



Briefing note

Reference: BN2017/675

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From: Richard Braae

Subject: **Consideration of the start date for an R&D tax credit**

Purpose

1. This Note outlines factors to consider in relation to the commencement date of an R&D tax credit. For the reasons set out below, Inland Revenue recommends a 2020 start date rather than a 2019 start date.

Background and Context

2. There are three factors prompting this Note.
3. First, the incoming Government's policy is to re-introduce an R&D tax credit, with the goal of encouraging greater levels of business R&D. In taking this step, it is sensible to consider whether there are other parts of the tax system that might be frustrating firms from undertaking R&D.
4. Second, in response to the Supreme Court's decision in *Trustpower Limited v Commissioner of Inland Revenue* (the *Trustpower* decision), IR has been considering the approach to feasibility and black hole expenditure.
5. Finally, Minister Nash has received a letter from Business New Zealand, the Angel Association, New Zealand Private Equity and Venture Capital Association, and the Corporate Taxpayers Group. This letter argues that current tax law which prevents tax losses being carried forward if more than 51 per cent of ownership in a company changes hinders innovation in New Zealand. They instead propose the adoption of a same or similar business test.

6. These factors come together when considering companies in loss that are undertaking R&D and other productivity-enhancing expenditure– a relatively common outcome for start-ups. Will they be incentivised to undertake more R&D by the tax credit? Are there other settings in the tax system which are deterring them from undertaking R&D or treating them less favourably than other firms – perhaps older, larger and more established firms, that are in profit?

Relevant factors under current tax law

7. General factors:
 - There is no R&D tax credit, but Government policy is to introduce one.
 - As a general principle, losses are carried forward rather than being paid out. This non-symmetrical treatment of losses (compared to profits) is motivated by protection of the tax base.
 - Where there is a breach of (ownership) continuity, losses cannot be carried forward. This too is motivated by protection of the tax base, but is an asymmetry that discourages taking risk.
8. Within the tax system, there are some factors that already provide more favourable treatment for firms undertaking R&D:
 - R&D expenditure is deductible (can be expensed) even though it is often contributing to the creation of an asset
 - For R&D intensive firms, there is a (capped) cashing out of tax-losses
 - R&D expenditure can be allocated, in total or in part, to a later income year¹. This ensures deductions for R&D are not lost under the shareholder continuity rules when a company is sold.
 - Amendments were made in 2014 to allow deductions for certain black hole R&D expenditure, such as expenses incurred for the purpose of applying for a patent.
9. A final point is that there is currently no capital gains tax, which is potentially advantageous to start-ups. This issue, however, is within the terms of reference of the Tax Working Group.

Assessment of the current system

10. Firms that have current profits (perhaps from some other line of business), are currently able to realise the full value of their deductions for R&D. For firms that don't have current profits, R&D deductions must be deferred until the firm has profits. This non-symmetric treatment of firms in loss compared with firms in profit can be considered as treating the latter more favourably than the former. Given that the typical high-tech start-up company will be in loss, this could be argued as creating a disincentive for them, and of their undertaking R&D.
11. If the R&D tax credit is not refundable (ie, is not paid out if a firm is in loss) – and IR argues strongly it should not be because of fiscal risks that arise when the tax credit is refundable – it will provide weaker incentives for start-ups to undertake more R&D.
12. At the same time, it can be noted that within the tax system there are already provisions which recognise the circumstances that might afflict firms undertaking R&D and compensates for these.
13. In addition, grants provided by Callaghan Innovation are a means for Government directly supporting firms at an early, pre-profit stage which are undertaking R&D. The treatment of firms should be considered from a wider perspective than just the tax system.

¹ This provision will need to be considered in development of the R&D tax credit.

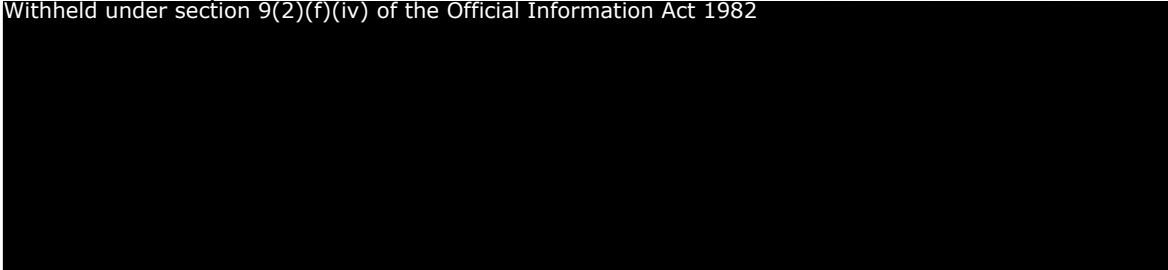
14. Nonetheless, it can be noted that the current system is not ideal. The concerns are:
- There is a patchwork of provisions that have been put in place to assist or compensate firms undertaking R&D. This creates complexity – complexity which is likely to be aggravated by the introduction of an R&D tax credit.
 - The patchwork creates fiscal risk if rationalisation of the rules is not undertaken at the same time any R&D tax credit is introduced.
 - Where these compensations have been put in place, they are tightly tied to R&D because this is a relatively tangible concept to define. However, there are innovative firms that are equally worthy of Government support, in terms of contributing to economic growth and the goals of a diverse, sustainable low-carbon economy, and these firms are not receiving special consideration.

Where IR would like to head

15. Pulling together these factors, Inland Revenue considers the tax system should ideally move in the following directions (though noting that some of these concepts do not currently have funding committed for them):

- Introduce an R&D tax credit to address the spillovers arising from firms undertaking R&D

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16.



Implications for introduction date of an R&D tax credit

17. In the cross-agency report on the introduction of an R&D tax credit (IR2017/644), Ministers are asked to consider introducing the credit on 1 April of either 2019 or 2020.
18. Inland Revenue has not previously expressed a strong preference with respect to these dates.
19. However, we now consider that ideally the R&D tax credit will be developed in the context of the above issues – particularly regarding loss continuity, to allow for consistent treatment of losses. The complexity of these issues and the time that will be required to resolve them leads us to recommend a 1 April 2020 start date for the R&D tax credit.

Consultation with Treasury

20. Treasury was informed about this briefing note.

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