R&D tax credit: questions and answers

1 Why is the R&D tax credit being introduced?

The credit is intended to encourage New Zealand businesses to invest more in R&D, to innovate and develop improved products and processes. This is expected to have wider benefits for the New Zealand economy and boost productivity and international competitiveness.

The credit is one of the business tax reforms that are a substantial and important part of the government's Economic Transformation agenda. The aim is to have a sustainable economy built on innovation and quality, producing the kinds of products for which other countries will pay a premium. The business tax reforms are intended to help foster an environment that enables New Zealand businesses to grow and compete in a global economy.

The Business Tax Review is a key feature in the government's Confidence and Supply Agreements with United Future and with New Zealand First.

2 Who will get the credit?

New Zealand businesses undertaking R&D on their own account or outsourcing it will be eligible. They will have to incur at least $20,000 of eligible expenditure in the year a claim is made unless the R&D is outsourced to a listed research provider. Businesses will be eligible, regardless of their legal structure, if the R&D is carried out predominantly in New Zealand. It is expected that up to 2,500 businesses could start claiming the credit.

3 How much is the credit?

The credit will be 15 per cent of the claimant's total eligible expenditure for the year. Income tax deductions for the expenditure will not be reduced by the amount of the claim received in relation to the expenditure.

4 What is R&D?

For the purposes of the tax credit, R&D is activity that is systematic, investigative and experimental which seeks to resolve scientific or technological uncertainty or that involves an appreciable element of novelty and that is carried on for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes or services. This activity is referred to as "core" R&D.

Support activities can also be eligible if those activities are commensurate with, required for, and integral to the carrying on of the activity described above.

5 What activities are not eligible as R&D activities?

Activities that are ineligible as a core activity include:

- research in social sciences, arts or humanities;
- making stylistic or cosmetic changes; and
- market research.

These activities are not eligible as core R&D because the credit is intended to incentivise scientific and technological advancement. They may be eligible as a supporting R&D activity.

6 Why restrict the credit to businesses in New Zealand?

Increased investment in R&D by New Zealand businesses has wider benefits for the New Zealand economy.

Extending the R&D tax credit to cases where R&D is carried out by a party who is not in business in New Zealand may have some benefits to the New Zealand economy, but would enable the wider benefits associated with firms developing and marketing new products and processes to be captured overseas rather than in New Zealand.

Extending the R&D tax credit to cases where R&D is performed as a service for an offshore commissioner would increase the fiscal cost of the R&D incentive, potentially unsustainably, as New Zealand accounts for a small share of global R&D. This extension is also likely to crowd out investment in R&D by New Zealand businesses as, at the margin, the capacity and capability to perform R&D are relatively scarce.

7 Why must the R&D be carried out predominantly in New Zealand?

Many of the wider benefits from doing the R&D are likely largely to arise in the location in which the R&D is carried out. The requirement is intended to ensure that New Zealand can capture those benefits. However, the credit will apply to R&D carried out overseas as part of a project based in New Zealand, for up to 10 per cent of the eligible expenditure incurred in New Zealand.

8 Why is there a minimum threshold of $20,000 of eligible expenditure?

The threshold exists to minimise compliance and administrative costs associated with the reclassification of small amounts of expenditure as R&D. However, there will be an exception to the threshold if the R&D is carried out by a listed research provider. The exception is designed to allow small businesses to access the credit at a low compliance cost.

9 Why are there requirements that the claimant must control the R&D, bear the technical and financial risk, and own the results of the R&D?

When R&D is subcontracted out, the incentive will go to the party commissioning the R&D, instead of the party carrying it out. These requirements are designed to prevent multiple claims for the same expenditure. Also, the requirements are intended to ensure that the incentive goes to the party making the R&D investment – which will be the party taking the risks, deciding how much R&D will be undertaken, and benefiting from the results.

10 Who is ineligible and why?

Crown Research Institutes, tertiary institutions and District Health Boards, their associates and entities controlled by them will be ineligible for the credit. However, if a New Zealand business commissions R&D from these institutions, the business may be eligible for the credit.

These entities are excluded because the credits are intended to encourage private sector investment in R&D, and there are more effective mechanisms for increasing the amount of R&D carried out by these institutions.

11 Why is the credit based on volume of R&D, rather than incremental R&D?

The credit is based on the volume of R&D done (that is, the total amount of R&D) rather than R&D done above a base-year level (an incremental system). The volume method is simpler to understand and apply. It will also give firms more certainty about the benefit of the R&D credit when planning their R&D investment over the longer term. International experience suggests that this certainty is important.

In addition, as the amount of R&D carried out grows over time, a fixed-base incremental credit will increasingly have the same effect as a volume credit.

12 What expenditure is eligible?

Eligible expenditure includes employee salaries and training, depreciation of tangible assets used primarily in conducting R&D, overhead costs, consumables, and payments to entities conducting R&D on behalf of the claimant.

13 What expenditure is not eligible?

Ineligible expenditure includes interest, the loss on sale or write-off of depreciable property, the cost of acquiring core technology (technology used as a basis for further R&D), expenditure funded from a government grant or the required co-funding, expenditure on intangible assets and professional fees in determining eligibility.

14 When does the credit come into effect?

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

15 How do claimants get the credit?

The credit will be claimed as part of the annual income tax return process. A supporting statement will also need to be filed. Businesses with only exempt income will need to file an income tax return to access the credit.

16 How will businesses without a tax liability get the credit?

The R&D credit will reduce tax payments, but if there is no tax to pay the credits will be paid out in cash. Therefore loss-making businesses, such as start-ups, or businesses, which only have exempt income will receive their credit in cash.

17 Won't the credit be clawed back when profits are paid to shareholders?

The credit has been designed to minimise claw-back. Imputation credits will arise for a tax liability satisfied by the R&D credit. Those imputation credits will therefore be available to be attached to dividends as though the tax was actually paid.

18 Why is there a $2 million cap on software developed for internal use?

Overseas experience highlights a risk that routine in-house software development may be reclassified as R&D expenditure. Expenditure on in-house software development as core R&D is therefore eligible only up to $2 million a year. However, the cap does not apply to software development that supports core R&D. Australia does not allow software developed solely for in-house use to qualify as core R&D.

The Minister of Finance may increase the eligible amount for internal software development if the Minister is satisfied that the R&D activity is in the national interest – that is, it will be exploited mainly for the benefit of New Zealand, New Zealand will receive a substantial net benefit from the activities, and the claimant is committed to keep the value of their business in New Zealand.

19 What about co-operatives that do R&D?

There are special provisions for industry research co-operatives, which are sector-based groups that undertake or commission R&D mainly on behalf of New Zealand businesses. If contributions or levies received by a co-operative from those businesses are applied to R&D that relates to the businesses, the co-operative may be eligible for the credit. The co-operative does not need to meet the requirement to be in business in New Zealand.