Market development tax credits

Definition, eligibility criteria, eligible expenditure

An officials' issues paper on matters arising
from the Business Tax Review

November 2006

Prepared by the Policy Advice Division of the Inland Revenue Department
and by the New Zealand Treasury

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CONTENTS

CHAPTER 1	**Introduction**	**5**
CHAPTER 2	**Definition of “market development” and “export”**	**8**
	Definition of “market development”	8
	Definition of export	9
CHAPTER 3	**Eligibility criteria**	**10**
	Who and what should qualify for the tax credit?	10
	Limitations on the size of the firm	10
	Businesses eligible for the credit	10
	Defining “goods and services”	11
CHAPTER 4	**Eligible expenditure**	**12**
	General principles	12
	Qualifying expenditure	12
	Non-qualifying categories of expenditure	14
	Minimum and maximum expenditure limitations	14
APPENDIX 1	**Market Development Assistance Scheme**	**16**
APPENDIX 2	**Australian Export Market Development Grant Scheme**	**17**

CHAPTER 1

Introduction

1.1 In July 2006 the government released the Business Tax Review discussion document for public comment. It set out a range of possible business tax initiatives that will help transform the New Zealand economy by enhancing our productivity and improving our international competitiveness. Feedback was sought on the relative priority of the initiatives given limited resources.

1.2 No decision has been taken on what initiatives will be introduced. In the meantime, officials are seeking further feedback on certain measures, including design of a market development tax credit.

1.3 The specific design issues on which feedback is sought are set out in the following chapters. These include proposed definitions of market development and export, eligibility criteria and eligible expenditure. The challenge is to develop a tax credit that is sufficiently broad to capture expenditure that generates wider benefits, but sufficiently precise to be clear and workable. It is also important that any tax credit minimises compliance costs and tax planning opportunities.

1.4 This issues paper has been prepared by officials from the Policy Advice Division of the Inland Revenue Department and from the Treasury, as part of the continuing consultation process. If the government decides to proceed with the tax credit initiative, submissions on the ideas explored in this issues paper will be taken into account in the design of the credit.

1.5 Submissions should be made by 1 December 2006 and be addressed to:

Business Tax Review, Market Development Tax Credits
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Or email: policy.webmaster@ird.govt.nz with "Business Tax Review, Market Development Tax Credits" in the subject line.

1.6 There is a very tight reporting timeframe, and extensions to the deadline are not feasible. Late submissions cannot be considered.

1.7 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials to contact those making submissions to discuss their submission, if required.

1.8 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those who consider there is any part of their submission that should properly be withheld under the Act should indicate this clearly.

SUMMARY OF A POSSIBLE APPROACH TO A MARKET DEVELOPMENT TAX CREDIT

What qualifies as market development?

- Market development is the process of creating or expanding a presence in markets outside New Zealand and Australia.

The definition of "export"

- Firms would be considered to be exporting if they export goods and services to overseas countries and if those goods and services are consumed overseas.

Qualifying businesses

- All New Zealand firms whose annual turnover is less than $50 million (GST-inclusive) would qualify for the tax credit.

Qualifying goods and services

- Firms that export goods and services that are substantially of New Zealand origin would qualify for the tax credit.

Eligible expenditure

- The market development tax credit would be limited to the following types of expenditure:
  - in-market visits;
  - overseas representation;
  - bringing overseas buyers to New Zealand;
  - advertising and promotion (excluding sponsorships);
  - marketing material;
  - trade shows and events; and
  - market research.

- To provide certainty for firms that visit markets or bring potential buyers to New Zealand, standard costs would be used for airfares and a daily allowance used for accommodation, sustenance, telecommunications and other incidental costs.

- The minimum level of expenditure that would qualify for the tax credit is $20,000 (GST-inclusive) a year.
- The amount of the tax credit would be capped at the equivalent of $1 million (GST-inclusive) of market development expenditure.

Expenditure not eligible

- The following classes of expenditure would not qualify for the tax credit, even though they may fall within the definition of "qualifying expenditure":
  - expenditure relating to developing markets in Australia;
  - salaries of employees in preparing marketing information or while visiting overseas markets;
  - costs of producing samples;
  - basic website development and maintenance;
  - expenditure covered by another government grant;
  - costs of setting up an overseas office or plant; and
  - fees relating to professional advice or testing/certifying products and services.

CHAPTER 2

Definition of “market development” and “export”

2.1 This chapter defines “market development” and outlines which exports of goods and services might qualify for the tax credit.

2.2 The objective of a market development tax credit is to support market development activities by exporters to countries other than Australia, subject to limits on eligibility and maximum and minimum expenditure.

2.3 The tax credit is broadly designed to deliver the assistance for the same sorts of activities covered by the Market Development Assistance Scheme (MDAS), which is administered as Enterprise Development Grant – Market Development by New Zealand Trade and Enterprise. A tax credit would have the advantage of greater visibility, and it would be available to more firms. Furthermore, having the credit claimed as a refund during the tax return process, rather than using a formal grant application process, would reduce compliance costs for firms.

2.4 Having criteria set out in legislation would provide greater certainty for firms because once they met the legislated qualifying criteria they would automatically qualify for and receive the tax credit. The credit could therefore be more effective than a grant in being integrated into (and influencing) a firm’s investment decisions.

Definition of “market development”

2.5 “Market development” would consist of the activities undertaken by a firm to develop a market presence overseas, in order to sell goods and services. It would not include the cost of selling those goods and services.

2.6 In principle, expenditure on these activities in relation to developing a presence in a market outside of Australia and New Zealand would potentially qualify for the tax credit. Given that under Closer Economic Relations, Australia and New Zealand are treated as core/home markets for most New Zealand firms, expenditure on these markets is not eligible for the tax credit.

2.7 Chapter 4 outlines the expenditure that would qualify for the tax credit.

Definition of export

2.8 "Export" could be defined as "the exporting of goods and services to overseas countries if those goods and services are consumed overseas". This would provide a clear administrable definition but would exclude inbound tourism and educational services provided to foreign students because those services are consumed in New Zealand. These exclusions are consistent with the rules used for zero-rating goods and services in connection with GST.

Submission point

Submissions are sought on the following matter:

- Is the definition of "export" broad enough and simple to apply?

CHAPTER 3

Eligibility criteria

Who and what should qualify for the tax credit?

3.1 Eligibility criteria should be as inclusive as possible, taking into account the variety of firms that engage in exporting. The criteria should be easily understood and, when applied, they should not impose unnecessary compliance and administrative costs.

Limitations on the size of the firm

3.2 Larger firms, because of their scale, are better able to bear the costs of market development themselves. The market development tax credit should aim to help small and medium-sized firms to become large firms that can support themselves.

3.3 The current MDAS grant is limited to firms with less than $50 million (GST-inclusive) turnover. Special rules enable larger firms to have access to the grant if they are in partnership with a smaller firm. Most other countries have caps on the size of firms that can qualify for assistance. The Australian Export Market Development Grant Scheme (EMDG) cap is currently AUD$30 million.

3.4 It may be desirable to restrict eligibility to firms with less than $50 million turnover (GST-inclusive), in order to target the credit to where it is most needed.

3.5 Anti-avoidance rules could be introduced to ensure businesses could not structure themselves in such a way as to get round the maximum turnover threshold.

Businesses eligible for the credit

3.6 All New Zealand tax-resident businesses should be eligible for the credit, regardless of whether they are undertaken in a corporate or other business structure. The definition of “business” could be the tax definition, which includes any profession, trade, manufacture or undertaking carried on for a pecuniary profit. Hobbies and activities and exploring whether there is the potential to produce and export a product would not qualify under this definition.

3.7 Under this approach, entities that are exempt from income tax might still be able to qualify for the tax credit provided they met the business test and the other qualifying criteria.

3.8 The role of Crown Research Institutes (CRIs) includes developing and selling research. Market development undertaken by CRIs in order to sell research should, in principle, be eligible for the credit – as long as it also met the other criteria.

Defining "goods and services"

3.9 The credit would be available for developing a market for goods and services of New Zealand origin. The definition of "place of origin" used in the guide to interpreting the Fair Trading Act could be used to determine whether goods qualify for the tax credit:

> *" . . .a place of origin can be defined as the country or region where the product was created in its final form from its raw materials or constituent parts. In other words, it is the country or region where the product's 'essential quality' was created. It is not necessarily the place where the most money was spent on a product - and it is not the place where only final assembly or packaging was done"*

3.10 Services would be eligible if they fall within the same "essential quality" criterion. Services when the labour is supplied by New Zealand tax-resident individuals would fall within this rule, as would some other services.

Submission points

- Is the "place of origin" definition used in the guide to interpreting the Fair Trading Act sufficient to claim that the good or service is New Zealand produced?
- Is the $50 million turnover threshold appropriate?

CHAPTER 4

Eligible expenditure

4.1 This chapter outlines expenditure categories that might qualify for the tax credit as well as maximum and minimum levels of expenditure.

General principles

Deductibility

4.2 The tax credit would be available only for expenditure that is ordinarily deductible for tax purposes. This requirement would exclude expenditure of a private or domestic nature or expenditure incurred before a business starts up.

Timing

4.3 The timing rules in the Income Tax Act would also apply to the tax credit, which would be available only in the year in which the deduction for the qualifying expenditure is allowed. In the case of tax-exempt entities, the tax credit would be allowed in the year in which the deduction would have been allowed had the entity been a taxpayer.

Qualifying expenditure

4.4 The existing market development grant covers the following categories of expenditure:

Standard costs	• in market visits; • attendance at trade shows and events; • bringing overseas buyers to New Zealand;
Actual costs	• advertising and promotional expenditure (excluding sponsorship); • time-based overseas representation; • marketing material; • trade shows and events; and • market research if it is related to refining an approach to a market, rather than establishing an overall strategic direction.

4.5 The market development tax credit would be limited to these types of expenditure. Most of these expense categories could be covered on an "actual expenditure" basis. However, to provide certainty for firms and to reduce administrative and compliance costs associated with making a claim, standard costs could be set for in-market visits, attendance at trade shows, and bringing overseas buyers to New Zealand. This is the approach taken under the MDAS scheme (varying amounts depending on the countries visited) and the Australian EMDG scheme (AUD$300 per day).

4.6 This would not, of course, limit the amount that firms could spend on market visits, but it would cap the amount for which a tax credit could be claimed. While simple, this approach could result in businesses being funded for less than their actual costs for overseas travel. This paper seeks feedback on whether this is a suitable approach.

4.7 Standard costs could cover the following:

Standard costs	Expenditure covered
Daily allowance	accommodation, sustenance, telecommunications, internal travel and incidentals
Airfares	all international air fares (amount set at return economy airfare to market)

4.8 An alternative could be to allow the credit to be claimed in relation to actual and reasonable expenditure, up to a specified amount, which could be set at a reasonably high level. However, higher compliance costs would be incurred in justifying and possibly apportioning expenditure and increased uncertainty around entitlement.

Expenditure on spouse

4.9 Many small firms are owned and operated by a husband and wife team. Under the MDAS scheme, when an applicant going overseas takes along a spouse the expenditure of the spouse is generally excluded from the grant. However, the applicant can submit a business case justifying why the spouse needs to accompany the applicant on the overseas visit to a market or trade show.

4.10 The introduction of an arbitrary boundary (such as excluding expenditure for a spouse) would increase compliance and administration costs and lead to the boundary being challenged. An alternative would be to enable firms to claim the travelling costs of both spouses if the expenditure meets the test of ordinary deductibility for tax purposes.

Non-qualifying categories of expenditure

4.11 All expenditure that does not fall within the qualifying expenditure would be excluded from eligibility for the tax credit. There would be some categories of expenditure that would be specifically excluded, even though they would otherwise fall within the definition of "qualifying expenditure". This would be consistent with the MDAS grant scheme.

4.12 Salaries of employees in preparing marketing information or while visiting overseas markets would not be eligible as that would be part of business-as-usual costs.

4.13 Costs of producing samples would not be eligible. Determining the costs of a sample can be difficult because the first sample can include set-up costs, which are then simply part of business-as-usual production costs. Also, it can be difficult to distinguish between samples and products because samples can often be turned into products later when payment is received, as happens with software. In effect, by allowing samples to be claimed, the credit could be used to underwrite the cost of sales, not the expenses associated with developing an export market. The MDAS experience is that samples are problematic and require considerable judgement.

4.14 Expenditure that is covered by another government grant would not qualify for the tax credit, nor would fees relating to legal, marketing, and other professional advice, and the testing and certification of products and services.

4.15 The costs of setting up or maintaining an office, plant, or subsidiary entity in an overseas market would be considered to be business as usual and would not qualify.

4.16 Expenditure on developing a generic website would not qualify for the tax credit as websites are seen as pre-requisites for operating businesses in New Zealand. However, expenditure on developing a website for overseas markets or translating the general website into a foreign language would qualify.

Minimum and maximum expenditure limitations

4.17 The existing MDAS grant is available only to firms that spend at least $40,000 (GST-inclusive) a year on eligible market development, providing a grant of $20,000 (GST-inclusive). The Australian EMDG has a minimum expenditure level of AUD$30,000 (providing a minimum grant of AUD$15,000). These limits act as qualifying thresholds whereby expenditure by the firm has to exceed this amount in order to qualify. Having a minimum level ensures that a firm is serious about developing the new market and reflects what a firm needs to spend in order to make a viable and sustained entry into a new market. However, the minimum threshold should not be set so high that small businesses are excluded from claiming the credit. Therefore the minimum expenditure level in order to qualify for the tax credit could also be set at $20,000.

4.18 The maximum MDAS grant is capped at $100,000 (GST-inclusive), equating to market development expenditure of at least $200,000 (GST-inclusive). If the tax credit were in the range of 7 to 15 percent, a maximum expenditure cap of $1 million (GST-inclusive) would apply to the tax credit. If expenditure above the maximum was incurred the credit would be available only for $1 million of expenditure.

4.19 Anti-avoidance rules could be introduced to ensure businesses could not structure to get round the maximum and minimum thresholds.

Submission points

Submissions are sought on the following matters, in particular:

- Would the classes of expenditure outlined here cover market development expenditure? If not, what other forms of expenditure should be included?
- Should expenditure on airfares and daily expenses for market visits and buyers' visits to New Zealand be capped? If so, how should the cap be set, and at what level? Alternatively, should standard costs be used, to reduce compliance costs? If so, how should the standard costs be set, and at what level?
- Should expenditure of a spouse travelling on business be excluded or should it be allowed subject to the ordinary deductibility test for tax purposes?
- Should expenditure on samples be excluded? If not, how can the boundary between samples and cost of sales be determined without significant compliance costs?
- Should expenditure covered by other government grants, legal, marketing and other professional advice, and testing and certification of products and services be excluded?
- Should the costs of setting up and maintaining overseas offices, plants and subsidiaries be excluded?
- Should ordinary website development and maintenance be excluded?
- Are the maximum and minimum threshold levels discussed here appropriate? If not, what should they be?

APPENDIX 1

Market Development Assistance Scheme

At present, assistance to develop export markets is provided through the MDAS scheme administered as the Enterprise Development Grant – Market Development by New Zealand Trade and Enterprise.

The MDAS scheme aims to encourage firms to develop new export markets. A firm breaking into a new market faces extra costs in developing that market. At the same time, some of the benefits of entering a new market flow to the wider business community and New Zealand in general through knowledge gained of that market and the exposure of New Zealand as a supplier of goods and services. The extra costs of developing the market and the inability to secure all of the benefits can result in firms under-investing in market development. The MDAS grant may encourage firms to enter and develop new markets, despite these extra costs.

The features of the MDAS scheme are as follows.

- The scheme provides assistance for new strategic export market activities, such as new market or new product development, but not business-as-usual activities.
- Eligibility is limited to small or medium enterprises, defined as firms with less than $50 million (GST-inclusive) turnover or less than 100 full-time-equivalent employees.
- The grant is provided at a rate of up to 50 percent of qualifying expenditure, on a GST-inclusive basis.
- Qualifying expenditure includes in-market visits, overseas representation, bringing overseas buyers to New Zealand, advertising and promotion (excluding sponsorships), marketing material, trade shows and certain types of market research.
- Expenditure which is the subject of other government assistance does not qualify.
- Expenditure relating to activities in the Australian market does not qualify and is consistent with the single market approach of CER. (The Australian EMDG has a similar restriction in respect of exports to New Zealand.)
- The minimum expenditure a New Zealand firm must undertake to qualify for the grant is $40,000 (GST-inclusive), which provides a grant of up to $20,000 (GST-inclusive).
- The maximum grant that can be claimed by a firm is $100,000 (GST-inclusive) per annum (GST-inclusive), in respect of at least $200,000 (GST-inclusive) of expenditure.
- To reduce compliance costs the grant scheme provides standard costs for airfares and a daily rate for accommodation.
- There is a lifetime cap on the total grant received of $500,000 per firm (GST-inclusive).
- A firm may claim the grant for five years. This means that if a firm does not claim the maximum grant in each year, it will not reach the $500,000 cap.

APPENDIX 2

Australian Export Market Development Grant Scheme

The Australian EMDG is administered by Austrade. The underlying principle of the Australian EMDG scheme is to provide an incentive for small and medium enterprises to promote their products overseas if the business can return significant net benefit to Australia.

The features of the EMDG scheme are as follows.

- Businesses with AUD$30 million turnover or less are eligible for the grant.
- The grant is provided at the rate of 50 percent of the qualifying expenditure.
- Qualifying expenditure includes overseas representation, in market visits, communication expenditure, free samples, trade shows and in store promotions, advertising and promotional literature, and bringing overseas buyers to Australia.
- Expenditure relating to activities in the New Zealand market does not qualify for the grant.
- The minimum level of grant paid is AUD$15,000, representing AUD$30,000 of expenditure.
- The maximum grant that can be claimed is AUD$200,000, relating to at least AUD$400,000 of eligible expenditure.
- Standard costs are provided for airfares and daily allowances (maximum of AUD$300 per day).
- The lifetime cap on the grant available to Australian firms is AUD$1.6 million.
- Firms may claim the grant for up to seven years.