Consultation on R&D Tax Incentive guidance to reflect proposed legislative changes

This document consults on draft R&D Tax Incentive guidance related to changes proposed in the Taxation

(KiwiSaver, Student Loans, and Remedial Matters) Bill.

The draft guidance is based on the Bill as introduced and will be updated to reflect feedback and changes made during the legislative process. The Finance and Expenditure Select Committee received a significant volume of submissions on the first 2 items listed below which may result in change during further consideration of the Bill.

The topics covered are:
- changes to the eligibility of organisations which receive exempt income
- changes to the refundability rules
- changes related to the internal software development definition.

Please provide any feedback on the Loomio forum at **govt.loomio.nz/rdtaxcredit** or by email to **R+Dincentive@ird.govt.nz**

If the feedback is to be considered for inclusion in the next update, please provide it by 11 February 2020.

Refunding R&D tax credits

Refundability from 2020-21

From the 2020-21 income year onwards, you may be able to get an R&D tax credit refund, subject to the proposed new refundability cap, if you are in a tax loss position or your R&D tax credits exceed your income tax liability for that income year. If you want to receive refundable credits, you must also make sure you do not have any other outstanding tax to pay. The proposed cap replaces the current refundability cap of $255,000, allowing you to claim refundable R&D tax credits for your total eligible R&D expenditure, up to the maximum eligible expenditure amount of $120 million.

Proposed new cap

It's proposed that the total amount of R&D tax credits you can receive as a refund is limited to a cap based on the amount of labour-related taxes paid by your business. The cap includes any PAYE (which includes withholding tax on schedular payments), FBT (fringe benefit tax), and employer superannuation contribution tax (ESCT) you pay for the relevant income year.

Calculating your refund

You can only get refundable credits if your R&D tax credits exceed your income tax liability for the relevant income year (for example, if you're in a tax loss position). Any surplus credits you have can be refunded, up to your refundability cap for the relevant income year. If your credits exceed your refundability cap, then any credits above your cap cannot be refunded in that year but can be carried forward to the next income year provided you meet the shareholder continuity requirements - refer to K. Receiving your R&D tax credit at **govt.loomio.nz/rdtaxcredit**

Example: Refunding credits under the refundability cap

In the year ended 31 March 2021, EmmaCorp has eligible R&D expenditure of $1 million, so it is eligible for $150,000 of R&D tax credits. The company has 12 employees and pays a total of $200,000 in labour related taxes (this amount is EmmaCorp's refundability cap). EmmaCorp has no income tax to pay in the 2020-21 income year.

Because its R&D tax credits ($150,000) are less than its refundability cap ($200,000) for the year, EmmaCorp can receive a refund of all its R&D tax credits.

Variation of facts: Insufficient labour-related taxes paid to refund all claimed credits

If EmmaCorp had only 6 employees and paid a total of $100,000 in labour-related taxes for the year, it would have a refundability cap of $100,000. Only $100,000 of its R&D tax credits would be refundable. EmmaCorp meets the shareholder continuity requirements, so the remaining $50,000 of R&D tax credits can be carried forward to the 2021-22 income year.

Cap can include taxes paid by controller or group companies

The refundability cap has grouping rules, which allow certain companies to allocate labour-related taxes they have paid to other companies they control or that sit within the same wholly-owned group.

The formula for calculating the refundability cap is:

Own payroll + other wholly-owned payroll + other controller payroll - double-dip allocation

Term	Definition
Own payroll	The labour-related taxes paid by a claimant for the relevant tax year.
Other wholly-owned payroll	The total labour-related taxes allocated to the claimant that have been paid by a member of the claimant's wholly-owned group for the relevant tax year.
Other controller payroll	The total labour-related taxes allocated to the claimant that have been paid by a company that controls the claimant for the relevant tax year.
Double-dip allocation	Any amounts allocated to a claimant that have already been allocated to another person. This prevents the same taxes going towards more than 1 claimant's refundability cap.

Misto Labs is an R&D-intensive firm eligible for $400,000 of R&D tax credits in the 2020-21 income year. It is in a tax loss position. Its refundability cap is made up of the following amounts:

Misto's refundability cap for the 2020-21 income year		
Formula component	**Amount**	**Explanation**
Own payroll	$75,000	PAYE, ESCT and FBT paid by Misto this year.
Other wholly-owned payroll	$100,000	PAYE, ESCT and FBT paid by Zeus Industries this year. Zeus is a company in the same wholly-owned group as Misto. Zeus has $200,000 of its own labour-related taxes but allocates $100,000 to Misto.
Other controller payroll	$100,000	Total PAYE, ESCT and FBT by ZigCo this year. ZigCo controls Misto and holds 65% of the shares in Misto.
Double-dip allocation	($0)	No amounts allocated to Misto by Zeus or ZigCo have been used by, or allocated to, other businesses for the purposes of calculating a refundability cap.
Misto's total cap	**$275,000**	

Since Misto has a refundability cap of $275,000, it can obtain an R&D tax credit refund for $275,000 of its credits. Its remaining $125,000 of R&D tax credits are non-refundable in the 2020-21 income year. Misto can carry these non-refundable credits forward to the 2021-22 income year provided it satisfies the R&D tax credit shareholder continuity requirements.

Example: Grouping rules with double-dip allocation

Same facts as the previous example, except ZigCo claims $100,000 of R&D tax credits, half of which it offsets against its income tax payable. As with the previous example, ZigCo has paid $100,000 of PAYE, ESCT and FBT for the year.

ZigCo indicates in its supplementary return that it has a refundability cap of $50,000, and so receives an R&D tax credit refund of its remaining $50,000 of credits. Despite this, ZigCo informs Misto that it will allocate $100,000 of labour-related taxes to Misto. Because ZigCo has already used $50,000 of its own labour-related taxes for its refundability cap, the double-dip allocation rules apply.

Misto's refundability cap for the 2020-21 income year (fact variation)		
Formula component	**Amount**	**Explanation**
Own payroll	$75,000	PAYE, ESCT and FBT paid by Misto this year.
Other wholly-owned payroll	$100,000	PAYE, ESCT and FBT paid by Zeus Industries this year. Zeus is a company in the same wholly-owned group as Misto. Zeus has $200,000 of its own labour-related taxes but allocates $100,000 to Misto.
Other controller payroll	$100,000	Total PAYE, ESCT and FBT by ZigCo this year. ZigCo controls Misto and holds 65% of the shares in Misto.
Double-dip allocation	($50,000)	ZigCo has allocated $100,000 to Misto, of which it has already used $50,000 for its own refundability cap. The same amount of tax can only go towards one person's refundability cap, so the $50,000 already used by ZigCo must not be included in Misto's cap.
Misto's total cap	**$225,000**	

$50,000 is subtracted from Misto's refundability cap, because this amount has already been included in ZigCo's cap. As a result, after deducting the double-dip allocation amount, Misto's refundability cap is $225,000.

Levy bodies and expenditure on approved research providers

There are 2 exceptions to the refundability cap. The cap does not restrict refunds for either:

- eligible expenditure on approved research providers
- claims made by levy bodies.

Example: Credits paid to levy bodies fully refundable

Levy Body A (LBA) is an industry organisation to which levies are payable under the Commodity Levies Act1990. LBA incurred $1 million of eligible R&D expenditure in the year ended 31 March 2021. It has no income tax liability and pays $50,000 of labour-related taxes for the year. LBA receives a full refund of its $150,000 R&D tax credits, because the refundability cap does not apply to levy body researchers.

Levy Body A - 31 March 2021	
Eligible R&D expenditure	$1 million
	x 15%
R&D tax credits claimed	$150,000
Income tax liability	$0
R&D tax credits refunded	**$150,000**

Exclusion of entities which derive exempt income

Income Tax Act 2007 LA 5(4B), LY 3(2)(f), LY 8(2B), CW 9, CW 10 and YA 1

The rationale behind this exclusion is that tax exempt entities sit outside the tax system, so should not benefit from incentives provided from within the tax system. Charities, which come within the tax-exempt entity exclusion, do not pay income tax, and receive additional Government support in the form of GST concessions, and exemption from FBT, and the donor tax credit regime.

A carve-in exists for levy bodies and claimants whose only exempt income if from foreign or intercompany dividends under section CW 9 or 10. Claimants who receive exempt dividend income will typically be businesses, and these businesses fund R&D performed by the levy bodies for their benefit, so levy body R&D is fundamentally business R&D.

Some entities which receive tax exempt income do not wholly sit outside the tax system and may conduct eligible R&D. To allow such entities to claim the credit, broader association rules have not been included in the scope of this exclusion. This allows these entities to set up non-tax exempt subsidiary businesses through which the can claim the credit.

From the 2020-21 income year, it is proposed that if you are an entity which derives tax-exempt income, you will be ineligible for the R&D tax credit regime, unless you are a levy body or your only exempt income is from foreign or intercompany dividends under section CW 9 or 10 of the Income Tax Act 2007.

Any R&D tax credits received in year 1 by an entity which is ineligible on these grounds cannot be refunded in year 2, nor can these be carried forward to year 2. These credits will be extinguished from the beginning of year 2.

Example: Charity's year 1 credits extinguished

In the year ended 31 March 2020, Charity X claims $100,000 of R&D tax credits. As Charity X does not pay income tax, it has no income tax liability to offset its R&D tax credits against. It is not eligible for refundability, because Charity X receives exempt income.

Charity X has a standard 31 March balance date. Its $100,000 of R&D tax credits form year 1 cannot be refunded in year 1 and cannot be brought forward to year 2. They are extinguished from 1 April 2020. Charity X also ceases to be eligible for the R&D tax credit from this date.

A carve-in exists for levy bodies and claimants whose only exempt income is from foreign or intercompany dividends under section CW 9 or 10 of the Income Tax Act 2007.

This exclusion of entities which derive tax exempt income does not include broader association rules in relation to entities excluded for deriving tax-exempt income. Therefore, a subsidiary taxpaying business is not ineligible for the credit merely because it is owned by an entity which derives tax-exempt income.

Example: Subsidiary not ineligible because its parent derives exempt income

Charitech is a charity which performs R&D to support its charitable work. It performs R&D on adapting traditional plant medicines so that they can be used alongside modern medicine to achieve better health outcomes. Charitech would like to claim the R&D tax credit for its R&D in the 2020-21 income year, but because it derives exempt income it is ineligible to claim the credit in its own right.

Charitech establishes a subsidiary company and shifts its R&D activities, so that the activities are performed by the subsidiary instead. The subsidiary does not derive any exempt income, so is not excluded from the credit through the exempt income exclusion. Assuming the subsidiary satisfies the other R&D tax credit eligibility criteria, it will be able to claim the credit, even though its parent organisation receives exempt income.

Internal software development

Income Tax Act 2007 Section YA 1 (definitions of internal software development expenditure and ineligible internal software development), Schedule 21 Parts A and B Clause 11 and Schedule 21B Part B Clause 16

The policy intent is for there to be 3 categories of software development under the R&D tax credit rules, with different treatment for each of the categories.

Type of software development	Policy intent
Internal software development undertaken for the purpose of internal administration	Ineligible for the tax credit
Other internal software development	Capped limit at $25 million of eligible expenditure
External software development (software developed for the main purpose of sale, or as an integral part of goods that are sold)	Eligible for the tax credit and uncapped limit

The rationale for excluding or limiting claims for internal software development is the fiscal risk and limited spill-over benefits associated with internal software development activities.

Internal administration exclusion

Internal software development undertaken for the purpose of internal administration is ineligible for the incentive. This is because there is likely to be limited public benefit from such activities. An example of software development this exclusion would apply to is a firm upgrading its internal HR system.

Other internal software development

All other software development, such as software development that enhances non-digital services to customers or enhances a business's manufacturing capability, is subject to an expenditure cap of $25 million. This kind of software development is not excluded, because it has an external focus or element. Therefore, the spill-over benefits associated with this type of software development are wider than the benefits associated with activities subject to the internal administration exclusion.

Projects to upgrade internal business processes can be very expensive in some industries. The Government is cautious about the fiscal consequences of including these activities within the scope of the R&D tax credit regimes. The internal administration exclusion and the $25 million cap are both aimed at reducing this potential fiscal risk.

Proposed amendment to the internal software development rules

The Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill proposes to clarify which software development activities are excluded, capped, or completely uncapped under the R&D tax credit rules.

This clarification is proposed because it may be unclear how the current rules apply to operational internal software development expenditure. It is possible that under the rules as currently enacted, operational internal software development expenditure is either completely ineligible (under the internal administration exclusion) or is uncapped as it does not clearly come within the $25 million cap. The policy intent is for software development expenditure to come within the $25 million cap if it is not:

- subject to the internal administration exclusion
- developed for the main purpose of sale, or as an integral part of goods that are sold (external software development).

We have chosen to present the proposed new rules for internal software development as a whole, rather than presenting the changes in isolation. This is to allow readers to get a full picture of how it is intended that the rules will work. It is proposed that any amendments to the rules will apply from the 2019-2020 income year.

Internal administration exclusion

If you develop software for the purpose of the internal administration of your business (or an associate's business - as defined in the Income Tax Act 2007 subpart YB), any expenditure you incur that relates to that development is not eligible for the R&D tax credit.

The purposes of internal administration include, but are not limited to:

- payroll
- accounting
- executive or management information
- human resources
- customer relationship management
- enterprise resource planning
- purchasing
- invoicing
- inventory systems.

This exclusion covers both core and supporting activities. However, software development in excluded areas may still be eligible for the tax credit, if they are developed with an external focus (so would be considered external software development instead).

Example: Software developed for internal administrative use

GeneriCo is working on improving its inventory processes in its warehouses around the country. It developes new software which resolves technological uncertainty in managing its inventory.

Because this software was developed entirely for internal administrative purposes, it is excluded from eligibility for the tax credit.

Variation of facts: Developed for sale

If GeneriCo were developing its inventory software primarily for sale to other companies, rather than for internal use, it may be eligible for the tax credit (as this expenditure could be considered external software development expenditure instead).

Software development subject to the $25 million cap

A $25 million cap applies to all other software developed for internal purposes. This means that you can only claim $25 million of expenditure on this kind of software development in your income year, regardless of how much you have actually spent - this equals a maximum tax credit of $3.75 million.

The cap applies to software developed for internal purposes unrelated to administration. This includes such purposes as manufacturing, testing, quality control, or enhancing non-digital services to customers.

The cap groups your expenditure with internal software development expenditure claimed by your associates, so the total you can claim combined is limited to $25 million. This is to prevent businesses from artificially splitting up their internal software development activities to get around the cap.

You will be required to tick a box on your supplementary return indicating if an associate is intending to or has made a claim for the tax credit. This will trigger personal contact from us to ensure that together your claimed expenditure on internal software development does not exceed $25 million.

If you and your associate are claiming for different parts of the same R&D project, you will need to set out what part each associate is claiming for an ensure no expenditure has been claimed twice.

Eugene works for a manufacturing company developing shatter-resistant glass for car windscreens. He develops software that can track stresses on the glass during impact testing in very fine details, increasing the quality of the testing process.

This satisfies the definition of internal software development expenditure, as the software being developed is solely for internal use in improving the quality of the testing process. As it is unrelated to back office administrative purposes, the expenditure Eugene's business incurred to develop the software is eligible - however, it is subject to the $25 million cap.

Internal software that enhances non-digital services to customers

A service is a non-digital service if the main reason why your customers uses the service is to obtain a service other than the use of your software (even though that service may be enabled, supported or facilitated by computer or software technology). Software which is not being developed for sale or licence, but which is intended to enhance non-digital services to customers, is considered internal software and is covered by the $25 million cap.

Example: Software that enhances non-digital services to customers

Mohammad runs a courier business and develops software that enables his customers to pinpoint the exact location and condition of their packages.

This satisfies the definition of internal software development expenditure, because Mohammad's customers are using his services to receive the goods he delivers (a non-digital service), not to use the software Mohammad has developed. The expenditure Mohammad's business incurred to develop the software is subject to the $25 million cap.

External software development

External software development is not subject to the $25 million cap. The normal expenditure rules apply.

There are 2 types of external software development.

Software that is sold

If you develop software with the main purpose of disposing of it to someone not associated with you, then it is considered external software development and not subject to the $25 million cap.

Software that is an integral part of goods that are sold

Software you develop that forms an integral part of goods that you sell in your business is also considered to be external software development, and not subject to the $25 million cap.

This exception is targeted at firmware - such as software that runs inside a washing machine or TV remote.

Purpose behind your software development

Your purpose at the time you develop your software determines what test you fall under. For example, if you develop your software for the purpose of internal administration and then later decide to sell it, this software would still be classified as ineligible internal software development and therefore excluded.

If you develop software with the purpose of both internal use and sale, it will depend on your main purpose at the time you developed it. If your main purpose was internal purposes other than administration it will be subject to the $25 million cap, or, if intended for internal administration purposes, it will be ineligible. If your main purpose was to sell the software, it will be external software development and not subject to the $25 million cap.