firm to design a new type of base to provide maximum protection in the event of an earthquake. Construction of the building is not an eligible support activity as the main purpose of construction is use in BCo's business. None of the construction costs are eligible for the credit.

"Required for" means that the supporting activity must be only to the degree necessary to support the project. For example, if a drilling company is developing an innovative piece of drilling equipment that can be adequately tested using computer simulation, drilling is not "required for" the SIE R&D activity. If drilling is required to test the equipment, only drilling that is the minimum necessary qualifies.

"Integral to" means that such activities must be part of an R&D project (rather than indirect supporting activities such as cleaning and administration, which are dealt with as expenditure on overheads).

Examples of support activities that could be eligible are scientific or technological planning activities, mathematical analysis or modelling used to analyse the results of the experiments and routine data collection.

Activities excluded from "SIE" activities (Schedule 21 Part C)

Certain activities are routinely excluded from R&D tax incentives. This can be because governments do not wish to incentivise a particular activity through an R&D tax concession, or to remove uncertainty over whether a particular activity could be considered R&D, or to clarify the boundary between development and post-development activity, or innovative and routine work.

The activities listed below are excluded from being SIE activities in paragraph (a) of the R&D definition:

- prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal reserves;
- research in social sciences, arts or humanities;
- market research, market testing or market development, or sales promotion (including consumer surveys);
- quality control or routine testing of materials, products, devices, processes or services;
- the making of cosmetic or stylistic changes to materials, products, devices, processes or services;
- routine collection of information;
- commercial, legal and administrative aspects of patenting, licensing or other activities;
- activities involved in complying with statutory requirements or standards;
- management studies or efficiency surveys;
- the reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information; and
- pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs.

The exclusions are similar to those in Australia. As in Australia, these activities are excluded from being SIE activities only – they may still be support activities within paragraph (b) of the definition. For example, routine data collection will not be eligible as an SIE activity but can qualify as a support activity.

Prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal energy (clause 1)

It is possible to have R&D in extractive industries – for example, R&D to develop new exploration techniques, but the exploration in itself is not R&D. Drilling can be a supporting activity if it is wholly or mainly for the purpose of, required for and integral to the development of a new exploration technique or new equipment – for example, testing of new drilling equipment.

Research in social sciences, arts or humanities (clause 2)

Research in these disciplines is excluded in each of the jurisdictions considered in the development of the R&D definition. The focus of R&D tax incentives is on extending business scientific and technological know-how rather than promoting research in these areas which are funded by other means.

The exclusion covers, for example, research in economics, classics, languages, literature, music, philosophy, history, religion, and visual and performing arts. Examples of activities excluded under this head would be the study of the historical development of a language or the role of the family in society, or writing a novel or screenplay.

If a business is developing an innovative product and the development process satisfies the criteria in the definition in section LH 7, the development is not excluded simply because the product is used in the arts or humanities. For example, if a business develops computer software for use in the film industry in a process that satisfies the criteria in the definition, the software development is not excluded under this paragraph. Similarly, if a business develops and manufactures innovative ceramic glazes, the development is not excluded under this paragraph because glazes are used in the visual arts.

As with the other exclusions, this research is excluded from being an SIE activity only. Where research in these fields is required for development of a new product or process, the research can be an eligible support activity. For example, if research into human behaviour is required for the development of an innovative product, the research can be an eligible R&D support activity.

Market research, market testing or market development, or sales promotion (including consumer surveys) (clause 3)

Conducting of market research is excluded. However, it can be a supporting activity when the research is wholly or mainly for the purpose of, required for and integral to development of a product or process.

Example

ACo is developing a new can opener for use by those with arthritic hands. It has two options for handle design and selects a group to test both trial models to determine which handle is more easily manipulated. This market testing is eligible as a support activity.

Quality control or routine testing of materials, products, devices, processes or services (clause 4)

Quality control in itself is excluded as a SIE activity. However, the development of new or improved methods of quality control testing can be eligible R&D. Quality control may also be a supporting activity – for example, in the development of a new manufacturing process, checking that the products in a trial run meet the desired quality.

Making cosmetic or stylistic changes to materials, products, devices, processes or services (clause 5)

Changes that are purely cosmetic or stylistic (such as changes to colour or pattern) are excluded from being an SIE activity. For example, this would include design changes for fabrics and wallpapers.

However, work to create a desired cosmetic or aesthetic effect through the application of science or technology can advance the science or technology and be R&D.

Also, cosmetic or stylistic changes that meet the requirements in paragraph (b) of the R&D definition can be a supporting activity. For example, if a firm is improving a product it manufactures in a way that falls within the definition of an SIE activity, work on required associated stylistic changes can be eligible R&D.

Commercial, legal and administrative aspects of patenting, licensing or other activities (clause 7)

This is post-R&D work which is very unlikely, even in the absence of the exclusion, to qualify as an SIE activity. It is also unlikely to be a supporting activity because patenting or licensing would seldom be wholly or mainly for the purpose of, or required for, an SIE activity.

Activities involved in complying with statutory requirements or standards (clause 8)

This exclusion targets routine testing and analysis of materials, products and processes to check that they comply with statutory requirements or standards. It does not apply to development of new technologies to comply with standards. Activities involved in developing, rather than complying with, standards is also not excluded. Checking that new products meet relevant standards can be an eligible R&D support activity.

Management studies or efficiency surveys (clause 9)

This includes studies relating to inventory control (such as Just-in-Time), work practices, industrial relations and feasibility analysis, and time and motion studies. The exclusion also covers industry research – for example, where a company carries out a survey into a particular industry's characteristics and future needs.

These studies or surveys can be a supporting activity. For example, if a manufacturer's improvement to a process is R&D, a monitored test to determine how efficient the new process is would be eligible as a supporting activity.

The reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information (clause 10)

No R&D is involved in simply reproducing an existing product or process from the plans or publicly available information, and this is excluded as an SIE activity.

Pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs (clause 11)

This paragraph is intended to clarify the boundary between R&D and post-R&D pre-production activities. Activities either satisfy the definition of SIE activities in paragraph (a) of the R&D definition **or** fall within the exclusion. If activities that satisfy the definition of R&D in paragraph (a) arise during a pre-production process, they will be eligible regardless of the exclusion. However, most pre-production activity is unlikely to be eligible as SIE R&D.

Trial runs could be eligible as a qualifying supporting activity, as could tooling up (for example, to test a new manufacturing process). It is unlikely that demonstration of commercial viability satisfies the test to be a supporting activity.

Eligible expenditure (Schedule 21 Part A)

Only the following expenditure is eligible for the credit:

- salaries and other remuneration of employees conducting R&D;
- depreciation of tangible assets used in conducting R&D;
- costs of staff training, recruitment, relocation and travel incurred directly as a result of R&D;
- the cost of materials incorporated into prototypes;
- certain overheads that relate to administration, human resources, repairs and maintenance, cleaning and security,
- rates, utilities, insurance and leasing of buildings, plant and equipment;
- the cost of items consumed, and the net cost of items processed or transformed, in R&D activities; and
- payments to an entity or person for R&D services performed on behalf of the claimant.

Salary and other remuneration of employees conducting R&D (clause 1)

Salary, wages, allowances, bonuses, commissions, extra salary, overtime, fringe benefits, holiday pay and long-service pay paid to an employee who is conducting SIE or supporting R&D activities are eligible for the credit. Superannuation contributions, fringe benefit tax, specified superannuation contribution withholding tax and insurances paid in respect of such employees are also eligible.

If an employee works part-time on R&D, the credit only applies to remuneration in relation to that portion of the employee's time that is spent on R&D.

Depreciation of tangible property (clause 2))

Annual depreciation on **tangible** property used in conducting R&D is eligible (depreciation on intangible property is excluded under Part B clause 15). The credit is available to the extent the property is used in conducting R&D (the excess above this is excluded under Part B clause 5).

Depreciation attracts the credit in two circumstances:

- For "facilitative" assets that are used in the R&D process but that are not the object of the R&D;
- For certain "end-result" assets that are the object of the R&D and that are used in the R&D process (for example, for testing, analysis and data recording).

Example – facilitative assets

ACo has a computer that is used 20 percent of the time on R&D, and 20 percent on other activities. For the remaining 60 percent of the time it is idle (evenings, weekends, holidays). The credit may be claimed in relation to 50 percent of the annual depreciation deduction.

End result assets

Paragraphs (b) and (c) relate to depreciable tangible assets that are developed as the object of the R&D activities and that are to be used in the business other than in the R&D process. Expenditure on developing these assets does not attract the credit when it is incurred. Rather, the credit may be able to be claimed in relation to depreciation on such an asset while it is being used in the R&D process (for example, for testing) provided construction of the asset is an eligible R&D activity. This requires that either the construction itself is an SIE activity (a sufficiently innovative construction technique) or that it is a support activity (mainly for the purpose of, required for, and integral to the SIE activity).

Example

ACo is a utility company experimenting with a new material for underground pipes. It constructs a small area of the network for testing before rolling out the pipes in the region. Assume that the construction of that part of the network is an eligible support activity (that is, that it is mainly for the purpose of, is required for and integral to, the SIE R&D). The pipes supply gas to the neighbourhood and will remain in place following the test if they are satisfactory. The salary and materials inputs into construction of the pipe network are not eligible for the credit when they are incurred, but depreciation on the network may be eligible while it is being tested.

Construction of an asset that is mainly for non-R&D commercial purposes is not eligible for the credit at all.

The credit does not apply to depreciation of an end-result asset if the expenditure incurred in its development would be eligible for the credit as it is incurred.

No clawback or loss on sale

To minimise compliance costs, there is no clawback of credits on disposal of assets for more than their tax book value. When an asset is sold to an associate for more than its book value, the price above the vendor's book value does not attract the credit in the hands of the associated purchaser (Part B clause 6).

Generally, any loss on sale or write-off of depreciable property also does not attract the credit. However, there is an exception in relation to certain end-result assets that are a failure and written off. The exclusion in relation to loss on sale is discussed further below under "ineligible expenditure" (Schedule 21 Part B clause 2).

Pooled property

The credit does not apply to depreciable assets in a tax depreciation pool unless the pool consists solely of R&D assets used wholly in conducting R&D.

Depreciation of asset by business with tax exempt income

Special rules are provided in section LH 14 to calculate the amount of depreciation loss in relation to tax exempt entities.

Employee training, recruitment, relocation and travel (clause 3)

The cost of training, recruitment, relocation and travel of employees is eligible when it is incurred directly as a result of R&D activities.

Materials incorporated into prototype products and plant (clause 4)

The cost of materials incorporated into a trial model or preliminary version of a product or plant is eligible for the credit.

Overhead costs (clauses 5 and 6 and section LH 8)

Certain listed expenditure on overheads is eligible for the credit. Apportionment is required when overheads are only in part incurred directly in respect of R&D activities.

If the overheads relate to administration of internal business activities, the human resources section of a business, repairs and maintenance, or cleaning and security, then employee remuneration, consumables and payments to contractors for services are eligible.

Rates, utilities (including telecommunications) and insurance and the cost of leasing buildings, plant and equipment are also eligible.

Overheads must be incurred ***directly*** in respect of R&D activities. So, for example, while a part of a cleaner's salary will be eligible if he cleans the R&D laboratory, and a part of the secretary's salary will be eligible if she supports R&D personnel, the cleaning of the secretary's office is not eligible.

There is a regulatory power to exclude overheads that are too remotely connected with the R&D. The broad intention is that overheads not eligible for the 125 percent concession in Australia will be excluded in New Zealand. Examples are directors' fees, entertainment expenses and canteen and recreational facilities.

Remuneration of employees performing SIE or support R&D activities are eligible under clause 1, not clause 5. Support activities must be integral to – that is, part of – SIE activities. This would include, for example, the salary of a technician collecting data used in experiments. Human resources personnel, cleaners and security officers generally do not perform activities that would be part of the R&D project so their remuneration will be eligible (if at all) as overheads under clause 5.

This clause does not include depreciation deductions, which may only be claimed under clause 2.

Example

ACo has an R&D division with employees engaged full time in R&D. The human resources officer spends on average 10 percent of her time attending to issues relating to that division. These are considered to be directly in respect of R&D activities and 10 percent of her remuneration is eligible.

ACo employs a cleaner who spends 10 percent of her time cleaning the R&D division. Again, this is considered to be directly in respect of R&D activities and 10 percent of her remuneration is eligible. However, the cleaning of the human resource officer's office is not directly in respect of R&D activities.

Items consumed in R&D activities (clause 7)

Items consumed in the R&D process are eligible for the credit. This would include, for example, laboratory chemicals and stationery.

Net cost of items processed or transformed in R&D process (clause 8)

For items that are processed or transformed during R&D activities, only the net expenditure is eligible – that is, the excess of the cost of the items which are the subject of processing or transformation, over the value of the output. The value of the output is the sale proceeds when the products are sold in an arm's-length transaction and, when they are not, the market value of the products.

The provision applies to the acquisition or production of raw materials or products that are "put through" an R&D process. This will most often be trading stock and would include the catching of fish put through an experimental fish processing plant, milk processed into powder in an experimental drying process, sheep shorn or cows milked in an experimental process and timber acquired and cut using a novel technique.

It encompasses the manufacture or acquisition of a product that does not change during the R&D process or changes in a manner that is not visible.

Payments to a person for R&D services (clause 9)

When part or all of an R&D project is outsourced, a payment to the person or entity conducting the R&D is eligible. The performer of the R&D does not get a credit. (It will fail the requirement to control the project, bear the risk and effectively own the results.) When the R&D is outsourced to an associate, some of the payment is likely to be ineligible under Part B clause 3.

The payment must relate only to the R&D conducted by the third party. If the payment is for multiple items (such as R&D services and marketing), costs must be separately identified.

The provision applies to payments for both SIE and supporting activities and covers the costs of engaging independent contractors, agency workers and temporary staff to work on R&D.

In order to be eligible for the credit, expenditure must be listed in Schedule 21 Part A and not listed in Schedule 21 Part B. The intention is that generally expenditure in Part B is ineligible whether it is incurred by the claimant in doing its R&D inhouse or where the R&D is contracted out to a third party.

So, for example, if a Crown Research Institute, performing contract R&D for an eligible business, arranges for the work to be subcontracted overseas, the expenditure limit in relation to overseas R&D still applies. The same principle applies to internal software development.

The wording of certain restrictions – for example, section LH 6 (for R&D done overseas) and Part B clause 9 (internal software development) – achieves this already. However, it is not so clear in relation to other clauses in Part B. The government will review this at the earliest opportunity. Business should not be able to avoid rules relating to excluded expenditure by outsourcing R&D.

Ineligible expenditure (Schedule 21 Part B)

The following expenditure is ineligible:

- interest;
- loss on sale or write-off of depreciable assets (except in one situation);
- profits on R&D services and property provided by an associate;
- amounts in excess of market value for leasing property of an associate;
- depreciation attributable to the time an asset is not used in R&D;
- certain depreciation deductions on assets acquired from an associate;
- the cost of feedstock other than the net cost referred to in Part A clause 8
- the cost of acquiring core technology (technology used as a basis for further R&D);
- in-house software development costs exceeding $3 million (unless the cap is increased by Ministerial waiver);
- expenditure funded from a government grant or any required co-funding;
- donations;
- professional fees in determining whether the person, activities or expenditure are eligible;
- the cost of acquiring intangible assets; and
- expenditure of an industry research co-operative funded by an ineligible person.

Some of this expenditure (for example, professional fees and donations) would not be eligible in any event, as it would not fall within the list of eligible expenditure in Part A. It is inserted to make the provisions as clear as possible, and for avoidance of doubt.

Interest (clause 1)

Expenditure incurred under a financial arrangement – essentially, interest – in financing R&D activities is not eligible.

Depreciation loss on disposal or write-off of assets (clause 2)

To reduce compliance costs, there is no clawback of credits when depreciable property used in R&D is sold for more than its adjusted tax value. There is generally a corresponding restriction in relation to a loss on disposal of depreciable assets and the write-off when depreciable items are no longer used (sections EE 11(3) to (5) and EE 39). No credit is available in relation to this loss or write-off.

Example

ACo purchases an asset for $1 million which is used wholly in R&D for three years. Credits are claimed in relation to that depreciation. The adjusted tax value at the time of sale is $700,000. The asset is sold for $650,000. No credit is available for that $50,000 loss.

End-result assets to be used for commercial purposes

As noted earlier, the cost of assets that are the object of the R&D (such as prototypes) do not attract the credit when they are incurred unless their sole intended use is in R&D. If they are to be used in commercial activity, either simultaneously or subsequently to their R&D use, and if the construction of the asset is an R&D activity, the credit may be claimed in relation to depreciation on the asset for the time it is used in R&D.

If the asset is a failure and is written off, the credit can be claimed for the balance of the costs provided the conditions in Part B clause 2 paragraphs (a) to (c) and Part A clause 2 are met. In particular, the asset must be wholly or mainly used in the R&D activities and not used after they end, and development costs must not be eligible for the credit in the year they are incurred.

Example

ACo is an energy distribution company that is developing an innovative household meter. It instals the meters in 100 households before installing them more widely and plans a monitoring and testing programme over two months. Construction and installation of the test meters is an eligible support activity as the meters are mainly constructed and installed for the SIE R&D activities, and are required for and integral to them. However, if they are satisfactory, they will be left in place and used in ACo's normal business operations. The expenditure in constructing and installing the meters is treated by ACo as capital expenditure for tax and accounting. The materials and labour in constructing the meters are therefore not eligible for the credit as they are incurred. However, depreciation on the meters attracts the credit during the testing period.

One month after the trial begins, ACo finds that the meters are unsuitable. It removes and scraps them. The balance of the construction and installation cost of the meters are eligible for the credit at that stage.

R&D services and property purchased from an associate (clause 3)

When R&D is outsourced to an associate of the claimant, or property used in R&D is acquired from an associate, the credit cannot be claimed for any profit margin of the associate in supplying the services or property. The credit is payable on the lesser of the amount paid to the associate (eligible under Part A clause 9) and the eligible expenditure of the associate incurred in a third-party transaction.

Example

ACo contracts its sister company BCo to perform R&D services. BCo obtains all the services and property used to perform the R&D from third parties unassociated with the company (for example, employees and contractors). Unassociated T Co provides core technology to BCo to enable BCo to perform the services. BCo spends $30,000 on the core technology and incurs $50,000 eligible expenditure on performing the R&D services (salary of employees and depreciation on equipment). BCo charges ACo $100,000 for the services. ACo may claim the credit only on $50,000.

Property leased from an associate (clause 4)

When property is leased directly or indirectly from an associate at more than market value, the excess over market value is not eligible for the credit.

Depreciation in excess of time asset used in R&D (clause 5)

This is the apportionment rule for depreciation on assets used in performing R&D. See the explanation of Part A clause 2.

Depreciation deduction on property purchased from associate (clause 6)

Because there is no clawback of credits when depreciable property used in R&D is sold for more than its tax book value, a rule is required to prevent associated entities claiming credits twice for depreciation. Clause 6 therefore provides that when depreciable property is sold to an associate for a price in excess of the vendor's tax book value, the excess over the vendor's tax book value does not attract the credit in the hands of the purchaser. This rule is required even if the sale price is less than the vendor's cost (that is, it is required even though there are restrictions on the associated purchaser's ability to deduct depreciation under section EE 40).

Example

ACo sells computer equipment used in its R&D to associated BCo for its market value of $1300. The equipment cost $2000 and has a tax book value of $1000. The $300 is not eligible for the credit in the hands of BCo.

Feedstock expenditure in excess of net expenditure (clause 7)

This excludes all feedstock expenditure in excess of the net expenditure allowed under Part A clause 8.

Core technology (clause 8)

Core technology is technology which is used as a basis for further R&D. It may be intellectual property or a tangible asset such as a prototype. Core technology that is acquired or leased from another person is ineligible for the credit. The definition is in substance the same as it is in Australia.

Cap on certain in-house software development (clause 9)

This is discussed under sections LH 9 to LH 13 and LH 17 at the end of this report.

Grants and required co-funding (clauses 10, 11, 12)

Expenditure funded by a grant from a public authority or local authority or from funds required as a condition of the grant (co-funding) by the public or local authority is ineligible for the tax credit. This is because the R&D project is already subsidised by government.

The rule applies when the co-funding is required from the recipient of the grant or from another party.

"Public authority" and "local authority" are defined in section YA 1 of the Income Tax Act 2007.

Example 1

ACo receives an R&D grant of $50,000 from the Foundation for Research Science and Technology. As a condition of the grant, ACo is required to contribute $100,000 of its own funds towards the project. The $150,000 is used to pay for R&D salaries and to purchase items consumed in the R&D. None of it is eligible expenditure.

Also as a condition of the grant to ACo, BCo is required to fund $20,000 of salary expenditure on another R&D activity. A tax credit is not available to BCo for its expenditure of $20,000.

Example 2

CCo receives a grant of $40,000 from a local authority for R&D activities. The total expenditure on the activity by CCo will be $120,000 consisting of $90,000 for the purchase of core technology and $30,000 of salary expenditure. The local authority has not stipulated that CCo should apply the funds to the purchase of core technology or to paying salaries. CCo can therefore apply the grant to the purchase of core technology and claim a tax credit in relation to the salary expenditure.

Donations (clause 13)

Making donations towards the R&D of others is not eligible. In Australia, making of donations is excluded as an activity.

Professional fees in determining eligibility (clause 14)

Fees paid to accountants, lawyers, scientists and others in determining whether claimants, activities and expenditure are eligible and calculating the amount of the claim are not eligible for the credit.

Cost of acquiring intangible assets (clause 15)

The credit is not available for the cost of purchasing, leasing or obtaining the right to use intangible assets. The expenditure on intangibles can be by way of royalties or a lump sum capital cost.

The extent to which they can be included in eligible expenditure requires careful consideration as such assets tend to be the focus of tax avoidance schemes. This policy work will be done once the R&D credit is in effect.

Example

ACo acquires a licence to use software in its R&D process. Depreciation on, or licence fees for, the software are not eligible.

The paragraph does not exclude the cost of creating intangible assets from R&D.

Certain expenditure of an industry research co-operative (clause 16)

Clause 16 provides that expenditure of an industry research co-operative that is sourced from funds contributed by a person who does not have a business in New Zealand or who is ineligible under section LH 1(2) is not eligible expenditure of the co-operative. This is to prevent co-operatives being used to circumvent the requirements for eligibility.

Industry research co-operatives are discussed in more detail in relation to section LH 16.

Listed research providers (section LH 15)

Section LH 15 sets out the requirements to be listed with the Commissioner of Inland Revenue as a research provider and the administrative rules for listing. Payments to an unassociated listed research provider are not subject to the minimum threshold of $20,000 of eligible expenditure each year. However, the payment must be for eligible expenditure (as calculated under section LH 4)

If a provider is delisted, payments under an arrangement entered into when the provider was still listed are not subject to the minimum threshold. See discussion above on section LH 2(3) and (4).

To be listed, a person must give notice to the Commissioner that it has the capability to perform contracted R&D, has R&D facilities in New Zealand, and undertakes to meet the continuing requirements set out in subsection (3).

The continuing requirements are that the provider will charge fees on commercial terms, be available to undertake work on behalf of unrelated parties, and will maintain records to show that it satisfies the requirements to be listed and to show the amounts derived and incurred in carrying out R&D on behalf of others.

Inland Revenue will check the first two requirements and list the research provider if it is satisfied they are met. Listing does not constitute an endorsement of the provider. It means the research provider has satisfied Inland Revenue it has the capability to undertake R&D for others and has facilities in New Zealand. The list will be publicly available on the Inland Revenue website from 1 April 2008.

The provider is listed until it seeks to be removed from the list or is delisted by the Commissioner. Either party must give notice to the other and subsections (6) and (7) set out the dates on which the delisting takes effect.

The Commissioner may refuse to list a person who has been delisted in the past if the Commissioner considers that the person does not meet the start-up requirements or will not meet the continuing requirements on listed research providers.

No challenge is available to the Commissioner's decision to delist a provider.

Industry research co-operatives (section LH 16)

Industry research co-operatives fall into two categories. They can be organisations, generally in the primary sector, that collect levies from those in an industry and apply them to various purposes including R&D.

Outside of the primary sector, they may be co-operatives set up within an industry that receive contributions for various activities including R&D.

These organisations are unlikely to be in business, but the R&D they either conduct or commission on behalf of businesses in the relevant industry is eligible for the credit. Those in business in the industry and making payments to the co-operative will not be eligible for the credit in relation to those levies or contributions. Industry research co-operatives are therefore not required to be in business (see discussion above on section LH 1(1)(b)). The exemption does not flow through to entities controlled by the co-operative.

The co-operative must be undertaking or commissioning R&D mainly on behalf of its members who:

- must be New Zealand businesses (either as residents or through a fixed establishment in New Zealand);
- would meet the requirements in LH 2 if they carried out or commissioned the R&D and if the minimum threshold did not apply; and
- contribute to the financing of the R&D activity.

Also, the R&D activities must relate to the businesses of those who make contributions or pay levies (see discussion above on section LH 2(2)(a)(ii)).

Expenditure of an industry research co-operative that is sourced from funds contributed by a person who is not eligible is not eligible expenditure of the co-operative. This is to prevent co-operatives being used to circumvent the requirements for eligibility. See discussion above on ineligible expenditure schedule 21, part B, clause 16.

Depreciation base for tax-exempt entities (section LH 14)

R&D tax credits are potentially available to most entities undertaking an R&D activity, including charities and not-for-profit entities which have only exempt income.

The normal rules for calculating depreciation loss are ineffective for entities which generate only exempt income from an asset. Section LH 14 provides rules to calculate the amount of depreciation loss these entities can claim a credit for.

When an entity conducting or commissioning R&D has not previously been allowed a deduction for an amount of depreciation loss for an asset because it derives only exempt income, it is treated as acquiring the asset on the first day of the 2008–09 income year for market value, or on the actual date of acquisition at cost, whichever is the later.

These entities are then considered, solely for the purposes of calculating the amount of depreciation loss for the purposes of the credit, to have had deductions for depreciation in every year since acquisition. This does not allow the entity to actually claim a deduction for depreciation loss, but does lead to the correct amount of depreciation loss to use in calculating the amount of R&D tax credit.

Example

A, a charitable society, undertakes R&D in 2010–11. A Digital Serial Analyser, purchased new in 2007, is mainly used in the R&D activity and the resulting depreciation loss would be deductible if A derived assessable income. A's income year runs from 1 April to 31 March, and an independent valuation of the analyser on 1 April 2008 puts its market value at $35,000.

For the purposes of calculating the depreciation loss which is eligible for the credit in 2010–11, A assumes the analyser was purchased on 1 April for $35,000. The applicable depreciation rate for the analyser is 26.4 percent (diminishing value rate for an oscilloscope with 20 percent loading).

A is treated as being allowed a deduction for depreciation loss in each of the 2008–09, 2009–10, and 2010–11 income years, being the completed income years following deemed acquisition. Therefore, the assumed amounts of depreciation loss and adjusted tax values (ATV) in each year are:

Income year	***ATV at beginning of year***	***Depreciation loss***
2008–09	Cost = $35,000	26.4% x $35,000 = $9,240
2009–10	$35,000 – $9,240 = $25,760	26.4% x $25,760 = $6,800
2010–11	$25,760 – $6,800 = $18,960	26.4% x $18,960 = $5,005

In the 2010–11 income year A can claim a tax credit for $5,005 of eligible depreciation loss.

If the Digital Serial Analyser, instead of being purchased new in 2007, was previously used in New Zealand, the applicable depreciation rate for the analyser would be 22 percent (diminishing value rate for an oscilloscope without 20 percent loading).

R&D tax credits and imputation accounts (sections OB 4(3)(eb), OB 7C, OK 2(3)(cb), OK 4B, OP 5(2)(bb), OP 7(3)(fb), OP 11B)

In other jurisdictions, such as Australia, tax credits to companies are "clawed back" when paid out as dividends. The New Zealand credit has been designed to reduce such "clawback".

If an entity has an imputation credit account or a Māori authority credit account, an R&D tax credit will lead to a credit to that account. A refund of R&D tax credit (including a transfer of the surplus credit to satisfy most other liabilities under an Inland Revenue Act) will lead to a debit. The result is that the entity receives an imputation credit for the income tax liability satisfied by way of the credit.

The credit is equal to the amount of the R&D tax credit (sections OB 7C, OK 4B, OP 11B), and the debit is equal to the amount of the refund. The credit arises on the day the relevant income tax return is received by Inland Revenue.

Examples: Tax credit leads to credits and debits to imputation credit account

1. Company A receives a tax credit of $10,000 for expenditure incurred in its 2008–09 income year, reducing its tax-to-pay to $100,000. Company A's income tax return for the 2008–09 year is received by Inland Revenue on 1 June 2009. On 1 June 2009, there is a credit to A's imputation credit account of $10,000.
2. Company B receives a tax credit of $10,000 for expenditure incurred in its 2008–09 income year, pushing it from tax-to-pay of $5,000 to a tax refund of $5,000. Company B's income tax return for the 2008–09 year is received by Inland Revenue on 1 March 2010. B receives a cash refund of $5,000, being the amount of the surplus refundable tax credit, on 1 April 2010. On 1 March 2010, there is a credit to B's imputation credit account of $10,000. On 1 April 2010, there is a debit to B's imputation credit account of $5,000.

To prevent more than one imputation credit arising because of an R&D tax credit, there is no credit for income tax paid by an R&D tax credit (sections OB 4(3)(eb), OK 2(3)(cb) and OP 7(3)(fb)). In addition, where a consolidated imputation group has a credit to its imputation credit account for an R&D tax credit, the same credit does not arise in the accounts of any of the members of the group (section OP 5(2)(bb)).

Claiming the credit

Businesses will claim the tax credit in an income tax return. The claimant will work out the liability for tax in the normal way, and then subtract the amount of the credit. If the amount of the credit exceeds the tax liability the balance is used to reduce other tax liabilities, or is refundable in cash.

The tax will reduce residual income tax, which will reduce provisional tax liability, allowing taxpayers to receive the benefit of the credit closer to the time the related eligible expenditure is incurred. This reduction will be immediate for people who estimate provisional tax, but delayed for people who use the "uplift" method for calculating provisional tax.

To be eligible for the credit, the claimant must provide – in addition to the income tax return – a detailed statement of R&D activities and expenditure, containing essential information for administrative purposes, by a due date.

Example: Claiming the tax credit

In 2010, Company A has assessable income of $200,000 and allowable deductions of $170,000, $100,000 of which is eligible expenditure on R&D. A claims an R&D tax credit of $15,000 and files a detailed statement by the due date.

Assessable income	$200,000
Less	
Deductions	$170,000
Net income	$30,000
Tax liability (@ 30%)	**$9,000**
Less	
R&D tax credit	$15,000
Tax to pay	**$0**
Refund of surplus credit	**$6,000**

Addendum

Credit to imputation credit account	$15,000 (on date return is received)
Debit to imputation credit account	$6,000 (on date refund is paid)

Requirement for a detailed supporting statement (section LH 2(1)(d) Income Tax Act 2007; sections 68D and 68E Tax Administration Act 1994)

A business claiming a tax credit in an income tax return is required to file electronically a detailed supporting statement. The detailed statement contains essential information to be used for audit, forecasting, statistical and evaluation purposes.

If a business is a member of an internal software development group, the detailed statement must be filed by a nominated member of the group on behalf of all group members.

A partnership may elect to file the detailed statement, in relation to the partnership's R&D activities, on behalf of all the partners, for convenience. A partnership which elects to file a statement on behalf of all the partners, and does internal software development, is not an internal software development group merely because it makes this election. Alternatively, if the partnership does not make this election, partners must separately file their own detailed statements, including their share of the partnership's eligible expenses and tax credit.

The statement must be filed by the due date. If a statement is filed late, there will be no tax credit for the year and there could be use-of-money-interest and penalties to pay.[1]

Because businesses and their agents need sufficient time to prepare the statement, the statement is never required to be filed before the due date for the associated income tax return.

The due date for the detailed statement for an individual is 30 days after the due date for the business's income tax return (including any extensions of time). The due date for an internal software development group is 30 days after the latest income tax return due date of any of the group's members. The due date for a partnership which elects to file a statement for all the members of the partnership is 30 days after the latest income tax return due date of any of the partners.

Example: Due date for filing a detailed statement

A's income year runs from 1 April to 31 March. B and C have income years which run from 1 November to 31 October. A, B and C are members of an internal software development group and have amounts eligible for a tax credit. B and C have a tax agent who is granted an extension of time, until 31 March 2020, to file B and C's 2018–19 income tax returns. A's internal accountant files its income tax return.

A must file its 2018–19 income tax return by 7 July 2019. B and C have until 31 March 2020. The group's detailed statement must therefore be furnished by 30 April 2020.

[1] There may be an exception in one situation: when a group return is filed on time but is incorrect because of a simple oversight, the Commissioner has discretion to grant an extension of time to file a corrected version. This exception was created to avoid the situation in which a group accidentally omits a member from its group return, causing the other members of the group to lose entitlement to their credits. It is not intended that the exception would be used in other situations.

It is possible that a business will be required to file (or have filed on its behalf by a group or partnership) more than one detailed statement for an income year.

Special rules for 2008-09 and 2009-10 years

In the early years of the R&D tax credit, it is recognised that some businesses will still be coming to grips with the requirements of the new rules. Some additional flexibility has been provided for businesses which do not initially file a claim for an R&D tax credit, enabling them in some cases to file their detailed statements at a later date.

In the 2008-09 and 2009-10 years, if a business has not claimed an amount of R&D tax credit in the relevant income tax return, the due date for the detailed statement for an individual is two years after the due date for the income tax return. If none of the members of an internal software development group have claimed an amount of R&D tax credit in the relevant income tax returns, the due date for the group's detailed statement is two years after the latest due date for filing an income tax return for any of the group members. If none of the partners in a partnership electing to file a detailed statement on behalf of all partners has claimed an amount of R&D tax credit in the relevant income tax returns, the due date for the partnership's detailed statement is two years after the latest due date for filing an income tax statement of any of the partners.

If a business (or any member of an internal software development group or any partner) has claimed an amount of R&D tax credit in the relevant income tax return, the special rules for 2008-09 and 2009-10 do not apply. A detailed statement must be filed by the normal due dates.

Provisional tax (section YA 1 Income Tax Act 2007; section 3(1) Tax Administration Act 1994 – definition of residual income tax)

The R&D tax credit reduces residual income tax. Taxpayers therefore have the option of reducing their provisional tax payments in anticipation of an R&D credit at the end of the year.

Example: estimating provisional tax including tax credit

Company A expects to have a tax liability of $100,000 for the 2008–09 income year (before credits). A also expects to receive a credit of $40,000, so estimates its RIT to be $60,000. A furnishes this estimate to Inland Revenue and thereby elects to use the estimated provisional tax method. On each provisional tax instalment date, A pays provisional tax payments of $20,000.

Changes to the disputes and reassessment rules

Time limit for notice of proposed adjustment (section 3(1) Tax Administration Act 1994 – definition of response period)

Because claimants and their agents will require time to prepare and check their claims for tax credits, the time for reassessing the amount claimed has been extended from the standard four months.

In the case of a notice of proposed adjustment (NOPA) relating *solely* to an amount of R&D tax credit, the time limits within which the claimant can issue the NOPA are:

- For a business that is neither a member of an internal software development group nor a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, one year following the date the income tax return is received by Inland Revenue.
- For a business that is a member of an internal software development group or a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, from the date the business's income tax return is received by Inland Revenue, up until one year after the due date for the group's detailed statement of R&D activities.

Example: Claimant issues NOPA within the new response period

Company A is in the process of internally auditing its R&D expenditure. On 15 March 2020, A's agent files A's 2018–19 income tax return and files a detailed statement of R&D activities, claiming a $50,000 tax credit. Inland Revenue receives the tax return on 17 March. When A completes its audit, A discovers that it was actually entitled to a tax credit of $60,000 and issues a notice of proposed adjustment relating solely to the R&D tax credit.

As long as Inland Revenue receives the notice of proposed adjustment by 16 March 2021 the disputes process will begin and, subject to the outcome of the process, A could receive the additional $10,000 credit. If the notice of proposed adjustment is received after 16 March 2021, the notice will not be effective.

Issuing a NOPA solely for an amount of R&D tax credit does not allow the business to reopen any other aspect of the income tax return.

Special rules for 2008-09 and 2009-10 years

In parallel with the extension of time to file a detailed statement in some cases during the early years of the credit, the time periods for issuing a NOPA relating solely to an R&D tax credit are also extended.

For the 2008-09 and 2009-10 income years, the time periods within which a NOPA relating solely to an amount of R&D tax credit may be issued are:

- For a business that is neither a member of an internal software development group nor a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, two years following the date the income tax return is received by Inland Revenue.
- For a business that is a member of an internal software development group or a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, from the date the business's income tax return is received by Inland Revenue, up until two years after the due date for the group's detailed statement of R&D activities.

Time limit for Commissioner's reassessment (sections 108(1B), 113D Tax Administration Act 1994)

Overseas experience suggests that when businesses are given long periods to reconsider their original claims, practitioners have incentives to trawl through past years' accounts and identify R&D expenditure that the business was unaware was R&D. This practice of "grave-digging" is at odds with the intent of the R&D tax credit policy, which is that the credit should provide an incentive to undertake R&D. If credits are being given for R&D which the business was unaware it was undertaking, it is clear that the credit has not provided any incentive.

To prevent "grave-digging", the Commissioner will not be allowed to reassess an amount of R&D credit upwards if one year has passed since the end of the tax year in which the original income tax return was filed.

Example: Claimant requests amendment after more than a year

Company A claims a $50,000 credit for R&D undertaken in the 2018–19 year, by filing an income tax return on 6 June 2019. The return is filed in the 2019–20 tax year, which ends on 31 March 2020.

On 1 June 2021, A discovers that it was actually entitled to a $60,000 credit for R&D and asks the Commissioner to amend the amount originally self-assessed. However, Inland Revenue may not amend the amount to $60,000 after 31 March 2021.

There is an exception to the new rule. When the claimant has issued a NOPA on its claim for an R&D credit within the response period for doing so, the Commissioner has the normal period to reassess the amount of credit, allowing time for disputes procedures to be completed. In no case, however, may the Commissioner increase the amount of the R&D tax credit by more than the adjustment proposed in the NOPA which arrived within the original response period.

Example: Claimant requests amendment after more than a year, having issued a NOPA

Company A claims a $50,000 credit for R&D undertaken in the 2018–19 year, by filing an income tax return on 6 June 2019. The return is filed in the 2019–20 tax year, which ends on 31 March 2020.

On 1 June 2020, A discovers that it was actually entitled to a $60,000 credit for R&D and issues a notice of proposed adjustment. The notice is issued within the response period (one year following the date the tax return was received), so the disputes process begins. The disputes process is concluded on 30 August 2021, and Inland Revenue agrees the credit should be $60,000. Normally, Inland Revenue would be unable to reassess the amount of the credit, since the date for doing so (31 March 2021) has passed. However, because the claimant had issued a NOPA relating to the amount of the R&D tax credit, Inland Revenue will reassess the amount to $60,000.

Example: Claimant requests amendment after more than a year, having issued multiple NOPAs

Company A claims a $50,000 credit for R&D undertaken in the 2018–19 year, by filing an income tax return on 6 June 2019. The return is filed in the 2019–20 tax year, which ends on 31 March 2020.

On 1 June 2020, A discovers that it was actually entitled to a $60,000 credit for R&D and issues a notice of proposed adjustment. The notice is issued within the response period (one year following the date the tax return was received), so the disputes process begins.

On 20 August 2020, A issues another NOPA, revising up the credit again to $70,000.

The disputes process relating to the first NOPA is concluded on 30 August 2021, and Inland Revenue agrees the credit should be $60,000. Because the claimant issued a NOPA relating to the amount of the R&D tax credit within the response period, Inland Revenue will reassess amount to $60,000.

The second NOPA is ineffective because it was issued outside the relevant response period, being the first year after the income tax return was originally filed. Inland Revenue is unable to reassess the tax credit amount above $60,000.

Special rules for 2008-09 and 2009-10 years

For R&D tax credits arising in the 2008-09 and 2009-10 years, the Commissioner will not be allowed to reassess an amount of R&D credit upwards if *two years* have passed since the end of the tax year in which the original income tax return was filed. This is in line with the extensions, in some circumstances, for filing detailed statements or issuing a NOPA relating solely to an amount of R&D tax credit.

Determinations (sections 91AAP, 91C(4) Tax Administration Act 1994)

Businesses that are uncertain about their eligibility for the tax credit will be able to apply for a determination of whether:

- they meet the eligibility criteria in Section LH 3 of the Income Tax Act 2007;
- their expenditure or depreciation loss meets the requirements of the definition of eligible expenditure in Section LH 4; and
- their activity meets the requirements of the definition of research and development activities in Section LH 7.

Businesses will not be able to obtain binding rulings about these matters.

There will be regulations to prescribe how businesses should apply for a determination on these matters. The determinations will be binding on the Commissioner, from the date the determination is signed by the Commissioner, but not binding on the person who applies for the determination.

When there is an amendment to or repeal of the law relevant to the determination, and it would detrimentally affect the business to continue relying on the determination, the determination does not have to be relied on.

Where the applicant has misrepresented or omitted facts relevant to the determination, whether intentionally or not, the determination is no longer binding and cannot be relied upon.

Inland Revenue may withdraw the determination by notice, at which point it can no longer be relied upon. There is an exception, however – when the business is already undertaking an activity in reliance on the determination, and was doing so before the notice of withdrawal, the business can continue to rely on the determination as originally set down for the activity.

A determination may not be disputed or challenged.

The ability to apply for a determination will not be available immediately. The provision allowing for determinations will come into force by Order in Council, not later than 1 April 2010.

Record-keeping (sections 22(2) and 22(7) Tax Administration Act 1994)

Claimants must keep sufficient records to support their claim for an R&D tax credit. For a business, general record-keeping requirements are laid out in detail in section 22(1). An entity which does not derive assessable income is expected to keep records of a similar standard to support its claim for a tax credit.

In addition, all entities claiming a tax credit will be expected to keep a wider range of records than specified in section 22(1). For example, non-accounting documents such as project plans or test-reports might be required to provide evidence of a systematic, investigative and experimental approach to an activity.

Listed research providers must keep additional records to show that they meet the requirements of section LH 15(2) and (3) of the Income Tax Act 2007, and to show the amounts derived and incurred by them in performing research and development activities on behalf of other persons.

No exemption from filing an annual return of income (sections 33A(2) and 43A(2) Tax Administration Act 1994)

A business that has a tax credit under section LH 2 of the Income Tax Act 2007 must file a return of income for the year the credit relates to. The exemption from filing in section 33A does not apply to a person who claims the tax credit.

A non-active company which has a tax credit under section LH 2 ceases to be a non-active company and must file an income tax return.

Use-of-money interest and penalties (section 141(7C) Tax Administration Act 1994)

Use-of-money interest and penalties generally apply to amounts of tax credit as they would apply to other amounts of tax.

However, there is an exception to the normal shortfall penalty rules, applying only to internal software development groups. Where the members of an internal software development group reallocate the credits for internal software development undertaken by the group, there will not be a shortfall as long as the reallocations are offsetting. This recognises that group members who file a tax return early might not yet know the internal software development expenditure of other group members.

Example: reallocation of credits for internal software development (no shortfall)

Company A and Company B, standard balance date companies, are members of an internal software development group from 1 October 2008 to 31 March 2009.

The following expenditure is undertaken:

- Company A spends $1 million on internal software development in the period from 1 April 2008 to 30 September 2008, and $2 million on internal software development in the period from 1 October 2008 to 31 March 2009. Company A also spends $6 million on other R&D over the year.

- Company B spends $0.5 million on internal software development in the period from 1 April 2008 to 30 September 2008, and $1.5 million on internal software development in the period from 1 October 2008 to 31 March 2009. Company B also spends $4 million on other R&D over the year.

Company A files its tax return on 1 May 2009, claiming a tax credit for $8,495,890 of R&D expenditure ($1 million of internal software development expenditure before it was part of the group, $1,495,890 of internal software development expenditure afterwards, and $6 million for other R&D expenditure). This gives a total credit of $1,274,383.

Company B files its tax return on 1 July 2009, claiming a tax credit for $4.5 million of R&D (internal software development expenditure of $0.5 million incurred before it was part of the group, and $4 million of other R&D expenditure). This gives a total tax credit of $675,000. Company B would also like to claim for internal software development expenditure incurred while in the group, but is aware that the group's expenditure cap has been reached.

Company B negotiates with Company A. Company A files a notice of proposed adjustment and reduces its claims for tax credits by $90,000 (relating to eligible expenditure on internal software development of $600,000). Company B files a notice of proposed adjustment and increases its claim for tax credits by $90,000. The Commissioner makes both adjustments. Because $90,000 is less than the credits Company A received for internal software development expenditure incurred while in the group, and because Company B is entitled to more than $90,000 of credits for internal development expenditure incurred while in the group, Company A has no tax shortfall.

The provision only applies where there is reallocation of credits for internal software development expenditure incurred while in the group. It allows neither reallocation of any credits for expenditure incurred outside the group, nor reallocation of any credits for expenditure which is not on internal software development. The business that is allocated a greater amount of credits must also have sufficient eligible expenditure relating to internal software development undertaken while in the group to justify those credits.

Refunds of surplus credits not subject to GST (section 6 Goods and Services Tax (Grants and Subsidies Order) 1992)

A refund of surplus tax credits under section LH 2 of the Income Tax Act 2007 is not subject to GST.

Cap on internal-use software expenditure eligible for a credit (sections LH 9 to LH 13, LH 17)

A maximum of $3 million of internal software development expenditure will be eligible for an R&D tax credit in any year. Where businesses undertaking internal software development are under common control, they form an internal software development group and must count their expenditure on such development towards a single $3 million cap.

In exceptional cases the level of the cap may be increased by the Minister of Finance for an individual or an internal software development group if certain conditions, essentially relating to national interest, are met.

In other jurisdictions, claims for R&D incentives relating to internal software development have been problematic. In Australia, the 125 percent and 175 percent deductibility R&D tax incentives are not available for software developed for solely internal use.

The New Zealand credit allows claims for internal software development, but caps these claims to limit the fiscal risk of abuse.

The cap does not affect a business's entitlement to credits for expenditure that does not relate to internal software development.

Outline of the sections

Section LH 9 adjusts the eligible expenditure on internal software development a business can claim a credit for. Subsection (1) determines when a business is eligible for a credit for internal software development and therefore has to apply LH 9. Subsection (2) determines which other sections to use in adjusting the eligible expenditure.

Section LH 10 adjusts eligible expenditure on internal software development for periods when the business is not a member of an internal software development group.

Section LH 11 adjusts eligible expenditure on internal software development for periods when the business is a member of an internal software development group in which all members have the same income year.

Section LH 12 adjusts eligible expenditure on internal software development for periods when the business is a member of an internal software development group in which not all members have the same income year.

Section LH 13 sets the maximum annual eligible expenditure on internal software development, and provides for Ministerial discretion to increase the maximum in certain circumstances.

Section LH 17 defines the terms "associated internal software developer", "internal software development", "internal software development controller" and "internal software development group".

Internal software development

In section LH 17, "internal software development" is defined as a research and development activity of developing software that:

- does not have as its main purpose sale, rent, license, hire or lease to two or more people who are not associated with the developer or with each other; or
- has as a purpose the use of the software in the internal administration of the business activities of the developer (such as payroll, bookkeeping or personnel management) or of an associate; or
- has as a purpose the provision of services to customers of the developer or an associate, if the main reason those customers use the services is to obtain services other than the use of the developer's (or associate's) computer technology or software (such as if they use the services to obtain accounting, consulting or banking services).

There is an exception to the definition – software which is an integral part of an electrical or mechanical device for which the software is developed is not internal software development if the electrical or mechanical device is developed mainly for sale, rent, lease or license to customers as part of the developer's business.

Software developed as a supporting activity, as well software developed as an SIE activity, is subject to the cap.

Examples: definition of internal software development (main purpose of sale)

1. Company B is undertaking R&D to develop software which it will use internally. The cap applies, because Company B is developing the software with no purpose of sale. Company B may not claim credits in any year for more than $3 million of its software development expenditure.

2. Company C is undertaking R&D to develop software which it will sell to Company D, its parent. The cap applies, because Company C is developing the software with a purpose of sale only to an associate.

3. Company E is undertaking R&D to develop software which it will use internally. The board members of Company E have also discussed the possibility of sale of the software to other large companies that are not competitors, to recoup some development costs. The board members have instructed a staff member to investigate the potential market for the software and to ensure that the software is easily customised. The developers have been advised that they need to build some flexibility into the design of the software. The cap applies, because Company E has a purpose of sale of the software, but does not have a main purpose of sale of the software. The purpose of sale is ancillary to the purpose of internal use.

4. Company F is undertaking R&D to develop software which it will sell to utility companies. It has signed contracts with three companies to supply the software and it is actively marketing to other interested parties. F will not be using the software in the internal administration of its business. None of these companies is connected in any way to Company F or to each other. In this case, the cap is unlikely to apply, since the main purpose of development is sale to multiple non-associates.

Examples: definition of internal software development (internal use or use to provide services)

1. Company G is undertaking R&D to develop software which it will sell to utility companies. It has signed contracts with eight companies to supply the software and it is actively marketing to other interested parties. G's parent company will also be using the software to bill its customers. The cap applies, since there is a purpose of using the software in the internal administration of the business activities of an associate of G.

2. Company H is undertaking R&D to develop software to integrate a new enterprise resource planning package with its legacy information systems. Once it has done this, it intends to sell an integration package to other companies with the same legacy systems. The cap applies even though there is a purpose of sale of the software, because there is another purpose of using the software in the internal administration of the business.

3. Company J, a management consultant, is undertaking R&D to develop software that will allow its clients to view all work they have commissioned and all past communications between the client and J. The software will run on J's web server. A portion of clients' fees implicitly entitles them to authenticated access to a web site controlled by the software. The cap applies – clients are using the service mainly to obtain management consulting services they have commissioned, and not mainly to obtain the use of J's computer technology or software.

4. Company K, a telecommunications company, is undertaking R&D to develop software which will allow its customers to independently configure account settings, and add and remove lines and services. K plans to charge customers a license fee for using the software. The cap applies because the software will be used by K's customers mainly to obtain a telephone service, and not mainly to obtain the use of K's computer technology or software.
5. Company L, a bank, is undertaking R&D to develop web-banking software. L plans to charge its customers a license fee for using the software. The cap applies because the software will be used by L's customers mainly to obtain a banking service, and not mainly to obtain the use of L's computer technology or software.

6. Company M, a bank, is undertaking R&D to develop a computer game which simulates financial markets. The game is to be played on-line, and will run on the bank's servers. M plans to license access to the game to schools, and will not use the R&D for any other purpose. The cap is not likely to apply in this case, since schools which buy an access license are doing so primarily to obtain the use of the software and not to obtain another (e.g. banking) service.

Examples: definition of internal software development (exception where integral to hardware)

1. Company N develops a stand-alone video recorder for sale. Software is developed to run inside the recorder and remove offensive language or images from incoming video as it is recorded. Assume the software development meets the definition of R&D. The software is written specifically for the video recorder and the video recorder cannot operate without it. The video recorder is developed for sale to the public. The software is integral to the recorder, and the recorder is developed for sale to customers as part of N's business, so the cap does not apply.

2. Company P develops software to be used for conducting cash transfers between its customers over the Internet. P also buys computer hardware and modifies it to prevent physical tampering. The software will run on the tamper-proof hardware, which will be administered by P's customer at its own premises. P intends to mass-produce the modified hardware and sell it to non-competitors who can use it to run their own security-sensitive applications. The software is not integral to the modified hardware and will not be supplied as part of the hardware when sold to external customers. It could also, with minor modifications, be run on other hardware. The software is subject to the cap, because it is not integral to the modified hardware and is not developed with the main purpose of sale.

Internal software groups (section LH 17)

To prevent multiplication of caps through the use of subsidiaries or other controlled entities, businesses that undertake internal software development are required to group themselves with other developers under the same control, and the expenditure of the entire group counts towards a single cap.

Each business undertaking internal software development (a "developer") has an internal software development controller (a "controller"). The controller is the person, or group of people, who have ultimate control over the developer. In simple cases, the developer and the controller might be the same person. The intent is to ensure that the *ultimate* controller is identified, rather than any intermediate entity in a chain of controlling entities.

The test for control of an entity by a person is that the person has the power to govern the financial and operating policies of the entity to obtain benefits from its activities. The test is based on the definition of "control" in New Zealand International Accounting Standard 27 (Consolidated and Separate Financial Statements), so if two people would be required to consolidate for financial reporting purposes, it is highly likely that they would be under common control.

When a business has the same controller as other businesses, those businesses are members of an internal software development group (a "group"). A business is a member for as long as its controller does not change, provided that there is at least one other business with the same controller at the same time.

A business can be a member of no group for all or part of the year, one group for all or part of the year, and more than one group over the course of a year. [2]

[2] The legislation refers to the expenditure of members of an internal software development group for income years corresponding to a tax year (LH 11(5)(a) and 12(4)(a)). This includes only expenditure for the period the businesses are members of the group, since any other expenditure is no longer expenditure of a "member".

Examples: mechanics of internal software development groups

- ACo, BCo and CCo have the same internal software development controller (implying they undertake internal software development) and are therefore members of an internal software development group. ACo stops doing internal software development. Therefore, ACo no longer has an internal software development controller, and ACo is not a member of the group any longer. The group continues to exist, however, with BCo and CCo as members.

- DCo, ECo and FCo have the same internal software development controller and are therefore members of an internal software development group. DCo and ECo stop doing internal software development. Therefore, DCo and ECo no longer have an internal software development controller, and are not members of the group any longer. FCo no longer has any other person having the same internal software development controller, so the group ceases to exist.

- GCo and HCo both have the same, single shareholder, Carol. GCo undertakes internal software development, and Carol is GCo's internal software development controller. HCo does not undertake internal software development. HCo begins internal software development. Therefore, GCo and HCo are now the members of an internal software group.

- JCo and KCo are the members of an internal software development group, X, controlled by Mrs X. LCo and MCo are the members of another internal software development group, Y, controlled by Mr Y. Mr Y sells LCo and MCo to Mrs X. Group Y ceases to exist, and LCo and MCo become members of Group X.

- At the beginning of the year, NCo, OCo and PCo have the same internal software development controller and are therefore in an internal software development group, Z. OCo is sold to a non-associate in the middle of the year. QCo is purchased by PCo in the last quarter of the year. NCo, OCo, PCo and QCo are all members of Z at some time over the course of the year. NCo and PCo are members for the entire year, OCo is a member for the first half of the year and QCo is a member for the last quarter of the year.

Allocation of the cap (sections LH 10 to LH 13)

When not a member of any group (section LH 10)

For the period a developer is not a member of any internal software development group, the developer will have eligible expenditure on internal software development.

The eligible expenditure on internal software development for which a credit may be claimed is capped. The cap is $3 million for a full year. If the period for which the business is not a member of any group is not a year, then the formula in paragraph LH 10(1)(b) prorates the $3 million on a daily basis.

Example: credit for internal software development when not in a group

ACo undertakes internal software development. For the first 73 days of the year, ACo is not under common control with any other developer. However, on 13 June 2008, BCo – also a developer – purchases 100 percent of ACo. For the purposes of claiming a credit, ACo adjusts down its eligible expenditure on internal software development, for the period it was not in any group, to a maximum of $3 million x 73 ÷ 365 = $600,000. If ACo's eligible expenditure for the period in the absence of LH 10 is $300,000, ACo will be able to claim a credit for $300,000. If ACo's actual eligible expenditure for the period in the absence of LH 10 is $700,000, ACo will only be able to claim a credit for $600,000.

Allocation when a member of a group (sections LH 11 and 12)

For the period that a business is a member of an internal software development group, it is not entitled to any credits for eligible expenditure relating to internal software development, but might be entitled to a share of credits for the combined eligible expenditure of group members.

The entitlement to credits for a share of the combined eligible expenditure of group members depends on the nature of the group, but in no case can a group allocate more than $3 million across all its members for a full year. The group members are free to decide the exact allocation, subject to the restrictions described below.

An overriding requirement in all cases is that no member may have eligible expenditure relating to internal software development which is greater than the eligible expenditure that business would have had, during the period of membership, in the absence of sections LH 9 to LH 13.

Note that in the special case where a business leaves a group and one member or no-one is left in the group, the group ceases to exist. In that case, the business leaving and the business remaining (if any) will have their entitlement to credits determined on the basis of part-year membership.

Members of a group with identical income years (section LH 11)

If all the members of the group have the same income year (same length of year and same balance date), a member can have eligible expenditure allocated to it and claim a credit.

The maximum eligible expenditure relating to internal software development that is available to be allocated to all group members is $3 million for a full year, and this amount is required to be pro-rated on a daily basis where the period for which the member is in the group is less than a full year.

Members of a group with non-identical income years (section LH 12)

If any member, X, of the group has an income year which differs from the income year of another member, X will only be able to receive an amount of credit if X has been a member of the group for X's entire income year.

The maximum eligible expenditure relating to internal software development that is available to be allocated across all group members is $3 million for a full year.

Examples: allocation of the cap

- ACo and BCo are members of an internal software development group. ACo and BCo have the same (standard) income years, and are members of the group for the entire year. ACo would have eligible expenditure relating to internal software development expenditure of $2.2 million for the year, in the absence of sections LH 9 to LH 13. BCo would have eligible expenditure of $1.5 million. ACo and BCo may share credits for eligible expenditure of $3 million. The allocation may be made as the parties see fit, as long as ACo receives credits for no more than $2.2 million and BCo receives credits for no more than $1.5 million.

- CCo and DCo, which have standard income years, are not members of any internal software group, but are under common control. CCo and DCo begin internal software development on 1 July 2008. Therefore, they are the members of an internal software development group from 1 July. The group exists for 274 days of the income year (1 July 2008 to 31 March 2009), and CCo and DCo are members for this entire period. CCo would have eligible expenditure relating to internal software development of $4 million in the absence of sections LH 9 to 13. DCo would have eligible expenditure of $5 million. CCo and DCo can share credits for eligible expenditure of $3 million x 274 ÷ 365 = $2,252,054 (see subsection LH 11(5)). This can be shared in any way.
- ECo and FCo are members of an internal software development group. ECo and FCo have the same (standard) income years, and are members of the group for the entire year. ECo would have eligible expenditure relating to internal software development of $2.2 million for the year, in the absence of sections LH 9 to 13. FCo would have eligible expenditure of $1.5 million. GCo, an internal software developer with a standard income year, is bought by FCo on 1 July 2008, so is a member of the group for 274 days of the year. In the absence of sections LH 9 to 13, GCo would have eligible expenditure relating to internal software development of $1 million for the first 91 days of the year, and $3 million for the other 274 days. GCo calculates that the group can allocate up to $3 million x 274 ÷ 365 = $2,252,054 to it for the period it is a member (according to section LH 11). ECo and FCo calculate that the group can allocate up to $3 million to the pair for the full-year period they are members (again according to section 11). Assume GCo has received a credit for the full $2,252,054 available for the period it was a member. Then of the $3 million of eligible expenditure allocable to the group over the (full-year) period of ECo and FCo's membership, $747,946 is left for distribution to ECo and FCo. This distribution may be made as the pair see fit. GCo is also entitled to a credit for $3 million x 91 ÷ 365 = $747,945 for eligible expenditure relating to internal software development incurred during its time outside the group.
- HCo and ICo are members of an internal software development group. HCo and ICo have the same (standard) income years, and are members of the group for the entire year. HCo would have eligible expenditure relating to internal software development of $2.2 million for the year, in the absence of sections LH 9 to 13. ICo would have eligible expenditure of $1.5 million. JCo, an internal software developer with an income year ending 31 December 2008, is bought by ICo on 1 July 2008, so is also a member of the group for 184 days of its income year. In the absence of sections LH 9 to 13, JCo would have eligible expenditure relating to internal software development of $2 million for the first 181 days of the year and $2 million for the other 184 days. HCo and ICo share credits for an eligible amount of $3 million (according to subsections LH 12(3) and (4)). The allocation may be made as the parties see fit, as long as HCo receives no more than $2.2 million and ICo receives no more than $1.5 million. JCo receives no credit for the internal software expenditure incurred while a member of the group, because it is a member for less than its full income year (see subsection LH 12(2)). JCo is, however, entitled to a credit for $3 million x 181 ÷ 365 = $1,487,671 for the eligible expenditure relating to internal software development incurred during its time outside the group (section LH 10).
- KCo and LCo are members of an internal software development group. KCo has an income year ending 31 March and LCo has an income year ending 30 April. KCo would have eligible expenditure relating to internal software development of $2.2 million for the year, in the absence of sections LH 9 to 13. LCo would have eligible expenditure of $1.5 million. KCo is liquidated on 30 November 2008, and the group ceases to exist on this date. KCo and LCo are members of the group for only part of their 2008–09 income years and have different income years, so receive no credit relating to internal software development expenditure incurred while members of the group. LCo is entitled to credits for such expenditure incurred after the group dissolves, according to the formula in LH 10.

Level of the cap (section LH 13)

The level of the cap is $3 million for a year. This is the level for an individual and for an internal software development group.

The $3 million cap is not expected to be binding on many claimants, but if expenditure does exceed the cap, in exceptional cases a different level of the cap may be determined for an individual or an internal software development group, for a period, by notice in the New Zealand *Gazette*. The increase of the cap may be granted on application to the Minister of Finance if the Minister considers that three requirements, broadly relating to national interest, are met.

The three requirements are based on similar requirements for obtaining government-provided incentives in Australia and New Zealand, and are:

- *That the internal software development will be exploited mainly for the benefit of the New Zealand economy.* In practice, the Minister might look at 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.
- *That New Zealand will derive a substantial net benefit from intended completion of the internal software development.* In practice, the Minister might look at whether the R&D would 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).
- *That the person (or in the case of the cap being increased for an internal software development group, the internal software development controller) has a commitment to retain the value of their business in New Zealand.* In practice, the Minister might look at 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.

An increase in the level of the cap under section LH 13 does not automatically entitle a person or internal software group to an amount of R&D tax credit. All the other requirements in the legislation, such as the requirement that the activity meet the legislated definition of R&D, must still be met.

The Minister of Finance may impose conditions on a determination to increase the level of the cap, and the determination will not apply unless those conditions are met.