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*A special report from the*  
Policy Advice Division of Inland Revenue

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## **Remedial amendments to the research and development tax credit**

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As part of the recently enacted Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, remedial amendments have been made to the now-repealed research and development tax credit for the 2008–09 income year. The amendments clarify the policy intention of the tax credit and make some technical changes to the administration of the tax credit. This special report is intended to help claimants who are in the process of calculating their tax credit entitlements and preparing claims to understand the legislative consequences of the amendments.

This report outlines the amendments that clarify the policy intention of the original legislation. A description of the other technical amendments that have been made will be included in a more detailed account of the legislation, to be published in a *Tax Information Bulletin* later this year.

### **Background**

While the R&D tax credits have been repealed from the 2009–10 income year, the government signalled further work to align the tax credit legislation with the policy intention in a number of areas. The remedial amendments arising from that work relate to:

- eligibility of government agencies;
- company groups and the eligibility rules;
- feedstock rules; and
- eligibility of labour R&D costs.

### **Key features**

#### ***Government agencies (section LH 1 of the Income Tax Act 2007)***

The tax credit rules require a claimant to be in business or to be an industry research co-operative. Some Crown agencies are specifically excluded from eligibility.

Under the previous legislation Crown agencies that could meet the business test and that were not specifically excluded were eligible for the tax credit. This is contrary to the policy intent of the tax credit, which aims to incentivise R&D carried out by private sector businesses.

A new paragraph has been added to section LH 1(2) to exclude Crown entities as that term is defined in the Crown Entities Act 2004.

A consequential amendment has been made to paragraphs LH 1(2)(b) and (c) which exclude associates of and those controlled by entities that are specifically excluded.

***Company groups (sections LH 1 and LH 3 of the Income Tax Act 2007)***

To qualify for the tax credit, among other requirements, a claimant must:

- be in business;
- control the R&D activity; and
- effectively own the results of the R&D activity.

This can be problematic for larger firms that separate aspects of their operation for commercial purposes. For example, a firm may locate its R&D division in one subsidiary but hold any resulting intellectual property in another subsidiary to manage risk.

Group companies, which are essentially one economic unit, would be eligible for the tax credit if they restructured their activities so that one member of the group carried out all the necessary functions. Requiring firms to amalgamate these functions, which were previously carried out in separate subsidiaries within the group, in order to be eligible for the tax credit is inefficient and it would create unnecessary compliance costs.

Section LH 1 has been amended to enable a New Zealand-resident member of a group to meet the requirement to be in business in New Zealand if another New Zealand-resident member of the group would meet that requirement. A consequential amendment has been made to section LH 3(1)(a).

A new subsection LH 3(6)(a) has been added to allow a New Zealand-resident member of a group to meet the requirement to control the research and development activities if another New Zealand member of the group would meet that requirement. Similarly, the new subsection LH 3(6)(b) allows a New Zealand-resident member of a group to meet the requirements to effectively own the results of the research and development activities, if another New Zealand-resident member of the group, or another member that is controlled by a New Zealand-resident member, would meet that requirement.

***Feedstock rules (schedule 21 part A paragraph 8, and part B paragraph 7 of the Income Tax Act 2007)***

The feedstock rules apply when the R&D includes the testing of a production process. The objective of the feedstock rules is to limit the amount of the R&D credit which can be claimed when some valuable output is produced.

The feedstock rules have been rewritten to better reflect the intention of the original legislation. Paragraph 8, part A of schedule 21 makes it clear that, at first instance, expenditure or depreciation loss incurred in acquiring or producing things which are to be transformed as part of a production process is eligible for the credit. The limitation formerly in part A has been removed.

The limitation in part B has been rewritten to make it clear that:

- It only applies to things which are the input into the feedstock process.
- It does not apply when a trial model or preliminary version is the output of the process.

**Example**

A mountain bike manufacturer is developing a new coating for bike frames which will be more durable than paint. It applies several different trial formulations of the coating to batches of frames to see whether the colour is consistent.

Cost of inputs (value of bare steel frames and coating)	\$2,000
Other production costs (labour, electricity etc)	\$1,000
Total costs	\$3,000
Value of coated frames	\$2,500

The credit will not be available for the input cost of \$2,000. The other production costs of \$1,000 remain eligible for the credit.

***Labour R&D costs (section LH 5(4)(c)(ii) of the Income Tax Act 2007)***

The R&D credit is generally only available for expenditure which is deductible for income tax purposes. However, the credit is also available for capital expenditure where that expenditure is incurred in the intended development of depreciable property that is intangible property, or tangible property intended only for use in the R&D activities.

These rules mean that R&D expenditure on labour which is capitalised and is:

- incurred in relation to a tangible asset which is intended to be used in the business, or
- incurred on intangible property which is not depreciable–

will not be eligible for the R&D credit when the expenditure is incurred.

New section LH 5(4)(c)(ii) allows the credit for certain R&D labour costs. To be eligible for the credit, the costs must be:

- of the type which falls within clauses 1, 3 or 9 of part A of schedule 21. These clauses refer to labour costs, costs which relate to labour, and contracted-out expenditure respectively;
- incurred in scientific, investigative, and experimental activities referred to in section LH 7(1)(a), and not those which fall under the “support costs” limb in section LH 7(1)(b); and
- not incurred directly in the construction of tangible property.

#### **Example**

A business is developing a new production line to produce items in a way that has never been done before. Developing the new production line involves the following stages:

- The company’s production scientists design the new production line. On the facts of this case, designing the production line qualifies as R&D.
- The company’s engineers construct the new machinery which makes up the production line. They are supervised by the production scientists.

If the production line works satisfactorily, the business will use it in its normal business. The costs of the production scientists, the engineers, and the various materials used to construct the production line are capitalised as part of the costs of the new production line.

The work of the production scientists in designing the new production line is eligible for the R&D tax credit under new section LH 5(4)(c)(ii). So is any expenditure relating to those scientists falling under paragraph 3 of part A of schedule 21. The expenditure on the engineers who build the production line, and the production scientists in supervising them, is not eligible because it is incurred “directly in the construction of tangible property”. The expenditure on materials does not qualify.

In this example, if the production line, once completed, is used in the R&D process – perhaps for testing – depreciation on the production line will not be eligible for the credit. This is because the requirement in schedule 21, part A, paragraph 2(b) that “all the activities involved in the construction of the property are research and development activities” is not met because the construction of the production line is neither a scientific, investigative or experimental activity, and the production line is not constructed mainly for the purpose of scientific, investigative and experimental activities. The main purpose of the production line is use in the business.

## **Application date**

The amendments are retrospective and will apply for the 2008–09 income tax year. The provisions were repealed from the 2009–10 income year by the Taxation (Urgent Measures and Annual Rates) Act 2008.