Taxation (Research and Development Tax Credits) Bill

Officials' report to the Finance and Expenditure Committee on submissions on the Bill

March 2019

Prepared by Policy and Strategy, Inland Revenue and Innovation Policy, Ministry of Business, Innovation and Employment

CONTENTS

Research and development

OVERVIEW

The Bill introduces a tax credit for research and development (R&D) conducted by businesses in New Zealand from the 2019–2020 income year.

The Government has set a target of raising the total amount of R&D performed in New Zealand to two percent of gross domestic product (GDP) by 2028. To meet this goal, there needs to be a significant increase in the amount of business R&D performed in New Zealand.

By providing a tax incentive in the form of a tax credit, the Government will lower the cost to businesses of performing R&D. This will create an incentive for firms already performing R&D to do more, and for other firms to start undertaking R&D.

The rationale for providing R&D tax credits to businesses is that there is under-investment by businesses in R&D because the investing firm does not capture all the benefits of the investment. Some of the benefit is captured by other businesses or consumers, rather than by the investing firm. The tax credit is intended to provide an offset for the likely spill-over benefits to other firms and individuals in New Zealand. This is expected to help transform the New Zealand economy into a high-skill, knowledge-based economy. There will be an evaluation of the tax credit in five years to determine whether it is effective in meeting these objectives.

A tax credit has been selected as the instrument for providing the subsidy because of the wide reach of the tax system. The tax system also provides certainty because firms can access support based on predefined rules.

The tax credit is available for eligible businesses that have incurred eligible expenditure on R&D activities. Below is a high-level summary of how the credit works, the eligibility criteria for the credit (set out in the Bill as introduced into Parliament), and the main themes from submissions.

How the credit works

The tax credit is used to offset the income tax payable by claimants who are in a tax paying position. Limited refundability (up to $255,000) is available to some businesses in loss, or with insufficient tax payable to offset all their tax credits.

To be eligible for limited refundability, a business must be a company (but not a listed company), must not derive exempt income, and twenty percent or more of its labour costs must be R&D-related. The Government has committed to reviewing and potentially introducing revised refundability criteria from 1 April 2020.

Eligibility requirements

Eligible person

To be eligible for the tax credit a person must:

- Perform a core R&D activity in New Zealand, or have a contractor perform one on their behalf;
- Carry on business through a fixed establishment in New Zealand (unless the person is a tax charity or levy body);

- Have controlling rights in relation to the core R&D activity (or ensure these rights are held by a member of the person's corporate group); and

- Own the results of their R&D activities or have the right to use the results of the activities for no further consideration.

The person can also satisfy the ownership requirement if the results of their R&D activities are owned by a member of their corporate group, as long as that company is a tax resident of a jurisdiction with which New Zealand has a double tax agreement.

A person is not eligible if they meet one or more of the following:

- Fail to file their income tax return and R&D supplementary return in time;

- Receive a Callaghan Innovation Growth Grant for any part of the relevant income year;

- Are an R&D contractor for the R&D activity;

- Are, or are controlled by or associated with, a Crown research institute, district health board, or tertiary education organisation.

R&D activity

A core R&D activity is an activity that:

- Is conducted using a systematic approach;

- Has a material purpose of:

  - Creating new knowledge, or new or improved processes, services, or goods; and

  - Resolving scientific or technological uncertainty; and

- Is performed in New Zealand; and

- Has its day-to-day management conducted in New Zealand.

An activity does not satisfy the uncertainty requirement if the knowledge required to resolve the uncertainty is:

- Publicly available; or

- Deducible by a competent professional working in the relevant scientific or technological field.

An activity that does not satisfy the core R&D activity definition may be eligible as a supporting R&D activity provided it is inextricably linked to a core R&D activity. Certain activities are expressly excluded from being core R&D or supporting R&D activities.

Eligible expenditure

- A person needs to have approved research provider expenditure, or at least $50,000 of eligible R&D expenditure, to be eligible for the credit.

- The maximum amount a person can claim is \$120m, unless they have received approval from the Commissioner to exceed this amount.

- Most types of expenditure incurred on R&D activities are eligible, including expenditure on wages and salaries, consumables, depreciation, and the costs of creating intangible property.

- Some expenditure is expressly excluded. This includes the up-front cost of acquiring assets, amounts that go towards creating tangible depreciable assets, interest, expenditure that relates to Government grants, and some employee-related expenditure.

- Some expenditure is capped:

  – Eighty percent of amounts paid to R&D contractors (people paid to do R&D on behalf of claimants) is eligible.

  – A \$3 million cap applies to eligible internal software development expenditure.

  – No more than ten percent of a person's claim can relate to expenditure on R&D activities performed overseas.

- Where expenditure is incurred on an R&D activity performed in the course of commercial production, a person's claim is limited to the additional expenditure incurred because of that R&D activity.

Submissions

Thirty-two submissions were received on the R&D tax credit legislation. Most generally support the introduction of the credit. General themes were that sustainability and longevity of the regime are important, as well as clear legislation and guidelines.

Eligibility of software R&D

- **Core R&D activity definition too narrow:** the current core R&D activity definition is too narrow in the context of software. Software development activities are unlikely to have a material purpose of resolving scientific or technological uncertainty.

- **Internal software development cap too low:** the \$3 million cap on internal software development expenditure is too low and should be increased or removed.

Expenditure on R&D contractors

- **Profit margin should not be split out:** a principal's R&D tax credit claim, when engaging an R&D contractor, should not be reduced by twenty percent to account for the R&D contractor's profit margin.

- **Ineligible expenditure on R&D contractors should be eligible:** ineligible expenditure incurred by R&D contractors should not be removed from calculations performed by principals to determine the amount of tax credit principals are entitled to.

Foreign R&D expenditure cap

- **The foreign R&D expenditure cap is too low:** the ten percent cap that applies to foreign expenditure is too low and should be increased.

- **Cap applies too broadly:** the cap should not apply to non-residents who perform R&D in New Zealand.

Refundability

- **Broad refundability from year-one:** there should be a broader refundability mechanism from the first year of the regime.

- **Entities that derive exempt income:** the exclusion from refundability for entities that derive exempt income is too broad.

Eligibility criteria

- **Sole control requirement may exclude joint ventures (JVs):** the requirement that each claimant must have "sole" control over their R&D activities prevents JVs from being eligible for the credit. Only one JV member can have "sole" control, but in practice multiple members of a JV will often have control over the JV's R&D.

- **Ownership requirement may exclude JVs:** the requirement that each claimant own the results of their R&D activities would be difficult to meet for JVs. Businesses working together in a JV may not all own the results of the JV's R&D activities.

- **R&D contractor exclusion may exclude subsidiaries of multinationals:** subsidiaries of multinationals performing R&D in New Zealand on behalf of foreign parents should not be ineligible under the R&D contractor exclusion.

In-year approval

- **Providing supporting information before claims declined:** claimants whose applications would otherwise be declined should have the opportunity to provide additional information in support of their application first.

- **Allow significant performers to access general approval regime:** a person who opts into the significant performer regime should also be able to obtain general approval for some of their R&D activities (if, for example, they are uncertain about the eligibility of the activities).

- **Extend general approval to include supporting R&D activities:** the general approval process should be extended to include supporting activities.

- **In-year approval pilot in year one:** the significant performer approval process should be available as early as possible, with the submitter wanting to be involved in a pilot process.

- **R&D certifier penalty regime overly punitive:** the process for revoking R&D certifier status is overly punitive and should be amended.

Other submissions

- **R&D expenditure should be recognised on an accruals basis:** this would make the treatment of R&D expenditure more consistent with how expenditure is generally recognised for tax purposes.

- **Employee-related payments should be eligible:** currently, expenditure on employee share schemes, bonuses, employee recruitment and relocation is ineligible.

- **Orders in Council power needs constraints:** Lack of appropriate criteria to limit the power, and no requirement that affected parties are consulted.

Issue: General support

Submission

(EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Fisher & Paykel Limited, Fisher & Paykel Healthcare, Corporate Taxpayers Group, ExportNZ, ManufacturingNZ, Zespri, Air New Zealand Limited)

We support the introduction of the R&D tax credit.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Support for refinement of proposals since the discussion document

Submission

(Air New Zealand Limited, EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Fisher & Paykel Limited, ExportNZ, ManufacturingNZ)

We support the refinement of the proposals since the discussion document. *(EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Fisher & Paykel Limited, ExportNZ, ManufacturingNZ)*

We are pleased that state owned enterprises (SOEs) will be eligible for the credit. *(Air New Zealand Limited)*

We support the Government replacing the dual-purpose rule that was proposed in the discussion document with the commercial production rule. *(ExportNZ, ManufacturingNZ)*

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Integrity and sustainability of the regime must be balanced against compliance and administrative costs

Submission

(Corporate Taxpayers Group, Deloitte, EY)

The regime must have longevity and stability. Taxpayers need certainty because they invest considerable effort in understanding new tax regimes. *(Corporate Taxpayers Group, Deloitte)*

Integrity is essential but must be balanced against compliance and administrative costs. (*EY*)

Comment

Officials welcome this perspective. The incentive has been designed with integrity measures to help ensure it is sustainable. These measures have been balanced with compliance and administrative costs.

Recommendation

That the submission be noted, no further action required.

Issue: The effect of the R&D tax credit on business expenditure on R&D

Submission

(Fisher & Paykel Limited, NZTech, PwC)

The R&D tax incentive has the potential to significantly grow business expenditure on R&D, increase demand for highly skilled and well-paid jobs, and generate a wealth of technical knowledge and capability in New Zealand. *(Fisher & Paykel Limited)*

The R&D tax incentive will lead to more tech investment. *(NZTech)*

We have concerns about the R&D tax incentive in its current form, primarily because it will exclude a lot of software development. It is questionable whether it delivers upon the Government's policy intent of increasing private sector R&D in New Zealand. *(PwC)*

Comment

Officials welcome the perspective that the R&D tax incentive will increase R&D in New Zealand.

Officials note the concern about the form of the R&D tax incentive. One reason for requiring a 5-yearly evaluation (refer to proposed new section LY 10) of the regime is to ensure the policy is achieving its objectives.

The Government has decided to put in place the R&D tax credit because the credit offers wide applicability and reach. It also provides certainty and predictability to businesses and is expected to help support long-term investment decisions.

By providing a tax incentive in the form of a tax credit, the Government aims to lower the cost to businesses of performing R&D. This will create an incentive for firms already performing R&D to do more, and for other firms to start undertaking R&D.

The accessibility of the tax incentive for software development has been considered throughout the development of the policy. Whether to have a separate activity definition relating to software was considered but rejected because of the difficult boundaries this would create, especially as a lot of software development is integrated within other product or service development.

Officials note that the activity definition has the same structure that applies in other jurisdictions such as Australia, Canada and the United Kingdom. Canada, for instance, requires activities to advance knowledge or technology, and explains in guidance that this involves attempting to resolve scientific or technological uncertainty. These schemes support a wide range of software projects and the same outcome is expected in New Zealand.

The published guidelines provide examples of software projects that would qualify for the tax incentive.

Recommendation

That the submission be noted, no further action required.

Issue: R&D tax credit as part of a suite of incentives

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Roger Ford, NZRise)

We support the R&D tax credit being part of a suite of R&D incentives. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

The R&D tax incentive should be part of a suite of incentives. There has been no clear articulation of the context the incentive and the Government's overall R&D strategy. *(Roger Ford, NZRise)*

Comment

The R&D tax credit is only part of a suite of incentives available to encourage R&D by businesses. Callaghan Innovation continues to operate R&D Project Grants and a range of other initiatives aimed at increasing R&D.

The Government is also developing a Research Science & Innovation Strategy, which will (among other things) set out how it plans to achieve the goal of raising R&D to two percent of GDP by 2028. It will include further initiatives to elicit the step-change in business R&D that will be required.

Recommendation

That the submission be noted, no further action required.

Issue: R&D controlling rights requirement should be deleted

(Clause 10 (proposed new section LY 3(1)(c)))

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Russell McVeagh, Zespri)

Proposed new section LY 3(1)(c) (the controlling rights requirement) should be deleted:

- The "sole" controlling rights requirement only allows one person to have controlling rights. This is problematic because in a JV more than one party might have the right to stop, start or change the direction of the JV's R&D activities.

- R&D contractors are excluded already through an explicit exclusion (proposed new LY 3(2)(c)). The ownership/right to use requirement in LY 3(1)(d) should also exclude R&D contractors, because R&D contractors are unlikely to own the results of the R&D activities they perform on behalf of other people.

- The controlling rights requirement is inconsistent with commercial practice for service contracts. It is unusual for a principal to have the sole right to stop contracted activities. A contractor would normally reserve the right to cease their activities should a principal fail to pay for their services as agreed.

- It is unclear what "change the direction of an activity" and "choose whether results are followed up on or not" mean, and how these R&D controlling rights would be documented in commercial contracts.

Comment

Proposed new section LY 3(1)(c) requires a person (or a person in the same group of companies as the person) to have the sole right to control their R&D activities ("R&D controlling rights"). This includes the right to start and stop an activity and change its direction.

The controlling rights requirement is aimed at ensuring that R&D contractors are not able to claim for R&D activities they perform for other people. It is expected that only principals will have controlling rights.

It is the policy intent that joint ventures and informal R&D collaborations be eligible for the R&D tax incentive. Officials agree with the rationale provided by submitters for deleting LY 3(1)(c). In the absence of the controlling rights requirement in LY 3(1)(c), other criteria in the legislation should exclude R&D contractors from claiming tax credits for expenditure they incur performing R&D activities on behalf of other people.

Recommendation

That the submission be accepted.

Issue: Subsidiary performing R&D on behalf of multinational parent company

(Clause 10 (proposed new section LY 3(2)(c)))

Submission

(EY, Fisher &Paykel Appliances Ltd)

A subsidiary of a multinational company performing R&D in New Zealand should be able to receive the R&D tax credit.

Comment

The policy intent is for subsidiaries of multinationals to be eligible for R&D activities if they perform R&D activities on behalf of foreign parents.

As currently drafted it may be unclear whether proposed new section LY 3 (in conjunction with the proposed new definition of "research and development contractor" in YA 1) allows a subsidiary of a foreign company doing R&D in New Zealand on behalf of its foreign parent to qualify for the R&D tax incentive.

Section LY 3(2)(c) provides that an R&D contractor is not eligible for the tax credit. An R&D contractor is defined to include a person who performs an R&D activity on behalf of another person. Section LY 3(1)(b) prevents a person who does not carry on business through a fixed establishment in New Zealand from claiming the credit.

The Bill as introduced could be interpreted so that it excludes:

- A New Zealand subsidiary performing R&D activities on behalf of its foreign parent, because of the R&D contractor exclusion in LY 3(2)(c); and
- The foreign parent of the subsidiary performing R&D on its behalf in New Zealand, because of the fixed establishment requirement in LY 3(1)(b).

The general intention is that only principals can claim the credit, and not R&D contractors, so that the person who decides to invest in the R&D is incentivised. This is especially the case where both the principal and contractor are based in New Zealand, and (absent the R&D contractor exclusion in section LY 3(2)(c)) would both potentially be eligible for the tax credit.

Officials recommend that the R&D contractor exclusion in LY 3(2)(c) be amended so that it allows an R&D contractor to be eligible for activities they perform on behalf of other people, where:

- the R&D contractor satisfies the tax credit eligibility criteria (ignoring the existing R&D contractor exclusion in LY 3(2)(c)); and
- the principal does not carry on business through a fixed establishment in New Zealand (that is, the principal is essentially based off-shore and would not itself be eligible for the tax credit).

The aim of the R&D tax credit is to encourage R&D to be undertaken in New Zealand, because of the spill-overs associated with R&D being physically performed in New Zealand. A principal who does not carry on business through a fixed establishment in New Zealand is not eligible for the tax credit. Therefore, allowing a New Zealand-based R&D contractor to be eligible in this situation will incentivise the performance of R&D activities in New Zealand without the risk of the same expenditure qualifying for the tax credit twice.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: The R&D ownership requirement in the context of joint-ventures and commercialisation partnerships

(Clause 10 (proposed new section LY 3(1)(d)))

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, KiwiNet, Auckland UniServices Limited)

The requirement that a claimant must own the results of their R&D or have the right to use the results for no further consideration may prevent JVs from qualifying. Businesses working together in a JV may not necessarily own the results of the JV's R&D, or there may be restrictions on their use of the R&D results.

Further, commercialisation arrangements exist whereby a business is furthering the R&D that was started by another party, with the results of that further R&D being licensed back to the business for consideration. These parties would not be able to access the credit, but there is no good policy reason to exclude such businesses provided the R&D activities are undertaken in New Zealand. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

"Consideration" in LY 3(d)(ii) should be defined. It is unclear how the rules apply to a commercialisation entity under a commercial partnership model. This is where a public research organisation has advanced a research discovery to where there is a possibility for commercialisation. A commercialisation entity is formed – shareholders being private sector investors and the public research organisation. The intellectual property is held by the public research organisation and often licensed to the commercialisation entity, usually for no financial consideration. Absent a definition of consideration, however, there is a risk that where a commercialisation entity enters into a commercial arrangement that requires the provision of non-financial consideration in exchange for using the results of R&D, the commercialisation entity would be ineligible for the R&D tax credit. Commercialisation entities are currently eligible under the Callaghan Innovation Growth Grants regime and should continue to be eligible for support through the R&D tax credit. *(KiwiNet, Auckland UniServices Limited, PwC)*

Comment

Officials are sympathetic with the argument that not all parties to a JV may necessarily own the results of the JV's R&D or have the right to use the results of the R&D for no consideration.

Officials also consider that individual members of JVs may struggle to satisfy the criteria in section LY 3(1)(a) and (b). Section LY 3(1)(a) requires a claimant to have a core activity. Section LY 3(1)(b) requires a claimant to carry on a business in New Zealand through a fixed establishment. For example, neither member of a JV will be eligible (applying the Bill as introduced) where one member provides the funding and the other performs the R&D activities.

Officials recommend that joint ventures are able to satisfy all limbs in LY 3(1) as a collective, similar to how the rules operate for partnerships. In addition to this amendment, officials also recommend that section LY 3(2)(e) is amended so a member of a JV is ineligible if the member is not New Zealand tax resident. This second amendment brings the JV rules in line with the existing partnership rules in subpart LY and ensures that a member of a JV can only receive an R&D tax credit if they themselves have sufficient ties to New Zealand to be considered a New Zealand tax resident.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Allocation of R&D tax credits to members of Joint Ventures

Submission

(Matter raised by officials)

That the R&D tax credit is allocated to members of JVs in accordance with their interest in the JV.

Comment

Officials recommend that the R&D tax credit is allocated to members of JVs in accordance with each member's interest in the JV. This is similar to the treatment of partnerships. For partners in partnership, each partner receives R&D tax credits in accordance with their interest in the partnership.

Recommendation

That the submission be accepted.

Issue: Definition of "on behalf of" in the context of contractors

(Clause 21(15), clause 10 (proposed new section LY 3))

Submission

(EY)

The legislation should define what "on behalf of" means in the context of an R&D contractor performing R&D on behalf of another person.

Comment

Officials recommend that the meaning of "on behalf of" is clarified in guidance. A key consideration is whether a claimant is contracting for:

- an outcome, for example producing a product – claimant is unlikely to be an R&D contractor); or

- to perform an R&D activity – claimant is likely to be an R&D contractor.

Control over an R&D activity, ownership of the results of an R&D activity, who bears the financial risk are also relevant considerations. A claimant that funds, controls, and owns the results of an R&D activity is highly likely to be considered a principal in respect of the R&D activity.

Note that whilst officials recommend removing the controlling requirement in section LY 3(1)(c), control is still relevant when determining whether a person is performing R&D "on behalf of" another person.

Recommendation

That the submission be declined.

Issue: Adopting the "on behalf of" test from 2008 tax credit regime

(Clause 10 (proposed new section LY 3))

Submission

(KPMG)

Separate out the control and ownership eligibility tests from the rest of LY 3, and group them together under a single concept, similar to the legislative framework used for the "on own behalf of" tests in the 2008 R&D tax credit regime (which required financial risk, ownership, and control over R&D activities).

Comment

Officials acknowledge that it is important the legislation is not confusing for taxpayers, and that many taxpayers are familiar with the "on behalf of" tests used in the 2008 tax credit regime.

The proposed R&D tax credit regime is aimed at incentivising R&D that occurs in New Zealand because of the positive externalities associated with R&D being performed in New Zealand. Provided a taxpayer's R&D activities are performed in New Zealand, the proposed regime is less concerned with whether the funding for the R&D activities comes from overseas, who ultimately owns the results of the R&D activities, and whether the activities are controlled by a New Zealand or foreign-based entity.

As long as only one person can make a claim in respect of the relevant eligible expenditure and the R&D activities are performed in New Zealand, the proposed regime is intended to provide support for the activities through an R&D tax credit. In saying this, control, ownership and financial risk are still relevant to determining the meaning of "on behalf of" and therefore who is a principal or who is a contractor. Officials consider that this is best clarified in guidance, rather than in legislation.

Recommendation

That the submission be declined.

Issue: Contractor performing activities outside New Zealand resulting in ineligibility

(Clause 10 (proposed new section LY 3(1)(a)))

Submission

(Corporate Taxpayers Group)

A "to the extent" test should be added to subsection LY 3(1)(a) to ensure that to the extent a research and development contractor performs activities outside New Zealand, the person for whom those activities are performed is not ineligible for the R&D tax credit.

Comment

Officials disagree with the submitter. Section LY 3(1)(a) simply provides that the R&D rules apply to a person where a contractor performs a core R&D activity in New Zealand on their behalf. There is nothing to suggest that all their activities will be rendered ineligible if an activity is performed outside New Zealand – just those ones performed outside New Zealand may not be eligible. This point will be clarified in guidance.

Recommendation

That the submission be declined.

Issue: Restrict ownership requirement to core R&D activities

(Clause 10 (proposed new section LY3(1)(d)))

Submission

(Corporate Taxpayers Group, Deloitte)

It should be sufficient to own the results of core R&D activities, not also supporting activities. There are situations where supporting activities may include trials that are outsourced to a third party, and the third party undertaking those trials may own these results. The person performing the R&D should still be eligible despite the results of the support activity being controlled by other persons.

Comment

Officials disagree with the submitter. A person's outsourced supporting activities (for example, trials outsourced to a third party) may still qualify if the person owns the results or is able to use the results for no consideration, despite the third party owning the results.

Recommendation

That the submission be declined.

Issue: Half of intellectual property rights should be held by New Zealand

(Clause 10 (proposed new section LY 3(1)(d)))

Submission

(TEPHRA)

Intellectual property rights should be held fifty percent by New Zealand and placed in the New Zealand superfund trust for the future.

Comment

Officials disagree with the submitter. The focus of the credit is on where the R&D activity is performed, not creation or ownership of the intellectual property. Giving effect to the submission would require a different framework for how the Government has decided to support research and development activity.

Recommendation

That the submission be declined.

Issue: Contractually allocating rights to the results

(Clause 10 (proposed new section LY 3(1)(d)(ii)))

Submission

(Fletcher Building Limited)

Subsection LY 3(1)(d)(ii) should be amended to allow parties to contractually allocate their rights to the results of the R&D activities to another person.

Comment

A person can contractually allocate their rights to the results of the R&D activities to another person, provided they still own the results (or a person in the same corporate group owns the results) or have the right to use the results for no consideration.

Recommendation

That the submission be noted, no further action required.

Issue: Using the results of the R&D within a corporate group

(Clause 10 (proposed new section LY 3(1)(d)(ii)))

Submission

(Russell McVeagh)

A person should be able to satisfy LY 3(1)(d)(ii) if a member of their corporate group has the rights to use the results of the person's R&D activity for no further consideration.

Comment

The Bill proposes that where neither a person nor their corporate group own the results of the R&D activities performed, the person will only be eligible if they may use the results of the R&D for no consideration. Subsidising R&D activities where a New Zealand company is required to pay to use the results of their R&D activity would degrade the externalities produced from the subsidised R&D performed in New Zealand.

If there is evidence that this rule creates a significant barrier to the performance of R&D in New Zealand, then consideration could be given to amending the rule. Officials do not recommend amending the rule at this stage.

Recommendation

That the submission be declined.

Issue: New Zealand parent company should be able to own the results of the R&D

(Clause 10 (proposed new section LY 3(1)(d)(i)))

Submission

(Matter raised by officials)

Subsection LY 3(1)(d)(i) should be amended to include a company that is resident in New Zealand.

Comment

Proposed new section LY 3(1)(d)(i) provides that a person satisfies the subsection where a company that is both resident in a country with which New Zealand has a double tax agreement, and in the same group of companies as the person, owns the results of the R&D activity.

As currently worded, a person would not satisfy this requirement where the parent company in New Zealand owned the results of the R&D, as New Zealand does not have a DTA with itself. This was unintended.

Recommendation

That the submission be accepted.

Issue: Exclusion of non-resident partners and owners of look-through companies

(Proposed new section LY 3(2)(e))

Submission

(Corporate Taxpayers Group)

Unsure why a non-resident partner or non-resident owner of an interest in a look-through company is ineligible, if the person carries on business in New Zealand through a fixed establishment.

Comment

Absent this exclusion, claimants who do not have a New Zealand fixed establishment will be able to receive the R&D tax credit. The tax incentive has been designed to ensure that only people with sufficient presence in New Zealand receive R&D tax credits. This is important from an integrity perspective because claimants with ties to New Zealand are easier to follow up with if, for example, a claim is reassessed downwards, and credits need to be repaid (which is especially important for recipients of R&D tax credit refunds).

Recommendation

That the submission be declined.

Issue: Growth Grant exclusion should be narrower

(Clause 10 (proposed new section LY 3(2)(b)))

Submission

(Corporate Taxpayers Group, Deloitte)

Growth Grant recipients should also be able to receive the R&D tax credit, to the extent that the R&D undertaken is not covered by the Growth Grant.

The exclusion for Growth Grant recipients should also not preclude those who choose to have their Growth Grant extended to 31 March 2020 from receiving an R&D tax credit for eligible R&D undertaken after this date. For example, a Growth Grant recipient with a 31 December 2021 balance date should be able to receive a Growth Grant for R&D undertaken from 1 January 2021 to 31 March 2021, and R&D tax credits for R&D undertaken from 1 April 2021 to 31 December 2021.

Comment

The Callaghan Innovation Growth Grant scheme will end on 31 March 2021. The R&D Grants Ministerial Direction has been implemented to effect this change. The R&D tax incentive replaces the Growth Grant, so claimants must make a decision as to which form of government assistance suits them best, and the best transition approach for their business.

For some recipients, this may mean ending their Growth Grant in 2020 to avoid a gap in their R&D funding. Alternatively, claimants may claim the Growth Grant for part of the year, and then claim the R&D tax incentive from the start of the next year.

Recommendation

That the submission be declined.

Issue: Association test should be narrower

(Clause 10 (proposed new section LY 3(2)(d)))

Submission

(Corporate Taxpayers Group)

A person should not be excluded from the R&D tax credit if they are associated with a Crown research institute (CRI), district health board (DHB), or tertiary education organisation (TEO) under sections YB 6 to YB 9 (these sections associate beneficiaries of trusts with other trust participants). Absent this, inadvertent association may be formed with a CRI, DHB or TEO if they are beneficiaries of a trust which undertakes R&D.

Comment

Officials disagree with this submission. The associated person rules apply in many areas of the tax system without modification. The operation of this rule will be monitored once the regime comes into force, to ensure it gives rise to appropriate results.

Recommendation

That the submission be declined.

Issue: Non-business researcher – industry organisations

(Clause 21(13))

Submission

(Corporate Taxpayers Group)

The eligibility rules need to be flexible enough to allow industry organisations to qualify when they operate under a mixture of different organisation types. For example, the rules need to enable an incorporated society (which receives levies) with a one hundred percent investment in a company who undertakes R&D to be eligible for the incentive.

Comment

Officials agree that the rules should be flexible to accommodate, as much as possible, the various corporate structures that claimants use. Officials have recommended that amendments are made to better enable JVs to qualify for the incentive.

Officials consider that the situation described by the submitter would be eligible under the existing provisions in the Bill as introduced. The company would receive R&D tax credits, which the incorporated society could benefit from through dividends paid by the company to the incorporated society.

Recommendation

That the submission be noted, no further action required.

Issue: Consolidated groups

(Proposed new sections 68CB and 68CC, subpart LY and any associated provisions)

Submission

(EY)

Consideration should be given to how the in-year approval rules will apply to businesses that are members of a consolidated tax group.

Comment

Officials agree with this submission. No changes are required to the legislation, but the treatment of consolidated tax groups will be taken into account operationally when designing the systems and processes for R&D tax credit claims. The treatment of consolidated tax groups will be clarified in guidance.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Alternative R&D activity definitions

(Clause 10 (proposed new section LY 2))

Submission

(Roger Ford, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)

The R&D definition needs to be brought in line with international best practice. *(Roger Ford)*

Having a tax credit specific definition that is different from R&D definitions for financial reporting and other tax regimes will lead to significant compliance costs for businesses. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

Comment

Officials consider that the proposed R&D activity definitions are in line with international best practice. It is based on the Frascati Manual (an OECD publication) and has the same elements as the tax credit definition used in Australia, Canada and the United Kingdom. Some modifications to the core R&D activity definition were made following the release of the discussion document to make it more inclusive of all sectors of the economy.

Officials consider it necessary to have a definition of R&D activity that differs from the accounting standard. The accounting standard is based on creating a boundary between expensed and capitalised expenditure and does not have the robustness that is preferred for distinguishing between expenditure that is eligible for a subsidy and expenditure that is not. This robustness is achieved in the R&D tax incentive definition through the introduction of the scientific and technological uncertainty test.

While differences between the proposed R&D activity definitions and existing definitions already used in New Zealand (such as the definition used for the R&D tax loss credit) will increase compliance costs, officials note the Government has commenced further work to review the R&D tax loss credit.

Recommendation

That the submissions be declined, subject to officials' comments.

Issue: Core R&D activity – day-to-day management

(Clause 10 (proposed new section LY 2(1)(a)(iv)))

Submission

(EY, Chartered Accountants Australia and New Zealand, Deloitte, Corporate Taxpayers Group, KPMG)

This requirement should be:

- Deleted *(EY, Chartered Accountants Australia and New Zealand)*
- Defined *(Deloitte)*
- Amended *(Corporate Taxpayers Group)*
- Moved to section LY 3(1)(c) and reconciled with the controlling rights requirement *(KPMG)*

Comment

The day-to-day management requirement in proposed new section LY 2(1)(a)(iv) currently forms part of the core R&D activity definition.

Officials agree with EY and Chartered Accountants Australia and New Zealand's suggestion that this provision be deleted. The day-to-day management requirement does not add any additional rigour to the core R&D activity definition. There is already a requirement that to be a core activity, an activity must be performed in New Zealand (section LY 2(1)(c)). If a person performs their R&D activity in New Zealand, day-to-day management of that activity must also (impliedly) take place in New Zealand.

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Core R&D activity – material purpose

(Clause 10 (proposed new section LY 2(1)(a)(ii) and (iii)))

Submission

(Corporate Taxpayers Group, Deloitte, EY)

The use of "material purpose" is likely to result in uncertainty, because materiality is generally applied as an accounting concept relating to whether misstatements could reasonably be expected to influence the decisions of users. There is a risk that the definition could include the accounting definition of material, which could be as low as five percent. Material purpose should be replaced with "significant purpose" or a purpose that is "not minor or incidental".

Comment

Officials disagree with the submitters. Accounting concepts are not relevant in determining the meaning of "material" in this context because the R&D tax incentive regime is tax-based.

"Material" is not defined in the legislation. The Oxford Dictionary defines material as meaning "significant" or "important". The meaning of "material" and how this limb applies to claimants will be clarified further in the guidelines.

Recommendation

That the submission be declined.

Issue: Core R&D activity – remove "working" from the competent professional test

(Clause 10 (proposed new section LY 2(1)(b)(ii)))

Submission

(Corporate Taxpayers Group, EY, Deloitte)

"Working" should be removed from the phrase "a competent professional working in the relevant scientific or technological field". The inclusion of the term "working" makes the test too restrictive because it could exclude the knowledge of academics or professionals who are relevant and knowledgeable but not necessarily "working" in the relevant field.

Comment

Officials agree with the submitters.

Recommendation

That the submission be accepted.

Issue: Core R&D activity – knowledge required to resolve the uncertainty

(Clause 10 (proposed new section LY 2(1)(b)))

Submission

(Corporate Taxpayers Group, Deloitte)

The wording "knowledge required to resolve the uncertainty" should be replaced with "knowledge required that resolves the uncertainty" to make clear that the answer to resolve the uncertainty must be publicly available or deducible by a competent professional, rather than just the process. In other words, if the person knows the process to resolve the uncertainty but doesn't know the outcome, this should be sufficient uncertainty to qualify for the tax credit.

Comment

Officials disagree with the submitters. If the person knows an existing methodology or process to resolve the uncertainty, then it is not the kind of uncertainty that is eligible for the tax credit. The tax credit is available for "difficult" problems in science or technology. If a person doesn't know the answer to a problem off the top of their head, but knows the process to determine the answer, then it is not the kind of problem that the tax incentive is seeking to incentivise the resolution of. Notwithstanding this, if what the person is trying to achieve goes beyond what is currently known to be achievable, and the person needs to investigate possible solutions, then this process of investigation could be R&D. This point will be clarified in guidance.

Recommendation

That the submission be declined.

Issue: Core R&D activity – excluding overseas activities

(Clause 10 (proposed new section LY 2(1)(c)))

Submission

(Corporate Taxpayers Group, Deloitte, Fisher & Paykel Healthcare)

Core R&D activities should be able to be performed outside New Zealand.

Comment

Officials disagree with the submitters. The requirement that the R&D is undertaken in New Zealand is at the heart of the tax incentive. Given that the core activity is the essential part of the R&D, requiring core activities to be undertaken in New Zealand follows logically.

Activities that are performed overseas can be eligible for the tax incentive if they qualify as supporting activities. This means that an overseas activity, which in other circumstances might be considered a "core activity", could be eligible if it supports an eligible core activity that is being undertaken in New Zealand.

Recommendation

That the submission be declined.

Issue: Supporting R&D activity definition

(Clause 10 (proposed new section LY 2(3)))

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, EY)

"Required for" is too restrictive and should be removed. Many activities are undertaken to make R&D more efficient but aren't necessarily required for the R&D to take place. *(EY, Deloitte)*.

"Only or main purpose" should be amended or removed. This part of the definition may exclude genuine expenditure on overheads in support of core R&D activities. *(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte)*.

Comment

Officials disagree with the submitters. The supporting R&D activity limb is designed to add precision to the questions of "when does an R&D activity start and stop" and "what is the scope of an R&D activity". Removing parts of the definition would weaken this provision.

Officials recommend that no changes are made to the wording of the supporting R&D activity definition. Officials recommend that the Government review the supporting R&D activity limb as the regime evolves, to ensure it continues to apply effectively and in a way that is consistent with the purpose of the R&D tax credit regime.

In relation to the submitters' point on "required for", officials note that the wording is not intended to prevent claimants from structuring their activities in the most efficient way.

In response to the point on "only or main purpose", overheads may qualify as an expense in relation to a core R&D activity. The overheads do not necessarily have to meet the supporting R&D activity definition.

Recommendation

That the submission be declined.

Issue: Site-specific R&D

(Clause 10 (proposed new section LY 2 generally))

Submission

(Fletcher Building Limited)

It should be made clear in legislation or guidelines that site-specific R&D will be eligible for the tax incentive. In the construction industry, there is often significant innovation arising from R&D performed at specific sites because of the unique features of the terrain.

Comment

Officials disagree with the suggestion to include this in legislation. This is not appropriate as there are no specific activity inclusions in the legislation. The guidelines will clarify the circumstances in which site-specific R&D may qualify for the tax credit.

Recommendation

That the submission be declined.

EXCLUDED ACTIVITIES

Issue: Activities that are part of another eligible activity

(Schedule 1 (proposed new schedule 21 part A))

Submission

(Deloitte)

The words "by themselves" should be added to the title of schedule 21 part A so that the title becomes "activities that, by themselves, are excluded from the definition of core research and development activity". This would make clear that these activities could be part of another eligible R&D activity.

Comment

Officials disagree with the submitters. The suggested amendment would significantly reduce the impact of the exclusions in schedule 21. The amendment would enable claimants to argue that an excluded activity is eligible as a core R&D activity where it is performed in conjunction with another activity. This is not the policy intent.

Activities excluded from the core R&D activity definition are outright excluded from being core R&D activities. These activities may be eligible as supporting R&D activities to the extent they are not also excluded from the supporting activity definition.

The legislation as it currently stands is clear in this respect.

Recommendation

That the submission be declined.

Issue: Impact of exclusions on software

(Schedule 1 (proposed new schedule 21 generally))

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)

The list of exclusions should be reconsidered from a perspective of the commercial impact on businesses, particularly the exclusions relating to software development. This includes whether the proposed R&D tax credit will result in less support than currently provided to these businesses under the Callaghan Innovation Growth Grant regime.

Concerned that the exclusion for testing will place significant restriction on software development because testing is integral to the agile software development methodology.

Comment

In developing the tax credit and associated policies, such as the transition arrangements for Growth Grant recipients, the Government has wanted to minimise any disruption to R&D performers. In switching from one scheme to another, however, it is not possible to guarantee that all firms will get the same support as they did with the Growth Grant. There are inherent differences between a tax credit and a grant.

Some firms may be entitled to less money under the R&D tax credit, while other firms may be entitled to more than they would have received under the Growth Grant. Overall, the government considers that the settings within the tax credit will mean that a greater amount of support to a larger number of R&D performers will be provided.

In relation to the submitters' point about testing, testing is currently eligible as a supporting R&D activity.

Recommendation

That the submission be noted, no further action required.

Issue: Pre-production activities, commercial viability and tooling up

(Schedule 1 (proposed new schedule 21 parts A and B clause 1))

Submission

(Corporate Taxpayers Group, EY, Fisher & Paykel Healthcare, PwC)

The blanket exclusion of preproduction activities is ambiguous as all R&D is preproduction and could be caught. *(Corporate Taxpayers Group, EY)*

Preproduction activities should still qualify as a supporting activity. This is still a high bar. "Tooling up" is too broad – prototyping of goods often requires tooling up where the tool will never enter commercial production. *(EY)*

The preproduction exclusion should be limited to activities which take place after the R&D has been resolved and which take place as part of undertaking commercial production. The process of testing whether something is capable of commercial production should not be regarded as a "preproduction activity". Demonstrating commercial viability and resolving uncertainty often occur together as part of the R&D phase. *(Corporate Taxpayers Group)*

Some technological uncertainty can still take place during preproduction and tooling up. The current exclusion is too broad and could capture activities that should be eligible, such as developing a specific tool that directly relates to a core R&D activity.

Whether a product can be commercially produced – for example, whether products can be produced at sufficient volumes, within quality and cost constraints – may involve uncertainty. The exclusion should be removed, or at least amended to clarify the policy intent. Detailed guidance with examples should also be provided. *(Fisher & Paykel Healthcare)*

There needs to be support for businesses to commercialise their R&D. *(PwC)*

Comment

Clause 1 of schedule 21 parts A and B excludes from the core R&D activity and supporting R&D activity definitions respectively, "preproduction activities, including demonstration of commercial viability and tooling up".

Officials are sympathetic to the submitters' concerns but do not recommend that the legislation is amended as an amendment may reduce the effectiveness of the exclusion. Instead, guidelines will be used to clarify how the exclusion is intended to apply.

The exclusion is intended to prevent activities that occur after the scientific or technological uncertainty associated with a core R&D activity has been resolved from receiving the credit, such as commercial production. If a scientific or technological uncertainty arises which a competent professional cannot resolve using publicly available information, this may give rise to a separate eligible R&D activity. In response to Fisher & Paykel Healthcare's concern, such an activity could include whether a product could be produced at scale, or within quality and cost constraints.

Officials acknowledge the importance of commercialising R&D but consider standard market arrangements provide incentives for firms to do this without requiring government subsidy.

Recommendation

That the submission be declined.

Issue: Complying with statutory requirements and standards

(Schedule 1 (proposed new schedule 21 parts A and B clause 8)

Submission

(Corporate Taxpayers Group, Deloitte, Fletcher Building Limited)

Concerned that this exclusion will prevent any R&D from being eligible where something new is produced (or an existing product is improved) in response to a new standard. It should be clarified whether the alteration of an existing product due to changing standards constitutes a new product. *(Corporate Taxpayers Group, Deloitte)*

Complying with statutory requirements or standards for pre-existing processes, services, or goods should be an eligible R&D activity. Most of our products exist in a highly regulated market with constantly evolving regulations. Compliance with these regulations is used to evaluate the success of the R&D. *(Fletcher Building Limited)*

Comment

Schedule 21 excludes activities involved in complying with statutory requirements or standards from being core R&D activities. A similar exclusion from supporting R&D activities also applies, but this is limited to pre-existing products. In other words, complying with statutory requirements or standards for a new product may qualify as a supporting R&D activity.

Officials disagree with submitters that this exclusion will prevent R&D from being eligible where a new product is produced, or an existing product is improved in response to a new standard. The legislation is clear that compliance with statutory requirements or standards for a new product may qualify as a supporting activity.

Officials are sympathetic to submitters' concerns regarding when the alteration of an existing product constitutes a new product. The answer will largely depend on the circumstances and the extent of the alteration. This will be clarified in guidance.

The exclusion is also targeted at the testing and analysis of products or processes to determine whether they meet a new standard. Testing, by itself, is not intended to be an eligible activity; if R&D activity were required to develop or re-develop a new product in response to a new standard, the testing might be eligible as a support activity.

Recommendation

That the submission be declined.

Issue: Management studies

(Schedule 1 (proposed new schedule 21 parts A and B clause 9))

Submission

(Deloitte)

Does the management studies exclusion extend to all management studies? If not, the term should be clarified.

Comment

Proposed new schedule 21, parts A and B, clause 9 excludes management studies from being eligible as a core or supporting R&D activity. The term "management studies" is intended to include all types of management studies.

Recommendation

That the submission be noted, no further action required.

Issue: Social sciences

(Schedule 1 (proposed new schedule 21, part A, clause 12))

Submission

(Corporate Taxpayers Group, Deloitte)

Supports revisiting the exclusion of social sciences, arts and humanities at a later date.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Minor adaption of, or improvement to, existing processes, services, or goods

(Schedule 1 (proposed new schedule 21, part A, clause 15))

Submission

(Corporate Taxpayers Group)

This exclusion should be amended to "minor adaptation of, or improvement to processes, services or goods in current commercial use". Absent this amendment, incremental improvements to products or processes which have not yet been commercialised would be excluded. Alternatively, it would be useful to understand what is a new good and what is an existing good – for example, is a kiwifruit which has less "fur" a new or an existing good.

The definition of "minor" should be explained in guidance, for example, would R&D to create a new battery manufacturing technique which increases battery life by one percent be considered minor?

Comment

Officials will clarify in guidance when the alteration of an existing product constitutes a new product, and what is considered "minor".

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Reverse engineering

(Schedule 1 (proposed new schedule 21, part A, clause 22))

Submission

(Matter raised by officials)

The exclusion for reverse engineering should include the reproduction of a product or process by a physical examination of an existing product.

Comment

The exclusion for reverse engineering in the Bill only applies to products or processes reproduced by a physical examination of an existing system or from plans, blueprints, detailed specifications, or publicly available information. It should be extended to cover products or processes reproduced by a physical examination of an existing product. Absent this extension, many products that have been reverse engineered may not be excluded, such as generic pharmaceuticals.

Recommendation

That the submission be accepted.

Issue: Exclusions from the supporting R&D activity definition

(Schedule 1 (proposed new schedule 21, part B))

Submission

(EY, Corporate Taxpayers Group, Fletcher Building Limited, Deloitte)

Delete all supporting activity exclusions *(EY, Corporate Taxpayers Group, Fletcher Building Limited)*, or reduce them significantly *(Deloitte)*.

Blanket exclusions from both the core and supporting R&D activity definitions may exclude genuine R&D expenditure from the regime. The supporting R&D activity definition sets a very high bar, so it is unnecessary to also specifically exclude items. *(Deloitte)*

All items in part B should be cased in the language of “routine”. *(Deloitte)*

Comment

Officials disagree with the submitters. Outright exclusions remove uncertainty over whether something is eligible, so reduces compliance and administrative costs.

There is a balance within an R&D tax incentive scheme between accommodating all R&D activities and the risk of non-R&D activities receiving a subsidy. There is also a balance between excluding some genuine R&D to ensure activities that are not R&D are not subsidised. Officials consider the submitters’ suggestions would tip this balance unfavourably.

Recommendation

That the submission be declined.

Issue: Exclusion for market research, testing, development, or sales promotion

(Schedule 1 (proposed new schedule 21, parts A and B, clause 6))

Submission

(Matter raised by officials)

The supporting activity exclusion in schedule 21, part B, clause 6 should mirror the core activity exclusion in schedule 21, part A, clause 6. That is, the supporting activity exclusion should read: “Market research, market testing, market development, or sales promotion, including consumer surveys”.

Comment

The supporting activity exclusion in schedule 21, part B, clause 6 currently says “Market development or sales promotion, including consumer surveys”. Officials recommend broadening the exclusion so that it mirrors the core activity exclusion and extends to cover market research and market testing. Market research and market testing activities go towards resolving commercial uncertainty and supporting commercial objectives, so should not be eligible for the R&D tax credit. If an R&D project has a technological objective that can only be measured through testing that involves customers, such as sensory evaluation, that testing is not affected by this exclusion.

Recommendation

That the submission be accepted.

Issue: Internal software development expenditure and the $3 million cap

(Clause 21(10), schedule 1 (proposed new schedule 21 parts A and B, clause 11 and proposed new schedule 21B part B, clause 17))

Submission

(ASB Bank Limited, Air New Zealand Limited, Corporate Taxpayers Group, Deloitte, EY, Fletcher Building Limited, KPMG, WSP Opus, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)

The cap should be removed or increased to $10 million. *(ASB Bank Limited, Air New Zealand Limited, Corporate Taxpayers Group, WSP Opus, Deloitte).*

- It should not matter that the business is not selling or publicising its R&D. The internal R&D will enable the business to be more profitable and pay more tax.
- Software development can switch from being for internal use to both internal and external.
- Should not have bias against certain types of software innovation. There are many spill-overs from encouraging software R&D. A lot of R&D will have a software component (for example, motor vehicles) *(Corporate Taxpayers Group, WSP Opus).*

Absent removing the cap, there should be clear rules to differentiate between internal and external software development. Paragraph (a)(ii) of the internal software development expenditure definition (which relates to internal software development for the purpose of enhancing services to customers) should not be subject to the cap. *(Corporate Taxpayers Group, WSP Opus).*

At a minimum, there must be a legislative commitment to review the cap at regular intervals. If the $3 million cap remains, amend the rules so that shareholding as low as fifty percent does not result in an internal software development group being formed. *(Corporate Taxpayers Group, WSP Opus)*

Lift the cap to $5 million. *(EY)*

Taxpayers should be able to apply to exceed the cap. *(ASB Bank Limited, Air New Zealand Limited, Corporate Taxpayers Group, WSP Opus, Deloitte, Fletcher Building Limited, KPMG)*

Relax the definition of "internal software development expenditure" definition but require specific pre-approval for internal software development expenditure *(Deloitte).*

Modify (b)(ii) so that software which is an integral part of services that are sold is not subject to the cap. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

Software that is disposed of for no consideration (for example an app developed for free download) should be considered external software development expenditure and therefore not subject to the $3 million cap. "Disposal" should include where software is sold or made available to customers, even where the business retains a right to the products. *(Corporate Taxpayers Group, Deloitte)*

Comment

The Bill proposes that internal software development expenditure be subject to a $3 million cap.

"Internal software development expenditure" is defined in a proposed amendment to section YA 1 to mean amounts spent by a person to develop software for the purpose of:

- Enhancing services provided by the person to their customers; and/or
- The internal administration of the person's business or that of their associates.

The cap does not apply to software developed for the main purpose of disposal or as an integral part of goods that are disposed of the ordinary course of business. These activities are considered external software development.

Some software development undertaken for the purpose of internal administration is excluded outright (that is, some amounts are effectively capped at $0 rather than $3m). Activities that are excluded outright include the software development of payroll, accounting, executive or management information, human resources, enterprise resource planning, invoicing, and inventory systems for use in the person's business or that of their associates.

Experience from other jurisdictions indicates that internal software development can be an area of fiscal risk, especially software development by financial institutions. Spill-overs in this area are also likely to be low because firms generally will be able to control the benefits arising from this R&D. Nonetheless, officials are sympathetic to submitters' concerns, in particular, that there could be an arbitrary distinction between customer facing software that is considered internal because it is not sold and other software that is considered external because it is sold.

Officials recommend two key amendments to the Bill as introduced.

First, increasing the internal software development cap from $3m to $25 million. This recognises that there is an imprecise distinction between some types of internal and external software development.

Second, broadening the outright exclusion for internal software development undertaken for the purpose of internal administration, so that it does not have an exhaustive list of excluded activities. That is, officials recommend that activities captured by paragraph (a)(i) of the internal software development expenditure definition are excluded outright.

This broader internal administration exclusion is consistent with the rationale behind the internal software development exclusion. The spill-overs from internal software development are limited as they are often specific to the firm performing the internal software development activity. The exclusion is also consistent with Australia's approach to internal software development expenditure and will help to offset some of the fiscal cost of extending the internal software development cap from $3m to $25m.

Officials disagree with:

- Removing the cap altogether. A cap is prudent to ensure the fiscal sustainability of the scheme, at least until we have more experience with the scheme and claims in this area.
- Allowing taxpayers to apply to exceed the cap or having a pre-approval process for internal software development expenditure. These processes would increase compliance and

administrative costs and should not be necessary if the cap is increased in line with officials' recommendations.

- Widening the exclusion from the cap to include software that is an integral part of services that are disposed of. The current exclusion is limited to software that is an integral part of goods that the person disposes of. This is targeted at firmware – such as the software that runs inside a washing machine or TV remote.

- Treating software that is disposed of for no consideration (such as an app developed for free download) as external software development expenditure. This is due to the fiscal risk of allowing this kind of expenditure. The increase in the internal software development cap from $3 million to $25 million should go some way to addressing the submitters' concern. This will ensure that, for all but the largest R&D performers, there is no difference between the treatment of external software development, and internal software development that enhances services to customers.

Recommendation

That the submission be accepted, subject to official's comments.

Issue: R&D activity definition in the context of software

(Clause 10 (proposed new section LY 2))

Submission

(Corporate Taxpayers Group, BusinessNZ, Deloitte, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, NZRise, ExportNZ, ManufacturingNZ, NZTech, Advanced Management Systems Ltd, Matthew Sagen)

The current core R&D activity definition is too narrow in the context of software. Software development activities are unlikely to have "a material purpose of resolving scientific or technological uncertainty*". (Corporate Taxpayers Group, Deloitte, BusinessNZ, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, ExportNZ, ManufacturingNZ, NZTech, Advanced Management Systems Ltd).*

Uncertainty in the context of software development should be "we are not sure we can pull this off" rather than "we are not sure if this is technically possible". A lot of software development involves a clever combination of publicly available approaches, components and processes. This should be eligible. *(Matthew Sagen)*

Consider adopting:

- The Australian core activity definition *(BusinessNZ)*

- A novelty test *(Corporate Taxpayers Group, Deloitte)*

- Canada's R&D definition *(Advanced Management Systems Ltd, NZRise)*

Comment

Officials consider that the current definition adequately incentivises software development. Widening the definition, such as by introducing a novelty test, would create an easier test and may let in activities of the kind that the government does not wish to incentivise. Officials have already made changes to the definition from what was originally proposed in the discussion document by dropping the requirement that the R&D is conducted using a scientific method, in order to better accommodate software development.

By introducing a novelty test, a claimant could qualify where they have created something 'new', without it necessarily incorporating the degree of difficulty and risk required by the uncertainty concept (that is, being 'hard').

Officials disagree that uncertainty in the context of software development should be "we are not sure we can pull this off". This is a capability uncertainty – that is, do staff have sufficient expertise, rather than a scientific or technological one which asks whether the answer can be deduced by a competent professional in the relevant field.

Officials note the guidance provides examples where software will be eligible.

Recommendation

That the submission be declined.

Issue: Exclusion for software development for ordinary internal administration activities

(Schedule 1 (proposed new schedule 21 parts A and B clause 11))

Submission

(Corporate Taxpayers Group, Deloitte)

This exclusion is not appropriate, provided the R&D activity definition is met. Improvements in administrative systems can lead to significant productivity increases within an organisation. *(Corporate Taxpayers Group)*

This exclusion should be linked to the definition in section YA 1. *(Deloitte)*

Comment

Clause 11 of schedule 21 parts A and B excludes from the core R&D activity and supporting R&D activity definitions respectively, software developed for use in the ordinary administrative functions of the claimant's business, such as payroll, accounting or invoicing. Software development in these areas may still be eligible for the tax credit, if developed with the main purpose of selling the software.

Officials disagree with Corporate Taxpayers Group's submission. Software development related to ordinary administrative functions of a business is specific to the firm and likely to have limited spill-over benefits. This is not consistent with the policy intent of the regime. As mentioned earlier in the report, officials recommend extending this exclusion to cover all internal software development other than that which enhances services to customers.

In relation to Deloitte's submission, it would be incorrect to link this exclusion to the definition of internal software development expenditure. It is only relevant for the cap on internal software development contained in clause 17 of schedule 21B part B.

Recommendation

That the submission be declined.

Issue: Testing exclusions

(Schedule 1 (proposed new schedule 21 part A, clauses 16 to 19))

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Corporate Taxpayers Group, Deloitte)

Testing is a critical R&D activity for software development and should not be excluded.

Comment

Clauses 16 to 19 of schedule 21 Part A exclude various types of testing in software development from the core R&D activity definition.

Testing is not, however, excluded outright. Testing that is required to assess whether the scientific or technological uncertainty has been resolved may qualify as a supporting activity. The guidance makes this point clear.

Officials do not consider it appropriate to allow testing to be an eligible core R&D activity. It does not seek to resolve scientific or technological uncertainty but identifies problems that need to be resolved.

Recommendation

That the submission be declined.

Issue: Converting existing systems to new software platforms

(Schedule 1 (proposed new schedule 21 part A, clause 20))

Submission

(Corporate Taxpayers Group, Deloitte)

Converting existing systems to new software platforms should not be excluded if the business is able to satisfy the core R&D activity definition. There can be material technical risk associated with converting systems. *(Corporate Taxpayers Group)*

Is the exclusion limited to data migration activities, such that the creation of new software platforms is still eligible? This exclusion overlaps with 17 and therefore is redundant. *(Deloitte)*

Comment

Officials disagree with Corporate Taxpayers Group's submission. Activities related to converting existing systems to new software platforms are often specific to a business. Therefore, the spill over benefits from resolving technological uncertainties related to such work are considered insufficient to justify the monetary risk to the Government of including such activities, hence the exclusion.

In response to Deloitte's submission, the exclusion is not limited to data migration activities, it covers all conversions of existing systems to new software platforms. The creation of new software platforms may still be eligible.

Recommendation

That the submission be declined.

Issue: Integrating existing systems with new software platforms

(Schedule 1 (proposed new schedule 21, Part A, clause 20))

Submission

(Matter raised by officials)

The exclusion for converting existing systems to new software platforms should be amended to also exclude integrating existing systems with new software platforms.

Comment

Officials recommend that integrating existing systems with new software platforms is excluded for the following reasons:

- Limited spill-over benefits: integrating an existing system with a new software platform is likely to be specific to the business, and therefore the spill-over benefits are limited.
- Fiscal risk: the cost of integrating large and complicated legacy systems with new software platforms can be very expensive.

Recommendation

That the submission be accepted.

ELIGIBLE EXPENDITURE

Issue: Commercial production rule

(Clause 10 (proposed new section LY 5(1)(c)))

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, KPMG, Fletcher Building Limited, Fisher & Paykel Healthcare, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, WSP Opus)

Eligible overheads should be allowed where R&D is performed in the course of commercial production. *(KPMG, Fletcher Building Limited, Fisher & Paykel Healthcare)*

"In the absence of" test is too restrictive and will narrow the scope of the credit for businesses who undertake R&D as part of their ordinary business. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

Unclear how the rule is intended to apply. We understand that "commercial production" is intended to refer to bulk production manufacturing processes, but this language could equally apply to R&D performed in other commercial contexts. *(WSP Opus)*

This test will be difficult for taxpayers to apply. *(Corporate Taxpayers Group)*

"Commercial production" and "employee's contribution to a research and development activity" should be clarified in legislation or guidance. *(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group)*

"Employee contribution" should be reworded as the language is unusual. It should also cover contributions made by contractors. *(Corporate Taxpayers Group)*

Instead of a commercial production rule, a specific anti-avoidance rule could be introduced. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

Comment

Where an R&D activity is performed in the course of commercial production, the amount a business may claim is limited to the amount relating to an employee's contribution to the R&D activity, and expenditure that would not have been incurred in the absence of the R&D activity (in other words, the additional expenditure incurred because of the R&D).

An R&D activity that occurs in the course of commercial production, for example, conducting experiments on the production line of a factory, or conducting software R&D in the course of implementing a new IT system, is a legitimate form of R&D that should be eligible for the tax incentive. However, the amount that is claimed in these circumstances must be appropriate. In particular, officials consider that it is not appropriate for all the costs of the commercial operation to be claimed as R&D expenditure. The commercial production rule is designed so that the extra costs associated with R&D are eligible but that the costs that would have been incurred anyway as a result of the commercial operations are not eligible. Officials consider this is the appropriate approach and therefore recommend that the submissions are declined.

In response to WSP Opus's submission, the rule is not solely intended to apply in the manufacturing context. For instance, it also applies in the context of a professional services firm performing R&D in the course of designing a product for the customer.

The meaning of "commercial production" and "employee's contribution to a research and development activity" will be clarified in guidance.

Officials disagree with Corporate Taxpayers Group's suggestion that "employee's contribution" should also cover contributions made by contractors. This would result in an exclusion much wider than intended – for example, a cleaner contracted to clean the production line may be covered. This exclusion is intended to ensure that the costs of staff performing R&D are not ineligible under the commercial production rule. During consultation, there was a concern that the costs of staff who were redeployed to work on R&D may not be covered as the firm would have incurred their salary costs anyway, absent the R&D.

Officials disagree with the suggestion to implement a specific anti-avoidance rule in lieu of the commercial production rule. The commercial production rule ensures the correct outcome from the outset by preventing business-as-usual expenditure from being claimed. Officials note that the Bill does contain a specific anti-avoidance rule in clause 7, which will be in addition to the commercial production rule.

Recommendation

That the submission be declined.

Issue: Contracted R&D expenditure – profit margin

(Clause 10 (proposed new sections LY 6(2) and LY 7(3)))

Submission

(EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Deloitte, Russell McVeagh, Fletcher Building Limited, Fisher & Paykel Healthcare, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, KPMG, Biotelliga, WSP Opus, Zespri)

A principal's R&D tax credit claim, when engaging a contractor to perform R&D on their behalf, should not be reduced by twenty percent to account for the contractor's profit margin.

- All goods and services purchased by an entity claiming an R&D tax credit contain a profit margin.
- It would create a bias towards doing R&D in-house. In many instances it is more efficient and cost effective to outsource aspects of the R&D.
- Driving businesses to in-house their R&D will create duplication of resources across industries and may also fail to capture the opportunity available as it excludes specialised resources which may not be able to be in-sourced.
- Twenty percent margin may be too high in many cases.

Comment

Officials agree with the submitters.

The 0.8 figure was proposed to remove the contractor's profit margin. A person doing R&D in their own right does not get to claim the credit for any profit margin or finance cost, so the reduction on contracted R&D was designed to provide equivalent treatment. This approach is consistent with the approach that some other countries take.

However, officials have been persuaded by submitters' arguments. The contractor's profit margin is a true cost to the principal in getting the R&D performed. Further, firms may be incentivised to conduct R&D in house even though it would be more efficient to outsource it. Officials therefore agree with submitters that the 0.8 figure should be removed from proposed new sections LY 6 and LY 7.

Recommendation

That the submission be accepted.

Issue: Contracted R&D expenditure – ineligible expenditure

(Clause 10 (proposed new sections LY 6(2), LY 6(3)(b), LY 7(3) and LY 7(4)(b)))

Submission

(Corporate Taxpayers Group, Russell McVeagh, Fisher & Paykel Healthcare, Fletcher Building Limited, EY, KPMG, Chartered Accountants Australia and New Zealand, Deloitte)

Ineligible expenditure should not be removed from the contract amount when determining the amount eligible for the R&D tax credit:

- Difficult for businesses to obtain this information from a contractor.
- The information is commercially sensitive.
- It requires the principal to rely on a declaration made by the contractor.
- Introduces complexity for contractors to comply with something where they do not benefit.
- Limiting eligible expenditure is inconsistent with the wider objective of the R&D tax incentive, which is to increase R&D spend in New Zealand. *(Corporate Taxpayers Group, Russell McVeagh, Fisher & Paykel Healthcare, Fletcher Building Limited, EY, KPMG)*

An R&D contractor should be required to provide a declaration describing the work undertaken and the amount of the ineligible expenditure. A principal should be able to rely on this declaration and not be subject to the proposed anti-avoidance rule in GB 56. *(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte).*

A de minimis rule of $10,000 should be considered to reduce the overall compliance burden *(Corporate Taxpayers Group, Deloitte).*

Comment

The Bill proposes that where a person engages an R&D contractor to perform R&D on their behalf, expenditure that is ineligible must be removed from the contract price before determining the amount of R&D tax credit the person is entitled to. Ineligible expenditure must also be taken out where a person is performing R&D on their own behalf, and therefore the rule ensures consistency in that respect.

Officials disagree with submitters that this provision should be removed. If ineligible expenditure is not taken out of the contract amount for R&D tax credit purposes, then the integrity of the scheme would be undermined. There would effectively be no list of ineligible expenditure where a contractor was engaged, resulting in claimants receiving a credit on expenditure that was not intended, for example, the cost of purchasing depreciable property used in the R&D.

The legislative requirement could be complied with by including a condition in the contract whereby the contractor must declare the amount of ineligible expenditure in the contract price. Officials disagree that this is commercially sensitive information. The commercially sensitive aspect of the contract is more likely to be the contractor's profit margin. This could not be ascertained from determining how much of the contract price was spent on ineligible expenditure, as the contract price is also made up of eligible expenditure and profit margin.

Officials disagree that a principal relying on the contractor's declaration should not be subject to the anti-avoidance rule in proposed new section GB 56. Reliance on the declaration is likely to be evidence that the person has taken reasonable care, and therefore penalties are unlikely to apply. The anti-avoidance rule is still necessary to enable the Commissioner to reconstruct the person's claim to the appropriate amount.

Officials do not recommend including a de minimis rule as allowing ineligible expenditure for a large number of small claims may undermine the integrity of the regime.

Recommendation

That the submission be declined.

Issue: Use of "incurred"

(Clause 10 (proposed new subpart LY), schedule 1 (proposed new schedule 21B))

Submission

(Corporate Taxpayers Group, Deloitte, EY, Chartered Accountants Australia and New Zealand)

Replace "paid" with "incurred" in all sections that use "paid", such as LY 6(3)(a) and Schedule 21B:

- "Paid" would require businesses to keep a set of accounts for R&D purposes only.
- Certain expenses may be deemed ineligible if the activity occurs in year one, but the expenses haven't been paid until the following year.
- Inconsistent with other sections which use "incurred".

Comment

A general concept in the tax system is that a taxpayer can claim a deduction for expenditure once that expenditure has been incurred. This means that the taxpayer is definitively committed to paying the amount, and it can be reliably estimated. For tax purposes, a deduction would be allowed where a person had contracted to pay an amount, despite not having paid it.

Officials agree with submitters. It would be inefficient to require accounts to be kept on a "cash" basis for R&D purposes, when accounts are kept on an accruals basis for tax purposes.

Recommendation

That the submission be accepted.

Issue: R&D performed in New Zealand by non-residents

(Clause 10 (proposed new section LY 7))

Submission

(Corporate Taxpayers Group, EY, Deloitte, WSP Opus)

The ten percent cap should not apply to activities undertaken in New Zealand.

- This is inconsistent with the policy to increase R&D in New Zealand.
- There is already adequate spill-overs from the non-residents performing R&D in New Zealand.
- There are not enough skilled workers in New Zealand. There are spill-overs from New Zealand staff learning from non-residents.

Comment

The Bill proposes that foreign R&D expenditure can be no more than ten percent of a person's overall R&D claim. Foreign R&D expenditure is made up of expenditure incurred on an R&D activity outside New Zealand that is integral to a core R&D activity performed in New Zealand, as well as salary payments and payments for services to non-resident employees or contractors performing the R&D in New Zealand.

Officials disagree with submitters. There are virtually no restrictions on a foreign multinational from undertaking R&D in New Zealand and having its New Zealand subsidiary receive the credit. Generally, officials consider this will produce the right outcomes in terms of encouraging R&D to be performed in New Zealand. However, we consider it prudent to guard against a multinational establishing an R&D operation in New Zealand solely to take advantage of the tax credit and with minimal connectivity to other economic activity in New Zealand. This restriction limits that risk. The ten percent threshold recognises that suitably skilled workers will not always be able to be found in New Zealand.

Recommendation

That the submission be declined.

Issue: Alternative approach to the ten percent cap

(Clause 10 (proposed new section LY 7))

Submission

(Air New Zealand Limited)

The Bill should be more inclusive of overseas joint venture R&D. Air New Zealand is actively involved in joint ventures with overseas partners.

Comment

The intent of the legislation is to incentivise New Zealand-based R&D, not New Zealand investment in foreign-based R&D. R&D undertaken offshore may be eligible for an R&D incentive in that jurisdiction.

Recommendation

That the submission be declined.

Issue: The ten percent cap is too low

(Clause 10 (proposed new section LY 7))

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, ExportNZ, ManufacturingNZ)

The current cap of ten percent is too low:

- The necessary expertise is often offshore.
- Quarantine restrictions prevent importation of particular items which may be necessary for the R&D.
- Certain environmental conditions do not exist in New Zealand.
- Targeted populations don't reside in New Zealand.

(EY, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, ExportNZ, ManufacturingNZ)

The cap should be lifted to twenty percent *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Chartered Accountants Australia and New Zealand).*

The cap should be across the life of the project, so that taxpayers can exceed the cap in a given year provided that the overseas expenditure doesn't exceed ten percent of the overall project cost. Otherwise, firms will be unduly disadvantaged simply because there are greater overseas costs in one year than in others. *(Corporate Taxpayers Group)*

Comment

Officials disagree with the submitters. There are significant spill-over benefits from the R&D being done in New Zealand. Benefits to New Zealand are diluted the more the cap is increased. The ten percent cap recognises that some R&D needs to be performed overseas and is a compromise between the different perspectives. Officials note that this approach is slightly more generous than that in 2008 (because that also included project by project restrictions) and more generous than the Growth Grant, which treats all overseas expenditure as ineligible.

Allowing taxpayers to apply the cap over the life of the project would add complexity to administration and compliance as it would require tracking over time. The way the rule is currently drafted does allow a taxpayer to take advantage of amounts under the cap within its portfolio of projects.

Recommendation

That the submission be declined.

Issue: Formula doesn't work

(Clause 10 (proposed new section LY 7(2)))

Submission

(Corporate Taxpayers Group, Deloitte)

The formula in LY 7(2) does not work if either of the components in sections (3) or (5) is $0.

Comment

The formula in LY 7(2) provides that a person's eligible research and development expenditure includes the lesser of the person's overseas expenditure or their capped overseas expenditure amount (this is the amount eligible under the ten percent cap).

Officials disagree with submitters. If one of the components in the formula is $0, then no expenditure is added to a person's eligible research and development expenditure.

Recommendation

That the submission be declined.

Issue: Approval process for overseas expenditure

(Clause 10 (proposed new section LY 7(2)))

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Woolalchemy NZ, Corporate Taxpayers Group, Fletcher Building Limited, Zespri, EY)

Should have the ability to exceed the cap via an approval process where the relevant expertise is not available in New Zealand.

Comment

The focus of the incentive is to increase R&D in New Zealand and maximise spill-over benefits to New Zealand. New Zealand receives limited benefit where the R&D happens overseas, even if there is no choice but to perform the R&D overseas. A separate approval process would add to compliance and administration costs.

Recommendation

That the submission be declined.

Issue: Evidence of eligible expenditure

(Clause 10 (Subpart LY and schedule 21B part A generally))

Submission

(Corporate Taxpayers Group)

It should not be necessary to collate invoices to show what eligible expenditure has been incurred. If documentation doesn't contain sufficient detail, businesses should still be able to self-assess.

Comment

Businesses will not be required to provide invoices with their supplementary R&D return, and therefore can still self-assess. However, businesses will be expected to keep records of these invoices in the event of a review. Officials consider it reasonable that where public money is being claimed, the claimant has an obligation to have sufficient records to substantiate that claim.

Recommendation

That the submission be noted, no further action required.

Issue: Depreciation allowed for full income year where equipment available for use

(Schedule 1 (proposed new schedule 21B, part A, clause 1))

Submission

(Fletcher Building, Corporate Taxpayers Group)

Depreciation on R&D specific equipment should be allowed for the full income year provided the equipment is available for use. *(Fletcher Building Limited)*

When calculating the time an asset has been used in R&D, the calculation should be based on actual use, not idle time. *(Corporate Taxpayers Group)*

Comment

Depreciation on R&D equipment is calculated based on the amount of time the asset is used for R&D purposes as a proportion of total use. Therefore, if an asset is used ten percent of the time for R&D purposes and not used for any other purpose, then the full depreciation will be eligible for the R&D tax credit.

However, if an asset is not used for R&D purposes during the income year, but is just available for use, none of the depreciation will be eligible for the tax credit, given the calculation is based on actual use.

This will be clarified in guidance.

Recommendation

That the submission be noted, no further action required.

Issue: Depreciation rate on buildings

(Schedule 1 (proposed new schedule 21B, part A, clause 1))

Submission

(Corporate Taxpayers Group)

For R&D tax credit purposes, the depreciation rate on buildings should be three percent because buildings do depreciate.

Comment

Officials recommend following the depreciation rules which exist for tax purposes, which do not allow depreciation for buildings. Following the rules that exist for tax purposes will reduce the compliance and administration costs associated with calculating depreciation on assets used in R&D.

Recommendation

That the submission be declined.

Issue: Anti-double dip provision

(Clause 10 (proposed new section LY 5))

Submission

(Matter raised by officials)

An anti-double dip provision should be added to prevent two firms being able to claim an R&D tax credit twice for the same expenditure.

Comment

The exclusion for R&D contractors in LY 3(2)(c) should largely prevent both the principal and contractor from claiming a credit on the same expenditure. For the avoidance of all doubt, however, officials recommend an additional provision that says a credit will only be given once for an amount of eligible R&D expenditure.

Recommendation

That the submission be accepted.

INELIGIBLE EXPENITURE

Issue: Scope of schedule 21B part B

(Schedule 1 (Proposed new schedule 21B, part B))

Submission

(Corporate Taxpayers Group)

The group appreciates the need to constrain what costs are eligible for the credit, however the current constraints are too extensive:

- Unduly restricts part of the true cost of performing R&D from being eligible.
- Undermines the attractiveness of the regime
- Reduces the effective tax credit to below fifteen percent.

Comment

Officials agree that the exclusion list is overly restrictive in some areas and are recommending some amendments.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: $120 million cap

(Schedule 1 (proposed new schedule 21B, part B, clause 1))

Submission

(Corporate Taxpayers Group)

It is unnecessary to include the $120 million cap in schedule 21B, part B when it is already covered in section LY 4. It causes confusion over how the legislation applies if the business has obtained an "approved research and development cap".

Comment

Officials disagree with the submitter that schedule 21B part B, clause 1 should be removed. The difference between the rule in section LY 4 and the one in schedule 21B, part B is that in schedule 21B, part B the associated person rule is brought in.

Officials do however recognise the submitters' point in relation to the approved research and development cap, and therefore recommend that schedule 21B part B clause 1 is amended so that the associated person rule applies to a person's $120 million cap or the approved research and development cap as appropriate.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Eligibility of capitalised expenditure

(Schedule 1 (proposed new schedule 21B, part B, clause 3))

Submission

(Air New Zealand Limited, Corporate Taxpayers Group, Fletcher Building Limited, Fisher & Paykel Healthcare, Deloitte)

Capitalised R&D expenditure should be eligible for the credit. In practice, expenses are capitalised early - capitalisation for financial reporting purposes is not linked to whether the uncertainty has been resolved.

Delete the exclusion in schedule 21B, part B, clause 3 which relates to expenditure that contributes to the cost of creating tangible depreciable property.

Comment

Officials agree with submitters that, in principle, capitalised R&D should be eligible for the credit, though note that if expenditure has been capitalised, this can indicate that any scientific or technological uncertainty associated with the activity to which the expenditure relates has been resolved. For that reason, capital account expenditure that goes towards creating depreciable intangible property is eligible.

The specific exclusion in schedule 21B, part B, clause 3 excludes capital account expenditure that goes towards the production of depreciable tangible property. Officials consider this exclusion necessary from a sustainability and fiscal risk perspective, because of the potentially high cost of producing some depreciable tangible assets, so do not agree with deleting the exclusion. A similar exclusion applies in Australia.

Recommendation

That the submission be declined, subject to officials' comments.

Issue: Pooled depreciation

(Schedule 1 (proposed new schedule 21B, part B, clause 5))

Submission

(Corporate Taxpayers Group, Deloitte)

A person should be able to calculate depreciation for R&D tax credit purposes separately from the pool if the person is willing to incur the compliance costs to undertake the recalculation. The exclusion for pooled property penalises taxpayers who have legitimately taken advantage of compliance cost saving pooling rules.

Comment

Schedule 21B, part B clause 5 excludes from the tax credit depreciation loss for an item of pooled property, unless all items in the pool are used solely in performing R&D.

Officials disagree with submitters. If a person wishes to calculate depreciation separately, then the property should not be put into the pool.

Recommendation

That the submission be declined.

Issue: Expenditure on employee share schemes

(Schedule 1 (proposed new schedule 21B, part B, clause 9))

Submission

(Corporate Taxpayers Group, Deloitte)

A business should be able to claim an R&D tax credit on the value of a benefit provided under an employee share scheme, to the extent it relates to their employees performing R&D.

Comment

Officials agree with the submitters that employee share schemes should be eligible. They are a common form of remuneration for start-up firms performing R&D.

It is recommended that the credit value is calculated on the value for tax purposes, with apportionment between R&D and non-R&D activities determined on the vesting date.

Example: Employee share scheme

Liam is employed by A Co, a pharmaceutical company developing a cure for a trial fibrillation. On 1 June 2020 he was granted an option to buy 1,000 shares for $500. The option vests on 1 June 2021. Liam has two years to exercise the option.

Between 1 June 2020 and 1 June 2021, Liam spends seventy percent of his time on R&D. On 1 December 2021, A Co's shares are worth $2 per share. Liam exercises his option for $500. The cost to A Co for tax purposes is $1,500 on 1 December 2021.

Result for R&D tax credit purposes

A Co may claim an R&D tax credit on $1,500 x 0.7 = $1,050. This is because at the vesting date Liam spent seventy percent of his time on R&D. The R&D tax credit A C o is entitled to is therefore $1,050 x 0.15 (15% credit rate) = $157.50. The tax credit may be claimed in the 2021 year.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Employee recruitment, relocation and bonuses

(Schedule 1 (proposed new schedule 21B, part B, clauses 10 and 11))

Submission

(Corporate Taxpayers Group, Deloitte, EY, Fisher & Paykel Healthcare, NZRise)

Employee recruitment, relocation and bonuses should be eligible for the R&D tax credit because they are:

- A genuine business cost
- Critical for businesses to attract competent R&D staff
- A common reward and retention mechanism particularly for early stage businesses.

Comment

These costs were excluded in the Bill as introduced because of the risk that their nexus with R&D activities might be difficult to establish, so there was a risk that these amounts would not be appropriately apportioned. Officials recognise, however, that the fiscal cost associated with these amounts is likely to be low and agree that such amounts should be eligible because they represent a genuine cost of R&D to businesses.

Recommendation

That the submission be accepted.

Issue: Acquiring an interest in intangible property other than software

(Schedule 1 (proposed new schedule 21B, part B, clause 15))

Submission

(Corporate Taxpayers Group, Zespri)

This exclusion may prevent a business claiming an R&D tax credit for R&D in creating new plant varieties. The legislation should be amended, or clear guidance given on how the rules are intended to apply to plant variety rights.

Comment

This clause is not intended to exclude plant variety rights. The R&D tax credit is not available for expenditure to acquire an interest in intangible property, such as expenditure incurred on purchasing, leasing or obtaining a right to use intangible property. The exclusion does not apply to expenditure incurred to create that interest in intangible property, such as creating a new plant variety right. For the avoidance of doubt, it will be clarified in guidance that plant variety rights will be eligible for the credit.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Acquiring bespoke or customised software

(Schedule 1 (proposed new schedule 21B, part B, clauses 15 and 16))

Submission

(Corporate Taxpayers Group, EY)

This exclusion is too wide and should be deleted. On current drafting it could exclude expenditure on contractors to build software.

Comment

The current exclusion in schedule 21B, part B, clause 16 reads "expenditure or loss in relation to software that is bespoke or customised or is not widely commercially available".

This exclusion is intended to target the purchase of customised software for fiscal cost reasons. It also prevents a firm from getting a credit for essentially purchasing another firm's R&D. It is not intended to capture software that is created through R&D or as a supporting activity.

Officials recognise that the exclusion as drafted is currently too wide. Officials recommend that the exclusion is amended so that it only applies to expenditure or loss that relates to purchasing, leasing, or acquiring software that is:

- Bespoke
- Customised, or
- Not widely commercially available.

Officials also recommend that clause 15 (which relates to acquiring interests in intangible property other than software) is similarly amended so that it is consistent with the recommended amendment to clause 16.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Gifts

(Schedule 1 (proposed new schedule 21B, part B, clause 19))

Submission

(Corporate Taxpayers Group)

The cost of gifts should be eligible when provided to non-employees. For example, a gift voucher for participating in a trial. Given gifts are likely to be small, the compliance costs associated with finding and removing them would likely outweigh the revenue cost of allowing them.

Comment

The cost of a gift voucher given to a participant in a trial is still consideration for a service and therefore eligible for the R&D tax credit.

The gift exclusion is intended to prevent a person treating the nominal value of a gift used in R&D as expenditure for R&D purposes. Further, it prevents the donor of the gift from claiming an R&D tax credit on its value. This exclusion will prevent disputes as to whether a gift relates to R&D and is eligible for the credit.

Recommendation

That the submission be noted, no further action required.

Issue: Feedstock

(Schedule 1 (proposed new schedule 21B, part B, clause 23))

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand)

The drafting of the feedstock rule could be clearer, and further guidance on the feedstock rule would be appreciated. It is unclear:

- Why energy is specifically mentioned
- Whether the cost of energy is always ineligible, or only the amount, in conjunction with other inputs, that exceeds the value of the output
- How expenditure for energy is identified and linked to the "good" produced.
- What overhead costs are expected to be subject to feedstock
- What is the market value – that is, a specific selling price of average for the year.

Comment

This will be clarified in guidance.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Loss on sale or write-off of depreciable property

(Schedule 1 (proposed new schedule 21B, part B))

Submission

(Matter raised by officials)

Depreciation loss arising from an asset being written off or sold below its adjusted tax value should be ineligible for the tax credit.

Comment

To minimise compliance and administrative costs, there is no claw-back of R&D tax credits when depreciable property used in R&D is sold for more than its adjusted tax value.

To ensure symmetry of treatment, officials propose that there is a corresponding restriction preventing an R&D tax credit claim for depreciation to the extent an asset is written off or sold below its adjusted tax value.

Example – no tax credit for loss on disposal

A company buys an asset for $1 million which is used wholly in eligible R&D. The R&D tax credit is claimed for depreciation on the asset. The asset is sold for $500,000. The book value of the asset at the time of sale is $600,000. No tax credit is available for the $100,000 loss.

Recommendation

That the submission be accepted.

Issue: Cost of purchasing land

(Schedule 1 (proposed new schedule 21B, part B))

Submission

(Matter raised by officials)

The cost of purchasing land should not be eligible for the R&D tax credit.

Comment

It is not appropriate to give an R&D tax credit for land purchased for use in R&D for two reasons. The first is it is difficult to apportion what cost of the land relates to R&D given the land could be used for non-R&D purposes later. The second reason is that land generally increases in value and therefore can be sold to recoup the cost.

Rent or lease payments for buildings used in R&D (which might include the cost of land) are eligible for the credit however.

Recommendation

That the submission be accepted.

Issue: Adjustments to eligible expenditure

Submission

(Matter raised by officials)

Adjustments should be made to prepaid eligible expenditure to ensure the amount of R&D tax credit claimed is appropriate.

Comment

For tax purposes, the unused portion of prepaid expenditure is added back as income at the end of each year. This prevents a taxpayer from claiming a deduction for something which has been prepaid but not yet used in the derivation of income.

Similar rules are required for the R&D tax credit to ensure a taxpayer does not receive a tax credit for prepaid expenditure on something that has not yet been used in relation to an R&D activity. For example, if a person incurs $100,000 on consumables to be used in R&D but those consumables haven't been used in the R&D process by the end of the year, eligible expenditure needs to be adjusted so that the person is not able to claim an R&D tax credit on the portion of the expenditure that relates to the unused consumables.

Recommendation

That the submission be accepted.

CALCULATING THE CREDIT

Issue: Support for minimum threshold and tax credit rate

(Clause 10 (proposed new section LY 4))

Submission

(Corporate Taxpayers Group)

Corporate Taxpayers Group supports the $50,000 minimum expenditure threshold, and the 15% tax credit rate.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Minimum threshold is too high

(Clause 10 (proposed new section LY 4))

Submission

(Fleur Foods, TEPHRA)

The minimum threshold should be reduced to $10,000 to incentivise SMEs. *(TEPHRA)*

There should be no minimum threshold. *(Fleur Foods)*

Comment

Officials disagree with submitters. Setting a reasonable threshold helps avoid disproportionate compliance and administrative costs being incurred on small claims, where the cost might outweigh the benefit to both the Government and claimants from the incentive.

The minimum threshold also acts as a filter to prevent claims for activities that do not satisfy the R&D activity definitions but are too small to warrant investigation. Officials note that businesses below the threshold may still qualify for the R&D tax credit if they use an approved research provider to perform R&D activities on their behalf.

Recommendation

That the submission be declined.

Issue: JVs satisfying minimum threshold as a collective

(Clause 10 (proposed new section LY 4))

Submission

(Matter raised by officials)

JVs should be able to satisfy the minimum threshold as a collective.

Comment

Officials recommend that section LY 4 is amended so that members of a JV may satisfy the $50,000 minimum threshold as a collective. This is consistent with the treatment of partnerships. This amendment would mean that where two members of a JV fail to satisfy the minimum threshold themselves, they may nevertheless satisfy the minimum threshold provided the JV (as a collective) has $50,000 or more of eligible R&D expenditure.

Recommendation

That the submission be accepted.

Issue: Replace tax credit with cash investment

(Clause 10 (proposed new section LY 4))

Submission

(TEPHRA)

The tax credit should be abandoned in favour of cash investment.

Comment

As the tax system has been chosen to incentivise R&D, a tax credit is deemed to be the most appropriate option to deliver this incentive.

Recommendation

That the submission be declined.

Issue: Support for maximum threshold

(Clause 10 (proposed new section LY 4))

Submission

(Corporate Taxpayers Group, Fisher & Paykel Healthcare)

The submitters expressed support for the $120m cap and the discretion to exceed the cap.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Exceeding the maximum threshold

(Clause 30 (proposed new section 68CD))

Submission

(Corporate Taxpayers Group, Fisher & Paykel Healthcare, Deloitte, EY)

There should be a three-month deadline for the Commissioner to respond to requests to exceed the cap. *(Corporate Taxpayers Group, Fisher & Paykel Healthcare, Deloitte)*

"Substantial net benefit" should be defined in legislation. *(EY)*

Concerned about the "substantial net benefit for New Zealand" test. It should not be necessary to meet all the criteria listed in the commentary. The applicant should be able to look wider than themselves when assessing the criteria. That is, the process or product being created will create opportunities for other businesses to grow jobs. *(Corporate Taxpayers Group)*

Comment

The Bill proposes that a person may only receive an R&D tax credit on a maximum of $120 million of eligible R&D expenditure in a year. The Commissioner of Inland Revenue may approve a cap greater than $120 million provided the R&D gives rise to a substantial net benefit to New Zealand, and the chief executive of the Ministry of Business, Innovation and Employment has been consulted.

Officials disagree with imposing a three-month deadline for responding to claims in the legislation. In its administration of the R&D tax credit, Inland Revenue will set a performance standard for processing applications but does not think time constraints should be set in legislation.

Officials propose that the "substantial net benefit" test is defined in guidance, rather than legislation. The criteria listed in the commentary are not definitive but are indicative of the type of things that will need to be established to show that the R&D gives rise to a substantial net benefit for New Zealand. Ultimately, a holistic view will be taken, with the weight of each criterion considered.

Recommendation

That the submission be declined.

Issue: Increasing the rate of the credit

(Clause 10 (proposed new section LY 4))

Submission

(Dave Moskovitz, Anonymous submitter)

The rate is not competitive with Australia who can access a 42% rebate. Increase the rate to at least 30%. *(Anonymous submitter)*

Concerned that start-ups are not treated more generously. There should be an increased credit for firms that fall under certain thresholds – such as less than 10 employees, or less than $1 million revenue. *(Dave Moskovitz)*

Comment

Officials disagree with submitters. The 15% rate is similar to the median tax credit rate for R&D available across the OECD. The Australian scheme is a tax offset not a tax credit. The numbers describe different things and cannot be directly compared. The 43.5% rate in Australia for SMEs (37.5% for large businesses) is the headline rate taking into account corporate tax. The actual effective rate ends up being closer to 8.5%. The New Zealand scheme is actually more straightforward than the Australian scheme because there is one rate for small and large businesses.

Officials disagree with having a more generous rate for start-ups. The purpose of the credit is to encourage more firms to undertake R&D. The focus is not on increasing R&D done by small firms only. Higher rates for smaller firms can create disincentives for firms to grow.

The Government has already agreed to lower the threshold of eligible expenditure from $100,000 to $50,000. We estimate that this will allow an additional 250 small and start-up businesses to access the tax credit. The Government is also mindful that start-up businesses in particular often do not make a profit in their early years and so has made provision in the first year of the scheme for a measure of refundability (up to a maximum of $255k), which should help businesses with their cash-flow challenges.

Work is also well under way for a second phase of the scheme to have a more developed policy on refundability in place by April 2020. More broadly the Government supports start-up businesses through a range of measures including the funding of a number of incubators and accelerator programmes to build capability amongst entrepreneurs, and in providing advice to new firms on how to access finance to grow.

Recommendation

That the submission be declined.

HOW TAX CREDITS ARE APPLIED

Issue: Ordering rules

(Clause 8)

Submission

(Deloitte, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand)

R&D tax credits that have been carried forward should be used before credits from the current year.

Comment

Officials agree with submitters. The oldest R&D credits should be used first in order to minimise potential credit loss following a shareholding change.

Recommendation

That the submission be accepted.

Issue: Provisional tax

(Clause 21(17))

Submission

(Deloitte)

There should be a midway point in year one of the R&D tax credit regime which allows taxpayers to access the benefit of the provisional tax regime without compromising their status as a standard uplift method provisional taxpayer.

Comment

Firms in profit can access the benefit of the tax incentive through reduced provisional tax payments during the year. As the standard uplift method for provisional tax is based off the outstanding tax to pay from the previous year, taxpayers will only be able to obtain the benefit of the R&D tax credit in the first year if they estimate their provisional tax payments. Taxpayers who use the estimation method may be subject to penalties and interest if their estimation is incorrect.

Officials disagree with submitters. It is appropriate that penalties and interest apply in the event of an incorrect estimate, due to the inherent uncertainty that arises from estimating tax payments. Tax payments are more likely to be correct when based on a five percent uplift from the previous year, and therefore a waiver of penalties and interest is appropriate for uplift taxpayers.

Recommendation

That the submission be declined.

Issue: Continuity period

(Clause 10 (proposed new section LY 8))

Submission

(Corporate Taxpayers Group, Deloitte)

The continuity period should start on the first day of the next income year after the credit arises. Otherwise a shareholding change that occurred during the income year but before the R&D took place could result in a loss of the R&D tax credit.

Comment

Officials are sympathetic to submitters' concerns, but disagree with the proposed solution, as this could result in shareholders who didn't incur the cost of the R&D benefitting from the credit – for example, if the company were to do R&D in the first half of the year, with the business being sold in the second half of the year. If the continuity period didn't begin until the following year, those new shareholders would be able to benefit from the credit.

Instead, officials recommend that part-year continuity rules are introduced, similar to what exists currently for losses. This would largely address submitters' concerns.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Alternative shareholder continuity tests

(Clause 10 (proposed new section LY 8))

Submission

(Corporate Taxpayers Group, Deloitte, BusinessNZ, Russell McVeagh)

A business should be able to carry forward credits if the company's underlying business remains the same or similar. This would make the tax system more neutral, by removing the asymmetric tax consequences arising from risk taking. *(Corporate Taxpayers Group, Russell McVeagh, BusinessNZ).*

There should be no continuity rule applying to carry forward R&D tax credits. Start-ups are likely to breach continuity as more capital is needed to fund R&D activities. *(Corporate Taxpayers Group, Deloitte)*

Comment

Officials recommend that the continuity rules for the tax credit mirror those that apply for losses. Therefore, a switch to a same or similar test would not be considered until the same test was used for losses. The Tax Working Group has considered loss continuity and ongoing consideration by government is possible.

Officials disagree with the submission that no continuity rules should apply to the tax credit. This would allow shareholders who didn't incur expenditure giving rise to the credit, to benefit from it later once the firm became profitable.

Officials also note that to the extent firms in loss qualify for refunds of their tax credit, continuity is not an issue. The Government has committed to reviewing the policy on continuity with the likelihood that a different policy will apply from year 2.

Recommendation

That the submission be declined.

Issue: Part-year continuity rules

(Clause 10 (proposed new section LY 8))

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)

The part-year provisions that apply for tax losses should be included in the proposed R&D tax credit regime.

Comment

Officials agree with the submitters and recommend that the portion of the R&D tax credit that relates to the period where continuity was met may be carried forward to the next tax year, as long as adequate accounts are provided setting out the amount of the R&D tax credit attributable to that part year (in the case of continuity being lost during the year in which R&D is performed), or the amount of tax attributable to that part year (in the case of continuity being lost part way through a profitable year).

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Refundability – year 1

(Clause 9)

Submission

(PwC, Roger Ford, SonaSafe International Ltd, Biotelliga, NZTech, EY, Deloitte, Fisher & Paykel Appliances Ltd)

Refundability is important to provide support to early stage businesses and needs to be progressed as a priority. *(PwC, Roger Ford, SonaSafe International Ltd)*

Lift the refundability cap that applies in year 1 *(Biotelliga, NZTech, EY, PwC)*

If refundability is not applied broadly in 2019–20, R&D tax credits carried forward should be refundable in subsequent years if requirements are met. *(EY)*

There should be enhanced cash-out provisions for current growth grant recipients, such as a cap equal to existing growth grant funding. *(Deloitte, Fisher & Paykel Appliances Ltd)*

Refundability should be broader from year 1 - everyone should be able to access refundability but cap it at $5 million. Other eligibly hurdles, such as PAYE cap, should be minimised. *(EY)*

Comment

Officials recognise that refunds are important to many businesses (especially start-ups) and that the issue needs to be progressed as a matter of priority. Officials note that the government has committed to having a more comprehensive policy in place on refundability from April 2020. In developing this regime, consideration will be given to allowing R&D tax credits that were carried forward from the 2019–20 year to be refundable.

Officials recommend that the refundability policy currently in the Bill, which mimics the tax loss cash-out, continues to apply for the first year of the regime. A tighter regime in the first year of the regime is a useful precaution because in-year approval of the R&D activity will not apply until the second year of the regime.

Officials disagree with providing enhanced cash-out provisions to growth grant recipients as it is unfair to give growth grant recipients greater assistance.

Recommendation

That the submissions be declined.

Issue: Full refundability

(Clause 9)

Submission

(Corporate Taxpayers Group, Fisher & Paykel Limited)

The tax credit should be fully refundable:

- Cashflow will be essential to ensuring "borderline" projects succeed.
- Will ensure investment in R&D continues during periods where businesses face funding challenges.
- Non-refundability will disincentivise multinationals to undertake R&D in NZ.
- Otherwise growth grant recipients won't be encouraged to transition.

If the credit cannot be fully refunded then it should be limited by some measure, such as a cap. If this is not possible, then a same or similar test should be introduced so that tax credits may be carried forward without adversely disadvantaging start-ups seeking new capital.

Comment

The Government has committed to reviewing the refundability rules that apply from year 2 of the regime. These views will be considered as part of that review.

Recommendation

That the submissions be declined.

Issue: Refundability – entities that derive tax exempt income

(Clause 9)

Submission

(Deloitte, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand)

The exclusion from refundability for entities that derive exempt income is too broad and should be deleted. For example, the rule could prevent the following entities from qualifying for refundability:

- A company receiving a dividend from a foreign subsidiary or from another company in the same wholly-owned group.
- A company with a shareholder employee, who pays an exempt reimbursement
- Any charity
- An organisation that has received a distribution from a Māori Authority

Comment

Officials acknowledge that the scope of the exclusion for exempt income is broader than the policy intent (which was aimed at non-taxpaying organisations). Officials therefore recommend that the exempt income provision is amended so that a person is not excluded from refundability if they derive exempt income under sections CW 9 and CW 10 (foreign dividends and dividends within New Zealand wholly-owned groups).

While this will not fully address submitters' concerns, it will cover the majority of situations and is consistent with how this issue has been treated elsewhere in the Income Tax Act 2007. For example, see sections OB 1(2)(a)(iv), CD 53(3), FM 31(1)(c) and FO 3(1)(c).

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Standalone refundability rules

(Clause 9)

Submission

(EY, Deloitte)

Create standalone refundability rules instead of adopting the tax loss cash-out rules.

Comment

The refundability rules for the first year of the regime are based off the tax loss cash-out rules due to the limited time that was available to develop a new set of rules. From the second year of the regime, broader refundability will be available, which will be based on a standalone set of rules.

Recommendation

That the submission be declined.

Issue: Refundability for non-business researchers

(Clause 9)

Submission

(EY, Deloitte)

The requirement that businesses must spend twenty percent or more of their salary costs on staff performing R&D will exclude non-business researchers from refundability.

Comment

The Bill defines a non-business researcher to mean a tax charity and an industry levy body.

Officials recognise that any organisation which does not incur twenty percent or more of their salary costs on staff performing R&D will be excluded from refundability in the first year of the regime. This is likely to include charities and industry levy bodies. As noted above, a wider refundability regime will be available from year 2 of the regime.

Recommendation

That the submission be noted, no further action required.

Issue: Legislative requirement for future work phases

Submission

(Corporate Taxpayers Group)

There should be a legislative requirement for intended future phases of the regime to be completed, for example the work on refundability by 2020.

Comment

This can be achieved operationally, without the need for a legislative requirement.

Recommendation

That the submission be declined.

Issue: Applying the credit to outstanding tax first before carrying it forward

(Clause 9)

Submission

(Deloitte)

The R&D tax credit should first be applied to outstanding tax liabilities from previous tax years before being carried forward to a future tax year.

Comment

Under the current amendment to section LA 5, only the R&D tax credit that is refundable (that is, amounts up to $255,000 where the recipient meets the specified criteria in LA 5(4B)) is first offset against outstanding tax liabilities from previous tax years.

Officials disagree with the submitter's suggestion that non-refundable R&D tax credits are first applied to outstanding tax liabilities from previous tax years before they can be carried forward. This effectively elevates the credit to a refundable one, as instead of a person paying their tax liability with cash, they can use their R&D tax credit and keep the cash.

Recommendation

That the submission be declined.

Issue: Support for imputation

(Clauses 11 – 20)

Submission

(Corporate Taxpayers Group)

The group supports giving an imputation credit equal to the R&D tax credit.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Imputation debits

(Clauses 11 – 20)

Submission

(Corporate Taxpayers Group)

The rules should provide for imputation debits in the event an R&D claim is reassessed downwards.

Comment

Officials agree that an imputation debit should arise where an R&D claim is reassessed downwards, so that the amount of imputation credits does not exceed the amount of R&D tax credit that the submitter was entitled to, however believe that the bill as drafted already allows for this.

Proposed new sections OB 9C, OK 6C and OP 11C provide that a person has an imputation credit (or Māori authority credit, as applicable) equal to the R&D tax credit they are entitled to. The use of the words "entitled to" will ensure that where an R&D claim is assessed downwards, so is the amount of imputation or Māori authority credit.

Recommendation

That the submission be noted, no further action required.

Issue: Applying R&D tax credits to shortfall penalties

Submission

(Matter raised by officials)

The legislation should be amended so that refundable R&D tax credits are required to be offset against all shortfall penalties before they are offset against outstanding income tax to pay, other outstanding tax, or refunded to claimants. An ordering rule should apply to ensure that refundable R&D tax credits are offset against shortfall penalties before losses are used.

Comment

Officials recommend introducing a provision that requires refundable R&D tax credits to be offset against shortfall penalties, so that a claimant's R&D tax credits are only refunded once they have been used to pay any shortfall penalties, outstanding income tax, and other outstanding tax. It also makes the treatment of refundable R&D tax credits consistent with the current treatment of other tax credits.

Officials do not recommend allowing non-refundable R&D tax credits to be offset against shortfall penalties, because this would essentially treat the R&D tax credit like a refundable tax credit. Any unused non-refundable R&D tax credits can be carried forward to a future income year provided shareholder continuity requirements are met.

Recommendation

That the submission be accepted.

Issue: Approved research provider requirements – facilities in New Zealand

(Clause 25 (proposed new section 15ZB of the Tax Administration Act 1994))

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, Deloitte)

It is unclear what is meant by "facilities". Does this mean that if an approved research provider has no facilities (that is, because they undertake their activities at the client's site) they are excluded? *(Corporate Taxpayers Group, Deloitte)*

The words "to the extent" should be inserted before "has in New Zealand the facilities…", to ensure a person is not precluded from becoming an approved research provider if facilities are not required and the services are performed on the client's premises. *(Chartered Accountants Australia and New Zealand)*

Comment

The Bill provides that in order for the Commissioner to approve a person as an approved research provider, the person must, among other things, have in New Zealand the facilities needed to perform research and development activities. Officials are of the view that the legislation is sufficiently clear due to the use of the word "needed". The application of this provision and the meaning of "facilities" will be clarified in guidance.

Recommendation

That the submission be declined, subject to officials' comments.

Issue: Approved research provider requirements – services at market value

(Clause 25 (proposed new section 15ZB))

Submission

(Corporate Taxpayers Group, Deloitte)

The Commissioner should accept that if an approved research provider is providing services to a non-associated party that the activities are undertaken at market value.

Comment

One of the requirements to become an approved research provider is that the person performs or will perform research and development activities on behalf of other persons for market value consideration.

Officials disagree with the submitters' suggestion. Experience with the Australian regime has indicated that non-market value transactions can occur even where the parties are not associated. For the integrity of the regime it is important that safeguards such as this remain in place.

Recommendation

That the submission be declined.

Issue: Notification in writing

(Clause 25 (proposed new section 15ZB(6)))

Submission

(Corporate Taxpayers Group, Deloitte)

If the Commissioner approves a person to be an approved research provider, the Commissioner's notification of that approval should be in writing.

Comment

Officials agree with the submitters that notification should be in writing. This can be carried out operationally, without the need for legislative change.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Duplicate requirements

(Clause 25 (proposed new section 15ZB(4)))

Submission

(Corporate Taxpayers Group, Deloitte)

Sections 15ZB(4)(a) and 15ZB(4)(c) essentially say the same thing and should be condensed into one paragraph.

Comment

Section 15ZB(4) outlines the requirements a person must satisfy for the Commissioner to approve them as an approved research provider. Section 15ZB(4)(a) is about whether the person is capable of performing R&D activities on behalf of others, whereas (c) asks whether they are available to perform those activities.

Officials disagree with the submitters' that these requirements are the same. Capability looks at whether the person has the necessary skills and expertise to perform R&D on behalf of others, whereas availability looks at whether or not they have the time available to perform services on behalf of others not associated to them.

Recommendation

That the submission be declined.

Issue: Support for record keeping

(Clause 26)

Submission

(Deloitte)

Supports keeping records.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Compliance costs of record keeping

(Clause 26)

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Chartered Accountants Australia and New Zealand, NZTech, Corporate Taxpayers Group, Deloitte)

Concerned about the compliance costs, particularly for small businesses. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Chartered Accountants Australia and New Zealand, NZTech)*

Records should be able to be created after year end, as opposed to contemporaneously, and should not have to record who created them. *(Corporate Taxpayers Group, Deloitte)*

A simplified compliance regime should be introduced for smaller firms. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Chartered Accountants Australia and New Zealand)*

A less stringent set of requirements should apply in the first year of the regime because of the Bill being introduced after the regime starts to apply to early balance date taxpayers. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*

Comment

Officials note that it is important for compliance costs to be minimised as much as possible. However, at the same time, to uphold the integrity of the regime, a sufficient level of record keeping is required.

In relation to keeping contemporaneous records and naming the creator, this is not an absolute requirement but adds legitimacy to the records.

Officials recognise the important of a suitable compliance regime for small businesses. In addition to the 5-yearly evaluation required by the legislation, Inland Revenue will, as part of its administration of the scheme, review the appropriateness of its requirements for all claimants.

Officials disagree with introducing a less stringent set of record keeping requirements in the first year of the regime. Businesses could reasonably expect that if they wanted to claim an R&D tax credit, they would need to keep records. Since the Bill will not be enacted until after the regime starts to apply, there will be some leniency taken in respect of the compliance approach taken.

Recommendation

That the submission be declined, subject to officials' comments.

Issue: R&D supplementary return

(Clause 27 (proposed new section 33E))

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)

Worried that R&D supplementary returns might require significant information from businesses. Any information required should be information that is already available to businesses as part of their normal commercial and business activities. Additional information requirements should be kept to a minimum.

Comment

Information businesses already collect will be used to the extent possible. However, additional information will be required to verify claims, evaluate the regime, and maintain policy outcomes.

Recommendation

That the submission be declined.

Issue: Filing of R&D supplementary return

(Clause 27 (proposed new section 33E))

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, Deloitte)

Section 33E presupposes that the person eligible for the R&D tax credit is filing an income tax return. The section should be amended to cover persons who are not required to file a tax return, such as a charity.

Comment

Officials agree with the submitter and recommend that an amendment is made to resolve this issue.

Recommendation

That the submission be accepted.

Issue: Fixed date for filing

(Clause 27 (proposed new section 33E))

Submission

(Corporate Taxpayers Group, Deloitte)

Provide a fixed date for filing, such as the last working day of the month. Counting 30 days from a variable date creates unnecessary compliance costs and risk of error.

Comment

The Bill proposes that the R&D supplementary return is due 30 days after the person files their tax return.

Officials are sympathetic to the submitters' point, however, due to operational constraints, recommend that the return is due 30 days after the tax return is due to be filed under section 37 of the Tax Administration Act 1994.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Credit date for imputation and Māori authority credits

(Clauses 12, 13, 15, 16, 17 and 19)

Submission

(Matter raised by officials)

Imputation and Māori authority credits should be credited from the date the company or Māori authority files its income tax return.

Comment

The Bill as introduced requires imputation credits (proposed new section OB 9C and OP 11) and Māori authority credits (proposed new section OK 6C) to be credited on the date a claimant files their R&D supplementary return for the relevant income year.

Officials submit that the credit date for imputation credits and Māori authority credits should be amended so that it is the date a claimant files their income tax return. Operationally, a person will claim their R&D tax credits through their income tax return. Therefore, the date the return is filed is a more appropriate credit date for imputation credits and Māori authority credits. The R&D supplementary return itself does not create an R&D tax credit claim, but rather requires the provision of information to:

- support an income tax return in which R&D tax credits are claimed; and
- satisfy the Commissioner that a claimant is eligible and has complied with the legislative requirements.

Recommendation

That the submission be accepted.

Issue: Exceptions from secrecy too broad

(Clause 31)

Submission

(Corporate Taxpayers Group, Deloitte)

Subsection (w) should be amended to provide that only aggregated statistical information will be shared and that there will not be any sharing of details of R&D activities.

Subsection (x) should be amended to state that information will only be provided which is necessary for the administration of section 68CB (general approval).

Comment

Clause 31 provides for some exceptions from tax secrecy. Subsections (w) and (x) allow Inland Revenue to share information with select government agencies.

Officials disagree with submitters. It will be necessary in some circumstances to share taxpayer specific details rather than rely on aggregated data. Information will only be shared with a small set of carefully selected government agencies.

Recommendation

That the submission be declined.

Issue: Publication of claimant details

(Clause 30 (proposed new section 68CE))

Submission

(EY, Corporate Taxpayers Group, Deloitte, Chartered Accountants Australia and New Zealand)

It should be clarified what details of claimants will be published and whether businesses will receive advance notification. Disclosure shouldn't extend to the ultimate parent. *(EY)*

The time period between the end of the year to which the R&D tax credit relates and the publication of claimant details should be extended from two years to:

- Three years. For late balance date taxpayers, the lag is only 18 months between year-end and publication of the R&D tax credit details. This is because the two-year time period in legislation is based on a tax year concept. *(Corporate Taxpayers Group, Deloitte)*

- Five years. Alternatively, allow it to be extended if the R&D project is still ongoing. R&D projects may be jeopardised where the claim information is published before the R&D

project has been finalised and the IP protected. *(Chartered Accountants Australia and New Zealand)*

The published names should be on a group basis, not individual companies. This is because R&D may be undertaken in special purpose entities and the publication of the name may give additional information about what type of R&D is being undertaken, for example, a company named "square apple limited". *(Corporate Taxpayers Group)*

Schematically, this provision sits better in "Part 4- Secrecy" of the Tax Administration Act 1994. *(Chartered Accountants Australia and New Zealand)*

Comment

Proposed new section 68CE requires the Commissioner to publish the names of people who have received R&D tax credits, and the amount of the claim, in appropriate dollar bands. This information must not be published until at least two years have passed since the end of the tax year to which the person's R&D tax credit relates.

In response to EY's submission, the legislation is clear that it is the names of claimants that will be published. Businesses will be notified as part of the claim process that their name and claim amount within an appropriate dollar band will be published – this can be carried out operationally without the need for legislative change. The intention is that the claimant is named, not the ultimate parent company.

Officials disagree with extending the time period for publication beyond two years. Publication of a claimant's name is unlikely to jeopardise their R&D project as it provides no information about their actual R&D project.

Officials disagree with Corporate Taxpayers Group's suggestion that group names are published, rather than the individual claimant. Officials recommend that if a claimant does not want to give additional information away about their project, that they do not name their company after their commercially sensitive R&D programme.

Recommendation

That the submission be declined.

Issue: Support for 5-year evaluation

(Clause 10 (proposed new section LY 10))

Submission

(EY, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, BusinessNZ, ExportNZ, ManufacturingNZ)

We support that the R&D scheme will be objectively and independently reviewed every 5 years.

Comment

Officials welcome the support.

Recommendation

That the submission be noted, no further action required.

Issue: Frequency of evaluation

(Clause 10 (proposed new section LY 10))

Submission

(EY, ExportNZ, ManufacturingNZ, BusinessNZ)

Evaluation should be ongoing. *(EY)*

The R&D tax incentive should be evaluated within 4 years of commencement. *(ExportNZ, ManufacturingNZ, BusinessNZ)*

Comment

Government agencies' monitoring of the scheme will be ongoing. Inland Revenue and MBIE have set up the Research and Development Advisory Group comprising various private sector representatives. The Group will meet quarterly to discuss issues relating to the R&D tax credit, including the monitoring and evaluation of the scheme.

Officials consider 5 years an appropriate timeframe for evaluation.

Recommendation

That the submission be declined, subject to officials' comments.

Issue: Content of evaluation

(Clause 10 (proposed new section LY 10))

Submission

(Deloitte, Chartered Accountants Australia and New Zealand, Fisher & Paykel Healthcare, Corporate Taxpayers Group)

The following should also be included in the evaluation:

- The appropriateness of including social sciences *(Deloitte)*
- The approach to internal software *(Deloitte)*
- The appropriateness of the $3 million internal software development cap and the inclusion of additional core and support activities *(Chartered Accountants Australia and New Zealand)*

- $120 million cap *(Fisher & Paykel Healthcare)*
- Thresholds generally *(Corporate Taxpayers Group)*

Comment

The criteria listed in section LY 10 are not intended to be absolute. The evaluation could cover the items listed by submitters. Officials recommend that another paragraph is added to LY 10 to cover "anything else specified by the Minister of Research, Science, and Innovation".

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Party responsible for evaluation

(Clause 10 (proposed new section LY 10))

Submission

(EY)

Responsibility for the 5-year review should lie with an independent party, not the Minister of Research, Science and Innovation.

Comment

Officials disagree with the submitter. The responsibility must rest with the Minister of Research, Science and Innovation as the Minister is accountable for the research and development tax incentive. The Bill requires that the Ministers' report is objective and independent.

Recommendation

That the submission be declined.

Issue: Independent and objective

(Clause 10 (proposed new section LY 10))

Submission

(Deloitte)

The Bill should introduce additional specifications on how the evaluation will be independent and objective.

Comment

The legislation already requires that the review is independent and objective. Officials consider that the ordinary meaning of these words is sufficient to ensure that the review is independent and objective, without the need for additional criteria.

Recommendation

That the submission be declined.

Issue: Measuring success of the regime

(Clause 10 (proposed new section LY 10))

Submission

(EY, BusinessNZ, ExportNZ, ManufacturingNZ)

Measure of the success of the regime should go beyond R&D expenditure as a proportion of GDP and include things like growth in science/technology employment, revenue, profit growth or export revenue growth for R&D tax incentive recipients. This could be achieved by capturing appropriate data during the application process. *(EY)*

The review should seek to ascertain whether there has been any meaningful increase in innovation, investment and productivity on a national basis due to the tax incentive's introduction. The review should involve a comprehensive cost-benefit analysis and recommend whether or not the incentive should continue. *(BusinessNZ, ExportNZ, ManufacturingNZ)*

Comment

As mentioned above, the criteria in LY 10 are not intended to be exhaustive. The Minister may take the above into account when measuring the success of the regime.

Recommendation

That the submission be noted, no further action required.

Issue: Policy intent of the regime for evaluation purposes

(Clause 10 (proposed new section LY 10))

Submission

(EY)

The Bill should specify what sources can be relied upon for outlining the policy intent of the regime.

Comment

Officials disagree with submitters. The usual documents that are used to explain the policy intent of tax law, such as the cabinet papers, Bill commentary and tax information bulletin, can be relied upon for identifying the policy intent of the regime.

Recommendation

That the submission be declined.

Issue: Orders-in-Council - safeguards

(Clause 10 (proposed new section LY 9))

Submission

(Legislation Design and Advisory Committee, DAC, EY, Corporate Taxpayers Group, Fletcher Building Limited, Fisher & Paykel Healthcare, Chartered Accountants Australia and New Zealand)

The Governor General should be required to consult with businesses before amending the schedules. *(EY, Corporate Taxpayers Group, Fletcher Building Limited, Fisher & Paykel Healthcare, Chartered Accountants Australia and New Zealand)*

At a minimum, the Research and Development Advisory Group should be required to consider any Order in Council before it is issued by the Governor General. *(Corporate Taxpayers Group)*

Any change to the schedules should apply from the beginning of the following year. *(EY, Fletcher Building Limited)*

This power covers a matter of policy that could be better dealt with by primary, rather than secondary, legislation. Important policy should be a matter determined by Parliament through an open, democratic process.

The Order in Council proposes to amend what qualifies for the R&D tax credit – which goes to the core of the Bill.

Legislation should empower secondary legislation to amend or override an Act only if:

- there is a strong need or benefit to do so
- appropriate criteria are included to limit the power to only what is needed to achieve the objective; and
- consultation with people affected by the power occurs. *(Legislation Design and Advisory Committee)*

Comment

The Bill proposes that the Governor-General have the ability to make changes to schedules 21 and 21B on the joint recommendation of the Minister of Revenue and the Minister of Research, Science and Innovation. Schedules 21 and 21B determine what activities are considered to be R&D, and what kinds of expenditure qualify for the credit.

Officials have subsequently consulted with the Legislation Design and Advisory Committee (LDAC), and recommend:

- An explicit reference in section LY 9 to the purpose section (section LY 1(1))
- Adding a requirement to consult with affected parties
- Adding a requirement that any additions or removals have to meet the purpose stated in LY 1(1).

Officials are consulting further with LDAC on section LY 9, and will keep the Committee informed as consultation with LDAC progresses.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Broadening the scope of the Order in Council provision

(Clause 10 (proposed new section LY 9))

Submission

(Corporate Taxpayers Group, Deloitte, KPMG)

The scope of this provision should be extended to include an ability to amend sections LY 2, LY 3 and the $3 million cap on internal software development. *(KPMG)*

There should be an ability to increase thresholds (that is, refundability cap) contained in the legislation, as well as the tax credit rate, the expenditure cap and the capped overseas expenditure amount via Order in Council. *(Corporate Taxpayers Group, Deloitte)*

Comment

Officials disagree with submitters. Consistent with Legislation Design and Advisory Committee's submission above, Orders in Council should only be used where there is a strong need or benefit to a prompt response. Officials do not consider that the above suggestions meet this threshold.

Recommendation

That the submission be declined.

Issue: The general anti-avoidance rule is sufficient

(Clause 7 (proposed new section GB 56))

Submission

(EY)

Clause 7 should be deleted. The general anti-avoidance rule in section BG 1 would cover R&D tax credit arrangements.

Comment

Officials disagree with the submitter. The general anti-avoidance rule does not apply to R&D tax credits as they are not defined as "income tax". The specific anti-avoidance provision is targeted specifically at R&D tax credit arrangements as well as non-market transactions, which may not be "arrangements". In that respect it is broader than tax avoidance arrangements that the general anti-avoidance provision is targeted at.

Recommendation

That the submission be declined.

Issue: Indirect purpose or effect

(Clause 7 (proposed new section GB 56))

Submission

(Corporate Taxpayers Group, Deloitte)

Delete "or indirect" as it does not add anything. The language "direct or indirect purpose or effect, not being a merely incidental purpose or effect" is redundant language as an indirect effect is likely to be merely incidental. Replace the language with "an arrangement has a purpose or effect" to be consistent with the language of other specific anti-avoidance provisions.

Comment

Officials agree with the submitter. The direct and indirect distinction was intended to capture effects or purposes from persons not party to the arrangement, however this is covered in section GB 56(2) so is unnecessary. Officials recommend that the provision is amended to read "an arrangement has a purpose of effect, not being a merely incidental purpose or effect…".

Recommendation

That the submission be accepted.

Issue: Non-market rule is unnecessary

(Clause 7 (proposed new section GB 56))

Submission

(Corporate Taxpayers Group)

Section GB 56(1)(b) (the non-market value rule) is unnecessary given that schedule 21B already limits non-market value expenditure.

Comment

Officials agree with the submitter. Schedule 21B part B clause 18 already disallows expenditure to the extent it is greater than the market value of the goods or services.

Recommendation

That the submission be accepted.

Issue: Transactions should be readjusted to market value

(Clause 7 (proposed new section GB 56))

Submission

(Deloitte, Corporate Taxpayers Group)

Section GB 56(2) should be clarified so that the Commissioner, in the case of an inflated transaction, is required to reduce the person's claim to the amount that would have arisen had the transaction occurred at market value.

Comment

Officials are recommending that the non-market value provision is removed from the anti-avoidance rule, as outlined in the above submission. This addresses the submitters' point.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Promoter penalties – contingency fee arrangements

(Clause 37)

Submission

(Corporate Taxpayers Group, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Chartered Accountants Australia and New Zealand)

A person shouldn't be considered a promoter because they offer services on a contingency fee basis. It should only apply where a person deliberately assists a claimant to inflate their claim. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, Chartered Accountants Australia and New Zealand)*

The Group understands that the concern with contingent fees is that they might encourage aggressive positions and also "grave digging" in prior periods to increase R&D tax credit claims. However, the Bill contains some additional protections from "grave digging". *(Corporate Taxpayers Group)*

Comment

Officials disagree with submitters. A promoter penalty will only apply where the advisor has offered 10 or more contingency fee arrangements in relation to R&D tax credit claims, and one or more of the advisor's clients has been subject to a shortfall penalty for abusive tax position in relation to that arrangement. An abusive tax position is a very high standard and requires a dominant purpose of avoiding tax (reducing tax liabilities or increasing tax benefits). For example, it would apply where an advisor has assisted a taxpayer to recharacterize non-R&D expenditure as R&D expenditure.

In relation to Corporate Taxpayers Group's submission, promoter penalties for contingency fee arrangements are still necessary to disincentivise aggressive tax positions and to prevent inflated claims from the limited "grave digging" (this is where a person reclassifies their expenditure as R&D expenditure after the end of the year) that is allowed under the Bill. The Bill does not prevent a person operating on a contingency fee basis.

Recommendation

That the submission be declined.

Issue: Promoter penalties – software

(Clause 37)

Submission

(Corporate Taxpayers Group, Deloitte)

Unclear how the use of software should be subject to promoter penalties unless there is outright fraud being undertaken (in which case other penalties apply).

Comment

The Bill proposes amendments to the definition of promoter, so that a promoter includes a person party to, or significantly involved in, formulating software from which an arrangement is offered.

This rule is intended to capture people who offer software which calculates R&D claims. This person will be subject to a promotor penalty where they have offered the arrangement involving use of the software to ten or more people, and one or more of these people has become liable to a shortfall penalty for abusive tax position as a result of the R&D credit calculation undertaken as a result of the arrangement.

Recommendation

That the submission be declined.

Issue: Promoter penalties – definition of contingency fee

(Clause 37)

Submission

(Corporate Taxpayers Group, Deloitte)

"Contingency fee" should be a defined term. It should not include an arrangement where a fee has a ceiling of a maximum percentage of the R&D tax credit, but otherwise the costs are based on market rates.

Comment

Officials consider that the ordinary meaning of "contingency fee" is sufficient. The arrangement described by submitters would not be classified as a contingency fee as the fee is not conditional on the claim being successful.

Recommendation

That the submission be declined.

Issue: Deadlines for filing and amending assessments

(Clause 35)

Submission

(EY)

Clause 35 should be deleted. There should be no restriction on the number of NOPAs or section 113 requests that can be made by a taxpayer within the time bar period.

Comment

The Bill proposes that a person is only able to adjust their R&D tax credit claim upwards once and must do so within two years of the due date of their income tax return for the relevant income year. This restriction applies whether a person issues a NOPA or requests an amendment under section 113.

Officials disagree with the submitter. This restriction is intended to limit taxpayers' ability to retrospectively reclassify expenditure as R&D expenditure. This practice is seen with the Australian R&D scheme.

As outlined in a later submission, officials are recommending reducing the two-year time period to one year, to further limit claimants' ability to retrospectively reclassify expenditure.

Recommendation

That the submission be declined.

IN-YEAR APPROVAL

Issue: Cost of in-year approval applications

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(KPMG)

No fees should be applied to in-year approval applications.

Comment

Officials agree with the submitter. Cost is not referred to in the legislation, but the guidance will clarify that no fees will be charged for in-year approval applications.

Recommendation

That the submission be noted. No further action is required.

Issue: Support for certainty provided by in-year approval

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(Corporate Taxpayers Group)

General support for both the general approval and significant performer regimes as a practical way for taxpayers and Inland Revenue to obtain more certainty.

Comment

Officials welcome the support.

Recommendation

That the submission be noted. No further action is required.

Issue: Administrative burden on Inland Revenue

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(EY)

Concern regarding Inland Revenue's access to sufficient resources to conduct due diligence on in-year approval applications, with a rush of applications expected in January to May each year.

Comment

Officials are confident that Inland Revenue will have access to sufficient resources. This submission will be taken into consideration operationally when allocating resources to the in-year approval process.

Recommendation

That the submission be noted. No further action is required.

Issue: In-year approval process should not be compulsory

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(EY)

In-year approval should be optional, because while it would improve the integrity of the regime, it could lead to a greater compliance burden. Many businesses would be comfortable with self-assessment in exchange for a reduced compliance burden.

Comment

Evidence from other jurisdictions suggests that the integrity of the system requires compulsory in-year approval. In any event, it is not anticipated that in-year approval will result in an additional compliance burden for claimants, because the provision of information via in-year approval applications will result in less information being requested at the R&D supplementary return stage.

For general approval customers, the effect of the new in-year approval requirement in year two is, therefore, a timing difference. Instead of providing all claim information at the end of the year in an R&D supplementary return, a claimant will be expected to provide some of their claim information in an in-year approval application and the rest of their claim information in their R&D supplementary return. Splitting the provision of information between these two interaction points with Government/claimants is expected to help smooth the workload of both officers administering the regime and claimants.

Compared with general approval applications, significantly less information will be required from customers seeking to opt into the significant performer regime. Officials are still working on the requirements of the significant performer criteria and methodologies approval process but are considering the compliance burden on claimants as part of this work.

Recommendation

That the submission be declined.

Issue: Timeframe for processing applications

(Clause 43 (proposed new section 68CB))

Submission

(EY, Chartered Accountants Australia and New Zealand)

The Commissioner should be required to process and respond to an application within 28 days of receiving the application. *(EY)*

There should be a legislative requirement that the Commissioner must respond to applications within a set time frame, such as three months following receipt of an application. The deadline could be subject to a waiver by the taxpayer if the Commissioner asks for additional information. *(Chartered Accountants Australia and New Zealand)*

Comment

Officials agree that expedient processing of in-year approvals is a necessary foundation of the scheme in order to provide businesses with certainty to support their R&D programmes. No change to legislation is proposed because this is an operational consideration.

Recommendation

That the submission be declined.

Issue: Process for declining applications

Clause 43 (proposed new sections 68CB and 68CC))

Submission

(Corporate Taxpayers Group, Deloitte, EY)

If the Commissioner declines a person's application, the person should be entitled to provide additional information to support their application.

Comment

Officials agree that before a person's application is declined, the Commissioner should be required to contact the person to discuss their application (and, where appropriate, provide the person with the opportunity to supply additional information). It is recommended that the legislation be amended to require the Commissioner to contact a claimant before declining their application.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Dual eligibility for general approval and significant performer regime

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(EY)

A person who opts into the significant performer regime should also be able to obtain general approval in respect of some of their core R&D activities.

Comment

Officials acknowledge that significant R&D performers would benefit from the certainty afforded by the general approval process for some of their R&D activities.

Recommendation

That the submission be accepted.

Issue: Disputing the Commissioner's decision to decline applications

(Clause 43(proposed new sections 68CB, 68CC) and clause 44 (amendment to section 138E))

Submission

(EY)

Applicants should have an option (additional to judicial review) to dispute decisions made by the Commissioner to decline approval applications. Proposed new sections 68CB and 68CC should be removed from the proposed amendment to section 138E.

Comment

In-year approval applications which would otherwise be declined will not be declined until the Commissioner has contacted the applicant about their application. If an application is declined despite contact with the applicant, the applicant is nevertheless able to file another application provided they are within the prescribed timeframe for in-year approval applications. An additional disputes process is unnecessary.

Recommendation

That the submission be declined.

Issue: Due date of applications and variations to applications

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(EY, Deloitte)

Approval applications (and any variations to them) should be due by the end of the fifth month after the end of the relevant income year. Requiring applications (and variations to applications) to be made on or before the seventh day of the second month after the end of the relevant income year provides businesses with insufficient time, seems unnecessarily arbitrary, and is a time of year that is generally very busy for most businesses who will be undertaking year-end lodgements and audits. It also does not provide businesses with enough time to vary their applications if they require a variation due to a significant transaction or restructure. *(EY)*

The variation limitation means taxpayers have significantly less flexibility for R&D projects that span multiple years. This does not encourage innovation. *(Deloitte)*

Comment

Businesses can file their applications any time from the start of their income year to the seventh day of the second month after the end of the relevant income year. That is, businesses have thirteen months and seven days to lodge their applications, and any variations to their applications, with Inland Revenue.

If businesses file their applications and receive approval from Inland Revenue earlier in the year, they will receive certainty that their R&D activities are eligible and may even be able to use their approval to obtain finance.

The in-year approval process has been designed to encourage businesses to discuss their intention to do R&D with Inland Revenue before commencing their R&D activities. Businesses are also encouraged to use their R&D plans as a basis for their applications and to keep contemporaneous records of their R&D activities. Pushing out the in-year approval deadline would reduce the incentive for businesses to discuss their activities with Inland Revenue up-front and keep contemporaneous records.

Recommendation

That the submission be declined.

Issue: General approval of supporting activities

(Clause 43 (proposed new section 68CB))

Submission

(Deloitte, EY, KPMG, Corporate Taxpayers Group)

General approval should be available for core and supporting activities, so that businesses have certainty regarding whether their activities are eligible. Experience with other jurisdictions indicates that the eligibility of supporting activities can be contentious, so the ability to obtain approval of supporting activities could minimise these issues.

Comment

General approval is currently only available for core activities, but officials agree with extending the general approval process to supporting activities. The distinction between core and supporting activities is not always overtly clear so the extension will provide businesses with more certainty

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Multi-year approvals

(Clause 43 (proposed new sections 68CB and 68CC))

Submission

(Deloitte)

A person should only have to apply for in-year approval once if they intend for it to span three years. Requiring a person to apply each year is administratively inefficient.

Comment

The legislation only requires a person to apply for in-year approval once if they intend for the approval to apply for multiple income years. Applicants with multi-year approval of their activities are only required to confirm that there have been no material changes to their R&D in subsequent income years.

Recommendation

That the submission be noted. No further action is required.

Issue: General approval application form

(Clause 43 (proposed new section 68CB))

Submission

(KPMG)

Businesses should be required to provide a brief explanation of how their R&D activities satisfy the relevant definitions. If a business has to vary an existing approval, there should be a fast track procedure to obtain approval of the variation.

Comment

The legislation gives the Commissioner the power to prescribe a general approval application form. There is no legislatively prescribed timeframe for processing variations to existing general approvals. The Commissioner will take this submission into consideration when designing the general approval application process and deciding on the appropriate timeframes for processing variation requests.

Recommendation

That the submission be noted. No further action is required.

Issue: Early availability of significant performer approval process and pilot programme

(Clause 30 (proposed new sections 68CB and 68CC))

Submission

(Fisher & Paykel Healthcare)

We support the significant performer approval being available as early as possible and would welcome a pilot approach and working with officials on the detailed design.

Comment

Officials appreciate the support for the significant performer approval process.

Officials agree that a pilot approach has merit, and that the legislation should be amended to enable a binding pilot process for both general approval and significant performer criteria and methodologies approval in year one for a sample of appropriate claimants.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Requirements of R&D certificates unclear

(Clause 42 (proposed new section 15ZC))

Submission

(Corporate Taxpayers Group, Deloitte)

Section 15ZC does not specify what an R&D certificate has to cover.

Comment

It is a legislative requirement that any claimant who opts into the significant performer regime obtain an R&D certificate from an R&D certifier. It is envisaged that an R&D certifier will be an accounting or law firm with the relevant legal and accounting expertise to provide R&D certificates.

Each R&D certificate must be in the form prescribed by the Commissioner. Work is currently under way on the form that will be prescribed for R&D certificates. Officials will consult as appropriate with stakeholders on the design of the form. Guidance will also be provided on what the R&D certification process is expected to cover.

Recommendation

That the submission be noted. No further action is required.

Issue: Revocation where client has been subject to a shortfall penalty

(Clause 42 (proposed new section 15ZC(7)))

Submission

(EY, Corporate Taxpayers Group, Deloitte)

This provision should either be deleted or amended. If it is amended, it should be clear that section 15ZC(7) only applies to an R&D certifier where:

- The certifier has provided an R&D certificate in relation to a claim that resulted in a shortfall penalty being applied in relation to R&D tax credits;
- The shortfall penalty was for gross carelessness or a higher standard, such as aggressive tax planning or evasion; and
- The certifier has provided an R&D certificate in relation to ten claims that resulted in a shortfall penalty for gross carelessness (or a higher standard) being applied.

An R&D certifier should not have their approval revoked because of an omission or minor error. *(EY)*

This provision is unlikely to be effective because an R&D certifier could decline to complete another R&D certificate for any clients who receive a shortfall penalty. *(Corporate Taxpayers Group, Deloitte)*

Comment

Section 15ZC(7) requires the Commissioner to revoke an R&D certifier's approval if the R&D certifier has provided an R&D certificate to a claimant who has been liable to a shortfall penalty in relation to R&D credits at any time in the last two years.

Officials agree that since R&D certifiers will be at a firm level rather than an individual level, proposed new section 15ZC(7) is overly punitive.

Officials recommend amending the subsection so that it is triggered by a higher standard of non-compliance. The proposed amendment would require an R&D certifier's status to be revoked only if:

- The R&D certifier receives a promoter penalty; or
- The R&D certifier provides an R&D certificate to someone who is liable (in relation to an R&D tax credit claim) for shortfall penalties for tax avoidance, taking an abusive tax position, or tax evasion.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Whether an R&D certifier is at the individual or firm level

(Clause 42 (proposed new section 15ZC))

Submission

(EY, Deloitte)

It is unclear whether the "person" referred to in proposed new section 15ZC is an individual or an entire firm. It is also unclear how the penalty regime fits in with this.

Comment

An R&D certifier will be a firm as a whole (for example, a partnership or an entire company), rather than an individual within a firm.

Officials recommend that:

- Where a firm is approved as an R&D certifier, the firm be required to provide Inland Revenue with the names of individuals with delegated authority to issue R&D certificates on behalf of the firm.
- The section is amended so that it is clear that:
  - Once an application is approved, R&D certifier status starts from the date of a firm's application to be an R&D certifier; and
  - R&D certifier status ends on the date a firm's revocation is published in a publication chosen by the Commissioner.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Expertise required of an R&D certifier

(Clause 42 (proposed new section 15ZC(2)(b)))

Submission

(Corporate Taxpayers Group, Deloitte)

It may be difficult for a person to provide a statutory declaration that they have the legal, accounting, and scientific or technical expertise necessary to be an R&D certifier. Larger accounting and legal firms might have access to this expertise on a regional or global basis but may have insufficient local expertise to make the declaration.

Section 15ZC(2)(b) should be amended so that a person can make the declaration even if they do not have the required expertise themselves but have the ability to access to it.

Comment

Officials agree that it is important that potential R&D certifiers are able to satisfy the declaration required by section 15ZC (2), but foreign expertise does not necessarily translate to expertise of the New Zealand R&D tax credit regime. R&D certifiers must have the necessary accounting and legal expertise (required by proposed new section 15ZC(2)(a)) in-house to provide the statutory declaration needed to become an R&D certifier.

Recommendation

That the submission be declined.

Issue: Require R&D certifiers to be members of an appropriate professional body

(Clause 42 (proposed new section 15ZC))

Submission

(Chartered Accountants Australia and New Zealand, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)

The legislation should require each R&D certifier to be a member of an appropriate professional body, to ensure that they are competent and bound by professional ethics.

Comment

It is expected that most R&D certifiers will be members of an appropriate professional body. Such membership is not a legislative requirement, however, as the statutory declaration required by section 15ZB(2) regarding competency and expertise should be sufficient to ensure R&D certifiers have the ability to provide R&D certificates.

The penalty regime established by section 15ZC (which allows the Commissioner to revoke the approval of an R&D certifier in certain circumstances) should be sufficient to ensure R&D certifiers act ethically.

Recommendation

That the submission be declined.

Issue: No time limit on reapplication to be an R&D certifier where the person requested revocation

(Clause 42 (proposed new section 15ZC))

Submission

(EY)

There should be no timeframe limiting approval as an R&D certifier where the person has previously requested revocation of approval under section 15ZC(3).

Comment

Section 15ZC(6) allows the Commissioner to revoke an R&D certifier's approval at her discretion. She is also required to revoke approval, under section 15ZC(7), where an R&D certifier has provided an R&D certificate to a claimant who has received a shortfall penalty in relation to their R&D tax credits at any stage over the past two years (unless the claimant wilfully misled the R&D certifier).

R&D certifiers are also able to request the Commissioner revoke their approval under section 15ZC(3). Section 15ZC(4) provides that the Commissioner must not approve a person whose approval the Commissioner has revoked in the last 2 years, irrespective of why the approval was revoked.

Officials agree that the circumstances in which the Commissioner must decline an application (under section 15ZC(4)) should be limited to circumstances where the Commissioner has revoked an R&D certifier's approval under section 15ZC(7), or where the R&D certifier has surrendered their approval in anticipation of a revocation.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Commissioner should provide reason for revocation

(Clause 42 (proposed new section 15ZC))

Submission

(Corporate Taxpayers Group, Deloitte)

The Commissioner should be required to provide a reason for revoking approval as an accepted R&D certifier.

Comment

From an operational perspective, it is expected that the Commissioner will provide reasons for revoking her approval of R&D certifiers. No legislative amendment is required.

Recommendation

That the submission is noted. No further action is required.

Issue: JVs should be able to satisfy the $2 million R&D expenditure threshold as a collective

(Clause 43 (proposed new section 68CC))

Submission

(Matter raised by officials)

A JV should be able to satisfy the $2 million of eligible R&D expenditure threshold by grouping the expenditure of the members of a JV and considering their total eligible R&D expenditure as a collective.

Comment

Proposed new section 68CC provides that a person may opt-out of the general approval regime if they have, or reasonably estimate that they will have, more than $2 million of eligible R&D expenditure for the relevant income year.

The Bill as currently drafted allows a person to satisfy the $2m threshold in their own right, as a partner in a partnership (looking at the partnership's expenditure as a collective), or by grouping the person's expenditure with the expenditure of other members of their corporate group.

To be consistent with the treatment for corporate groups and partnerships, JVs should be able to satisfy this threshold as a collective. In other words, if a JV (as a whole) has, or expects to have, $2 million of eligible R&D expenditure, all members of the joint venture satisfy the $2m threshold in proposed new section 68CC.

Recommendation

That the submission be accepted.

Issue: Cost estimates should not be required from significant performers

(Clause 43 (proposed new section 68CC))

Submission

(Corporate Taxpayers Group, Deloitte)

Claimants wishing to opt into the significant performer regime should not be required to provide an estimate of their eligible R&D expenditure for the income year. Requiring an estimate will only cause problems if there ends up being a material difference between the estimate and a person's actual R&D tax credit claim as returned in their income tax and R&D supplementary returns.

If an estimate is required, then it needs to be clarified whether the estimate has to be filed on a global basis or for each individual R&D activity.

Comment

To be eligible for the significant performer regime, claimants will need to reasonably estimate that they will incur more than $2m of eligible R&D expenditure. Therefore, it is necessary for claimants to estimate their expenditure to confirm that they are eligible to opt into the regime. Claimants' actual eligible R&D expenditure, as filed, is not required to match the estimate.

Claimants will not be required to split their estimate up into amounts spent on individual activities. An estimate of the entire amount a claimant expects to incur over the course of an income year will suffice.

An estimate of eligible R&D expenditure is also useful because it can provide the Government with an indication of the likely fiscal cost of claims by larger R&D performers.

Recommendation

That the submission be declined, subject to officials' comments.

Issue: Material change to the provisions of subpart LY

(Clause 43 (proposed new section 68CC(2)(b)(iii)))

Submission

(Corporate Taxpayers Group)

Inland Revenue should contact affected claimants directly if it considers there has been a material change to the provisions in subpart LY that would affect the criteria and methodologies approval of a significant R&D performer. There should not be many claimants with criteria and methodology approval, so contacting each claimant should not be overly administratively burdensome for Inland Revenue.

Section 68CC(2)(b)(iii) should be amended so that it also refers to the schedules. Alternatively, there could be a defined term of "R&D tax credit rules" that lists all the relevant provisions.

Comment

Criteria and methodologies approval provided by the Commissioner under section 68CC(2)(b) binds the Commissioner for up to three years, provided certain criteria are met. One of the criteria is a requirement that no material change in the provisions in subpart LY, or any associated provisions, has taken place for the income year.

Officials agree that any material change to the R&D tax credit legislation that would have a material impact on approval applications would need to be communicated to affected claimants. Any legislative change would be accompanied by appropriate communication and a reasonable notice period.

It is expected that changes that take effect during an income year would only occur in exceptional circumstances, and that for the most part any legislative change would take effect from the income year after the change is first announced. Any approvals in place at the time a legislative change takes place would only be affected to the extent the legislative change is directly relevant to the approvals, and the impacts – and equity – of any legislative change on existing approvals will be taken into consideration before any changes are made.

Officials do not consider it necessary to specifically refer to the schedules as it is clear from the drafting of subpart LY that the schedules are associated provisions.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: More information needed on criteria and methodologies approval process

(Clause 43 (proposed new section 68CC))

Submission

(Fletcher Building Limited, Deloitte)

The Government should provide additional information on what protection criteria and methodologies approval provides applicants. It would also be helpful if there were more guidance on what information will be required as part of the criteria and methodologies approval application process *(Fletcher Building Limited).*

The legislation is currently ambiguous as to the nature of criteria and methodologies approval claims where a person has multiple, distinct R&D activities *(Deloitte).*

Comment

Work is currently under way on the criteria and methodologies approval process. Information on the regime and the likely information requirements will be publicised once the process has been further developed. Stakeholders will also be consulted, as appropriate, on their views regarding the criteria and methodologies approval process.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Circular logic

(Clause 43 (proposed new section 68CC))

Submission

(Deloitte)

Subsection LY 3(1)(bb) should be excluded from subsection 68CC(2). The proposed R&D certification process means that a certifier is required to certify compliance with subpart LY, however section LY 3(1)(bb) means that this cannot occur until approval is received under section 68CC. This is circular.

Comment

Officials disagree with the submitter. The legislation does not require the certifier to certify compliance with subpart LY and therefore there is no issue of circularity.

Proposed new subsection 15ZC(1) provides that a "research and development certificate" is in relation to a person's research and development tax credit. The information that must be contained in the certificate is not prescribed by legislation.

As outlined in the commentary it is expected that R&D certificates will be required to confirm that:

- an R&D certifier (typically a law or accounting firm) has reviewed a sample of a person's eligible R&D expenditure;
- the expenditure sample reviewed by the R&D certifier was calculated in accordance with the R&D tax credit rules; and
- the person incurred, or was reasonable in estimating that they would incur, more than $2 million of eligible R&D expenditure in the relevant income year.

Recommendation

That the submission be declined.

DRAFTING

Issue: Purpose statement – "business-as-usual activities" is too restrictive

(Clause 10 (proposed new section LY 1(1)))

Submission

(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, Deloitte, EY, WSP Opus, Fisher & Paykel Healthcare, Roger Ford, KPMG)

"Business-as-usual activities" is too restrictive, and for some companies includes eligible R&D. *(EY, WSP Opus, Fisher & Paykel Healthcare)*

"Business-as usual" should be defined *(Roger Ford, Deloitte, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, Fisher & Paykel Healthcare)* or replaced *(Corporate Taxpayers Group, EY, KPMG)* or clarified so that policy intent is clear *(Fisher & Paykel Healthcare).*

Replace: "ensure that business-as-usual activities do not qualify for" with "ensure that commercial or operational activities are not artificially reclassified to qualify for...". *(EY)*

Use more direct language, such as "ensuring that only eligible R&D activities are funded by the tax credit". *(KPMG)*

Comment

Officials agree with submitters that "business-as-usual activities" is too restrictive and recommend that section LY 1(1)(b) is amended to better reflect the policy intent of the regime. The policy intent is to provide a tax credit for activities that generate new knowledge, and to ensure that activities that are not R&D do not inappropriately qualify.

Officials are currently consulting with the Legislation Design and Advisory Committee (LDAC) on the content of the purpose statement, as it is relevant to LDAC's submission on Orders in Council.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Defined terms

(Clause 6, clause 10 (proposed new sections LY 1 and LY 3))

Submission

(Corporate Taxpayers Group, Deloitte, Chartered Accountants Australia and New Zealand)

"Input tax" should be added to the list of defined terms under section LY 1. *(Deloitte, Corporate Taxpayers Group)*

"Research and development tax credit" should be replaced with "research and development activities" in the list of defined terms in section EE 6. *(Deloitte, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand)*

"Group of companies" should be added to the list of defined terms under section LY 3. *(Corporate Taxpayers Group)*

Comment

Officials agree with the submitters.

Recommendation

That the submission be accepted.

Issue: Foreign research and development expenditure

(Clause 10 (proposed new section LY 7))

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte)

The drafting should make it clear that the R&D expenditure must relate to supporting activities. It is unclear why core activities are excluded from the overseas rule. *(Chartered Accountants Australia and New Zealand)*

Section LY 7(1)(a) refers to a research and development activity performed outside New Zealand", an R&D activity is defined to include both core and support activities. This makes the policy intent unclear that core R&D activities cannot be performed outside New Zealand. *(Corporate Taxpayers Group, Deloitte)*

Comment

Officials recommend that the legislation is amended to clarify that only foreign expenditure for an activity that is integral to a core activity conducted in New Zealand is eligible for the credit (that is, a supporting activity).

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Deadlines for filing and amending assessments

(Clause 35)

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte)

Section 113E could be more clearly drafted - it could cross-reference to section 89DA and 113. The cross reference to section 108(1E) (which is a 2-year period) is inconsistent with the four-month time period for taxpayers to file a notice of proposed adjustment. *(Corporate Taxpayers Group, Deloitte)*

Proposed section 113E is confusing and should be rewritten to clarify that a person can only:

- adjust their R&D tax credit claim upwards once; and
- the claim must be completed within two years of the due date of their income tax return for the relevant income year. *(Chartered Accountants Australia and New Zealand)*

Comment

Officials recommend that the drafting is simplified so that it is consistent with Chartered Accountants Australia and New Zealand's suggestion.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Ability to dispute assessments

Submission

(Matter raised by officials)

A person should only be able to make a section 113 request to amend their R&D tax credit assessment if they have provided an R&D supplementary return within the time allowed under section 33E.

Comment

Officials recommend introducing a provision to prevent a claimant from filing a section 113 request to amend their R&D tax credit assessment unless they have filed an R&D supplementary return within the time allowed under proposed new section 33E. Currently, proposed new section 89DA(1)(ab) only prevents a person filing a NOPA (but not a section 113 request) if they have not provided their R&D supplementary return within the time allowed under section 33E.

It is proposed that R&D supplementary returns be due within 30 days of the due date of a claimant's income tax return under section 37 of the Tax Administration Act 1994. This means that for a claimant with a standard balance date of 31 March, their R&D supplementary return would be due by 30 April.

Similar to proposed new section 33E and the amendment to section 108, the rationale for this recommended amendment is to limit claimants' ability to retrospectively reclassify expenditure. If a claimant receives R&D tax credits for R&D they were unaware of at the time the R&D activities took place, the R&D tax credit regime has not provided any incentive to the person to undertake additional R&D.

Recommendation

That the submission be accepted.

Issue: Time bar for amending R&D tax credit assessments

(Clause 33)

Submission

(Matter raised by officials)

Proposed new section 108(1E) should be amended so that the Commissioner may only amend an assessment so as to increase an amount of R&D tax credit if one year or less has passed from the latest date to provide a return of income for the relevant tax year.

Comment

The Bill as introduced allows the Commissioner to increase a person's R&D tax credit claim amount, provided the amended assessment takes place within two years of the person's latest date for filing their income tax return. For a person with a tax agent (so with an extension of time) claiming R&D tax credits for the year ended 31 March 2020, their income tax return would be due by 31 March 2021 and the Commissioner would be able to amend their assessment upwards any time before 31 March 2023.

The changes to section 108(1E) recommended by officials would reduce the amount of time available for increasing assessments to one year after a person's income tax return due date. So for the person in the above example, the Commissioner would only have until 31 March 2022 to amend the person's assessment to increase their R&D tax credit claim.

Similar to proposed new section 33E and the amendment to section 108, the rationale for this recommended amendment is to limit claimants' ability to retrospectively reclassify expenditure.

Recommendation

That the submission be accepted.

Issue: General structure of subpart LY

(Clause 10)

Submission

(Deloitte, Corporate Taxpayers Group)

Section LY 1(2)(c) should be expressed in the same way as (a) to (f). *(Deloitte)*

Sections LY 5, 6 and 7 are not explained in LY 1(2). *(Deloitte, Corporate Taxpayers Group)*

Comment

Officials' disagree with the submitter's suggested amendment to section LY 1(2)(c) as there would be no substantive difference if the provision was re-expressed as suggested. Section LY 1(2)(c) is merely a sign-posting provision.

Officials agree that sections LY 5, 6 and 7 should be explained in LY 1(2).

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: GST adjustments

(Clause 10 (proposed new section LY 1(5) to (7)))

Submission

(Corporate Taxpayers Group, Deloitte)

Section LY 1(5) is unnecessarily complicated – the Bill should refer to section DB 2 concepts.

LY 1(5) should only be overridden by LY 1(6) and (7) "to the extent" those sections apply.

In LY 1(6), GST adjustments can be positive or negative so "reduced" should be replaced with "adjusted".

Comment

Officials agree with the submitters and recommend that the drafting is simplified by referring to section DB 2.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Ordering of definitions

(Clause 10 (proposed new section LY 2))

Submission

(EY)

The definition of R&D activity should go before the definition of core activity.

Comment

Definition sections in tax legislation must be in alphabetical order.

Recommendation

That the submission be declined.

Issue: Unintended implication

(Clause 10 (proposed new section LY 3(1)(c)))

Submission

(Corporate Taxpayers Group)

The wording "the person or a company in the same group of companies as the person has" should be reworded to "the person, or if the person is a company, a company in the same group of companies as the person has…". The current draft implies that the person must be a company.

Comment

Officials are recommending that subsection LY 3(1)(c) be deleted. This will resolve the submitter's concern.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: No further consideration

(Clause 10 (proposed new section LY 3(1)(d)(ii)))

Submission

(Corporate Taxpayers Group)

Section LY 3(1)(d)(ii) should be amended to refer to "no further consideration".

Comment

Amending the legislation in line with the submitters' suggestion implies that some consideration for the results of the R&D is permissible. This is not the policy intention.

Consideration to use the results of the R&D activity is separate from any consideration to create the results of the R&D activity. Any consideration a principal pays a contractor to perform the R&D activity is not considered to be consideration to use the results of the activity.

Recommendation

That the submission be declined.

Issue: Consistency in referring to R&D activity or R&D activities

(Clause 10 (proposed new subpart LY))

Submission

(EY, Corporate Taxpayers Group)

The Bill should be consistent in referring to either "R&D activity" or "R&D activities". *(EY)*

All three definitions in section LY 2 should be refined as "activities" rather than "activity". For example, when applying the rule that expenditure that would have been incurred in the absence of the R&D activity is ineligible, applying a single activity approach would mean that if a business was running 2 concurrent R&D activities (one large project (Project A) and one smaller project (Project B)) which required an R&D lab facility to run trials, Project B couldn't have lab costs attributed to it because those lab costs had already been incurred for Project A. *(Corporate Taxpayers Group)*

Comment

Officials disagree with submitters. Under ordinary principles of statutory interpretation and the Interpretation Act 1999 singular and plural concepts can be interchanged.

In response to Corporate Taxpayers Group's point, if a claimant is performing R&D in a commercial environment, then the additional costs of the R&D would be claimable. Costs are only claimable once. If the lab costs have been claimed for project A, then they cannot be claimed for project B. If some of the additional costs relate to project B and have not been claimed as part of project A, then the commercial production rule wouldn't prevent them from being claimed. If the additional lab costs relate to both projects, then it is appropriate to claim the percentage that relates to each activity.

Recommendation

That the submission be declined.

Issue: Clarification that rules apply on an income year basis

(Clause 10 (proposed new section LY 3(2)))

Submission

(Corporate Taxpayers Group, Deloitte)

Section LY 3(2) should state "despite subsection (1), this subpart does not apply for a person for an income year", to make clear it applies on an income year basis.

Recommendation

That the submission be accepted.

Issue: Unnecessary drafting

(Clause 10 (proposed new section LY 3(3)))

Submission

(Corporate Taxpayers Group, Deloitte)

Not sure that LY 3(3) is necessary.

Comment

Section LY 3 outlines when subpart LY applies. LY 3(3) provides that where the person does not meet the eligibility criteria in LY 3(1) and (2), section LY 8 still applies to allow the person to carry forward their R&D tax credits to the next tax year. This rule is necessary to allow a person who has R&D tax credits from a previous year to carry them forward to the next tax year.

Recommendation

That the submission be declined.

Issue: "An" or "the"

(Clause 10 (proposed new section LY 5(1)(a)))

Submission

(Corporate Taxpayers Group)

Should the reference to "an income year" in LY 5(1)(a) be "the income year"?

Comment

Officials agree with the submitter that the reference should be to "the income year".

Recommendation

That the submission be accepted.

Issue: Punctuation

(Clause 7 (proposed new section GB 56), clause 43 (section 68CC(1)(a)))

Submission

(Corporate Taxpayers Group)

Sections GB 56(1)(a) and GB 56(1)(b) should be joined with "; and".

There are missing commas in section 68CC(1)(a). "Has or reasonably estimates that that" should be "has, or reasonably estimates that, the…".

Comment

Officials disagree with the submitter's proposed amendment to section GB 56 as it would substantially change the meaning of the section. Under the Bill as currently drafted, section GB 56 applies either where there has been an arrangement with the purpose of defeating the intent and application of subpart LY, or where there has been an inflated transaction. If the submitter's suggestion was adopted, both an arrangement and an inflated transaction would be required for proposed new section GB 56 to apply.

Officials consider that section 68CC(1)(a) would read better with commas as follows "…has, or reasonably estimates that the person will have, eligible research and development expenditure…".

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Definition of "R&D tax credit rules"

(Clause 21 (section YA 1))

Submission

(Corporate Taxpayers Group)

The Bill contains numerous references to the "R&D tax credit rules". Consideration should be given to defining this.

Comment

The Bill does not contain reference to the "R&D tax credit rules". Officials do not consider that a definition is necessary.

Recommendation

That the submission be declined.

Issue: Incorrect cross reference

(Clause 21(4))

Submission

(Corporate Taxpayers Group)

The cross reference should be to section LY 8(4) not LY 8(3).

Comment

Officials agree with the submitter.

Recommendation

That the submission be accepted.

Issue: Reference to associate should be to associated person

(Schedule 1 (proposed new schedule 21B part B))

Submission

(Corporate Taxpayers Group)

The reference to an "associate" in schedule 21B part B clause 8 should be to an "associated person".

Comment

Officials disagree with the submitter's suggestion. "Associated person" in section YA 1 of the Income Tax Act 2007 is defined to include "other expressions indicating the association of persons with each other". Therefore, the use of "associate" is correct.

Recommendation

That the submission be declined.

Issue: Replace "intent" with "purpose"

(Clause 43 (section 68CC(8)))

Submission

(Corporate Taxpayers Group)

Replace "intent" with "purpose".

Comment

Officials agree with the submitter that "purpose" would be more suitable in this context given subpart LY has a "purpose statement" in LY 1(1).

Recommendation

That the submission be accepted.

Issue: Drafting suggestion

(Clause 33)

Submission

(Corporate Taxpayers Group)

The reference to "the latest date to provide a return of income for the relevant tax year" should be a reference to the filing dates under section 37, consistent with the drafting in section LY 3(2)(a).

Comment

Officials disagree with the submitter. The current wording in clause 33 is consistent with the existing wording in section 108 of the Tax Administration Act 1994.

Recommendation

That the submission be declined.

Issue: Information that should be included in guidance

Submission

(Fletcher Building Limited, KPMG, Corporate Taxpayers Group, Deloitte, Chartered Accountants Australia and New Zealand, PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, EY)

Guidance should:

- Include examples of fact patterns from the 2008 regime *(Fletcher Building Limited)*
- Provide more information on when records need to be created *(KPMG)*
- Clarify that an R&D contractor can be undertaking an R&D activity on behalf of more than just one person, for example, in a joint venture between person A and person B, the contractor can perform the activity on behalf of both A and B *(Corporate Taxpayers Group, Deloitte)*
- Clarify that site-specific R&D can qualify. *(Fletcher Building Limited)*
- Explain:
  - the meaning of "relevant adjustment" in LY 1(6) *(Deloitte)*
  - the meaning of "business-as-usual" *(Chartered Accountants Australia and New Zealand)*
  - how the ordering rules will apply for consolidated groups *(Deloitte)*
  - how the legislation should be interpreted for software R&D *(EY, Deloitte, Corporate Taxpayers Group)*
  - the day-to-day management requirement *(Corporate Taxpayers Group)*
  - the meaning of "material purpose". *(Fletcher Building Limited, Chartered Accountants Australia and New Zealand)*
  - the work/costs/documentation needed to meet the uncertainty requirement, especially for multi-year projects. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund)*
  - what is required for someone to "own the results" of an R&D activity and that owning the results of the R&D refers to the IP of the R&D activity and not the product itself. *(Corporate Taxpayers Group, Fletcher Building Limited, Deloitte)*
  - how the Order in Council powers will be used *(Deloitte)*
  - when imputation credits arise for an entity in tax loss *(Corporate Taxpayers Group)*

- what constitutes a “material omission” or “material change” in section 68CB(2) *(Deloitte)*

- when it would be reasonable for the Commissioner to revoke approval to be an R&D certifier *(EY)*

- the meaning of “cosmetic” and “stylistic” *(Corporate Taxpayers Group)*

Comment

Officials will clarify these points in guidance, to the extent they remain relevant. Some points are already covered in the draft guidance material which has been published. Others points will be included in the revised guidance which will be published after the Bill receives Royal assent.

Recommendation

That the submission be accepted, subject to officials’ comments.

Issue: The R&D tax credit will make some people worse off compared to Callaghan Growth Grants

Submission

(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, ExportNZ, ManufacturingNZ, NZTech)

Concerned that growth grant recipients, especially software developers, will not receive any or as much support under the R&D tax incentive because of the lack of refundability and the narrow scope of the R&D tax credit regime. *(PwC, Angel Association New Zealand, New Zealand Venture Investment Fund, ExportNZ, ManufacturingNZ)*

Concerned that the cessation of the growth grant may disadvantage a number of New Zealand firms, particularly start-ups and SMEs. *(NZTech)*

Comment

In developing the tax credit and associated policies, such as the transition arrangements for Growth Grant recipients, the Government has wanted to minimise any disruption to R&D performers. However, in switching from one scheme to another, given the inherent differences between a tax credit and a grant, it is not possible to guarantee that all firms will get the same support as they did with the Growth Grant. Overall, the Government considers that the settings within the tax credit will mean that a greater amount of support to a larger number of R&D performers will be provided.

Recommendation

That the submission be declined.

Issue: Eligibility for the tax credit and Callaghan project grants differ

Submission

(KPMG)

It is relevant to the overall policy goal of supporting R&D that there is a misalignment of eligibility requirements between the R&D tax credit and the R&D Project Grant administered by Callaghan Innovation.

Comment

To some extent, different criteria are to be expected since the policies have different aims; some differences may be resolved when Project Grants are reviewed.

Recommendation

That the submission be noted, no further action required.

Issue: Reduce and then eliminate the Callaghan grants system

Submission

(Anonymous submitter)

Reduce and then eliminate the current Callaghan grants system.

Comment

Callaghan Innovation's Growth Grants will be phased out by 31 March 2021. All of Callaghan Innovation's other services and products, including R&D Project Grants and R&D Student Grants are not affected by this measure.

Recommendation

That the submission be noted, no further action required.

Issue: Deductibility of feasibility expenditure

Submission

(Corporate Taxpayers Group)

Feasibility expenditure should be deductible for tax purposes. The Group has long advocated for a "catch-all" provision which would allow business expenditure which is not otherwise deductible to be spread over an appropriate time period, for example, five years.

Feasibility and R&D go hand-in-hand. Failure to fix this issue will result in a significant risk that the regime does not lift R&D to desired levels.

Comment

This submission is outside the scope of the changes proposed in this Bill. The deductibility of feasibility expenditure will be considered as part of the Government's response to the Tax Working Group report.

Recommendation

That the submission be declined.

Issue: Company tax rate

Submission

(Anonymous submitter)

The company tax rate should be twenty percent for local SMEs (not multi-nationals) and then increasing one percent per additional $1 million revenue through to $18 million (28% tax rate).

Comment

Officials note that this submission is outside of the scope of the current changes.

Recommendation

That the submission be declined.

Issue: Future measurement of R&D – Statistics New Zealand's R&D survey

Submission

(ExportNZ, ManufacturingNZ))

Statistics New Zealand's R&D survey definition should take into account the new R&D tax credit definition. MBIE and StatsNZ need to determine:

- The extent to which the R&D tax credit definition will influence the current definition used in the StatsNZ R&D survey; and
- Given any changes to the R&D definition, how best to ensure the statistics collected for the R&D survey prior to the enactment of the Bill match what is classified as R&D from the 2019–20 tax year onwards.

Comment

Officials have referred these points to MBIE for their consideration.

Recommendation

That the submission be noted, no further action required.