Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

Volume 3

Research and development

Penalties

Company tax rate consequentials

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Research and development

OVERVIEW

Clauses 2(21), 100, 108, 111, 129, 135(8), (9), (22), (26), (33), (42), (44), (49), (54), (55), (56), (60), 146, 147, 151, 156, 158, 166, 167, 169, 171, 172, 182 and 270

The bill introduces a tax credit for research and development activities conducted by New Zealand businesses. This brings New Zealand into line with many other countries which offer tax concessions for R&D. The rationale for R&D tax concessions is that there is under-investment by businesses in R&D because the investing firm does not capture all of the benefits of the investment. Some of the benefit is captured by other businesses or consumers. The tax incentive 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 credit in three years to determine whether it is effective in meeting these objectives.

The credit is available for eligible businesses that have eligible expenditure on "research and development activities". We outline some of the eligibility requirements below, focussing on those that are the subject of submissions.

Eligibility requirements

In the bill as introduced, in order to be eligible, a claimant must be in business in New Zealand, with a fixed establishment in New Zealand. The expenditure for which a claim is made must relate to that business. Crown research institutes, tertiary institutions, and district health boards, their associates and entities under their control are not eligible for the credit.

A claimant must bear the financial and technical risk of the project, have control over the work and own the project results. When R&D is outsourced, this distinguishes the person who commissions the R&D (who is eligible for the credit) from the person who merely performs that R&D (who is not eligible). This ensures that the incentive is provided to the party making R&D investment decisions and that there are not two claims for the same R&D.

The claimant must have at least $20,000 of eligible R&D expenditure in a year unless the R&D services are purchased from a listed research provider.

The R&D must be conducted predominantly in New Zealand. The credit can apply for R&D conducted overseas up to a limit of 10 percent of the eligible expenditure incurred in New Zealand where the project must be based. Businesses can do more R&D overseas but it does not attract the credit.

R&D activities must be systematic, investigative and experimental. They must either seek to resolve scientific or technological uncertainty or involve an appreciable element of novelty and be directed at acquiring new knowledge or creating new or improved products or processes. These are "core" R&D activities. Certain activities are excluded from core activities, as they are in other jurisdictions, generally to delineate more clearly the boundary between innovative and routine business activity. Activities that support core R&D activities can be eligible.

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

Certain expenditure is ineligible. The main items are interest, 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.

There is a cap of $2 million on eligible expenditure when the R&D core activity is in-house-use software development. This can be waived by the Minister of Finance when the R&D is in the national interest. Claimants under common control that undertake software development will be required to calculate this expenditure as a group and to allocate the cap between members.

Submissions

Thirty-six submissions were received on R&D tax credits and generally supported their introduction. NZICA noted its general preference for a low-rate, broad-based tax system that does not create incentives for certain activities over others.

A general theme, expressed both in submissions and consultation with submitters, was that clear legislation and guidelines were important, with wide consultation on guidelines. Submissions covered a wide range of concerns, focussing on the requirements to be in business, undertake R&D related to the business and to control and bear the risk of the R&D, the exclusion of Crown research institutes, tertiary institutions and district health boards and entities associated with them, the limit on R&D done overseas, the exclusion of required co-funding when a grant is provided and the $2 million cap on internal software development.

Key issue: sustainability of credit

The key issue for the government and private sector is sustainability of the credit. Overseas experience is that stability in the scope of an R&D tax concession is a critical factor in increasing R&D. If the credit is not fiscally sustainable, it will be reduced in scope and business confidence in it will be eroded, reducing its effectiveness.

In proposing amendments to the bill and responding to submissions, officials have therefore adopted a cautious approach to reduce the likelihood that substantive changes to reduce the scope of the concession will subsequently be required.

To ensure that the credit is sustainable, it is important that it rewards R&D and not routine business activity or expenditure. In designing the credit, therefore, the government has drawn on aspects of the R&D definitions and expenditure rules in Australia, Canada, the United Kingdom and Ireland, where concessions have proved sustainable. It has also considered the practical experience of overseas jurisdictions in administering the credit where certain activities – such as internal software development and retrospective claims – have proved problematic.

PURPOSE TEST

Clause 100

Submission
(33 – Corporate Taxpayers Group, 44 – Fisher & Paykel, 37 – Zespri, 60 – Building Research, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The R&D legislation should contain a "purpose" section as an aid to its interpretation.

Comment

A number of submissions note that the Australian R&D tax legislation has a purpose provision and have proposed that the New Zealand R&D provisions should also have one. NZICA and the Corporate Taxpayers Group go further to suggest that the purpose provision should be similar to that in Australia as much of the New Zealand legislation is modelled on the Australian R&D provisions. The purpose clause in Australia is:

> The object of this section is to provide a tax incentive …to make eligible companies more internationally competitive by:
>
> (a) encouraging the development by eligible companies of innovative products, processes and services; and
>
> (b) increasing investment by eligible companies in defined research and development activities; and
>
> (c) promoting the technological advancement of eligible companies through a focus on innovation and high technical risk in defined research and development activities; and
>
> (d) encouraging the use by eligible companies of strategic research and development planning; and
>
> (e) creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies.
>
> The benefits of the tax incentive are targeted by being limited to particular expenditure on certain defined activities.

Purpose provisions are intended to give clear legislative expression to the underlying purpose of the provisions in question, and to set out their objectives, goals and conceptual basis. They are operative parts of legislation, with the same status as other provisions (not superior or of overriding status). They can give guidance to taxpayers, Inland Revenue and the courts about how the legislation should be applied and interpreted.

Submissions argue that a purpose clause would provide useful guidance for Inland Revenue as the tax credit is an entirely new line of business for them and one which requires a different mindset.

The rationale for the credit is the likely existence of externalities when businesses invest in R&D. That is, some of the benefits that arise from a business doing R&D are captured by other businesses. These wider benefits that arise from R&D are expected to help make New Zealand businesses more internationally competitive and transform the New Zealand economy into one that is more innovative. A purpose clause would therefore refer to externalities.

However, there is no requirement or reference in the substantive R&D provisions to externalities because the test would be difficult to apply at the individual business level. To incorporate the concept into a purpose clause is therefore likely to cause greater uncertainty than clarity.

The Australian purpose provision is an unsuitable model because it does not refer to externalities. The Explanatory Memorandum accompanying the introduction of the Australian purpose clause states that the reason for the insertion of the purpose section was to narrow the interpretation of the definition of R&D activities by the Administrative Appeals Tribunal and the Federal Court. In deciding cases before the introduction of the purpose section, those bodies had referred to the purpose clause in an associated R&D Act. This resulted in the Tribunal and Court interpreting the definition of R&D in tax legislation more widely than intended.

Recommendation

That the submission be declined.

REQUIREMENTS FOR ELIGIBILITY

Clause 100

Issue: Requirement to be in business in New Zealand through a fixed establishment

Submissions
(37 – Zespri, 40 – NZ Bio, 61 – KPMG, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

There should be no requirement for a claimant to be in business because this excludes research entities in a group that do R&D work on a cost recovery basis. Possible alternatives would be "enterprise" (in the Australian GST legislation) or "taxable activity" (NZ GST legislation). *(Zespri, New Zealand Institute of Chartered Accountants)*

The concept of a taxable activity (as defined for GST purposes) should be substituted for the requirement to carry on a business. *(KPMG)*

The wording of the business test should be amended to ensure the test is not too narrowly applied thereby excluding trusts and charities. An alternative could be that an eligible person must carry on a profession, trade or undertaking in New Zealand with a reasonable expectation to profit from those activities. *(Deloitte)*

The tax credit should be available to overseas investors in business in New Zealand who commission contract R&D regardless of whether they have a fixed establishment in New Zealand. *(NZ Bio)*

Comment

The aim of the credit is to encourage businesses to invest in R&D to secure the wider benefits to New Zealand that this R&D may generate. The requirement that the claimant be in business in New Zealand through a fixed establishment is designed to ensure that the credit is provided to claimants with a commercial activity within the New Zealand tax base.

The credit is designed to reside with the party making the decisions about how much R&D should be undertaken and what that R&D should be. The claimant therefore should be the party commissioning the R&D rather than the performer of the R&D. There does not appear to be sufficient justification for creating an exception to this rule for entities that do their R&D on a cost recovery basis within a group structure. The member of the group commissioning the R&D should be able to claim the credit in its own right.

Adopting a GST-based definition of "business" would inappropriately broaden the scope of the credit. The income tax definition of "business" requires an intention to make a pecuniary profit and therefore reflects the intention of the credit as an incentive to business R&D and to require there to be commercial activity. The GST concept of "taxable activity" targets economic activity more widely and would apply to entities such as government departments.

We do not consider it necessary to amend the income tax definition of "business" to ensure that trusts and charities in business can access the concession. The term "business" already applies to these organisations within the income tax legislation and should therefore not pose any barriers to them claiming the concession.

The requirement that non-resident claimants have a fixed establishment in New Zealand is aimed at ensuring that they have businesses within the New Zealand tax base. Without a permanent establishment, the application of double tax treaties would mean that they are not subject to income tax in New Zealand. This requirement could appear to be in conflict with the eligibility of tax-exempts. However, exemption from tax is a consequence of overriding social policy objectives.

NZ Bio states that overseas investors with a business in New Zealand who commission R&D carried out locally should be able to access the tax concession regardless of whether they have a fixed establishment. Without a fixed establishment the income derived by such businesses in New Zealand would not be taxed in New Zealand. While there may be some benefits to the New Zealand economy in subsidising foreign firms the objective of economic transformation is not to decrease costs for foreign firms, making them more internationally competitive. Therefore we do not support this submission.

Recommendation

That the submissions be declined.

Submission
(Matter raised by officials)

The requirement to have a fixed establishment should apply only to non-resident claimants.

Comment

As currently formulated, the requirement to have a fixed establishment in New Zealand applies to residents and non-residents. The criteria for determining whether a fixed establishment, which includes having a substantial business, determine which jurisdiction should be able to tax a business, and are not relevant if the business is a resident. Therefore requiring residents to have a fixed establishment is unnecessarily restrictive on resident firms.

Recommendation

That the submission be accepted.

Issue: Start-up businesses

Submission
(40 – NZ Bio)

A person who starts a business part-way through an income year should qualify for a tax credit if they meet the eligibility requirements of proposed section LH 2(2).

Comment

A taxpayer should be eligible to make a claim for any part of the year that they meet the eligibility requirements and also have relevant expenditure or an amount of depreciation loss.

We agree that the legislation could be drafted more clearly to give effect to that intention.

Recommendation

That the submission be accepted.

Issue: Partnerships carrying on R&D

Submission
(Matter raised by officials)

If a partnership meets the eligibility requirements the partners should be treated as having satisfied those requirements.

Comment

The tests of eligibility, such as being in business and meeting the minimum threshold, are also applied at the partnership level. However tax credits are claimed by individual partners rather than the partnership. Therefore it is necessary to treat partners as having met those requirements, in relation to R&D activities carried out by the partnership, if the partnership has met those requirements.

Recommendation

That the submission be accepted.

Issue: R&D activities must be related to business of claimant

Submission
(37 – Zespri, 91 – New Zealand Institute of Chartered Accountants, 61 – KPMG, 71 – PricewaterhouseCoopers)

The requirement that activities must be related to the business of the claimant should be removed. *(Zespri, New Zealand Institute of Chartered Accountants, KPMG)*

Confirmation is required that the term "business" in proposed section LH 2(2)(a)(i) will be given a wide interpretation to include both an existing business and any potential business of a claimant. This clarification could be provided in a *Tax Information Bulletin*. *(PricewaterhouseCoopers)*

Comment

The requirement that R&D activities must be related to the business of the claimant is intended to reduce the opportunity for a firm commissioning research to transfer the ability to claim the concession to another party. Particularly, if the firm commissioning the R&D activities is not entitled to claim the concession in relation to those activities, it should not be possible to transfer the activity to another party so that the other party can claim the concession instead.

However, the concession should be available to a claimant who undertakes R&D that is not directly related to their current business if it is carried out with a view to starting a new business. We agree that the requirement that the R&D activity must be related to the business of the claimant should be expanded to include a prospective new business of the claimant. Nevertheless, this expenditure would need to meet the general deductibility requirements in section LH 2.

Recommendation

That the submission to remove the requirement that R&D activities must be related to the business of the claimant be declined.

That the submission that the term "business" should include a prospective business be accepted.

Issue: Election to defer deduction for R&D expenditure

Submission
(33 – Corporate Taxpayers Group, 71 – PricewaterhouseCoopers, 74 – Deloitte)

The eligibility criteria should be amended to include as eligible for the tax credit R&D expenditure deferred in accordance with section EJ 21 of the Income Tax Act 2004. The deferred expenditure should be eligible in the year incurred. *(Corporate Taxpayers Group, PricewaterhouseCoopers, Deloitte)*

Comment

Under proposed section LH 2(2), to be eligible for the tax credit the claimant must have expenditure on R&D activities and the expenditure must be deductible in the year in which it is incurred.

This means that R&D expenditure that taxpayers have elected to deduct in a future year, under rules recently introduced to allow them to do so in section EJ 21 of the Income Tax Act 2004, will not be eligible for the credit. Those rules were introduced to prevent a company with no income in the year in which expenditure is incurred from accruing tax losses that are forfeited when new shareholders are brought in to raise capital.

Submissions propose that such expenditure should be eligible for the credit in the year it is incurred, although the deduction for it will be taken at a later date. We agree that this is the correct treatment.

Recommendation

That the submission be accepted.

Issue: Prepayments

Submission
(Matter raised by officials)

To be eligible for a credit, a person must have expenditure on R&D that is deductible in the year in which it is incurred. Expenditure that is incurred in one year and by virtue of a general timing provision is deductible in a subsequent year (such as prepayments) will therefore not be eligible. It should be eligible in the year in which it is deductible.

Comment

Under certain general timing rules in the Income Tax Act 2004, expenditure that is incurred in one year will, by virtue of an add-back mechanism, be deductible in a subsequent year. So, for example, if a taxpayer prepays expenditure on goods, a deduction for the expenditure on the goods not used in that year is deferred until the goods are used.

Such deferred expenditure will not meet the eligibility requirement that R&D expenditure must be deductible in the year in which it is incurred. In these situations, it is deductible in a subsequent year. The credit should be available in the year in which the expenditure is deductible as that is the year in which the nexus with R&D should be tested. Under this rule, in the case of prepaid goods, the credit would apply if and when the goods are used for R&D.

Recommendation

That the submission be accepted.

Issue: Capital expenditure

Submission
(33 – Corporate Taxpayers Group, 74 – Deloitte)

It should be explicit that capital expenditure on assets is eligible for the R&D tax credit (for example, a unique infrastructure asset). It appears this outcome is intended to be achieved by subsection LH 2(2)(e)(iii) but this is not clear from the drafting. *(Corporate Taxpayers Group, Deloitte)*

Comment

Capital expenditure is expenditure on creating or acquiring an asset that will provide an enduring benefit to an entity. It is generally deductible over the income-earning life of the asset. In the R&D context, this refers to expenditure that is capitalised for accounting because if expenditure is expensed for accounting it is generally immediately deductible for tax.

Facilitative assets

Capital expenditure on assets that are not the object of the R&D activities but that are used in R&D ("facilitative assets" such as buildings) are depreciated and annual depreciation deductions are eligible for the credit.

End-result assets

Capital expenditure on creating or improving assets that are the object of the R&D activities ("end-result assets") is dealt with in section LH 2(2)(e)(iii). We agree that these rules are unclear and propose that they be redrafted as follows. It is assumed that such expenditure is linked with the income earning process of the business.

End-result intangible assets

Capital expenditure incurred in seeking to create a depreciable **intangible** asset as the object of the R&D activities should attract the credit when it is incurred. Such expenditure would include the cost of labour, materials and depreciation on facilitative assets used in developing the asset.

End-result tangible assets used solely for R&D

Capital expenditure incurred in seeking to create a depreciable **tangible** asset that is developed as the object of the R&D activities (such as a prototype or innovative plant) should attract the credit when it is incurred only when it is to be used solely for R&D (for example, in testing) and not for any other purpose by that business or an associate. The expenditure would include the cost of labour, materials and depreciation on facilitative assets used in developing the prototype.

End-result tangible assets used partly for R&D and partly for commercial purposes

Capital expenditure of a business should not attract the credit when it is incurred if it is incurred in constructing a depreciable **tangible** asset that:

- is the object of the R&D activities; and
- is developed for use in the business other than in the R&D process.

A prototype may be used initially in the R&D process (for example, for testing) but either simultaneously or subsequently be used for commercial purposes. Alternatively, once developed, it may be sold to an associate for use in the income earning activity of the associate. In such circumstances, and assuming such construction is eligible R&D, depreciation on the asset while it is being used for R&D should attract the credit.

Example

A Co is a utility company experimenting with a new material for underground pipes. It constructs a small area of the network for testing before rolling out the pipes in the region. Assume that the construction of that part of the network is an eligible support activity. The pipes supply gas to the neighbourhood and will remain in place following the test, if they are satisfactory. The salary and materials input into construction of the pipe network should not be eligible for the credit when they are incurred, but depreciation on them should be eligible while they are used in R&D.

If, as a result of the testing, the asset is shown to be a failure and written off, the credit would apply to the balance of the construction costs.

We have discussed these proposed rules with the Corporate Taxpayers Group which agrees that the treatment in each case seems correct. However, both officials and the Group consider that the rules should be reviewed at an early stage to determine how appropriate they prove to be in practice.

Recommendation

That the submission be accepted in part and the R&D provisions be redrafted to clarify that capital expenditure is eligible to the extent discussed above.

Issue: Non-deductible expenditure

Submission
(33 – Corporate Taxpayers Group, 71 – PricewaterhouseCoopers)

Expenditure that is not deductible – that is, "black-hole expenditure" – should still be eligible for the R&D tax credit in the year the expenditure is incurred. *(Corporate Taxpayers Group, PricewaterhouseCoopers)*

Comment

"Black-hole" expenditure is expenditure that is not deductible for tax, either when it is incurred, or over the life of an asset. In the R&D context, it exists when expenditure that is capitalised for accounting purposes does not lead to a depreciable asset. There are three circumstances in which this can occur: when capitalised R&D expenditure does not result in an asset at all because the R&D project is abandoned, when R&D expenditure creates an intangible asset that is not depreciable, and pre-business expenditure.

Under the bill, to be eligible for the credit, R&D expenditure must be deductible or amortisable. Therefore, black-hole expenditure is not eligible. Submissions argue that there is no sound policy reason for denying access to the tax credit for otherwise eligible expenditure because it is "black-hole". It is argued that the fiscal risk of allowing the tax credit for black-hole expenditure would be properly managed by careful application of the eligibility criteria.

In general, the requirement that expenditure be deductible is a key element in reducing the fiscal risk associated with the tax credit because it provides a link with the income-earning process and excludes expenditure on hobbies, capital assets such as land that do not depreciate, and GST. We therefore recommend that it be retained.

However, we have recommended, in response to the submission considered immediately above, that capital expenditure incurred in **seeking** to create a depreciable intangible or tangible asset be eligible. If this is accepted, the first type of black-hole expenditure – abandoned R&D – will therefore be eligible.

This reduces the amount of black-hole R&D expenditure that will not be eligible for the credit. Black-hole expenditure is already a relatively small percentage of R&D expenditure and the question of its treatment will be considered for inclusion in the government's tax policy work programme.

Recommendation

That the submission be accepted in part as described above and that it be noted that the treatment of black-hole expenditure will be considered for inclusion in the government's tax policy work programme.

Issue: Minimum threshold of expenditure

Submission

(91 – New Zealand Institute of Chartered Accountants)

Clarification is required of the relationship between section LH 2 and subsection LH 2(4), which provides for a $20,000 minimum amount of R&D expenditure to qualify. Subsection (5) should also be clarified.

Comment

Section LH 2(4) sets out the minimum amount of expenditure or depreciation in a year that is necessary in order to claim the credit in that year. (If the expenditure is contracted out to a listed research provider there is no minimum threshold.)

The formula is: $\$20{,}000 \times \frac{\text{No. of days for which a person is eligible in a year}}{\text{No. of days in the year}}$

If a person is eligible for the whole year, the threshold is $20,000. If they are eligible for part of the year only, the amount is reduced accordingly. For instance, if they are eligible for half the year, the minimum threshold is $10,000.

NZICA incorrectly assumes that the formula targets a different situation. We consider that the provisions are clearly drafted and have advised NZICA of the intention of subsections LH 2(4) and 2(5).

Recommendation

That the submission be declined.

R&D MUST BE ON BEHALF OF CLAIMANT

Clause 100

Overview

The tax concession has been designed to vest with the party making decisions about what R&D investment should be undertaken. Therefore, when R&D is outsourced the concession should go to the party commissioning the research, and not to someone who performs the R&D on behalf of another person. Section LH 2(2)(b) in the bill sets out the three criteria for determining whether the R&D is being carried out on behalf of the claimant or on behalf of someone else. They are that the claimant:

- must control the R&D; and
- bear the financial and technical risk of the project; and
- own the results of the project.

In some cases, even when the R&D activity is carried out in New Zealand, a firm may not be eligible to claim a tax credit for the R&D because it is in substance being carried out on behalf of an ineligible entity.

Submissions were received on the individual criteria and also how they apply if parties jointly undertake R&D.

Issue: Joint R&D

Submissions
(7 – Dairy Insight, 19 – Deepwater Group Ltd, 23 – ISI, 48 – Dexcel Ltd, 43 – PGG Wrightson, 40 – NZ Bio, 91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

Claimants that share the costs of funding R&D activities should be eligible to claim the tax credit. *(New Zealand Institute of Chartered Accountants)*

In circumstances where the control, financial and technical risk and ownership of the R&D is divided between more than one eligible person, the eligible persons should be entitled to agree on the party that is eligible for the tax credit, or portions thereof; or, if this is not adopted, that the eligibility criteria be extended to require two of the three criteria to be met. *(Dexcel Ltd)*

R&D is often undertaken through consortia where more than one party has control over the R&D. The tax credit should be available if control of an R&D activity is shared between parties acting in collaboration towards a common goal. *(Dairy Insight, Deepwater Group Ltd, ISI, Dexcel Ltd, PGG Wrightson, NZ Bio)*

Current rules exclude co-operative development. In a co-operative R&D activity each participant should be entitled to a credit based on their contribution. *(ISI)*

It should not be necessary for a claimant to meet all three tests. There are cases in which this requirement means no one will be eligible for the credit. Someone should be able to claim the credit in each case and, if there are multiple parties (say in a joint venture), each party should be able to claim their proportionate share of total costs. *(Corporate Taxpayers Group)*

Proposed section LH 2(2)(b) should be amended so that it more clearly allows expenditure financed by a collection of persons to qualify for the R&D tax credit. This could be done by amending the opening words of the paragraph so that it reads "the person, *whether alone or jointly with other persons …". (New Zealand Law Society)*

Comment

As currently formulated, the three "on-behalf of" criteria (of controlling the activities, owning the results, and bearing the financial and technical risk) must all be met. The submissions point out that this can be problematic when multiple parties carry out R&D activities together. While the collaborative group would meet the tests, the individual parties would not.

This appears to be a problem for R&D carried out by unincorporated joint ventures and partnerships. Partnerships are dealt with as a separate issue below.

The problem could be addressed by applying the three tests to the joint venture rather than to the individual parties to the venture. As with other claimants, the individual parties in a joint venture can only claim the concession in relation to their own expenditure. Therefore, there does not appear to be a risk that applying the test to the group could result in the concession applying to R&D funded by ineligible parties. A supporting provision will be needed so that if the on-behalf of criteria are met by the unincorporated joint venture then the individual parties to the venture will be taken to have met those criteria in relation to their R&D expenditure.

A number of submissions sought clarification in this area. We consider that phrasing the general rule setting out the three criteria to state that the R&D must be on behalf of the claimant and not on behalf of another would add clarity to the rules. The rule applying the criteria to the joint venture would be an exception to the general rule.

The Corporate Taxpayers Group made the submission that one party in the jointly conducted R&D activity arrangement should always be able to access the tax concession. It is not a policy intent that all R&D carried out in New Zealand will be eligible for the tax concession. For example, the R&D may be performed on behalf of an ineligible business.

Dexel Ltd made the submission that one way to deal with the uncertainty arising from the requirement that all three criteria be met when the R&D is done collaboratively, would be to allow the parties to agree on which one of them should be eligible for the concession. As an alternative, they suggested that meeting two of the three criteria should be sufficient.

We do not favour the option of allowing collaborating parties to allocate the concession by agreement between themselves. Doing so would undermine the objective of providing the concession to the party making decisions about what R&D should be undertaken, and to compensate them for creating spill-over benefits that are captured by other firms.

Similarly, reformulating the provisions so that any one of the three criteria could be disregarded would have the same effect. For example, if the claimant bore no financial risk, then they are not funding any of the spill-over benefits from the activity that are captured by other firms and therefore do not need to be compensated for them. If the firm does not own the results of the activities it is poorly placed to exploit the results. Lastly, if a firm does not control the R&D activity (for example, determining the direction of the work and making decisions to stop unproductive lines of work) it is unlikely that they are the party making decisions about what R&D should be undertaken.

While we do not favour the alternative mechanisms proposed in submissions, the proposed solution should address the concerns underlying those suggestions.

Recommendation

That submissions to allow the on-behalf of criteria to be applied to collaborations be accepted.

That a new provision be included so that if R&D is carried out by an unincorporated joint venture, the on-behalf of criteria should apply to the unincorporated joint venture rather than to the individual parties to the venture.

That a supporting provision be included to state that if the on-behalf of criteria are met by the unincorporated joint venture then the parties to the venture will be treated as having met the criteria.

That a provision be included to state that the R&D activities must be carried out on behalf of the claimant and not on behalf of someone else.

That submissions proposing that:

- parties to a collaboration should be able to allocate the concession between themselves;
- only two of the three on-behalf of criteria should need to be met; and
- parties should not be required to meet all of the on-behalf of criteria

be declined.

Issue: R&D done in partnership

Submissions
(NZ Bio, PricewaterhouseCoopers)

Where a partnership does R&D, these requirements should be tested at the partnership level and not at the individual partner level. *(NZ Bio, PricewaterhouseCoopers)*

Comment

A number of eligibility tests are applied to a partnership rather than to the individual partners. While there does not appear to be a problem with applying the on-behalf of criteria to partnerships of eligible partners rather than to the partners, doing so to partnerships with ineligible partners could be problematic.

It would not be appropriate to apply the concession to R&D activities largely carried out with funds sourced from an ineligible partner. To do so would undermine the objective of excluding those parties from the tax concession. It would therefore be necessary to separate expenditure sourced from ineligible partners from the general partnership funds. However, financial contributions are fungible, once contributions are made by partners it is not possible to effectively trace those funds to the point they are applied to expenditure.

The tracing rules required would also have to take into account the contributions made at other times than at the beginning of the arrangement – partners having different rights, multiple projects or ventures being undertaken (whether R&D activities or unrelated activities) over different periods. This would be extremely complex and would require detailed consideration and consultation before being adopted.

For this reason we consider that the on-behalf of criteria could be applied to partnerships rather than to individual partners, except in the case of partnerships that include ineligible partners. Eligible partners in partnerships with ineligible partners would still be able to claim the concession if they could show that that they meet the on-behalf of criteria in their own right.

We consider that this treatment be adopted as an interim measure and that the rules relating to R&D activities carried on by partners be reviewed for a future tax bill. The treatment of limited partnerships, for the purpose of the tax concession, will also need to be considered once the Limited Partnerships bill is enacted.

Recommendation

That the submission to apply the on-behalf of criteria to partnerships rather than the individual partners be accepted in part. The tests should still apply to individual partners if one of the partners is an ineligible entity.

Issue: Ownership of results

Submissions

(7 – Dairy Insight, 43 – PGG Wrightson, 57 – Westpac, 61 – KPMG, 74 – Deloitte, 82 – Fonterra, 91 – New Zealand Institute of Chartered Accountants)

The requirement to own the results of the R&D activity needs to be better defined. *(Dairy Insight, PGG Wrightson)*

The requirement that the claimant must "own the results of the R&D activities, if any" should be worded to more closely match the government's intention, as set out in the Commentary, that it does not require the claimant to own the intellectual property arising out of the project. *(Deloitte)*

Effective commercial ownership or commercialisation rights should be sufficient to constitute ownership of the results. *(New Zealand Institute of Chartered Accountants, PGG Wrightson)*

The requirements for a person claiming the R&D tax credit to have control, risk and ownership should be modified to an effective and commercial ownership requirement consistent with that applied in Australia. If these requirements are to remain, guidelines should clearly set out how Inland Revenue will apply these criteria. *(Westpac, KPMG)*

The credit should be able to be claimed by the person with the effective ownership and ability to commercially exploit the R&D activities. *(Fonterra)*

If a group of companies is eligible to consolidate, the tests of control, risk and ownership should be able to be applied by considering the group as a whole. *(Fonterra, New Zealand Institute of Chartered Accountants)*

Comment

A number of submissions state that the requirement that the claimant own the project results needs to be better defined and be more in line with commercialisation rights. The Commentary to the bill explained that "ownership of the results" is intended to mean that the claimant must have access to and control over the results. It does not require the claimant to own the intellectual property arising out of the project, or to continue to own the project results, or mean that they cannot share the results. Matters of detail will be dealt with in guidelines.

We agree that there are benefits to adopting the Australian administrative test for ownership of results, particularly benefits of comparability. The administrative test as applied in Australia does not require the formal ownership of intellectual property, nor legal ownership of the results. But the ability to exploit the results for gain without further fee or payment is required. This matches the policy objective for the concession in New Zealand.

The Australian formulation has advantages over other terms such as "commercialisation rights" because there is a body of understanding about how the Australian test applies, and the introduction of new terms could create uncertainty, even though they may have largely the same results in practice.

We do not agree with the submissions that all three criteria should be replaced with a single test of effective and commercial ownership. The requirements to control the R&D activity and to fund the activity would no longer apply and thereby make the criteria less effective in targeting the concession at the party making the R&D investment decision.

The suggestion that companies able to consolidate should apply the criteria as a group seems unnecessary because the proposed solution would be expected to apply if the individual parties were able to consolidate.

We agree that detailed guidelines will be required in this area.

Recommendation

That the submission to amend the ownership test to "effectively owns the project results" is accepted.

That the submissions to:

- replace the on-behalf of criteria with a test of effective and commercial ownership; and
- apply the on-behalf of criteria to groups as a whole if they are able to consolidate

be declined.

Issue: Financial and technical risk

Submissions
(37 – Zespri, 91 – New Zealand Institute of Chartered Accountants)

There are two types of technical risk. It should be clear that the type of technical risk intended is the risk of the technology used in or arising from the R&D activities failing. This is effectively wrapped up in the financial risk component.

Comment

To be eligible, claimants are required to bear the financial risk and technological risk of undertaking the R&D.

The intention of the provision is to target the concession to those bearing the type of technical risk of the technology used in or arising from the R&D activities failing. We agree that this type of technical risk is addressed by the financial risk component and therefore consider that it should be removed from the provision for clarity.

Recommendation

That the submission be accepted.

Issue: Control of R&D activities

Submissions
(7 – Dairy Insight, 57 – Westpac, 82 – Fonterra, 91 – New Zealand Institute of Chartered Accountants)

The control requirement may not be met if R&D is subcontracted. *(Westpac, Fonterra, New Zealand Institute of Chartered Accountants)*

The government should issue guidance on the meaning of "control". *(Dairy Insight)*

Comment

As outlined in the Commentary on the bill, a person would be taken to have control over the R&D work if they have the ability to choose the project, decide on major changes of direction, stop an unproductive line of research, follow up an unexpected result and end a project. Day-to-day management of the activity is not a requirement.

Submissions expressed concern that sufficient control might not be retained in some cases when R&D is subcontracted.

What the elements of control involve in each case depends on the circumstances of each case. For example, it should not be fatal to the claim that some "control" decisions were taken jointly, or if they were taken before a project begins. Parties could agree before commencement of the work what R&D work will be undertaken and what criteria should be used to determine whether a line of research is unproductive and should be terminated. The control requirements would also be met for R&D on a "take it or leave it basis" where a major researcher may determine a programme of research and solicit industry participants to fund the work. While the researcher may have independently formulated the programme of R&D and control the day-to-day management of the programme, that control is subject to the agreement entered into by the funders and the researcher. In effect, the funders are exercising their control (albeit jointly) when they choose to participate and enter into the arrangement to fund that programme of work.

In practice, this may mean that the funder exercises that control at the beginning of an arrangement and is bound by it for the duration of the work. For example, a provider may only undertake a programme of work if the funder agrees to bind themselves to finance all of the programme. In these situations the funder has not abdicated control, but made its choices in advance in the contract. Even then, the funder should be entitled to check that the programme was being carried out and require the researcher to act according to their agreement. Arguments about the exercise of control at the outset of the project will have less force in situations where the scope of the activities is broad, or if the work involves several related projects over a substantial period of time.

It is not possible to provide a legislative solution to address all the permutations of control that might arise. Therefore we consider that further clarifications would be more appropriately provided through guidelines instead of through legislation.

Recommendation

That the submission to provide further guidance on the meaning of control be accepted.

Issue: R&D carried out on behalf of overseas affiliates

Submissions
(Harris Stratex Networks (NZ) Ltd, 38 – Merck Sharp & Dohme, Westpac, 61 – KPMG, 90 – Proacta Therapeutics Ltd)

Clinical trials that are performed on behalf of affiliates overseas as contract R&D should be eligible for the credit. *(Merck Sharp & Dohme, Proacta Therapeutics Ltd)*

The credit should be available for R&D carried out in New Zealand by a New Zealand-based member of a multinational group on behalf of non-resident members of the group. It should not be a requirement that the New Zealand company satisfy these three criteria in such circumstances. *(KPMG, Harris Stratex Networks (NZ) Ltd, Westpac)*

Comment

In order to be eligible, R&D must be carried out for a New Zealand business or by a New Zealand business on its own behalf. The rationale for this requirement is to encourage New Zealand firms to invest in R&D, and to secure the spill-over benefits for other New Zealand firms that the outcomes from this R&D may generate.

The concession is designed to allow New Zealand firms to capture spill-over benefits that arise in the location that the R&D is carried out and those that result from the proximity to the firm actually making the R&D investment. When R&D is carried out in New Zealand on behalf of a foreign affiliate, New Zealand firms capture fewer of these benefits – missing out on the benefits that would arise at the location of the foreign affiliate.

An offshore company can indirectly access the credit if it sets up business in New Zealand and that business undertakes R&D in New Zealand on its own account. In this case, the New Zealand business controls the R&D project, takes the financial risk associated with the project and can exploit the project results.

Submissions also stated that recent announcements in Australia, to relax the on-behalf of requirement for Australian-based subsidiaries of multinational companies doing R&D for their foreign members, may cause clinical R&D done on behalf of a foreign affiliate to be relocated to Australia. The amendments apply to the incremental tax concession in Australia which provides 175 percent deductibility for R&D activities in a given year compared with the average of the three years before that year. The amendments do not apply to the base concession of 125 percent deductibility in Australia.

We agree that the Australian amendments will provide a limited incentive to move R&D done on behalf of foreign affiliates from New Zealand to Australia. The effect of the amendment sought for the New Zealand rules would provide subsidies out of proportion to the expected subsidy from the amendments announced in Australia.

Merck Sharp & Dohme and Proacta Therapeutics Ltd also made the submission that there were indirect benefits from the clinical R&D being carried out in New Zealand, such as benefits to clinical patients and the development of close working relationships with clinical investigators and researchers in various New Zealand research organisations. These types of benefits accrue directly from the type of clinical R&D carried out by the firm. The tax concession provides a broad non-discretionary subsidy and is not designed to take into account relative benefits from different fields of research and development. Discretionary direct grants would be a more appropriate mechanism for delivering concessions if the government wished to provide an incentive targeted at a particular industry type or field of study.

Recommendation

That the submissions that the tax concession should apply to R&D carried out on behalf of foreign affiliates be declined.

DEFINITION OF RESEARCH AND DEVELOPMENT ACTIVITIES

Clause 100

Issue: Scientific or technological uncertainty

Submission
(91 – New Zealand Institute of Chartered Accountants)

The term "scientific" should be clarified to reflect a wide meaning.

Comment

R&D activities are defined as systematic, investigative and experimental activities that seek to resolve scientific or technological uncertainty, or that involve an appreciable element of novelty, and that are carried on for the purposes of acquiring new knowledge or creating new or improved products, processes or services.

The reference to "scientific or technological uncertainty" comes from the United Kingdom R&D definition where "science" is defined to be "the systematic study of the nature and behaviour of the physical and material universe". The definition excludes mathematical advances in and of themselves unless they are advances in representing the nature and behaviour of the physical and material universe.

NZICA is concerned that this definition of science is narrower than is intended in New Zealand and might be imported into our R&D definition.

It is intended that the word "science" be given its ordinary meaning (a branch of knowledge conducted on objective principles involving the systematised observation of and experiment with phenomena, especially concerned with the material and functions of the physical universe). We do not propose that it be defined.

Recommendation

That the submission be declined.

Issue: Advance in science or technology

Submission
(Matter raised by officials)

The first limb of paragraph (a) of the R&D definition should refer to activities that seek to achieve an advance in science or technology through the resolution of scientific or technological uncertainty.

Comment

The first limb of paragraph (a) of the R&D definition (activities that seek to resolve scientific or technological uncertainty) comes from the United Kingdom R&D definition. The definition there refers to activities that seek to achieve an advance in science or technology through the resolution of scientific or technological uncertainty. In drafting the proposed R&D definition, officials considered that it was unnecessary to refer to an advance in science or technology because that was implicit in activities that sought to resolve scientific or technological uncertainty. However, in discussing the application of the definition, we have found it more useful to ask whether there is "an advance in science or technology". We therefore propose that this be added to the definition.

In the United Kingdom, there is debate about whether resolving scientific or technological uncertainty inherently involves making an advance in science or technology and in Canada and Ireland these seem to be treated as separate tests. Although the Canadian R&D definition only refers to scientific or technological advancements, in their software guidelines they require an advancement **and** resolution of uncertainty. In Ireland, activities are not R&D unless they seek to achieve scientific or technological advancements **and** involve the resolution of scientific or technological uncertainty.

Nevertheless, in our view, adding these words would be useful and would not reduce the scope of the definition, but would make it clearer.

Recommendation

That the submission be accepted.

Issue: Screen content in the film/television industry

Submission
(31 – New Zealand Screen Council)

The definition should be amended to include content development applicable to the screen sector.

Comment

The New Zealand Screen Council proposes that the definition of R&D be extended to include developing content, in the form of concepts, formats, screenplays or script outlines, in the film and television industry. They note that each screen production is a new concept and/or needs new content which requires R&D.

We do not support such an extension of the definition. R&D tax concessions generally exclude arts-related activities and focus on advances in science and technology, which are more likely to generate spill-over benefits. We know of no other R&D definition used for tax-concession purposes that would include development of screen content. If the definition were to be expanded to include such creative activities, it would be fiscally unsustainable.

As the submission acknowledges, the industry is separately funded by government for screen development through New Zealand On Air and the NZ Film Commission (which the submission considers to be inadequate).

Recommendation

That the submission be declined.

Issue: Appreciable element of novelty

Submissions
(57 – Westpac, 61 – KPMG, 84 *– New Zealand Chambers of Commerce*, *91 – New Zealand Institute of Chartered Accountants)*

Despite several definitions of terms, it is difficult to predict whether an activity is covered or not. For instance, what is an "appreciable element of novelty" and what activity fails to meet such a threshold? Producing uncertainty in important matters such as tax liability should be avoided. Careful drafting of the legislation is required to provide maximum predictability. (*New Zealand Chambers of Commerce)*

The definition of "novelty" is supported, and the Australian guidelines from which it is drawn should be included as part of Inland Revenue's guidelines on the R&D provisions. *(New Zealand Institute of Chartered Accountants)*

R&D tax credits apply beyond "radical" innovation and are intended to apply to incremental innovation. This must be recognised by Inland Revenue in its guidelines. *(Westpac, KPMG)*

Comment

The "appreciable element of novelty" limb in the R&D definition comes from the Australian R&D definition. It is also a phrase used in the OECD Frascati Manual which provides guidance on what constitutes R&D for the purpose of surveys on R&D activities. We agree that it is somewhat uncertain, but the intention is that it expands the R&D definition to include new uses of existing technology.

The intention is for this term to have the same meaning as in Australia. The Australian R&D Guide notes that the element of novelty must be meaningful or significant. The guidelines in New Zealand will draw upon the Australian guide in explaining the term.

The intention is that R&D tax credits apply to incremental development and this will be recognised in guidelines.

Recommendation

That the submission on drafting be noted and the submission on guidelines be accepted.

Issue: Support activities must be "wholly or mainly for" core activities

Submission
(Matter raised by officials)

That activities should be eligible as support activities only if they are wholly or mainly for the purpose of core R&D activities (in addition to the existing requirements that they be required for and integral to core R&D activities).

Comment

Currently support activities in paragraph (b) of the R&D definition are eligible R&D if they are commensurate with, required for, and integral to the core activities described in paragraph (a) of the definition (that is, systematic, investigative and experimental activities that seek to resolve uncertainty or involve an appreciable element of novelty).

Five submissions have argued that the eligibility test for support activities should be relaxed (this submission is addressed next). However we propose that it be tightened. We are particularly concerned about the scope for routine business activities to be reclassified as support R&D. This is of particular concern when the potential fiscal cost of the project is high (such as construction of infrastructure assets with some innovative feature).

In order to limit the potential for routine business to be reclassified, we propose that support activities only be eligible when they are **wholly or mainly for the purpose of** the core R&D activities (as well as required for and integral to the core activities). This would exclude from the R&D credit the following types of activity:

- Construction of an asset with an innovative component when the primary purpose of construction is sale of the asset. In Australia, where it is sufficient for the support activities to have **a subsidiary** purpose of supporting core R&D, the tax concession has been claimed for the construction of boats with an innovative part that are intended for sale. The claimants argue that construction of the boat is required to test the innovative part and is eligible as a support activity.
- Construction of an asset with an innovative component when the primary purpose of the construction is to use the asset for commercial purposes. In Australia, the tax concession has been claimed for construction of significant engineering projects that will be used for commercial purposes, on the basis that construction is required to test the innovative component.
- Activities carried out simultaneously for routine business purposes and R&D but where the activities are carried out primarily for routine business purposes. This would apply, for example, to data collected by a business primarily for its routine business operations, but used also as an input to R&D. It would also exclude mining carried out primarily for production but also with a subsidiary purpose of supporting core R&D. In Australia, this is an eligible R&D support activity *(Industry Research & Development Board v Coal & Allied Operations Pty Ltd [2000] FCA 979).*

This proposal is likely to be opposed by those making submissions because it is tougher than the Australian requirement for support activities to be eligible. However, in principle, the credit should not apply to routine business activities. As the rate and nature of the credit are more generous than in Australia, there is more incentive to reclassify commercial activities as R&D and the higher risk warrants a more cautious approach.

It is nevertheless worth noting that in relation to the enhancements to the R&D concession recently introduced in Parliament in Australia, the test for support activities is the same as that proposed in this submission.

Recommendation

That, in order to be eligible, support activities should be wholly or mainly for the purpose of core R&D activities (in addition to the existing requirements that they be required for and integral to core R&D activities).

Issue: Support activities must be "commensurate with" core activities

Submissions
(16 – NZ Post, 60 – Building Research, 61 – KPMG, 57 – Westpac, 91– New Zealand Institute of Chartered Accountants)

The definition of "supporting R&D" should be aligned with the Australian definition, by removing the words "commensurate with" from the relevant section. This will ensure that all relevant supporting R&D is eligible. *(NZ Post, Building Research, Westpac)*

The words "commensurate with" and "integral to" should be removed. *(New Zealand Institute of Chartered Accountants, KPMG)*

Support activities should be recognised in the guidelines to the legislation as being broad in scope. *(New Zealand Institute of Chartered Accountants)*

Comment

Paragraph (b) of the R&D definition applies to support activities – that is, activities that do not qualify as "core" R&D activities in paragraph (a) but that support such activities. To qualify, support activities must be "commensurate with, required for and integral to" the core R&D activities.

Submissions propose that the "commensurate with" and "integral to" tests be removed because:

- "commensurate with" is not used elsewhere in tax legislation, or in Australia, and therefore will create uncertainty and confusion;
- "integral to" is an unnecessary addition which could be difficult to apply; and
- the tests that must be satisfied for support activities to be eligible are tougher than those in Australia when our R&D provisions should be competitive.

The test "commensurate with" is adopted from the Canadian R&D definition and is intended to make it clear that support activities must be only to the extent necessary to support the substantive R&D project. This could impose either a constraint on time or resources. For example, assume a nature reserve designs a predator-proof fence that is core R&D. They need to construct part of the fence to test the effectiveness of the design. Building the fence is likely to be a support activity. If a small enclosure is sufficient to test the design, construction of the whole fence would not be "commensurate with" the needs of the core activity.

However, we consider that "commensurate with" would not be required if support activities must be wholly or mainly for the purpose of the core R&D as proposed in the submission above.

Support activities still need to be “integral to” core activities. The scheme of the provisions is that support activities that are part of the project are R&D activities while less connected activities, such as cleaning, are not R&D in themselves. These costs are eligible as overheads.

In relation to the submission on guidelines, we note that the guidelines should accurately reflect the definition of support activities.

Recommendation

That the submission to remove the words “commensurate with” be accepted if the previous submission relating to support activities is accepted.

That the other submissions be declined.

EXCLUSIONS FROM RESEARCH AND DEVELOPMENT ACTIVITIES

Clause 100

Issue: Exclusion of activities from paragraph (a) R&D definition

Submissions
(61 – KPMG, 91 – New Zealand Institute of Chartered Accountants)

Inland Revenue's guidelines should clearly note that although excluded activities do not qualify as core activities in paragraph (a) of the R&D definition, they may still be support activities within paragraph (b) of the definition. *(New Zealand Institute of Chartered Accountants)*

Clarification of the scope of the proposed exclusions will be required in the guidelines. The information in the Commentary on the exclusions should be included in the guidelines. *(New Zealand Institute of Chartered Accountants, KPMG)*

Comment

The list of activities in section LH 5 are excluded only from core R&D activities described in paragraph (a) of the R&D definition and may still be support activities in paragraph (b). This is clear in the legislation and the point will also be made in guidelines. We expect that guidelines will also provide detail in relation to the scope of the exclusions.

Recommendation

That the submissions be accepted.

Issue: Exploring for or producing minerals, petroleum and natural gas

Submission
(33 – Corporate Taxpayers Group, 49 – Contact Energy, 74 – Deloitte)

The exclusion for oil and gas exploration includes "producing" minerals, petroleum, natural gas or geothermal energy. This should be removed. Also, the additional Australian qualification, that the activity is "for the purpose of determining deposits", should be included.

Comment

Oil and gas exploration is generally excluded from R&D. It is possible to have R&D in the extractive industries (for example, developing new drilling techniques), but the act of searching for oil and gas in itself is not R&D.

Accordingly, section LH 5(1)(a) excludes from paragraph (a) of the definition "prospecting for, exploring for, drilling for, **or producing**, minerals, petroleum, natural gas, or geothermal energy". This is also the formulation of the equivalent exclusion in both Canada and Ireland.

The equivalent exclusion in Australia and the United Kingdom is narrower. In Australia it is:

> "Prospecting, exploring or drilling for minerals, petroleum or natural gas for the purpose of discovering deposits, determining more precisely the location of deposits or determining the size or quality of deposits."

Submissions are concerned about the exclusion relating to "producing" petroleum and gas because it could exclude from being eligible production activities undertaken as a necessary part of systematic, investigative and experimental R&D activities. Deloitte notes that development of a low emission petroleum could potentially be excluded. We agree that this may be unduly restrictive and propose that reference to "producing" petroleum be removed.

Because we are concerned about recategorisation of exploration activities as R&D we do not support limiting the excluded exploration activities to those with certain listed purposes. The risk is that claimants will argue that exploration activity is conducted for a purpose not listed. (The Commerce Clearing House commentary on the Australian concession notes, in relation to this exclusion, that "practitioners should focus on establishing a core R&D activity which is performed for a purpose other than the three excluded purposes".)

Recommendation

That the submission to remove the reference to "producing" petroleum be accepted.

That the submission to add the Australian qualifications be declined.

Issue: Research in social sciences, arts or humanities

Submission

(31 – New Zealand Screen Council)

Clarification is sought that the exclusion for research in arts does not mean the screen industry would be excluded from the proposed credit. Research carried out for artistic and cultural reasons may have a major economic benefit and should not be excluded from the R&D credit solely on the basis that it is art. *(New Zealand Screen Council)*

Comment

Research in arts, humanities and social sciences is routinely excluded from R&D tax concessions which focus on advances in science and technology. The creative industries are separately funded.

However, it is possible to have R&D in relation to the screen industry or other arts. If a business is developing an innovative product and the development process satisfies the criteria in the R&D definition, the development is not excluded simply because the product is **used** in the creative arts. For example, animation software developed for use in the screen industry is not excluded under this paragraph. This will be clarified in guidelines.

Recommendation

That the submission be declined but that it be clarified in guidelines that the development of products and processes that otherwise satisfy the criteria in the definition of R&D are not excluded simply because they have application in the screen industry or another arts sector.

Issue: Pre-production activities

Submission
(91 – New Zealand Institute of Chartered Accountants)

Under the OECD Frascati Manual, some pre-production activities would be considered either "core" R&D or activities that support core R&D. Activities considered to be core R&D should not be excluded.

Comment

Paragraph (k) of section LH 5 excludes from core R&D "pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs". This is in the same terms as the Australian exclusion and is intended to exclude activities that are post R&D but pre-production.

NZICA refers to the Frascati Manual, which contains guidance on measuring R&D for survey purposes. It states that pre-production activities may include product or process modification, including further design and engineering, and that some activities, such as tooling up and process development, may contain an appreciable element of R&D. As NZICA notes, they could be eligible as supporting activities. However, NZICA is concerned that they would be excluded as core R&D.

Paragraph (k) is intended to clarify the boundary between R&D and pre-production activities. Activities either satisfy the definition of core R&D in paragraph (a) **or** fall within the exclusion. If activities that satisfy the definition in paragraph (a) arise during a pre-production process, they will be eligible regardless of the exclusion. This will be clarified in guidelines.

Recommendation

That the submission be noted but no amendment is required to achieve the outcome proposed.

ELIGIBLE EXPENDITURE

Clause 100

Issue: Apportionment of expenses

Submission
(48 – Dexcel Ltd, 95 – New Zealand Law Society)

While it is agreed that apportionment of expenditure is warranted when costs are only partly incurred on R&D, the Commissioner should issue a public ruling outlining his views on the correct apportionment methodologies for this expenditure, and explain what documentation taxpayers are expected to maintain in support of their apportionment calculations.

Comment

We agree that the Commissioner should provide clear guidance on what apportionment methodologies are acceptable and what documentation will be required to support that. However, it is envisaged that this will be in guidelines, rather than a public ruling.

Recommendation

That the submission be accepted in principle, but that acceptable apportionment methodologies be set out in guidelines.

Issue: Salaries of employees

Submission
(33 – Corporate Taxpayers Group, 44 – Fisher & Paykel, 37 – Zespri, 61 – KPMG, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

All employee remuneration, such as fringe benefits, fringe benefit tax, superannuation contributions, specified superannuation contribution withholding tax, insurances and share-based remuneration, should be eligible.

Comment

Eligible employee remuneration expenditure includes salary, wages, allowances, bonuses, commissions, extra salary, overtime, holiday pay and long-service pay. We agree that this should be extended to include other elements of an employee's salary package – provision of fringe benefits, fringe benefit tax, superannuation fund contributions, specified superannuation contribution withholding tax and insurance premiums paid on behalf of an employee.

We do not agree that the credit should apply to the value of share options. These are not currently deductible and their tax treatment is under review.

Recommendation

That the submission be accepted except in relation to share-based remuneration.

Issue: Depreciation of tangible assets wholly or mainly used in R&D

Submissions

(33 – Corporate Taxpayers Group, 37 – Zespri, 44 – Fisher & Paykel, 71 – PricewaterhouseCoopers, 61 – KPMG, 91 – New Zealand Institute of Chartered Accountants)

Depreciation of assets should be eligible when they are not wholly or mainly used in R&D, but used for some of the time in R&D. A just and reasonable allocation of depreciation should be treated as eligible. *(Corporate Taxpayers Group, Zespri, Fisher & Paykel, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

If this is not accepted, clarification is required in relation to the phrase "wholly or mainly". There is also an inconsistency between this provision and the provision relating to pooled property which refers to "wholly". *(Corporate Taxpayers Group, PricewaterhouseCoopers)*

Comment

Depreciable assets that are not wholly or mainly used in R&D are not eligible for the credit. We agree with submissions that this can be harsh and recommend that if an asset is used part of the time for R&D and part of the time for other activities in a year, the credit should apply to that portion of actual use attributable to R&D. For example, if in a year 25 percent of use is for R&D and 75 percent of use is for non-R&D, one-quarter of the annual depreciation on the asset will be eligible.

Recommendation

That the primary submission be accepted.

Issue: Depreciation of tangible assets in a pool

Submission
(33 – Corporate Taxpayers Group)

It should not be necessary for a pool of assets to be used wholly for conducting R&D activities in order to be eligible.

Comment

Depreciable assets can be "pooled", with the pool treated as one asset. Because pooled property is not individually tracked, the requirement that pooled assets attract the credit only if the pool is used wholly for R&D should remain.

Corporate Taxpayers Group argues that this is unnecessarily unfair to taxpayers who currently have elected to depreciate assets via the pool method. However, this appears unavoidable. For the same reason, the Australian R&D concession does not apply to pooled property. Where possible, taxpayers should keep assets used solely in R&D in a separate pool.

Recommendation

That the submission be declined.

Issue: Eligible overheads

Submission
(33 – Corporate Taxpayers Group, 74 – Deloitte)

The list of eligible overheads should be expanded, consistent with the overheads which may be apportioned to R&D under the Australian rules (although the lists appear similar). Officials should state where they believe there are differences from the Australian rules.

Submission
(Matters raised by officials)

The expenditure in relation to administration, human resources, repairs, maintenance, cleaning and security should be limited to the types of salary expenditure listed in subsection LH 6(1)(a), consumables and payments to independent contractors.

Overheads should be eligible only to the extent that they are incurred directly in respect of R&D activities.

Comment

Section LH 6(1)(e) provides for expenditure on certain listed R&D overheads to be eligible. It covers expenditure relating to administration, personnel, repairs and maintenance, cleaning and security, rates, utilities, insurance and leasing of buildings, plant or equipment when the expenditure is incurred for R&D activities. The Corporate Taxpayers Group wants to ensure that the list is consistent with Australia's.

In Australia, overheads are not listed in legislation but are eligible under the general category of "other expenditure incurred directly in respect of R&D activities". "Eligible apportionable expenses" are listed in *Taxation Ruling IT 2552*. The following items are eligible:

- Cleaning and security
- Consumables
- Electricity, gas, water, telecommunications
- Insurance premiums relevant to R&D activities
- Leasing charges on office equipment
- Payroll costs
- Postage, printing and stationery
- Rates and land taxes
- Rent and repairs and maintenance of a building used partly for R&D
- Remuneration of support staff that perform some duties connected with eligible R&D activities (typists, supervisors)
- Subscriptions to industry associations and for technical journals
- Training and recruitment

The ruling also lists ineligible items, including:

- Company establishment and registration fees
- Costs in preparing taxation returns
- Depreciation
- Directors' fees
- Distribution and selling expenses
- Employee benefits such as canteen and recreational facilities
- Entertainment expenses
- Maintenance of grounds and gardens
- Legal expenses not associated with any approved research project
- Patents and trademarks
- Tender costs.

The intention is that the list of overheads in New Zealand is broadly the same as in Australia. Rates, utilities, insurance and leasing costs are specifically listed as eligible overheads in paragraph (e). In relation to other overheads, paragraph (e) lists categories of expenditure – expenditure relating to administration, personnel, repairs, maintenance, cleaning and security. Rather than list in legislation the specific overheads that are not considered to be sufficiently linked to R&D, it is proposed that these be detailed in regulations. A regulation-making power for this purpose is therefore required.

We also propose the following modifications to paragraph (e) to increase certainty, or better align the provision with the Australian equivalent.

As in Australia, overheads should be eligible only when they are incurred directly in respect of R&D activities. For example, a part of the cleaner's salary will be eligible if he cleans the R&D laboratory, and a part of the human resource officer's salary will be eligible if she deals with R&D personnel, but the cleaning of the human resources office is not eligible.

Expenditure on "personnel" is intended to refer to the human resources area of a business but may be considered to include employee benefits such as canteen and recreational facilities which are excluded in Australia and should not be eligible. This should be reworded.

Expenditure on administration, human resources, repairs, maintenance, cleaning and security should be limited to expenditure on the type of employee remuneration listed in paragraph LH 6(1)(a), payments to contractors and consumables. Restricting employee remuneration to the type listed in paragraph (a) means that expenditure not eligible in relation to R&D staff is also not eligible in relation to other staff.

Recommendation

That it be noted that the list of eligible overheads is broadly in line with that in Australia but that a regulation-making power be provided to specify the overheads that are ineligible.

That the other submissions be accepted.

Issue: Scope of exclusion for items processed or transformed

Submissions
(74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The terms "processed" and "transformed" are vague terms which apply to almost every R&D activity. If these terms remain, sufficient guidance should be provided for taxpayers to determine their application to a given situation. *(New Zealand Institute of Chartered Accountants)*

It is not clear from the provision what is being sold – is it just a prototype or is it all sales of all products in the future? *(Deloitte)*

Comment

Section LH 6(1)(g) provides that for items processed or transformed into products in the R&D activities, only the "net" expenditure on the products is eligible – that is, the excess of the expenditure over the sale proceeds or market value of the products. The provision is based on the Australian "feedstock" rules.

This provision is intended to apply to the acquisition or manufacture of raw materials or products that are "put through" an R&D process. This will most often be trading stock and would include milk processed into powder in an experimental drying process, sheep shorn or cows milked in an experimental process, timber acquired and cut using a novel technique, trees grown in an experimental plot, and iron ore acquired and processed in an experimental smelter.

In line with an Australian interpretative decision recently released, the rule encompasses the manufacture of a product that does not change during the R&D process, or changes in a manner that is not visible.

The paragraph is not intended to apply to prototypes and should be reworded to clarify its scope. Sufficient information should also be provided in guidelines for taxpayers to determine its application in a given situation.

Recommendation

That the submissions be accepted and section LH 6(1)(g) be redrafted to clarify its scope.

Submission
(Matter raised by officials)

Expenditure on items processed or transformed in R&D activities should be excluded, except to the extent provided under section LH 6(1)(g).

Comment

In relation to items processed or transformed in R&D activities as described above, the intention is that only the net expenditure is eligible. Section LH 6(1)(g) provides for this. However, expenditure in excess of the net may be eligible under other paragraphs in section LH 6(1). To achieve the policy objective, expenditure in excess of the net expenditure on items processed or transformed should specifically be excluded in section LH 6(2).

Recommendation

That the submission be accepted.

Issue: Value of items processed or transformed

Submission
(61 – KPMG, 91 – New Zealand Institute of Chartered Accountants)

When market value is the appropriate measure to net off the costs of items processed or transformed, the legislation or guidelines should provide sufficient guidance to ensure that there is certainty about what form of valuation is required. *(New Zealand Institute of Chartered Accountants, KPMG)*

Comment

NZICA and KPMG are concerned to ensure that there is guidance on the meaning of market value in this context – in particular, the market that is to be referenced. NZICA gives the example of a food product that is not able to be sold in the usual market – should it be valued as animal feed, or can it have a scrap or nil value because it cannot be sold for human consumption?

Tax provisions commonly require calculation of market value and we do not recommend special legislative rules in relation to valuation of the items processed. However, we agree there should be guidance on the valuation requirements in guidelines or a determination. We also agree with NZICA that guidance should be provided on the industry sectors or types of R&D that this provision applies to.

Recommendation

That the submission be accepted, and details of the application of the provision and valuation requirements be discussed in guidelines.

Issue: Payments to persons conducting R&D

Submission
(33 – Corporate Taxpayers Group, 37 – Zespri, 74 – Deloitte)

It should be clear that the costs of independent contractors, agency workers or temporary staff conducting R&D activities under the supervision of the claimant are eligible.

Comment

Section LH 6(1)(h) provides that payments to another person for conducting R&D are eligible. It is intended that this include the costs of engaging independent contractors, agency workers or temporary staff to conduct R&D. Since there seems to be doubt on this point, it should be clarified.

Recommendation

That the submission be accepted.

INELIGIBLE EXPENDITURE

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

Submission
(37 – Zespri, 74 – Deloitte)

Loss on sale or write-off of depreciable property used in R&D should be eligible for the credit. It is accepted that there should also be a claw-back of credits when depreciable assets are sold for more than their tax book value.

Comment

When a depreciable asset is used in a business, an annual depreciation deduction is allowed in relation to the asset. If the asset is used in R&D, there will also be a tax credit in relation to the annual deduction (apportionment is required when the asset is used for part of the time in R&D).

When depreciable assets are sold or written off, there is an adjustment of deductions. If the sale price exceeds the tax book value, the difference is income. If the sale price is less than the tax book value, a further deduction is allowed. To reduce compliance costs, these adjustments are ignored for the purposes of the credit. There is no claw-back of a credit already allowed, and a loss on sale is not eligible for the credit.

Generally this approach was supported in submissions on the R&D issues paper, and only two negative submissions have been received on this approach. We therefore recommend retaining it.

Recommendation

That the submission be declined.

Issue: Core technology

Submissions
(85 – Minter Ellison Rudd Watts, 74, Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The costs of acquiring core technology from non-associated persons should be allowed when it is reasonable to consider that the vendor's costs of creating that technology did not attract the R&D credit in New Zealand. *(Deloitte)*

The acquisition of core technology should be included as an eligible item where R&D assets have been acquired. *(New Zealand Institute of Chartered Accountants)*

The credit should be available for core technology when there is an arm's-length payment made to a third party as consideration for conducting R&D activities on behalf of the taxpayer. *(Minter Ellison Rudd Watts)*

Comment

Core technology is technology that is used as a basis for further R&D and may be intangible or tangible property. Expenditure on acquiring core technology is not eligible because of the potential for fiscal abuse.

Firstly, it is difficult to value. In Australia, core technology was originally eligible for the concession but inflated core technology values led to its exclusion. It is now not only ineligible but the ability to deduct it at all for tax is limited.

Secondly, if core technology were eligible, it would seem possible, by transferring core technology to an associate, to:

- access the credit for R&D carried out before the 2008–09 year;
- claim the credit twice for development of the same technology.

Deloitte notes that one reason given for excluding core technology is that it may have already attracted the credit. They therefore argue that, where it is reasonable to conclude that the vendor's costs did not attract the credit, the underlying technology should be eligible. We do not agree with the submission. There are other reasons for excluding core technology which are set out above.

NZICA argues that the exclusion of purchased core technology means a business purchasing that technology is penalised relative to a business creating the technology. Officials do not think this is a sufficient reason to provide the credit in relation to core technology purchased by a business. The potential for fiscal abuse discussed earlier arises in relation to technology purchased rather than developed by a business. Also, the creation of that technology would not necessarily attract the credit as the technology may be publicly available.

Minter Ellison Rudd Watts is concerned that this restriction will affect arrangements to contract out R&D to a third party, which often provide that the benefit of any core technology developed becomes the property of the person commissioning the R&D. The exclusion for core technology would therefore require apportionment between the services supplied and the rights to core technology obtained under the agreement.

The exclusion does not apply in this case – it applies only to core technology that is purchased, leased or licensed from another party. In this case, under the contract, the core technology is always owned by the person commissioning the R&D and is not purchased or leased from the party performing the R&D.

Recommendation

That the submissions be declined.

Issue: Expenditure met from funds that are required co-funding

Submissions

(33 – Corporate Taxpayers Group, 44 – Fisher & Paykel, 48 – Dexcel Ltd, 40 – NZ Bio, 61 – KPMG, 76 – Genesis, 79 – Association of Crown Research Institutes, 82 – Fonterra)

Expenditure that is met from required co-funding should be eligible for the credit. *(Corporate Taxpayers Group, Dexcel Ltd, NZ Bio, KPMG, Genesis, Association of Crown Research Institutes, Fonterra)*

If the submission above is not accepted, rules that are more closely aligned to Australia's, where ineligible expenditure is twice the amount of a grant, should be considered. *(Dexcel Ltd, KPMG, Association of Crown Research Institutes)*

The tax credit should apply to all R&D expenditure. That would match accounting practice. *(Genesis)*

If the first submission is not accepted, the link between grant funding and ineligibility of expenditure should be more clearly defined. *(Dexcel Ltd, Association of Crown Research Institutes)*

The rules should be more closely aligned with those in Australia. *(Fisher & Paykel)*

Comment

The bill provides that expenditure funded from a government or local authority grant or any required co-funding is ineligible for the credit. Submissions agreed that expenditure funded by a grant should not be eligible for the tax credit. However, there was less support for making expenditure met by funds that are required as a condition of the grant ineligible for the tax concession (the "co-funding rule").

The rationale for providing government subsidies for R&D activities is to compensate firms for benefits that accrue to society (spill-over benefits) rather than to the firms. Generally, firms are unable to capture all the benefits of the R&D that they undertake.

Providing both forms of subsidies for the same R&D activity would therefore be a double subsidy. Ideally, all other costs of the R&D project should not be eligible for the concession. The conditional funds requirement in the bill was adopted as a proxy for all other costs of the R&D project because of potential problems with defining the scope of R&D projects.

Some submissions stated that the co-funding rule was contrary to the objective of providing a tax concession to increase R&D. We agree that the availability of both subsidies would create further incentives for recipient firms to increase R&D activity. However, grants are set at a level that is intended to compensate firms for the externalities generated by the R&D and access to the tax credit for the same R&D activity would be a double subsidisation.

Similarly, the argument that the restriction is disproportionate when the required co-funding is larger than the government-funded grant does not seem to take into account the fact that the value of the grant should already be aimed at offsetting likely externalities. This may appear inequitable for large projects which receive a small grant, but there is no economic rationale for further subsidies.

Some submissions claimed that the co-funding rule would lead to non-collaborative behaviour. We agree that there could be an incentive to divide previously collaborative R&D projects into components, some of which will receive a grant and some of which will not, but will instead attract the tax concession. This may reduce the collaborative nature of the R&D activity if the sub-projects are carried out in isolation. Funding providers will need to take this into account when determining whether their objectives for providing a grant will be met.

Submissions suggested that a suitable alternative to the co-funding rule is alignment with the Australian rules. Those rules require double the amount of the grant to be deducted from particular types of expenditure with the claw-back being applied on a project basis. While there would be benefits from comparability if the Australian rules were adopted here, we do not consider that the policy objective of avoiding double funding would be met. The claw-back applies to ineligible expenditure first and then eligible expenditure and therefore is not an effective way of preventing double subsidisation. Disallowing double the value of the grant seems an arbitrary measure. In addition, those rules require the claw-back to apply to the R&D project in relation to which the grant was provided. Problems with defining the scope of the project were the reason why the exclusion in the bill does not apply to project costs. While the co-funding rule will be more restrictive than the comparable Australian rules, other features of the concession such as wider eligibility and the rate of the concession still makes the New Zealand concession more favourable than Australia's.

Other suggestions, such as limiting the prohibition to the value of the grant would not meet the policy objectives of preventing double funding.

Dexel made the submission that co-funding requirements could be met with in-kind payments and arrangements with the funding provider that may not match expenditure requirements in the tax rules. How the rules will apply, to determine what a condition of the grant is, will depend on the particular facts of the grant agreement. It may be necessary to review this provision if it transpires that problems arise.

Genesis made a submission that the concession should apply to all non-grant expenditure because it would match accounting treatment of the expenditure. Alignment of the tax concession rules and accounting practice is not a design objective of the concession. Notwithstanding the co-funding rule, there are fundamental differences between accounting practice and the tax concession. This is because the objectives of accounting, to provide a true and fair view of a firm's financial position and performance, are not the same as those of the tax concession for R&D, which is to provide a sustainable, efficient incentive to increase business R&D.

Dexel also pointed out that co-funding could be required for reasons such as determining priority between competing grant applications. We agree that this could happen, and it is likely that there will be some inconsistencies in the treatment of R&D projects simply because of the objectives of funding arrangements. However, despite these problems, a more suitable alternative that efficiently meets the policy objective of preventing double subsidisation has not been identified.

The Association of Crown Research Institutes sought clarification on how the exclusion would apply in practice. Examples provided for this purpose have highlighted an area that needs to be clarified. The Commentary to the bill states that the exclusion applies whether the co-funding is required from the person receiving the grant or from another party. The bill does not achieve this objective. We consider that the bill should be amended to reflect the policy.

The Association also pointed out there needs to be a clear view of how the exclusion works between funding agencies and tax administrators. Inland Revenue will work with funding agencies to develop clear guidelines for grant recipients.

Recommendation

That the submissions to remove the co-funding rule be declined.

That the submissions to adopt the Australian treatment of grants, and to adopt the accounting treatment of R&D expenditure should be declined.

That the co-funding rule be amended to apply when the grant is provided to a party other than the claimant.

Issue: R&D conducted overseas as part of a New Zealand-based project

Submissions
(19 – Deepwater Group Ltd, 37 – Zespri, 43 – PGG Wrightson, 44 – Fisher & Paykel, 61 – KPMG, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

Limiting the credit to 10 percent of R&D done overseas seems harsh. *(Deepwater Group Ltd, Fisher & Paykel)*

The 10 percent cap should be increased to a more realistic percentage level. *(Zespri)*

There should be no cap on expenditure for R&D done overseas. If this is not accepted, claimants should be able to apply to Inland Revenue to receive approval for additional overseas R&D activities to be claimed over and above the 10 percent. *(PGG Wrightson)*

The 10 percent requirement should be relaxed if it can be proved that the R&D activity could not be undertaken in New Zealand, provided the overseas component still forms part of a New Zealand R&D project. *(Deloitte)*

The appropriate expenditure threshold should be 20 percent and/or a discretion should exist to allow a greater than 20 percent (or 10 percent) overseas spend in the case of exceptional circumstances that would justify a higher proportion. *(New Zealand Institute of Chartered Accountants)*

The threshold for R&D expenditure outside New Zealand should be 20 percent. *(KPMG)*

The allowed percentage should apply to the total expected R&D expenditure, or the balance of overseas expenditure unclaimed in a particular income year should be carried forward to future income years. *(New Zealand Institute of Chartered Accountants, KPMG)*

The definition of "New Zealand" should include the exclusive economic zone outside the continental shelf. *(Deepwater Group Ltd)*

Comment

The dual requirements, that the claimant must be in business in New Zealand – that is, they must have an intention to make a pecuniary profit and have a presence in New Zealand – and that the R&D must be done in New Zealand, are aimed at maximising the spill-over benefits that can be captured by the New Zealand economy from the subsidy.

Many of the spill-over benefits from R&D tend to accrue to the location in which the R&D is carried out. It is acknowledged that when R&D is carried out overseas there will be some benefits from transferring knowledge back to the New Zealand firms commissioning the work. However, wider benefits – for example, experience that can be applied elsewhere and R&D capability increases, would be expected to accrue to firms at the location in which the R&D was carried out. This is likely to be particularly the case for R&D that has to be carried out overseas to meet specific market or resource conditions.

As identified in submissions, there are several reasons why New Zealand firms require their R&D to be carried out overseas. Subsidising that R&D would result in increased benefits to those firms and possibly also to the New Zealand economy from those firms using the results to develop or improve products and processes. However it would decrease the efficiency of the concession – its aim to subsidise R&D in situations where the New Zealand economy is best placed to capture the spill-over benefits from that R&D would not be achieved.

An exception is made for some R&D carried out overseas – up to 10 percent of the value of eligible R&D expenditure incurred in New Zealand on a New Zealand-based project. Ten percent is also the limit in the Australian tax concession for R&D done outside Australia.

Australia recently announced that the incremental component of their tax concession will apply to R&D done in Australia on behalf of foreign affiliates. R&D done in Australia on behalf of a New Zealand affiliate could be eligible for the incremental concession in Australia as well as the tax credit in New Zealand up to the 10 percent limit in New Zealand. Therefore, increasing the 10 percent limit could encourage relocation of R&D activities from New Zealand to Australia up to the new limit in New Zealand.

Submissions identified situations when timing differences between R&D expenditure incurred in New Zealand and related overseas R&D expenditure could mean that the 10 percent allowance would not be available to claimants. As currently formulated, the rule is a yearly test requiring the value of the overseas component of the R&D to be compared with the local component on a yearly basis. This rule will create inefficiencies by creating an incentive for claimants to restructure their R&D activities so that they have sufficient local expenditure to cover their overseas expenditure in the year in which the overseas expenditure is incurred.

We agree that the rule should be amended so that expenditure incurred locally on the same R&D project before the overseas expenditure was incurred could be used to determine what amount of the overseas R&D expenditure is eligible for the claim. Similarly, if there is an excess of overseas expenditure in any given year it should be possible to carry it forward so that it could be linked to any new local expenditure on the same R&D project and thereby become eligible for a credit in later years. This amendment will require a consequential amendment to the rule that all expenditure must be incurred and be deductible in the year for which a claim is made.

The submission to amend the definition of "New Zealand" to include the exclusive economic zone may have some merit. Further consideration is needed to determine the possible effect of such an amendment on other activity that could take place in that zone – for example, mineral exploration activities. Work on this issue could be progressed for a subsequent tax bill.

Recommendation

That the submissions to increase the 10 percent limit for eligible overseas expenditure or provide a discretion to increase that limit be declined.

That the submission to allow overseas R&D expenditure to be matched to local R&D expenditure on the same project incurred either in earlier or subsequent years be accepted.

That the submission to change the definition of "New Zealand" to include the exclusive economic zone be noted.

Issue: Purchasing, leasing or obtaining a right to use intangible property

Submissions
(37 – Zespri, 40 – NZ Bio, 65 – NZ Bankers Association, 74 – Deloitte, 85 – Minter Ellison Rudd Watts)

R&D expenditure incurred in acquiring intangible assets should be included in the definition of "eligible expenditure". *(Zespri, NZ Bio, NZ Bankers Association)*

The exclusion should not apply to the cost of a licence to use third-party software, commonly incurred in an R&D project. *(Deloitte)*

The credit should be available for the acquisition of intellectual property when there is an arm's-length payment made to a third party as consideration for conducting R&D on behalf of the taxpayer. *(Minter Ellison Rudd Watts)*

Comment

Section LH 6(2)(o) excludes from eligibility expenditure or an amount of depreciation loss incurred in purchasing, leasing, or obtaining a right to use intangible property. Intangible assets tend to be used in tax avoidance schemes because they can be unique and hard to value. Officials will consider the extent to which they can be eligible following enactment of the bill.

Zespri notes that it has neither acquired nor needed to acquire intangible assets in order to conduct R&D but it may at some future date need to and this should be eligible. The Bankers Association considers that excluding intangible assets is not a principled approach. Deloitte argues that the cost of a licence to use third-party software is commonly incurred in an R&D project and this should be eligible.

Officials are concerned about the fiscal risk associated with the acquisition of intangibles and consider that a cautious approach is warranted. We therefore do not support allowing this expenditure to be eligible at present. Officials will consider the extent to which it can be eligible following enactment of the bill.

The exclusion does not apply in the circumstances discussed by NZ Bio and Minter Ellison Rudd Watts. NZ Bio is concerned that the exclusion renders ineligible the cost of a patent applied for by a person doing R&D to protect the R&D that it is engaged on. The exclusion does not apply to the costs of developing or protecting an intangible asset in the R&D process, but rather to acquisition of an intangible asset from another party.

Minter Ellison Rudd Watts is concerned that this restriction will affect arrangements to contract out R&D to a third party. They note that agreements for contracting out R&D will provide that the benefit of any intellectual property developed becomes the property of the person commissioning the R&D. The exclusion of intangible assets purchased would therefore require apportionment between the R&D services supplied and the intellectual property obtained under the agreement.

The exclusion does not apply in this case. It applies to intellectual property that is acquired from another party. In this case, under the contract, the intellectual property is always owned by the person commissioning the R&D and is not purchased or leased from another party.

Recommendation

That the submissions be declined.

CAP ON INTERNAL SOFTWARE DEVELOPMENT

Clause 100

Background

Software development is a significant proportion of total R&D, and so any R&D incentive needs to include software. The information, communication and technology software sector accounted for 18.7 percent of New Zealand R&D expenditure in 2004 ($126.6 million). [Source: Research and Development in New Zealand 2004, Statistics NZ.]

However, software development – particularly development of software for purely internal uses – has been a problematic area for tax authorities administering R&D tax incentives.

In Canada, uncertainty about the eligibility of information technology development for R&D tax credits contributed to a backlog of C$5 billion of claims in 1999, including hundreds of millions of dollars worth of claims in each of the finance and telecommunications industries. There was a strong suspicion that claimants who did not undertake software development as part of their core business had reclassified routine internal-use software projects as R&D.

In Australia, software not developed for the purpose of sale or licence (internal-use software) has been excluded from eligibility for R&D tax concessions. In practice, however, the "purpose of sale" test has been relatively weak. The courts have held that the purpose only has to be one of the purposes, and need not be the dominant or primary purpose. This has led to high values of claims from industries such as finance and telecommunications which do not undertake software development as their core business, just as in Canada. In 2004–05, the Australian finance, insurance and telecommunications industries claimed tax concessions for A$830 million of eligible R&D expenditure, or 10.6 percent of all eligible R&D expenditure.

The problem of reclassification of routine development to R&D, such as noted in Canada, exists because the legislative definition of R&D cannot be made precise enough to exclude all reclassification of routine processes, not normally considered to be R&D according to the ordinary meaning of that phrase, without also excluding genuine (not reclassified) R&D.

This is a generic difficulty but applies to a greater extent to software. The definition of R&D in the proposed legislation and the definitions in other jurisdictions draw on concepts developed to identify R&D which leads to tangible results in primary and secondary industries. Those concepts are less well-suited to identifying R&D in software development, particularly in the service sector.

In an ideal world, it would have been possible to create a new definition of R&D which took into account the special characteristics of software R&D while still remaining applicable to other R&D. We are not sure that such a definition is possible. Even if it were possible, creating it would have delayed the introduction of the credit.

A cap on internal-use software R&D reduces the fiscal risks of reclassification while preserving most of the incentive provided by the tax credit for software developers – as in Australia, companies intending to develop the software mainly for sale would not face any cap, and eligible expenditure is capped only where the main intention is not to sell or license the software.

The level of the internal-use cap is $2 million of eligible expenditure per year. Limited consultation before the introduction of the legislation suggested this would allow, for example, large manufacturing companies to claim credits for development of factory automation software, but that it would be substantially less than the total (and potentially re-classifiable) software budgets of large businesses in service industries such as finance, insurance and telecommunications.

Issue: Definition of internal software development

Submission
(57 – Westpac, 74 – Deloitte)

Internal software development is defined as developing software "other than with the main purpose of sale, rent, license, hire or lease to two or more persons" who are not associated. The "main" purpose test should be withdrawn so that the provision is the same as in Australia.

Comment

In Australia, the legislation states that software development is ineligible for an R&D tax concession if the software is not developed with "*the* purpose of sale". In Australia "*the* purpose of sale" is interpreted as *any* not insubstantial purpose of sale, which greatly reduces the applicability of the restriction. (See, for example, *Sree v Industry Research and Development Board* [1999] 99 ATC 2237).

A conscious decision has been made in the design of the New Zealand scheme to avoid the current Australian interpretation. To do otherwise would make the software cap largely ineffective.

Recommendation

That the submission be declined.

Issue: Removal of cap

Submission
(23 – Investment Savings & Insurance Association, 24 – AMP, 33 – Corporate Taxpayers Group

The $2 million cap on internally generated software R&D should be removed.

Comment

Removal of the cap would expose the government to significant fiscal risk. There are two reasons, applying in combination, for this risk:

- **Software budgets are large.** In the New Zealand context, oral submissions to the Finance and Expenditure Committee have indicated that the major trading banks undertake approximately $160 million per year of R&D, while ISI members undertake $100 million per year (previous analysis using official data sources had not indicated such significant R&D from these sectors). While not all of the $260 million of R&D is expected to meet the statutory definition of R&D, it is an indication of the likely quantum of claims in the absence of a cap.
- **There has been some difficulty in applying various definitions of R&D to software.** Both Canada and Australia have experienced high-value internal software claims. In Canada in the 1990s, these predominantly seem to have comprised re-classified routine internal-use software projects. A committee of experts set up by Revenue Canada concluded in 1996 that fewer than 10 percent of expenses claimed by financial institutions for software development were eligible, but as late as 2000 financial institutions were still challenging the assessment of rejected claims (Report of the Auditor-General of Canada, April 2000). There were similar problems in the telecommunications sector. These problems indicated that there was no consensus about the way the R&D definition applies to software.

Consultation with other jurisdictions shows that certainty about eligibility for the credit is necessary for investment in R&D. In particular, taxpayers require some certainty when making initial investment decisions that the rules will not later change to deny them credits they might have expected. For the reasons outlined above, the removal of the cap would significantly increase the probability of high fiscal costs leading to rule changes at a later date to control those costs, thereby undermining certainty.

Australia has attempted to limit claims for internal-use software R&D by statute, and the United States does not allow any claims for internal-use software unless there is a specific exemption in the statute or in regulations (the main exemption in the U.S. allows a credit but requires a higher standard of proof of innovation).

There is a Ministerial discretion to allow internal software spending on R&D at levels exceeding the cap in cases where net national benefit can clearly be shown.

Recommendation

That the submission be declined.

Issue: Banking sector doing information technology R&D

Submission
(57 – Westpac)

The banking sector invests heavily in information technology-related R&D activities and should be eligible for the R&D tax credit on an equal basis with all New Zealand businesses.

Comment

It is acknowledged that the banking sector invests heavily in software development. The New Zealand Bankers Association reported approximately $160 million of R&D expenditure per year when it provided evidence to the Finance and Expenditure Committee on this bill. While not all of that amount is expected to meet the statutory definition of R&D, it is a significant potential claim. The Investment Savings & Insurance Association has reported to the Committee a similarly large R&D expenditure of $100 million per year.

Officials note that these amounts are considerably larger than publicly available data previously gathered would imply. For example, the 2006 Statistics NZ Research and Development Survey showed only $98 million of annual R&D expenditure in the "Other services" category, a category which includes the banking, insurance and communications industries. Notwithstanding that some sampling error is expected in such surveys, the wide variability of reported expenditure in software-intensive industries increases our concerns about the difficulty of defining software R&D and the associated fiscal risk, and reinforces the need for a cap to limit that risk.

The cap on internal software development is more likely to be a binding cap for large entities which have high software expenditure but do not have a business which involves primarily selling software they develop. Banking entities, on the basis of the most recently reported expenditure levels, are likely to fall into that camp, but so are entities in other industries such as insurance.

Companies which are bound by the cap do have the ability to apply for a Ministerial waiver in cases where the net benefits of the R&D for New Zealand can be clearly demonstrated.

Recommendation

That the submission be declined.

Issue: Other options for cap

Submissions

(16 – NZ Post, 18 – Weta Digital, 23 – Investment Savings & Insurance Association, 25 – Express Couriers Ltd, 33 – Corporate Taxpayers Group, 44 – Fisher & Paykel, 54 – ASB Bank, 61 – KPMG, 85 – Minter Ellison Rudd Watts)

The amount of the internal software development cap should be increased from $2 million, with the facility for regular review. *(NZ Post, Weta Digital, Express Couriers Ltd)*

NZ Post supports the concept of a cap to avoid abuse.

The cap should be increased to at least $5 million. *(Fisher & Paykel, KPMG)*

If a cap is required:

- There should be a legislative commitment to review the need for, and level of the cap, at regular intervals. *(Corporate Taxpayers Group)*
- It should apply to each business activity. *(Investment Savings & Insurance Association, ASB Bank)*
- It should be replaced with a variable cap calculated by reference to the size of the corporate group. *(Investment Savings & Insurance Association, ASB Bank, Minter Ellison Rudd Watts)*
- There should be a rolling cap that applies over a three to five-year period. *(Minter Ellison Rudd Watts)*
- A person should be entitled to carry forward any unclaimed balance to future years. *(KPMG)*

Comment

The cap exists because the legislative definition of R&D cannot be made precise enough to exclude reclassification of routine in-house software expenditure, not normally considered to be R&D, as R&D. The level of the cap has been set for that reason.

Consultation before introduction of the legislation indicated that a minority of software R&D claims would be restricted by a cap of $2 million. We therefore expect that any increase in cap would primarily result in an increased fiscal risk.

The cap is not intended to limit the ability to claim tax credits against eligible software R&D expenditure; rather, it is intended to limit the ability to make large claims for R&D tax credits against expenditure which ultimately should not be eligible if R&D could be defined precisely in the software area. The Ministerial discretion is intended to ensure that genuine claims exceeding the $2 million cap still qualify for the credit albeit with some increase in compliance costs. Increasing the cap would allow more R&D to qualify for the tax credit but at the cost of increased reclassification of routine expenditure by other taxpayers up to the increased cap.

We agree with the submission that there should be a commitment to review the level of cap and therefore recommend that the threshold be reviewed as part of the evaluation of the R&D tax credit. We consider that part of this review should focus on the nature of R&D software claims just below the $2 million threshold to see to what extent they represent R&D which is not merely reclassified routine development.

A level of cap by reference to the income of the company incurring expenditure on software would tend to allow significant claims by the finance, insurance and telecommunications industries, the sectors that most raised concerns in the Australian and Canadian context. A fixed level of cap sets a clear dividing line above which all organisations have to show that there is net national benefit from their expenditure.

The cap is imposed on controlled groups at the level of the group, since it would otherwise be easy to create controlled entities to undertake small chunks of software development projects and avoid the cap.

The cap applies to an eligible amount within a year and cannot be carried forward if not used. Allowing carry-forward (or carry-back) of the cap would add undesirable complexity to the rules relating to internal software development, and introduce additional fiscal risk.

Recommendation

That the submissions be declined but that the level of the cap be reviewed as part of the evaluation of the R&D tax credit. Also see the following submission.

Issue: Tightening of internal-use software rules

Submission
(Matter raised by officials)

The internal-use software rules should be tightened to ensure they are effective. If the rules are tightened, the cap on internal software development should be increased to $3 million.

Comment

The internal software development cap is intended to prevent claims of more than $2 million of eligible expenditure for internal-use software R&D. Internal software development is defined as software which is developed "other than with the main purpose of sale, rent, license, hire or lease". The cap applies to expenditure on internal software development as a core R&D activity, but not as a supporting activity for some other core R&D activity. The purpose of sale needs to be the main purpose. This is a deliberately more rigorous test than in Australia, where "the purpose" of sale means *any* not insubstantial purpose.

Consultation in Australia and with some New Zealand taxpayers with trans-Tasman connections has revealed that in Australia it is rare for restrictions on internal software development to apply.

There are two reasons for the limited application of the restrictions.

Firstly, taxpayers can *implicitly* license software which is used internally, to customers, and it seems accepted in Australia that this constitutes a sufficient purpose of sale, rent, license, hire or lease.

Secondly, some taxpayers attempt to reclassify R&D which is "core" R&D (subject to the restrictions) as "supporting" R&D (not subject to the restrictions) for another core activity. For example, a taxpayer developing innovative software for a railway switching system might attempt to classify the software development as a supporting activity for the core activity of developing a switching system, even though there is nothing innovative or uncertain about the switching hardware. To do this the taxpayer might attempt, for example, to introduce some (unnecessary) element of innovation into the development of the hardware. The real core activity in this case is clearly the software development, but in some cases the boundaries are not well-defined.

Given the similarity between the New Zealand and Australian rules, officials are concerned that the limited scope of the Australian restrictions will be mirrored here.

To ensure that the internal software development cap is effective, officials recommend changing the definition of "internal software development". It should be changed to always include software which is used for the internal administrative functions of the taxpayer or in providing a non-computer service, regardless of any intent to sell (including "sale" by implicit licence). A non-computer service is a service offered by a taxpayer to customers who conduct business with the taxpayer primarily to obtain a service other than a computer service. This is even if the other service is enabled, supported, or facilitated by computer or software technology. This inclusion would apply in addition to the existing purpose of sale test. This addition to the definition is based on a definition of "primarily for internal use" found in the United States regulations relating to tax incentives for software R&D.

Example

A consulting firm develops a software package to allow customers to search for and view all previous work they have commissioned from the consultant. In the absence of the software cap, expenditure on the software is eligible for the R&D tax credit. The software is developed for use in providing a non-computer service, since customers deal with the consulting firm mainly for its consultancy services. The software development is therefore internal software development, and the cap applies (regardless of any purpose of sale of the software).

We also recommend that the internal software development cap apply to both core and supporting R&D activities, rather than just core activities. This would prevent attempts to reclassify core software development activities as supporting activities.

Officials acknowledge that if the cap is made to cover supporting as well as core activities, the level of the cap should rise. In this regard, officials also consider that the level of the cap should be raised to $3 million. This is primarily because some software development undertaken as a supporting activity, which would not previously have been subject to the cap, would be subject to the cap under the tighter rules.

We note that the effect of the additional restrictions is to make the cap work as intended. However, with the revised cap, there is the possibility that some valuable R&D activities will no longer be eligible to receive the credit. This problem is mitigated somewhat by the Ministerial waiver. It is acknowledged that the cap is a relatively blunt instrument, which does not distinguish between the least and most valuable activities which meet the legislated definition of R&D.

Over time, officials will consult with software industry representatives to develop robust guidelines. It is hoped that such consultation will lead to a common understanding – by industry and Inland Revenue – of the applicability of the definition of R&D to software, and this may permit a later review of the need for (or the level of) the cap.

Recommendation

That the submission to tighten the software cap rules and consequently increase the cap to $3 million be accepted. That it be noted that making the cap work effectively might – to the extent the Ministerial waiver is not sought or obtained – reduce the credit paid for some valuable R&D as well as reduce the fiscal risk associated with credits for the development of internal-use software.

Issue: Development of software as part of a hardware product (firmware)

Submission
(Matter raised by officials)

Where software is developed as an integral part of a hardware product which the taxpayer is developing mainly for sale, it should not be subject to the internal software development cap.

Comment

We recommend that it be clarified that the internal software development cap does not apply to firmware, such as the software which runs inside a television or washing machine, included in goods developed by the taxpayer mainly for sale. We regard this software as intended for sale.

Recommendation

That the submission be accepted.

Issue: Ministerial discretion to waive cap

Submissions

(16 – NZ Post, 18 – Weta Digital, 23 – Investment Savings & Insurance Association, 33 – Corporate Taxpayers Group, 57 – Westpac, 61 – KPMG)

The process for Ministerial discretion should be legislated for, providing for the discretion to be exercised prospectively and to include a timeframe within which Ministerial decisions on the lifting of the cap must be made. *(NZ Post, KPMG)*

The criteria for applying the Minister's discretion should be more definitively legislated for. *(NZ Post, Weta Digital, KPMG)*

The tests for Ministerial approval need to be capable of prospective application to provide certainty. Also the tests should allow for the failure of the project, which is not currently considered. *(Weta Digital)*

There should be clear guidance on the criteria for waiving the threshold. In relation to the test that the claimant has a commitment to retain the value of their business in New Zealand, there should be the presumption that investing $2 million or more on internal software is a high reinvestment by the taxpayer. *(Corporate Taxpayers Group)*

The criteria that the Minister can use to allow a greater tax credit claim should be narrowed to bring it in line with the rest of the section – does it benefit the growth of knowledge of the company. *(Investment Savings & Insurance Association)*

A Ministerial discretion should only be retained to the extent that it is required to restrict any actual R&D tax credit concession as it is in Australia. *(Westpac)*

Comment

The R&D to which the credit applies is expected to generate externalities (benefits which spill-over from the firm undertaking the R&D to other firms or consumers) as well as direct benefits for the firms undertaking the R&D. In general, the requirement for these wider benefits is not explicit in the legislation, because showing their existence can be difficult and imposes a compliance cost. However, for internal-use software development, and when eligible expenditure exceeds the cap, wider benefits must be demonstrated. This is because internal-use software is a high-risk area in terms of potential fiscal cost and reclassification of routine development as R&D.

The criteria in the national benefit test are derived from criteria in the R&D tax incentive in Australia, export market development grants in Australia and market development grants in New Zealand. The test is intended to be flexible, since net national benefit has many facets, and is therefore not prescriptive. Some guidance about the sorts of matters the Minister could consider when making a decision is provided in the Commentary on the bill. Therefore, officials do not agree that prescriptive conditions for applying the waiver should be included in the legislation.

We agree with the submissions that prospective applications should be allowed to provide as much certainty to taxpayers as possible. We therefore recommend that the legislation be amended to provide clearly that applications for the Ministerial discretion to apply can be made in advance of the R&D expenditure being incurred. As a consequence, the legislation will also need to be amended to give the Minister power to impose conditions on the decision (it is normal to impose conditions in Inland Revenue binding rulings, in which case the rulings apply only if those conditions are met).

We also agree that the provisions should be clear that the R&D does not have to be successful. Officials consider that in most respects the legislation already recognises that R&D may be unsuccessful. However, section LH 9(15)(b) currently requires that "New Zealand will derive a substantial net benefit from the internal software development". It should be made clear that the substantial net benefit is the net benefit which is expected if the R&D succeeds, and that the R&D need not succeed.

Submissions also raise the idea that the Minister be required to respond to a request for an increase in the cap within a required period of time. However, having a set time after which, officials assume, submitters envision that a non-response by the Minister results in an increase in the cap by default raises the possibility that taxpayers could adopt tactics leading to delays. For example, taxpayers could make less than full disclosure or delay provision of information with the hope of stringing-out the process to the expiry of the set period. Measures to address these concerns would make the rules more complex.

Recommendation

That the submissions be declined, except that applications for a waiver should be allowed before the R&D expenditure is incurred and that consequently, the Minister be allowed to impose conditions on the waiver. That a waiver by the Minister not require that the R&D be successful.

Issue: Grouping requirements for the internal software development cap

Submission
(16 – NZ Post, 25 – Express Couriers Ltd, 71 – PricewaterhouseCoopers, 74 – Deloitte)

The grouping requirements for the internal software development cap should be aligned with the definition of a "group of companies" under section IG of the Income Tax Act 2004, requiring commonality of 66 percent.

Comment

The grouping rules exist to prevent taxpayers establishing legal structures which allow taxpayers to by-pass the $2 million internal software cap. Using the group of companies approach would allow taxpayers to interpose non-company entities, such as trusts and partnerships, which would reduce the effectiveness of the cap.

Recommendation

That the submission be declined.

Issue: Minor amendment – purpose of sale of software

Submission
(Matter raised by officials)

It should be clarified that "purpose of sale, rent, license, hire or lease" means purpose of sale, rent, license, hire or lease of the software being developed.

Comment

The internal software development cap applies when the main purpose of the development of the software is not "sale, rent, license, hire or lease to two or more persons" (see section LH 11).

It should be clarified that sale, rent, license, hire or lease means sale, rent, license, hire or lease of the software.

It is possible that the purpose of sale or license could otherwise be a purpose of sale of something other than the software. This might allow, for example, point-of-sale software developed by a retailer (with a main purpose of selling products in the store) to satisfy the main purpose test even though the software itself will never be sold.

Recommendation

That the submission be accepted.

IMPUTATION

Clause 108 and 111

Issue: Partial claw-back of benefit of R&D credit on distribution to shareholder

Submissions
(37 – Zespri, 33 – Corporate Taxpayers Group, 74 – Deloitte, 82 – Fonterra, 91 – New Zealand Institute of Chartered Accountants)

The amount of the notional imputation credit should be increased as there is still some claw-back of the R&D tax credit when distributions are made to shareholders. *(Zespri, Deloitte, New Zealand Institute of Chartered Accountants)*

To ensure there is no claw-back of the R&D tax credit through the imputation system, all companies should be able to distribute the amount of the credit as exempt income. There should also be a credit to the imputation credit account equal to the R&D tax credit. If this is not accepted, the deemed credit to the imputation credit account needs to be increased to reflect that the tax credit, when distributed, will be a taxable distribution. *(Corporate Taxpayers Group)*

Any distribution of income by a taxpayer to its owners should be tax-free when it represents an R&D tax credit received. *(Fonterra)*

Comment

The economically ideal tax credit mechanism involves providing a tax credit and, at the same time, reducing the deduction for underlying expenditure by the amount of the credit. This is equivalent to the treatment of a grant, and ensures that marginal incentives are correct for taxpayers of all types. In practice, however, reducing the deductibility of eligible expenditure introduces undesirable complexity and so full deductibility is allowed. This leads to a credit which is more generous than the theoretical ideal.

For entities with imputation credit accounts or Māori authority credit accounts, a credit to the account is provided which is equal to the amount of tax credit. If the entity distributes all the proceeds of the tax credit, the amount of imputation credit is not quite sufficient to fully impute the distribution and there is partial "claw-back" of the credit in the shareholder's hands. This claw-back puts a shareholder in the same position as the economically correct position. Furthermore, if some or all of the credit is retained by the company, the extent of claw-back may be reduced.

It is acknowledged that the current imputation treatment creates differences between the position of companies, which pay taxable dividends, and partnerships or individuals who receive tax credits directly.

However, for two reasons, we do not recommend that the imputation treatment be altered. Firstly, it would move more entities away from the economically correct position, and secondly it would involve significant fiscal cost. We estimate that, relative to a baseline costing, moving to an imputation treatment which eliminates claw-back (for a shareholder with a 33% tax rate) would cost $20 to 30 million in 2008–09, rising to $50 to 70 million by 2012–13.

We also do not agree that credits should be able to be passed out to shareholders as exempt income. This would be a significant departure from the existing treatment of distributions from companies, which are typically subject to tax in the recipient's hands even if fully imputed.

Other jurisdictions, such as Australia, do not attach franking credits (their equivalent of imputation credits) to tax incentives at all.

Recommendation

That the submissions be declined.

Issue: Co-operative companies

Submission
(22 – Westland Milk Products, 73 – Ravensdowne Fertilizer Co-operative Ltd, 91 – New Zealand Institute of Chartered Accountants)

The R&D tax credit provided to co-operative companies will be clawed back on distribution to farmer-shareholders because distributions are by way of rebates and not dividends. The rebate provisions of the Income Tax Act should be amended to provide that a rebate is tax-free if it is a rebate of an R&D tax credit.

Comment

Our understanding is that the credit does not meet the statutory definition of a rebate for mutual associations (including co-operative companies), so cannot be paid out as a deductible rebate to members.

However, for co-operative companies, special "deductible dividend" rules apply and although the tax credit cannot be paid as part of a deductible rebate, it can be paid out as a deductible dividend. Our calculations show that if the amount of tax credit is passed out as a deductible dividend rather than as a normal dividend, the outcome for a shareholder will be the same as for a shareholder in a normal company.

Recommendation

That the submission be declined.

Issue: Date credit arises to imputation credit account for R&D tax credit

Submission
(71 – PricewaterhouseCoopers)

The credit to the imputation credit account should arise on the date the relevant income tax return is filed with Inland Revenue. *(PricewaterhouseCoopers)*

Comment

Companies and Māori authorities receiving R&D tax credits also receive corresponding credits to imputation credit accounts or Māori authority credit accounts. The proposed legislation currently deems that the credit arises on the day the income tax return, in which the credit is claimed, is received by the Commissioner.

For clarity, the date of filing could be used. However, the Tax Administration Act uses the term "furnished" in relation to returns rather than "filed". Therefore, we recommend that the credit to the imputation credit account arise when the return is *furnished* to Inland Revenue.

Recommendation

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

CROWN RESEARCH INSTITUTES, TERTIARY INSTITUTIONS AND DISTRICT HEALTH BOARDS AND THEIR ASSOCIATES

Clause 100

Issue: Exclusion of Crown research institutes, tertiary institutions and district health boards

Submission
(43 – PGG Wrightson, 48 – Dexcel Ltd, 61 – KPMG, 79 – Association of Crown Research Institutes)

Crown research institutes, tertiary institutions and district health boards should not be excluded.

Comment

The aim of the R&D credit is to encourage private-sector firms to increase the amount of R&D they carry out, which in turn should increase productivity in those firms, and other firms who benefit from spill-over effects from the R&D. The tax credit is being targeted specifically at private firms because research indicates that there is a more direct impact on the ability of private firms to absorb external knowledge and innovations when they commission or undertake research themselves rather than when research organisations such as Crown research institutes (CRIs) originate the research.

If the government wishes to increase R&D conducted by these types of research entities there are more effective ways to do so than by providing a non-discretionary grant through the tax system.

We would, however, expect the tax credit to provide some indirect benefit to these organisations as it may lead to an increase in private firms contracting them to undertake R&D projects on their behalf. (The private firms, as commissioners of the research, would be eligible for the tax credit.)

The Association of Crown Research Institutes states that several of the arguments made for excluding CRIs are flawed. It claims that:

- it would not be possible for CRIs to claim tax concessions for R&D activities financed from government sources;
- CRIs are expected to behave like private-sector businesses so they should have the same incentives as private firms; and
- government does not "fund" CRIs.

They state that excluding CRIs will distort the way collaborative ventures are set up, and encourage the misconception that CRIs are no more than tightly controlled government laboratories. They point out that allegations that CRIs will become "distracted" are without foundation and do not acknowledge the governance arrangements and business focus of CRIs.

While some of the above may be correct, it does not change the key motivation for the tax credit, and hence the reason for excluding CRIs from eligibility – which is to encourage private-sector entities to do more R&D which, in turn, should produce spill-over benefits for other firms.

Recommendation

That the submission be declined.

Issue: Associates of Crown research institutes, tertiary institutions and district health boards

Submissions
(33 – Corporate Taxpayers Group, 37 – Zespri, 43 – PGG Wrightson, 48 – Dexcel Ltd, 61 – KPMG, 71 – PricewaterhouseCoopers, 72 – Tait Electronics Ltd, 73 – Ravensdowne Fertilizer Co-operative Ltd, 74 – Deloitte, 76 – Genesis, 79 – Association of Crown Research Institutes, 91 – New Zealand Institute of Chartered Accountants)

Associates and subsidiaries of Crown research institutes (CRIs), tertiary institutions and district health boards (DHBs) should not be excluded. *(Dexcel, KPMG, Association of Crown Research Institutes)*

The test of association should be amended to limit the exclusion to persons controlled by CRIs, tertiary institutions and DHBs (or where tainted entities have significant influence or benefit from such persons). *(Dexcel Ltd, Ravensdowne Fertilizer Co-operative Ltd)*

A joint venture that is a partnership between a commercial partner and a CRI, tertiary institution or DHB should be eligible. *(PGG Wrightson)*

The association test in section OD 8(3) is too wide. (*New Zealand Institute of Chartered Accountants, Corporate Taxpayers Group, Zespri, Deloitte, Ravensdowne Fertilizer Co-operative Ltd, Tait Electronics Ltd, PricewaterhouseCoopers)*

A more appropriate level of association is set out in section OD 7. *(Corporate Taxpayers Group, Zespri, Deloitte)*

The tripartite test in section OD 8(3)(c) should not apply. Under this provision, if person A is associated with person B who is associated with a CRI, then person A becomes associated. *(Ravensdowne Fertilizer Co-operative Ltd, Tait Electronics Ltd, Genesis, Association of Crown Research Institutes)*

Comment

The policy to exclude CRIs, tertiary institutions, and DHBs from eligibility for the tax credit would be ineffective if associates of these entities were not excluded. R&D activities, that should not be eligible, could be transferred to an associate who could claim the concession on the activities instead.

The alternative tests suggested (firms controlled by CRIs, tertiary institutions and DHBs, or the tests of association in section OD 7) do not provide the necessary protection in the context of a tax concession. Excluding companies controlled by these types of entities would mean firms that are 50 percent owned by one of these entities and 50 percent owned by a private firm would be eligible. Control by the private sector is the required threshold. The tests of association in section OD 7 do not apply to trusts, and therefore if adopted could allow R&D transferred into trusts by the excluded entities to be eligible for the concession.

The aim of the concession is to increase the amount of R&D activities carried out by the private sector. The control by CRIs, tertiary institutions and DHBs of subsidiaries characterises those subsidiaries as more like the controlling owner rather than the private sector.

The tripartite test in section OD 8(3) means that if firm A is associated with firm B and firm B is associated with firm C, then A and C will also be treated as associated firms. We agree that the tripartite test is too wide in this context and creates unintended consequences.

Recommendation

That submissions to allow associates of CRIs, tertiary institutions and DHBs to be eligible for the concession be declined.

That the submission to substitute the test of association in section OD 7 for the test in section OD 8(3) be declined.

That the submission to remove the application of the tripartite test in section OD 8(3)(c) be accepted.

Issue: Subsidiaries partly owned by private sector firms

Submissions
(44 – Fisher & Paykel, 43 – PGG Wrightson, 61 – KPMG, 76 – Genesis, 82 – Fonterra, 91 – New Zealand Institute of Chartered Accountants)

Where a CRI or tertiary institution (and their associated parties) have entered into a commercial relationship with a third party, the third party or a joint entity should be able to claim an R&D tax credit. *(New Zealand Institute of Chartered Accountants, KPMG, Genesis, Fonterra)*

The proportion of an organisation's eligible R&D expenditure in a joint venture with a CRI, tertiary institution or DHB (or an entity associated with them) should not be tainted. *(Fisher & Paykel, PGG Wrightson)*

Comment

The policy to exclude CRIs, tertiary institutions, and DHBs from eligibility for the tax credit would only be effective if incorporated joint ventures were controlled by private sector firms. If the private sector has control there is a disincentive for excluded entities to move R&D activities, that they would normally carry out within their own organisations, into joint venture firms for the purpose of generating a refundable tax credit.

Ideally joint venture subsidiaries should be able to access the credit for expenditure financed by the eligible body. However, determining what that contribution is, how it should be apportioned over time and different classes of eligible and non-eligible expenditure would require complex ordering and valuation rules which would produce arbitrary results, high compliance costs and little net value to private firms. The example below illustrates this problem. Instead, a simple approach has been adopted; if a joint venture firm is controlled by private sector firms then the concession will apply to all of its eligible R&D expenditure.

Example

Firm A and a tertiary institution set up a firm B to undertake a joint R&D venture. Firm A has a 30% share in B and the tertiary institution has a 70% share. Firm A contributes to the venture by transferring intellectual property to firm B. The tertiary institution contributes labour and equipment. Firm B undertakes R&D and funds both eligible and ineligible R&D through borrowed funds. Part-way through the first year of operation the tertiary institution purchases 10% of the shares from firm A. Most of the R&D expenditure is incurred in the first half of the year.

In this situation it is not clear how B's entitlement to tax credits should be calculated. Should it be on the basis of actual contribution by A (A has not directly funded any eligible expenditure), or the proportion of ownership of B by A (taking into account the change in shareholding and the timing of eligible expenditure incurred over the year)? If B is able to claim the concession in relation to A's ownership, then should those credits be required to be transferred to A or should they reside in B? If they reside in B then some of the value of the credits would be transferred to the tertiary institution.

Private firms could access the credit by structuring their arrangements with ineligible entities through unincorporated joint ventures or by contracting the ineligible entity to perform the R&D on their behalf. However this would create costs for both the private firms and the ineligible entities, from the use of inefficient legal structures.

Recommendation

That the submissions be declined.

Issue: Partnerships with these entities

Submission

(Matter raised by officials)

The provisions in the bill to limit access to the credit to joint ventures where CRIs, tertiary institutions or DHBs have control should also apply to partnerships with these entities.

Comment

The control tests used in the bill to prevent firms accessing the credit if they are controlled by these three classes of entities does not apply to partnerships. Therefore it would be possible to circumvent the prohibition by structuring a collaboration through a partnership.

If a firm wished to access the concession for R&D carried out by these classes of entities it would either need to contract the entity to do the R&D on the firm's behalf or enter into an unincorporated joint venture arrangement with the entity.

Recommendation

That the submission be accepted.

INDUSTRY RESEARCH CO-OPERATIVES

Issue: Definition of "industry research co-operative"

Submissions

(7 – Dairy Insight, 33 – Corporate Taxpayers Group, 60 – Building Research, 74 – Deloitte)

The definition of an "industry research co-operative" should be extended to include wholly owned group companies of the industry research co-operative. *(Dairy Insight)*

The definition should not require each of the main industry members to contribute to the financing of the R&D activities. *(Corporate Taxpayers Group)*

The definition provides that each of the industry members must carry on a business activity in New Zealand. This conflicts with the Commentary, which states that the R&D activities must be undertaken **mainly** on behalf of New Zealand business. The wording of the bill should be amended to reflect the Commentary. *(Deloitte)*

The wording used in the definition of "industry research co-operative" can be difficult to interpret. It is not clear whether all members must satisfy paragraphs (a) to (c) or whether there must be only a subset of members (being at least 51 percent of total members) which satisfy those paragraphs. *(Corporate Taxpayers Group)*

Members should be able to contribute to the financing of the industry research co-operatives both in cash and in kind. *(Corporate Taxpayers Group, Deloitte)*

The definition of "industry research co-operatives" should be amended to ensure that Building Research is eligible to claim the R&D credit. *(Building Research)*

Comment

Industry research co-operatives are sector-specific organisations, generally in the primary sector, that receive levies or contributions from businesses in those sectors. Amongst other things, research co-operatives may conduct or commission R&D for the benefit of those businesses. They are unlikely to be in business themselves, but R&D they undertake should be eligible for the concession. Therefore, to enable them to claim the concession, they are exempt from the business test.

Dairy Insight states that an industry research co-operative may incorporate a wholly owned subsidiary to undertake a specific R&D project. This would be done to manage a commercial risk or to separate a particular project for accountability reasons. Extending the definition of an industry research co-operative to include wholly owned subsidiaries may have some merit, given that they are part of the same economic entity. However, it would create an exception to the general rule that the party commissioning the R&D, rather than the party performing the R&D activity, should be eligible for the credit. The consequences of creating such an exception require further consideration by officials. The result of that further work could be considered for inclusion in a subsequent tax bill.

We consider that the definition of "industry research co-operatives" is clear and consistent with the Commentary. The R&D activities must be carried out mainly on behalf of New Zealand firms who would have been able to claim the credit and who have made financial contributions towards the work. The definition does not prohibit the co-operatives from carrying out the R&D on behalf of other parties as well as those New Zealand firms.

The submission that the bill should be amended so that contributions could be able to be made in both cash and in kind would introduce additional complexity (requiring the inclusion of valuation rules to support the option). There is no minimum amount that members are required to contribute and therefore any contributions in cash will be sufficient. Therefore we do not consider that an amendment is warranted.

Building Research has pointed out that the definition of "industry research co-operative" could be amended to make it clear that they come within the definition. We agree that there is uncertainty about whether levies imposed under the Building Research Levy Act would come within the current wording of draft section LH8(c). Therefore a new limb should be added to the provision to include levies imposed under section 5 of the Building Research Levy Act 1969.

Recommendation

That the submissions to extend the definition of industry research co-operatives to include wholly owned subsidiaries of the co-operative should be noted.

That the general submission to clarify the definition of industry research co-operatives be declined.

That the submission to clarify the definition to include persons who receive funds for R&D from levies collected under the Building Research Levy Act 1969 be accepted.

Issue: Filing requirements

Submission
(7 – Dairy Insight)

Industry research co-operatives should have the ability to file their tax credit claims quarterly.

Comment

Taxpayers claim their tax credit in an annual income tax return. Taxpayers with provisional tax liabilities can, in principle, receive the benefits of the credit at each provisional tax payment date because their provisional tax liability will be reduced by the credit. Other taxpayers, including loss-making provisional taxpayers, need to wait until they file their income tax returns.

In general, the ability to make more frequent claims would increase fraud risk and impose higher design and administration costs.

In this specific case, the submission argues that:

- research co-operatives will only receive tax credits after filing an income tax return, because they do not pay significant amounts of tax (and therefore presumably will not have provisional tax liabilities which will be reduced by the credit); and
- research co-operatives undertake operations that are at the core of the government's R&D enhancement strategy.

We do not consider that these features apply only to industry research co-operatives or that the submission has made a sufficient case for making an exception for industry research co-operatives.

Recommendation

That the submission be declined.

LISTED RESEARCH PROVIDERS

Clause 100

Issue: Requirements to be a listed research provider

Submissions
(74 – Deloitte, 89 – Waikatolink Ltd, 95 – New Zealand Law Society)

The government should provide clear guidance to claimants on the definition and meaning of "capable" as set out in section LH 7(1)(a) of the bill and this definition should be inclusive of those entities that contract for R&D services. *(Waikatolink Ltd)*

The government should clarify that, when it requires that the provider has in New Zealand the facilities needed to carry out the R&D, the phrase "has in New Zealand" includes both the legal title and other enforceable arrangements. *(Waikatolink)*

The legislation does not provide any guidance on where the list will be – generally it is specified that notification must be given in *The Gazette*. *(Deloitte)*

The Commissioner should be required to maintain an up-to-date and publicly available list of listed research providers and should be required to confirm for any taxpayer whether or not any person is currently a listed research provider. *(New Zealand Law Society)*

Comment

An important aspect of the tax concession is to facilitate access by small firms to expert R&D services without creating significant compliance or administrative costs. Therefore an exception to the minimum threshold is provided for claimants who contract a listed research provider to perform R&D activities.

We do not support Waikatolink's submission to extend the scope of the definition of listed research providers. While intermediaries who help firms procure R&D services provide a valuable input, that input is not actually an R&D service and therefore payment to those intermediaries should not have the same treatment as payments to bodies providing R&D services.

The rationale for the exception is that the administrative risks associated with small claims based on reclassified expenditure can be mitigated if the R&D is actually performed by an unassociated third party who has a commercial function to provide such services. Although listed research providers may well have to sub-contract part of the research they undertake to carry out, extending the definition to include a body whose function is solely to sub-contract the R&D would not provide those same safeguards against the risk of reclassification. Therefore we do not consider that the word "capable" should be given a wider meaning than a party that actually has the ability to perform the R&D activity.

Waikatolink has also sought clarification that the phrase "has in New Zealand" will include legal access to facilities rather than ownership of them. While we consider that the legislation should not be amended to include such a detailed clarification, the guidelines to be prepared by Inland Revenue could address this issue.

Requiring the Commissioner to maintain an up-to-date and publicly available list of listed research providers will increase certainty for claimants. This could be done through web-based information services. Claimants are required to file their claims electronically and therefore can be reasonably expected to have access to Inland Revenue's website. Publication in *The Gazette* would not be as up-to-date and is therefore not favoured. Similarly, requiring the list to be maintained in a particular publication format may reduce the ability to provide the most accessible and up-to-date format available to claimants.

We consider that if the Commissioner is required to maintain an up-to-date list and make it publicly available that a further requirement to confirm for any individual taxpayer that a person is currently a listed research provider is unnecessary.

Recommendation

That the submissions seeking amendments to the application criteria of listed research providers be declined.

That the submissions that the list be maintained in a particular place and that the Commissioner be required to confirm the status of particular persons as listed research providers to any individual taxpayer, be declined.

That the submission that the Commissioner be required to maintain an up-to-date and publicly available list of listed research providers be accepted.

Issue: Effect of delisting

Submission
(71 – PricewaterhouseCoopers)

The legislation should be amended to allow for grandfathering of a client's right to an R&D credit in the income year in which a listed research provider is delisted if the taxpayer has adjusted its provisional tax liability in anticipation of receiving a particular level of tax credits. *(PricewaterhouseCoopers)*

Comment

The submission has identified a situation where a claimant could incur use-of-money interest because a listed research provider has failed to maintain their listed status. We consider that the problem could be wider than outlined in the submission. For example, a claimant could enter into an agreement with a listed research provider for purchase of R&D services but find that by the time they incur the fee for services that the provider has lost their listed status. In that situation the firm would not be able to

claim the concession for that contract (unless they met the minimum threshold in their own right).

We therefore consider that claimants who enter into arrangements to purchase R&D services should be able to make a claim in relation to that arrangement even if the provider has lost their listed status as such as long as the provider was a listed research provider at the time the arrangement was entered into.

Recommendation

That the submission be accepted in part, to grandfather claims for payments made to listed research providers under an arrangement to provide R&D services, as long as the provider had that status when the arrangement was entered into.

Issue: Power not to list and power to delist

Submissions
(Matter raised by officials)

The legislation should be amended to allow the Commissioner not to list an applicant if the Commissioner is satisfied that a person will not meet the requirements of listed research providers.

The Commissioner should be required to give notice of the reasons for the decisions not to list or to delist a provider, but those decisions should not be able to be challenged.

Comment

The Commissioner needs a power to refuse to list vexatious applications or to delist a provider to protect the integrity of the tax system. Similar powers exist in relation to the accreditation of listed PAYE intermediaries.

The reasons for the decision to delist or not to list a provider should be provided to the applicant so that they have an opportunity to make remedial measures. Not permitting a right to challenge decisions is required to give claimants certainty of the status of a provider. A protracted dispute over the status of a provider (when a provider has been delisted but has challenged that decision) would create uncertainty for a claimant entering into an arrangement contracting with the provider.

Recommendation

That the submissions be accepted.

FILING OF TAX CREDIT CLAIMS

Clause 158

Issue: Group companies

Submissions
(16 – NZ Post, 61 – KPMG, 91 – New Zealand Institute of Chartered Accountants)

Wholly owned group companies should have the facility to make R&D tax credit claims as a group, to minimise compliance costs. *(NZ Post)*

A group of companies should be able to group its R&D tax credit claim, or this process should at least be consistent with the consolidation process, with only one statement in relation to the R&D tax credits required to be submitted. *(New Zealand Institute of Chartered Accountants, KPMG)*

Comment

The proposed R&D legislation currently provides for group filing in two circumstances. The first of these is when an internal software development group exists, in which case a nominated member of the group must file a single detailed return on behalf of the group (this is filed in addition to each member's normal income tax return). The second is when a partnership elects to file on behalf of all the partners in the partnership, in relation to the activities undertaken by the partnership.

Officials are not averse to the prospect of other groups of companies filing a single detailed credit return. However, because of time constraints we have not yet considered the implications, either in terms of consequential amendments to the legislation or administrative systems design, of extensions to group filing. We therefore propose to consider the implications of group filing in more detail at a later date for possible inclusion in a future bill.

Recommendation

That the submissions be noted.

Issue: Date of filing

Submission
(54 – ASB Bank, 65 – NZ Bankers Association)

The Commissioner should be given discretion to negotiate extension of time arrangements with some applicants or classes of applicants in relation to filing the tax credit claim.

Comment

There are two documents which credit claimants need to provide to Inland Revenue. The first is an income tax return containing the amount of credit claimed and the second is a detailed tax credit return containing, amongst other things, more information about the R&D and related expenditure. The detailed tax credit return is essential to the effective administration of the credit – it will provide important information for audit, evaluation and statistical purposes. The tax credit rules have been deliberately designed so that taxpayers will lose the credit if they do not provide this information in a timely manner.

The due date for the detailed tax credit return is, for most taxpayers, the same as the due date for the income tax return. For some taxpayers in partnerships or internal software development groups, the due date for the detailed tax credit return will be later than the due date for the income tax return.

We consider this to be reasonable. The credit is designed to provide an incentive for businesses to undertake research and development. If businesses are undertaking R&D in response to the incentive, they will be well aware of what the R&D involves and will have had the opportunity to put in place processes to track relevant expenditure. In such circumstances, it should be relatively straightforward to provide the tax credit claim by the statutory deadline. In addition, to claim the credit on an income tax return with accuracy, taxpayers will have to have done most or all of the work necessary to also prepare the detailed return.

However, we do recognise that there can be circumstances which prevent a return being filed on time. Therefore, we recommend changing the proposed legislation to allow an extension of time to file of 30 days.

Recommendation

That the submission be accepted to the extent that there should be an extension of time to file of 30 days.

Clause 166

Issue: Determinations

Submissions
(33 – Corporate Taxpayers Group, 43 – PGG Wrightson, 61 – KPMG, 82 – Fonterra, 91 – New Zealand Institute of Chartered Accountants)

Inland Revenue should advise how taxpayers can seek advice on the eligibility of activities and expenditure for tax credits in the period before individual determinations become available in 2010, given the legislative inability to obtain binding rulings. *(Corporate Taxpayers Group, Deloitte)*

An R&D determination should not be binding on the applicant, and to avoid creating a new regime, the existing binding ruling process should be used. *(Corporate Taxpayers Group)*

An optional pre-approval process should be available for R&D tax credit claims. *(KPMG, New Zealand Institute of Chartered Accountants, Fonterra)*

If an optional pre-approval process is not available before the first deadline for lodgement of a statement in relation to R&D credits, then the deadline for a lodgement should be extended to allow eligible persons to evaluate confidently their eligible activities and expenditure. *(New Zealand Institute of Chartered Accountants)*

A private determination in relation to eligibility for the tax credit should be binding from the date of lodgement of the application for the determination in line with the Advance Registration process that applies in Australia. *(PGG Wrightson)*

Comment

Inland Revenue's priority is to ensure that comprehensive guidance is available to enable all businesses to be in the best position to assess their eligibility for the credit. To achieve this Inland Revenue is currently employing specialist staff.

Over time Inland Revenue will further develop these guidelines. The current intention is that once the general guidelines are robust, work will focus on developing more specific guidance.

For the R&D tax credit rules to work as effectively as possible Inland Revenue needs to focus its resources on outputs which provide greatest certainty to the largest number of taxpayers. There is a significant risk that because resources will be dedicated to providing general guidance of benefit to many businesses, individual determinations will not be available until 2010 (these determinations will serve the same need as an "optional pre-approval process").

Until individual determinations become available, businesses will be encouraged to refer to the available guidance and, if necessary, to seek further assistance from their professional advisor or tax agent to help them determine their eligibility.

We consider the current tax process of claimants self-assessing their entitlement, with assistance from guidance material and tax advisors, and filing their claim accordingly most efficient in the early years of the credit. Any subsequent disputes will be dealt with through the normal channel for disputes resolution.

See also the later submission (on *Reassessments*), in which we recommend that during the early period of the credit, when determinations are not yet available, there be some relief from reassessment deadlines.

Extending the deadline for lodgement

The legislation allows the typical claimant 12 months to lodge their claim. A lengthier period is not desirable and may encourage businesses to seek to “reclassify” expenditure; a process known as “grave-digging”. This has been the experience in other jurisdictions where tax professionals identify unclaimed historical R&D and make claims in return for a percentage of the benefit. There is no benefit from this process by way of increased R&D in the years for which the claim is made.

More broadly, given that for a claim to be successful the R&D must be scientific, investigative and experimental, and therefore documented, we consider that sufficient records should be available to support a claim within 12 months after the year in which the expenditure is incurred.

Determinations should not be binding on the applicant

We agree that private determinations on R&D should not be binding on the applicant.

Determinations should follow the existing binding rulings regime

The bill provides for a separate R&D determinations process. This reflects the different subject matter of R&D determinations, which are expected to involve matters of fact relating to science and technology, rather than simply the application of tax laws.

However, the design of the new determinations regime has significant similarities to the rulings regime and to other determination regimes.

Determination to be binding from the date of lodgement of the application

It is not desirable that the Commissioner be bound before he has been able to consider the application and the extent to which the proposed R&D activity meets the eligibility requirements of the legislation.

Recommendation

That the submissions be declined, except the submission that determinations should not be binding on the applicant.

Submission
(Matter raised by officials)

That a decision made about determinations under the draft section 91AAP of the Tax Administration Act 1994 be non-disputable.

Comment

Subsection 91AAP(7) in clause 166 of the proposed legislation allows taxpayers to dispute or challenge a determination made under subsection 91AAP (determinations about eligibility of activities and expenditure for an R&D tax credit).

It is not typical for decisions about rulings or determinations to be disputable. Furthermore, if disputes are possible, they could tie up resources which would be better used, particularly in the early years of the credit, in developing general or industry-specific guidance of benefit to a large number of taxpayers.

We therefore recommend that subsection 91AAP(7) be removed and that decisions made about determinations under subsection 91AAP be non-disputable.

Recommendation

That the submission be accepted.

Issue: Guidelines

Submissions
(43 – PGG Wrightson, 44 – Fisher & Paykel, 82 – Fonterra)

Inland Revenue should work closely with organisations after the legislation is passed to develop simple, fair and clear guidelines around the R&D tax credit to ensure organisations have certainty around eligible and ineligible expenditure. *(Fisher & Paykel, Fonterra)*

Inland Revenue should identify as a matter of urgency the guidelines, fact sheets, case law, Australian Tax Office Rulings and Interpretative Decisions that have been issued that could at least in the short to medium-term be relied on by New Zealand taxpayers. *(PGG Wrightson)*

Comment

Inland Revenue intends to have guidance available by 1 April 2008. We are according a high priority to developing industry-wide guidelines, drawing on the experience and materials of other jurisdictions. While Australian interpretative materials have been examined, these could not be relied upon by New Zealand taxpayers as the eligibility requirements of the New Zealand tax credit do not mirror precisely the Australian eligibility requirements.

Once the legislation is enacted and the draft guidelines completed, Inland Revenue will undertake external consultation to enable businesses to provide feedback on the draft guidelines and to identify additional issues on which further clarification is required to help businesses determine their eligibility.

Inland Revenue expects to work closely with industry groups in the progressive development of additional guidance. While the provision of industry-wide guidance by 1 April 2008 is Inland Revenue's immediate priority, as part of its ongoing administration of the regime, the Department will progressively update and expand guidance materials in response to specific problems identified by industry on which further clarification is required. This will be done as part of Inland Revenue's regular relationship management meetings with industry groups and bodies, such as the New Zealand Institute of Chartered Accountants.

Recommendation

That the submission that Inland Revenue should work closely with the private sector be accepted.

That the submission that the Australian guidelines be relied on in the medium term be declined.

ADMINISTRATION

Clauses 169, 172

Issue: Alternate administrator

Submission

(33 – Corporate Taxpayers Group, 37 – Zespri, 74 – Deloitte)

A government agency, separate from Inland Revenue, should be responsible for the determination of what constitutes R&D, as is the model in Australia. If this is not acceptable, at the very least appropriate centralised specialist staff ought to be employed by Inland Revenue to perform this function.

Comment

Consideration was given by policy-makers to alternative delivery models, with reference to the arrangements and experience of other jurisdictions.

The choice of a tax-administration centred delivery model was influenced by the limited timeframe for implementation of the credit. With a single agency accountable for the administration of the credit regime, delivery risk is reduced.

Further, given the inter-dependency between the R&D tax credit and the income tax regime, the choice of a tax-administration centred delivery model will reduce compliance costs for claimants. Dealing with two agencies with split responsibilities would increase compliance costs and, potentially cause delays that create further uncertainty for claimants.

Inland Revenue is currently assessing the organisational arrangements that it will need to put in place to ensure that the policy intent is realised. In doing so, Inland Revenue is drawing on the experiences of other jurisdictions in administering their respective R&D tax concessions. Inland Revenue is in the process of identifying the specialist organisational capability that it will need to recruit to administer the credit, supported by specialist advisors. In addition to the in-house capability that it acquires, Inland Revenue will have the ability to engage specialist external advisors to help it assess matters such as the eligibility of R&D activities.

Recommendation

That the submission that a government agency, separate from Inland Revenue, be responsible for the determination of what constitutes R&D be declined.

That the submission about appropriate centralised specialist staff be noted.

Issue: Reassessments

Submissions

(33 – Corporate Taxpayers Group, 61 – KPMG, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

The standard reassessment rules should apply to R&D tax credits. If standard reassessment rules do not apply, the same time limit should apply to both the Commissioner and the taxpayer. *(New Zealand Institute of Chartered Accountants, KPMG)*

Claims made for the first two years of the R&D regime should have a further extended period of 24 months (on top of the 12-month period provided for in the bill) in which to file a notice of proposed adjustment or request an amended assessment. This would enable taxpayers more time to ensure that systems were working correctly. *(Corporate Taxpayers Group)*

Some discretion should apply initially to allow taxpayers sufficient time and for sufficient guidance to be provided for the evaluation of R&D activities and expenditure. *(New Zealand Institute of Chartered Accountants)*

Clarification is sought on how new sections 68D and 68E, requiring electronic statements to be filed by the due date for filing the income tax return, interface with the rules relating to notices of proposed adjustment. A notice should be able to be filed regardless of the existence and timing of an electronic statement. *(Corporate Taxpayers Group)*

It should be legislatively clarified in section 89DA of the Tax Administration Act 1994 that a taxpayer can issue multiple notices of proposed adjustment for a single income tax return given the different response periods applying for general income tax issues (4 months) and R&D issues (12 months). *(Corporate Taxpayers Group, Deloitte)*

The Commissioner should not be limited to a one-year time period for amending assessments for an R&D credit claim. Further, the Commissioner should be able to amend an assessment more than once in respect of an R&D credit claim under section 113. Therefore proposed new sections 108(1B) and 113D of the Tax Administration Act should not be enacted. *(New Zealand Law Society)*

Comment

The normal tax rules allow a four-month opportunity for a taxpayer to amend a tax return. The taxpayer can also request, for a period of up to four years, that the Commissioner make an amendment, although there is no guarantee that the Commissioner will agree to the request.

The R&D tax credit raises particular risks which mean that different time periods for amendment are desirable.

On one hand it is acknowledged the R&D tax credit could add uncertainty to the tax return process. For this reason, the standard four months to amend a tax return is felt to be too short a period for the R&D credit and we have allowed a longer 12-month period.

On the other hand, overseas experience suggests that tax professionals will devote considerable resources to re-opening past-year tax returns to claim R&D if this is possible. In the overseas experience, tax professionals "mine" past returns for R&D that taxpayers did not know was eligible for a credit, and take a cut of the resulting credit claims. The credit claimed in these cases provides no benefit in the form of increased R&D activity in those years, since the R&D was undertaken without the knowledge it would attract a credit. To prevent such mining of past returns, we have not allowed the taxpayer to request that the Commissioner adjust the amount of credit upwards after the 12-month period has ended (requests for downward adjustments must still be allowed for a full four years so that taxpayers are not forced to incur penalties or use-of-money interest).

Both the submissions from NZICA and the Corporate Taxpayers Group request further time to amend claims made due to uncertainty in the first few years of the R&D tax credit. Given the possible lack of access to a determination process until 1 April 2010 we agree with this concern and recommend that the period in which an R&D tax credit statement and the R&D claim in the associated tax return be amended be temporarily extended from one year to two years. We consider the extension should apply to the 2009 and 2010 income years.

The Corporate Taxpayers Group asks for legislative clarification that multiple notices of proposed adjustment may be filed under section 89DA of the Tax Administration Act, so that separate notices can be filed for general tax issues (within the four-month period allowed) and R&D tax credit issues (within the 12-month period allowed). Our understanding is that multiple notices may be filed, providing each addresses different issues. We do not consider that the legislation requires clarification.

Corporate Taxpayers also has a concern about the situation in which a person initially does not claim tax credits and so does not file a detailed tax-credit return by the due date, but later files a notice of proposed adjustment within the period allowed and claims an R&D credit. Entitlement to a credit is foregone in this case because the detailed credit return is not filed on time. We do not envisage that this circumstance will be common.

However, we do recognise that in the early years of the credit there will be uncertainty about the application of the new law, and that this could be aggravated by the unavailability of determinations. This may lead some taxpayers, waiting for more certainty about how the law applies to their particular circumstances, to delay claims. By waiting for more certainty, the risk of over-claiming and incurring interest or penalties is reduced. For this reason, we propose that in the 2008–09 and 2009–10 years there should be an exception to the normal rule. We propose that the date for filing the detailed credit return be extended (but no further than the end of the period for issuing a notice of proposed adjustment in relation to the credit) if the taxpayer has not claimed any R&D tax credit in their income tax return. (If the taxpayer has made a claim in the income tax return, no extension will apply.)

The New Zealand Law Society submission states that the Commissioner should be able to amend an assessment more than once for an R&D credit claim under section 113 of the Tax Administration Act, and that section 113D should therefore not be enacted.

Section 113 allows the Commissioner to amend tax assessments. The proposed legislation limits the application of section 113 in relation to upward adjustments of R&D tax credits, to a period generally ending one year after the due date for the income tax return. As explained above, this one-year limitation is designed to prevent "grave-digging".

The limitation does not apply in cases in which the taxpayer has issued a notice of proposed adjustment in relation to the tax credit within the one-year period. In such cases, a disputes process is entered into and takes some time to complete. The Commissioner needs the ability to alter the assessment at the end of the process including, possibly, making an upward adjustment, even when this is after the one-year period.

However, this raises the possibility of "strategic" notices, in which a notice is issued merely to stop the one-year limitation applying, allowing time for grave-digging and further adjustment of claims during the disputes process. Section 113D prevents such strategic notices, by limiting the amount of credit to the amount claimed in a notice issued during the initial one-year period. The intention is that taxpayers will have the initial period for filing a tax return, plus a further year, to determine their entitlement to a credit, and no longer.

Recommendation

That the submissions raising the issue of uncertainty in the first few years of the tax credit be accepted in part by allowing, for the 2008–09 and 2009–10 income years:

- two years rather than one year for amending R&D tax credit claims; and
- an extension to the normal time for filing a detailed credit claim if no credit was claimed in the initial income tax return.

That the other submissions be declined.

Issue: Penalties and use-of-money interest

Submissions

(33 – Corporate Taxpayers Group, 91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

During the initial years of the tax credit there should be legislative relief from penalties for unacceptable interpretation and not taking reasonable care, similar to that being introduced for international financial reporting standards adjustments. *(Corporate Taxpayers Group)*

Penalty and interest relief would be appropriate for an initial (at least a two-year) period until taxpayers, advisors and Inland Revenue come to terms with the new rules. *(New Zealand Institute of Chartered Accountants)*

For income years during which taxpayers have no ability to receive determinations in relation to their R&D credit claims:

- the Commissioner should not be able to impose civil penalties when the taxpayer's ineligible claim is the result of not taking reasonable care or adopting an unacceptable tax position; and
- taxpayers should not be subject to any use-of-money interest for the relevant income year, when the invalid claiming of the R&D credit gives rise to an underpayment of income tax. *(New Zealand Law Society)*

Comment

It is acknowledged that in the early years of the tax credit there is likely to be a greater level of uncertainty about the application of the law than in later years. However, the unacceptable position penalty naturally reflects that uncertainty, as the standard taxpayers are required to meet is flexible. The obligation on taxpayers is to adopt a tax position that is "about as likely as not to be correct". Where the law is uncertain, this standard is easier to meet as there is less certainty about the correct answer. Further, Inland Revenue's focus will not be on application of penalties initially, but on ensuring compliance through education and support. However, without this penalty at least being available there are two risks:

- that taxpayers may file clearly ineligible claims with no risk of penalty in the hope that the claim is simply accepted; and
- that taxpayers know that they can take aggressive tax positions risk-free and do so.

We do not support any variation in the application of the use-of-money interest rules as they are not penal and act only to compensate for the timing benefits of under- or over-paid tax.

Recommendation

That the submissions be declined.

Issue: Surplus credits

Submission

(91 – New Zealand Institute of Chartered Accountants)

Section LH 1(6), which provides that the Commissioner must use surplus credits to pay a person's provisional tax for a subsequent tax year, should be removed as it could defeat the intended purpose of the government in cashing out surplus credits.

Comment

The R&D tax credits are refundable in cash if they exceed the tax liabilities of the taxpayer. The policy intent is that the credit will first be used to settle other tax liabilities, before any refund is paid.

It is not intended that surplus credits be applied to provisional tax payments which are not due at the time any refund is paid out.

Recommendation

That the submission be noted, and that the wording of the legislation be altered to clarify that surplus credits are used to meet provisional tax liabilities only where those liabilities are due.

APPLICATION DATE

Clause 100

Issue: Late balance date taxpayers

Submissions
(33 – Corporate Taxpayers Group, 49 – Contact Energy Ltd, 54 – ASB Bank, 65 – NZ Bankers Association, 74 – Deloitte, 82 – Fonterra)

Taxpayers should be able to obtain a tax credit for R&D activities undertaken from the earlier of the commencement of the 2009 income year and 1 April 2008. *(Corporate Taxpayers Group, Contact Energy Ltd)*

The application date should be a fixed date of:

- either 1 January or 1 April 2008. *(ASB Bank, NZ Bankers Association)*
- 1 April 2008. *(Fonterra)*
- 1 November 2007, or if this is not feasible, 1 January 2008. *(Deloitte)*

Comment

The R&D tax credit has been integrated into the tax system and is designed to work on an income-year basis. Providing the tax credit for part of the year would require legislation to provide for part-year claims. While some taxpayers may be willing to bear the associated compliance costs, it would mean that some of the value of the credit is simply wasted on the process of taxpayers claiming the credit.

Implicit in the claims is a fairness argument that late balance date taxpayers are "missing out" on tax credits as other taxpayers with early or standard balance dates can make claims before they can. However, an income-year application approach is standard and, in the case of taxpayer unfavourable measures, the opposite situation occurs with late balance date taxpayers benefiting. Continuing the fairness argument, it appears unfair for late balance date taxpayers to benefit from delays in application of unfavourable measures but have specific measures enacted to ensure early benefit in the case of taxpayer-favourable measures. Taxpayers choose non-standard balance dates for commercial reasons, such as minimising compliance costs by aligning balance dates with an overseas parent. This is done with the knowledge that this may result in deferring or accelerating the impact of tax changes.

At a practical level, Inland Revenue has designed systems to cope with enquiries and claims on the basis of income-year application, which implies a staged uptake of the credit and no claims relating to the 2007–08 or earlier years. Furthermore, part-year claims would pose verification difficulties for Inland Revenue auditors because taxpayers have incentives to allocate expenditure to the period of the year in which the credit is available. Moving to a fixed application date would entail significant difficulties in administration.

Recommendation

That the submissions be declined.

MISCELLANEOUS DRAFTING ISSUES

Clause 100

Submissions
(71 – PricewaterhouseCoopers)

Proposed section LH 2 needs to be amended to remove the inconsistency between references to "tax year" and "income year".

Proposed section LH 3(2) needs to be amended to remove the inconsistency between the reference to "tax year" and the associated cross-reference to "corresponding income year" in section LH 2(2).

Comment

"Tax year" and "income year" are different concepts. A "tax year" is always 1 April to 31 March and that is the year for which credits are calculated under the scheme of the core provisions in the Income Tax Act 2004. "Income year" is the taxpayers tax accounting year which may end on a date other than 31 March.

In section LH 2, eligibility of the claimant should be tested in relation to a period in an income year. This will be clarified.

In section LH 3(2), the reference should be to income year rather than tax year.

Recommendation

That the submissions be accepted in part and sections LH 2 and LH 3 be clarified as proposed.

Issue: Eligible amounts

Submissions
(33 – Corporate Taxpayers Group, 74 – Deloitte)

In section LH 1(1), the use of "a" tax credit indicates there is only one tax credit calculated. Under other provisions it is not clear that there can be multiple "eligible amounts". *(Deloitte)*

In section LH 2(4) the wording refers to eligible amounts both in the singular and plural. It would be impractical for there to be only one eligible amount, therefore perhaps the legislation should be clearer on this point. *(Deloitte)*

In section LH 3, for clarity, the definition of "eligible amount" in subsection LH 3(2) should define it as being the total of **all** eligible amounts calculated under section LH 2. *(Corporate Taxpayers Group, Deloitte)*

Section LH 9 refers to "an" eligible amount. The $2 million cap could be interpreted as being a total cap for all R&D for a developer not just the internal software development. *(Deloitte)*

Comment

In straightforward cases, there will be only one eligible amount. However, in other situations there may be more than one eligible amount (for example, if a taxpayer is eligible for two periods in an income year). The legislation needs to apply in both cases.

Section LH 1(1) does not refer to the eligible amount that gives rise to the tax credit for the tax year or to the period in the corresponding income year to which the eligible amount relates. These references should be inserted. Section LH 1 will then more clearly allow for the possibility of multiple eligible amounts for multiple periods in the corresponding income year. Section LH 3(2) should also refer to a period to which the credit relates.

We agree that the $2 million cap could be interpreted as being a total cap for all R&D and propose that it be clarified that the cap relates to internal software development only.

Recommendation

That the submission relating to "eligible amount" be noted and the legislation be clarified as proposed above.

That the submission to clarify that the cap apply only to internal software development be accepted.

Issue: Expenditure paid to an associate

Submission
(74 – Deloitte)

Section LH 6(2)(c)(i) has a circular reference and the use of the words "does not" in section LH 6(2)(c)(ii) is problematic. The wording in section LH 6(2)(d) could instead be used.

Comment

We agree that the drafting in section LH 6(2)(c)(i) is circular and that this should be remedied. The use of the words "does not" in section LH 6(2)(c) are intended to refer to third-party transactions and are not problematic.

The submission proposes adopting similar wording in paragraph (c) as that used in paragraph (d). However, the provisions are quite different in purpose and therefore this is not appropriate. Paragraph (c) applies when a person performs R&D on behalf of an associate, or supplies property used in R&D to an associate. The associate can claim a credit only in relation to the eligible expenditure of a person. Paragraph (d) provides that property leased from an associate must be at market value.

Recommendation

That the submission be accepted in part and the circularity in section LH 6(2)(c)(i) be removed.

Issue: Depreciable property acquired from an associate

Submission
(74 – Deloitte)

Section LH 6(2)(f) seems to duplicate the effect of section EE 33 of the depreciation rules which already limits the cost base of an asset to the purchaser. This provision would mean that any approvals under section EE 33(4)(a)(ii) to increase the cost base are not valid for R&D purposes. It might be simpler if the legislation referred to section EE 33 as if section EE 33(4)((a)(ii) did not exist.

Comment

Section EE 33 limits the cost base of a depreciable asset purchased from an associate – the cost base of the purchaser cannot exceed the cost of the asset to the vendor.

The intention of section LH 6(2)(f) is, for the purposes of the tax credit, to limit the cost base of a depreciable asset purchased from an associate who has used it in R&D. Because there is no claw-back of a tax credit on sale of a depreciable asset, the provision is required to prevent double-dipping of the credit. The section applies where the purchase price is less than the vendor's cost, so is required in addition to section EE 33.

However, it need only apply where the asset is acquired directly or indirectly from an associate who has used it in conducting R&D activities. The section should be redrafted to reflect this.

Recommendation

That the submission be declined, but that section LH 6(2)(f) apply only where the asset is acquired directly or indirectly from an associate who has used it in conducting R&D activities.

Issue: Consistency in drafting

Submission
(95 – New Zealand Law Society)

The word “conducted” in paragraph LH 6(2)(j) should be replaced by the word “performed” which is used in paragraph (i). The use of a different word to mean (presumably) the same thing is not desirable.

Comment

We agree that inconsistency in describing the carrying out of R&D is not desirable, and note that the word “conducting” is used also in several places in section LH 6(1). The same term should be used throughout these provisions.

Recommendation

That the submission be accepted, and in the bill, the same terminology used to refer to the carrying out of R&D.

Penalties

OVERVIEW

The compliance and penalties legislation in the Tax Administration Act 1994 came into effect on 1 April 1997. It was designed to promote effective and fairer enforcement of the Inland Revenue Acts by providing better incentives for taxpayers to comply voluntarily with their tax obligations.

The discussion document, *Tax penalties, tax agents and disclosures*, was released in October 2006. It examined the current compliance and penalty rules, and identified several areas where the rules could be clearer, more consistent and better targeted to encourage voluntary compliance. It discussed options for the relaxation of penalties when taxpayers have genuinely and consistently tried to do the right thing.

The discussion document also proposed that, in future, before recognising a person as a "tax agent" the Commissioner must be satisfied that doing so is consistent with protecting the integrity of the tax system. In addition, it proposed proceeding with earlier announced measures introducing a limited amnesty for business groups identified by the Commissioner.

Most of the amendments in this bill result from the proposals in the discussion document.

Submissions on the bill are generally very supportive of the proposals. The main areas of concern are:

- *The definition of "tax agent":* how the rule would apply to in-house tax advisors and the costs of complying with the proposals.
- *Late payment penalty notification:* that the two-year period should be reduced to one year.
- *Tax agents and not taking reasonable care:* that the proposal should be extended to apply to in-house tax agents; that clarification is needed on how the rule would apply to groups and the need to define "adequate" information.
- *Unacceptable tax position:* that the shortfall penalty should be repealed; a discretion should be introduced for "simple mistakes and clear oversights", and the amendment should be backdated.
- *Abusive tax position:* that the threshold should not be repealed.
- *Voluntary disclosures:* that the proposal was announced as no penalty being applicable whereas the draft legislation gives a 100 percent reduction of the shortfall penalty and the proposal should apply from an earlier date.

Officials note that the proposed amendments to the compliance and penalty rules in this bill are taxpayer-friendly and will assist in the rules being applied more consistently and fairly.

THE DEFINTION OF "TAX AGENT"

Issue: Professional bodies

Submission
(91 – New Zealand Institute of Chartered Accountants)

For organisations with members that have a significant function of giving tax advice or assistance with tax compliance, the regulation of tax agents should be left to the membership body.

Comment

Officials note that not all tax agents are members of professional organisations. We consider that a more consistent application of the provision will be achieved if the decision to apply it is made by one organisation. As the relevant information on the tax agent will be held by Inland Revenue, the decision should be made by Inland Revenue.

It is envisaged that the discretion to not grant or remove tax agent status will be exercised in a small number of cases only.

Recommendation

That the submission be declined.

Issue: In-house tax experts

Submission
(33 – Corporate Taxpayers Group, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

Corporate groups with in-house tax expertise should be eligible to be a tax agent in their own right under the proposed definition of "tax agent".

Comment

The current definition of "tax agent" includes any business in which 10 or more returns of income are prepared. This means, for example, that if a group of companies furnished 10 or more returns of income the group could list as a tax agent.

It was not intended that this amendment result in corporate groups not being eligible to list as a tax agent. Officials agree with submissions that the definition of "tax agent" should allow companies with in-house functions to be eligible to list as a tax agent.

Recommendation

That the submission be accepted.

Issue: Compliance costs

Submissions

(33 – Corporate Taxpayers Group, 74R – Deloitte, 95 – New Zealand Law Society)

The compliance costs of the tax agent provisions are too onerous in comparison to the level of risk posed to the integrity of the tax system. All existing corporate tax agents should have automatic registration (consistent with the proposal in the bill in relation to tax agents who are individuals). A particular concern is that the new information requirements could go as far as requiring the names of:

- all staff at non-partnership accounting firms with any involvement in the preparation of tax returns; and
- assuming corporate groups remain eligible to be tax agents, all members of an in-house tax team, the finance manager, chief financial officer, chief executive officer and board of directors to the extent to which each is involved in the preparation, review and signing of tax returns.

The requirement that details be updated within three months of becoming inaccurate is also excessive and will create unwarranted compliance costs.

Comment

The tax agent amendments allow Inland Revenue to not grant, or remove tax agency status, when the Commissioner is concerned about the integrity of the tax system. One of the requirements of the amendment is that Inland Revenue is provided with the names of:

- each person responsible for the filing of the entity's tax returns, if the entity is a body corporate;
- each shareholder of the entity, if the entity is a closely held company;
- each partner in the entity, if the entity is a partnership;
- each member of the entity, if the entity is an unincorporated body.

The amendment is aimed at ensuring Inland Revenue has the names of the relevant persons and that individuals who pose a risk to the integrity of the tax system cannot hide behind a corporate name. We have tried to keep the compliance costs low, for example, by requiring the names of all partners in a partnership – rather than limiting the request to just the tax partners, which might be more difficult to determine.

Officials do not agree that all existing corporate tax agents should automatically be accepted as tax agents under the proposal. We do, however, agree with the submission that the information requirements are much wider than necessary.

For corporate groups, we consider that the legislation should require only the names of the tax manager, the chief financial officer, the chief executive officer and the directors.

To ensure that the information Inland Revenue has is up to date, the proposal requires that when details change Inland Revenue is advised of the changes within three months. Officials agree with the submissions and recommend that this period be extended to 12 months so the information can be filed with the annual return.

If Inland Revenue became aware that the information had not been provided in the required 12-month period, it would request details of the change. The omission on its own would not be grounds for removing tax agency status.

Recommendation

That the submissions be accepted in part, subject to our earlier comments.

Issue: Information requirements

Submission
(91 – New Zealand Institute of Chartered Accountants)

The bill should be amended so that draft section 34B(4) provides that only information necessary or relevant to the purpose of considering whether to list the applicant as a tax agent should be collected by the Commissioner.

Comment

Officials disagree. The draft legislation follows the precedent of similar provisions in the Tax Administration Act 1994, which require information to be provided to the Commissioner. The words "necessary or relevant" are not used.

Also, case law prevents Inland Revenue going on "fishing expeditions". Inland Revenue can only request information for the purpose of administering the Inland Revenue Acts.

Recommendation

That the submission be declined.

Issue: Key factors

Submission
(91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

The key factors to be taken into account by the Commissioner in considering whether or not to list a person as a tax agent should be specified in an inclusive but not exhaustive list.

Comment

The proposed amendment sets out a framework for considering whether to list a person as a tax agent. Operational guidelines will set out the circumstances in which it might be decided not to list a person as a tax agent. Setting out the circumstances in the guidelines rather than the legislation gives the Commissioner more flexibility in applying the rules and also the ability to take into account a wider number of factors.

Recommendation

That the submission be declined.

Issue: Operational guidelines

Submission
(91 – New Zealand Institute of Chartered Accountants)

While supporting giving the Commissioner discretion to withhold recognition or remove a person as a tax agent to protect the integrity of the tax system, operational guidelines setting out how the discretion might be exercised are of critical importance.

Comment

Officials agree with the submission. Interested parties, such as NZICA, will be consulted in the development of the guidelines.

Recommendation

That the submission be noted.

Issue: Redundant legislation

Submission
(91 – New Zealand Institute of Chartered Accountants)

The bill sets out when a person must be listed as a tax agent (section 34B(5)), therefore it is unnecessary to set out when the Commissioner must refuse to list a person as a tax agent (section 34B(7)).

Comment

The bill sets out the process that will be followed when the Commissioner makes a decision to not list, or remove a person from the list. Therefore officials consider that it is appropriate that both provisions remain in the bill.

Recommendation

That the submission be declined.

Issue: Time period

Submission
(91 – New Zealand Institute of Chartered Accountants)

The legislation should provide that, in exceptional circumstances, an agent has more than 30 days to supply the information to allow the Commissioner to review the decision to refuse to list a person as a tax agent.

Comment

Under the proposals, if the Commissioner makes a decision to not grant, or remove tax agent status, the Commissioner must first notify the person, who then has an opportunity to provide any arguments that should be taken into account in making the final decision. The draft legislation gives the taxpayer 30 days to provide information to the Commissioner, or a shorter period if the Commissioner considers a shorter period is appropriate to protect the integrity of the tax system.

The submission suggests that the legislation should allow for longer periods. Officials agree and recommend that the proposal be amended, giving the Commissioner a discretion in setting the time period for the person to provide the information, taking into account the circumstances of the case.

Recommendation

That the submission be accepted.

Issue: Drafting clarification

Submission
(95 – New Zealand Law Society)

In proposed section 34B(5), the drafting could be clarified by substituting, in paragraph (a) the words "eligible to be a tax agent" for the words "entitled to make the application".

Comment

Officials disagree with the submission. The words "entitled to make the application" have been used here and elsewhere in section 34B because the section applies to persons who are not currently tax agents. If the words "eligible to be a tax agent" were used, the section would also apply to persons who are currently tax agents.

Recommendation

That the submission be declined.

Issue: Secrecy provision

Submission
(91A – New Zealand Institute of Chartered Accountants)

The secrecy clause needs to be redrafted to allow the Commissioner to supply the necessary information to a professional body before making a final decision on delisting or not listing a tax agent, when the basis of the decision relates to the integrity of the tax system.

Comment

As currently drafted, the information Inland Revenue can disclose to professional bodies when a member of that body poses a risk to the integrity of the tax system is limited to the decision to de-list the person. Officials agree with the submission and propose that the draft legislation be amended to include information "that would be relevant to a decision". Expanding the information that Inland Revenue can disclose and when it may be disclosed should benefit both the body and Inland Revenue in that relevant information may be shared before a decision is made.

As noted earlier, guidelines setting out how the discretion will apply will be prepared. The guidelines will also cover what information will be disclosed to professional bodies and how it will be disclosed. A decision to disclose information to professional bodies will be made at a very senior level within Inland Revenue.

Recommendation

That the submission be accepted.

EMPLOYER MONTHLY SCHEDULE LATE FILING PENALTY

Issue: Grace period

Submission
(91 – New Zealand Institute of Chartered Accountants)

There should be a period of five working days grace before the proposed warning is given. This would remove the vagaries of the postal system and processing malfunctions.

Comment

If the legislation were amended to provide a five working day grace period, the effective date for filing returns would move to the end of that period, with both a large consequent fiscal loss and requests for further grace periods.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(91 – New Zealand Institute of Chartered Accountants)

The amendment should be effective from the date the bill was introduced. This change is taxpayer-friendly and clarifies Inland Revenue's current practice. Applying the new rules as soon as possible would be better and provide certainty for taxpayers.

Comment

As currently drafted this proposal applies from 1 April 2008. Officials agree with the submission that the amendment be backdated. The amendment clarifies current practice. Currently, a late filing penalty is not imposed the first time an employer monthly schedule is filed late. Rather, the taxpayer is advised that the schedule is late and warned that subsequent late filing will be penalised. The late filing penalty is payable if a schedule is filed late in the 12 months following the warning. If all schedules are filed on time for a year, the process starts again – that is, if a schedule is late, the taxpayer is warned.

If the amendment was passed in its current form, taxpayers who have filed their employer monthly schedules late in the previous year will have their slates wiped clean and will receive a warning notice rather than a penalty. This was not intended; wiping the slate clean results in an inequity for those taxpayers who have filed their employer monthly schedules on time. The amendment was aimed solely at aligning the legislation with Inland Revenue's current practice. Officials consider that the draft legislation should be clarified, and apply from the introduction of the employer monthly schedule, 1 April 1999. As this amendment reflects Inland Revenue practice, taxpayers will not be disadvantaged if the amendment applies from this date.

Recommendation

That the submission be accepted in part and the amendment apply from 1 April 1999.

LATE FILING PENALTIES FOR GST RETURNS

Issue: Grace period

Submission
(91 – New Zealand Institute of Chartered Accountants)

There should be a period of five working days grace before the warning is given. This would remove the vagaries of the postal system and processing malfunctions.

Comment

If the legislation were amended to provide a five working day grace period, the effective date for filing returns would move to the end of that period, with both a large consequent fiscal loss and requests for further grace periods.

Recommendation

That the submission be declined.

Issue: Amount of the penalty

Submission
(91 – New Zealand Institute of Chartered Accountants)

The penalty should be tied to the return cycle, not the accounting basis. The $50 penalty should apply to registered persons on category A, B and C taxable periods and the $250 penalty to a category D registered person.

Comment

The discussion document, *Tax penalties, tax agents and disclosures*, proposed that a $250 penalty be imposed on all late GST returns. As a result of submissions on the discussion document, the proposal was amended to provide two levels of penalty – $50 for smaller taxpayers and $250 for larger taxpayers. Registered persons accounting for GST on a payments basis were seen as a proxy for smaller businesses and those on the invoice basis as a proxy for larger businesses. The threshold under which GST may be accounted for on a payments basis is taxable supplies of less than $1.3 million in a 12-month period.

While NZICA's submission has some merit, officials are concerned that some smaller businesses elect to account for GST on a monthly basis – for example, registered persons starting up their business, importers and exporters. Under the submission's proposal, these persons would face the higher rate of penalty. For this reason officials disagree with the submission.

Recommendation

That the submission be declined.

Issue: Nil or credit returns

Submission
(91 – New Zealand Institute of Chartered Accountants)

Any late filing penalties should be reversed if the return, when filed, is a nil return or results in a refund to the registered person.

Comment

Officials disagree. The GST Act requires that nil and credit returns be filed. To encourage taxpayers to file on time it is appropriate that late filing penalties are imposed.

GST returns that result in refunds to registered persons tend to be filed early. Nil returns can arise for a number of reasons – including, for example, that the registered person is undertaking seasonal work, or is winding up their taxable activity. Requiring these returns to be filed better ensures that registered persons with ongoing businesses stay in the system and those ending a business activity do not leave the GST base without first complying with their GST obligations.

Currently, when taxpayers fail to file their GST returns, Inland Revenue issues a default assessment. A default assessment is an estimation of tax liability and remains in place until the taxpayer files the return. The default assessment may be an excessive response to non-filing, particularly for those taxpayers with a nil or credit return. Imposing a late filing penalty would be a more appropriate response, with the default assessment reserved for significant or ongoing non-compliance.

Recommendation

That the submission be declined.

Issue: Good filing history

Submission
(91 – New Zealand Institute of Chartered Accountants)

When a registered person has a good filing history for the earlier of 12 months or six returns, the late filing penalty should not apply.

Comment

As is currently the practice with late-filed employer monthly schedules, the first time a GST return is filed late a late filing penalty will not be imposed. Rather, the taxpayer will be advised the return is late and warned that subsequent late returns will be penalised. The late filing penalty will be payable if a schedule is filed late in the 12 months following the warning.

Officials consider that a 12-month period is more appropriate than a "six returns" period as it is consistent with the period for late-filed employer monthly schedules. It also avoids any potential complications when a taxpayer changes the frequency in which they file GST returns.

Recommendation

That the submission be declined.

Issue: Hybrid accounting method

Submission
(Matter raised by officials)

The legislation should set out the amount of the penalty for taxpayers who account for GST on a hybrid basis.

Comment

The proposed amendment sets out two levels of penalty: for those who account for GST on an invoice basis the late filing penalty will be $250, and for those who account for GST on a payments basis the penalty will be $50.

The "hybrid basis" requires a registered person to account for output tax in the same manner as the invoice basis and input tax in the same manner as the payments basis.

The proposal should be amended so that the $250 penalty also applies to registered persons who account for GST on a hybrid basis.

Recommendation

That the submission be accepted.

Issue: Application to GST

Submission
(91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society, 71 – PricewaterhouseCoopers)

In relation to GST, the period in which Inland Revenue will not grant a further warning should be reduced from two years to one year. Or the two-year period should reduce to 12 months to align with the limit for the late filing penalty.

Comment

The proposal does not apply separately to each type of tax; rather it applies to a taxpayer. Providing a shorter period for GST is therefore not appropriate.

The proposal is aimed at ensuring that taxpayers who are usually compliant, but who have inadvertently missed a payment, do not incur late payment penalties.

A general reduction from two years to one year would not promote the best balance between not penalising an occasional error and providing the right incentives to comply.

Recommendation

That the submission be declined.

Issue: Drafting

Submission
(91 – New Zealand Institute of Chartered Accountants)

The drafting is difficult to understand without an appreciation of the policy intent behind the provision. The current wording makes it difficult to identify that these sections provide for a warning only and no late payment penalty to apply, if a taxpayer has paid all tax on time in the previous two years. Where possible, such relief should be expressed positively in words that clearly convey the policy.

Comment

Officials agree. The provisions should be moved to subsection (1) to make the format of the legislation consistent with other penalty provisions. The drafting will also be made clearer.

Recommendation

That the submission be accepted.

Issue: Grace period

Submission
(91 – New Zealand Institute of Chartered Accountants)

A period of five working days grace should be given for the payment before a warning is given of a late payment penalty imposition.

Comment

The initial late payment penalty is imposed in two stages:

- 1 percent the day after the due date; and
- 4 percent six days later.

The staggering of the penalty is designed to provide an incentive to pay tax on the due date and to not overly penalise taxpayers who are only few days late. As the legislation already provides a much lower rate which, in effect, allows a "grace period", officials do not agree with the submission.

If the legislation were amended to provide a five working day grace period, the effective date for payment would move to the end of that period, with both a large consequent fiscal loss and requests for further grace periods.

Recommendation

That the submission be declined.

Issue: Application of late payment penalties when liability not identified

Submission
(61 – KPMG)

As currently drafted, it is unclear how the taxpayer will be relieved by way of a notification from the late payment penalties for provisional tax payments as the penalty cannot be assessed until the final tax liability is calculated.

Comment

As noted earlier, this proposal is aimed at taxpayers who are generally compliant but who inadvertently miss a payment. Officials agree that the legislation is unclear when late payment penalties are imposed some time after the due date – for example, in the case of estimated provisional tax, when the taxpayer's residual income tax is determined. We consider that the late payment notification should not apply to provisional tax and this will be clarified in the legislation.

Recommendation

That the submission be accepted.

Issue: Due date for payment of tax

Submission

(61 – KPMG, 71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

Section 142A (which sets a new due date for payment of tax if the Commissioner increases an assessment) should be amended to allow a new due date to be extended by the Commissioner, irrespective of whether a return has been filed.

Comment

Under section 142A, if the Commissioner increases an assessment (for example, following an audit of the taxpayer), the increased amount of tax and any shortfall penalty has a new due date for payment set. However, if there is no assessment of tax (because the taxpayer did not, or was not required to file a return) and Inland Revenue assesses tax, the increased amount of tax does not have a new due date for payment set. This can result in both late payment penalties and shortfall penalties being imposed.

When the taxpayer is not required to file a return (and is not self-assessing a liability, as may be the case with non-resident withholding tax) officials consider that a new due date should able to be set because the imposition of the late payment penalty may result from a technicality in the legislation.

When the taxpayer is required to file a return (and self-assess) but fails to do so, a new due date should still be set, with the late filing penalty being the appropriate response.

Recommendation

That the submission be accepted.

Issue: Application date

Submission
(91 – New Zealand Institute of Chartered Accountants)

The amendment should be effective from 1 April 2003, or at a minimum, 1 April 2006. The proposal is taxpayer-friendly and is clarifying Inland Revenue's current practice around section 141KB, which provides a Commissioner discretion not to impose a shortfall penalty for an unacceptable tax position in certain circumstances.

Comment

Officials consider that this amendment neither clarifies current practice nor is it relevant to the application of section 141KB.

Inland Revenue's practice under the current legislation is to allow an offset of tax where the taxable or return periods of the two persons are the same. The proposal removes the requirement for the parties' periods to be the same. If this proposal were to apply retrospectively, cases that involved an inability to offset between associated persons where shortfall penalties had been imposed since 1 April 2003 or 1 April 2006, would have to be reviewed. Given that the legislation and practice have been sufficiently clear this does not seem justified.

Recommendation

That the submission be declined.

TAX ADVISORS AND THE SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE

Issue: Application to in-house tax advisors

Submission

(33 – Corporate Taxpayers Group, 54 – ASB, 58 – Trustee Corporations Association of New Zealand, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

Corporates with in-house qualified and dedicated tax groups have a capability at least equivalent to external tax advisors and should be entitled to the equivalent level of automatic relief from penalties. Requiring in-house advisers to obtain advice from external parties to enable the corporate to obtain the presumption of taking reasonable care is an unwarranted compliance cost for corporates.

Comment

Inland Revenue's practice is that taxpayers who have used tax advisors are usually considered to have taken reasonable care. There are exceptions – for example, where the taxpayer has not provided all of the necessary information to the tax advisor. Under this amendment the legislation will prescribe this and other limited circumstances in which a shortfall penalty for not taking reasonable care can be imposed when the taxpayer has used a tax advisor.

The amendment does not extend to in-house tax advisors. This is because it is more difficult to objectively determine whether in-house tax advisors have provided completely independent advice. This is not to say that in-house advisors do not in a similar way to external tax advisors perform the role of maintaining voluntary compliance.

The amendment does not mean that by using an in-house tax advisor the taxpayer has not taken reasonable care, but rather that if an independent tax advisor is used the taxpayer has clearly demonstrated that they have taken reasonable care.

Determining whether a taxpayer who has used an in-house tax advisor has taken reasonable care will depend on the relevant facts and there may be a considerable difference between the role of an in-house tax advisor for a large corporate and an in-house advisor for a smaller business. The in-house tax advisor may have systems in place that demonstrate that the taxpayer is taking reasonable care. This will be determined on a case by case basis.

Inland Revenue operational guidelines will address the application of the penalty for not taking reasonable care to the in-house tax advisor situation.

Recommendation

That the submission be declined.

Issue: Application to groups

Submission
(33 – Corporate Taxpayers Group, 74R – Deloitte)

The amendment fails to recognise that in many situations the taxpayer relying on the advice from an external tax advisor may not have engaged the tax advisor. For example, an external tax advisor may be engaged by the parent of a group of companies.

Comment

Officials agree that the amendment should extend to the situation of a tax advisor engaged by the parent of a group of companies and recommend that the bill be amended to reflect this.

Recommendation

That the submission be accepted.

Issue: Level of proof and non-disclosure

Submission
(33 – Corporate Taxpayers Group, 49 – Contact)

The proposal is silent on the level of proof Inland Revenue will require that a tax position has been taken on the basis of an action or advice of a tax advisor. If written advice is provided, will it be necessary for the taxpayer to forfeit the taxpayer's right to non-disclosure of the tax advice document to benefit from this provision?

Comment

Under the proposed amendment, if a taxpayer is able to demonstrate that they have used a tax advisor, the taxpayer will be treated as having taken reasonable care. The incidental burdens are no more or less than required for other tax administration purposes.

Officials consider that the legislation should not set out the specific requirements necessary to show that the taxpayer has taken reasonable care. To do so may result in further compliance costs for the taxpayer, and the current administrative processes allow the specific circumstances of each case to be taken into account.

Officials do not consider that the non-disclosure right should be forfeited as that could undermine the policy intent of the non-disclosure right. This will be dealt with in operational guidelines.

Recommendation

That the submission be declined.

Issue: Meaning of "adequate"

Submission
(33 – Corporate Taxpayers Group, 71 – PricewaterhouseCoopers, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

There is a lack of guidance provided in relation to what will constitute "giving adequate information to the tax advisor". "Adequate" should be defined.

Comment

There is no definition of "reasonable care" in the Tax Administration Act. Broadly, the standard envisages the effort required being commensurate with a reasonable person's actions in the taxpayer's circumstances.

The proposed amendment uses "adequate" in two places. A taxpayer who relies on an action or advice of a tax advisor is considered to have taken reasonable care, except if the taxpayer:

> "(b) does not provide to the tax advisor adequate information relating to the tax position:
> "(c) does not provide to the tax advisor adequate instructions relating to the tax position:"

Officials consider that "adequate" should not be defined as what is considered "adequate" information or instruction will depend on the taxpayer's circumstances.

Officials agree that there is a need for operational guidelines. There are currently operational guidelines – for example, standard practice statements and interpretation statements that relate to the shortfall penalty legislation. These statements will be updated as a result of the amendments in this bill.

Recommendation

That the submission be declined.

Issue: Corresponding tax positions

Submissions
(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

The bill provides that a shortfall penalty for not taking reasonable care can be imposed, when the taxpayer uses an agent, if the taxpayer has previously had a tax shortfall for the same type of tax arising from a corresponding tax position in an earlier return and does not take reasonable care to avoid the further tax shortfall. There should be a time limit imposed in this context. *(PricewaterhouseCoopers)*

This amendment should be removed and it should be decided on a case by case basis. Taxpayers can easily end up with a tax shortfall for the same types of tax arising from a corresponding tax position, say, through disputes on a technical interpretation basis. *(New Zealand Institute of Chartered Accountant)*

Comment

The proposed amendment sets out when a taxpayer who has used an agent may have a penalty for not taking reasonable care imposed. This includes when the taxpayer:

> "has previously had a tax shortfall for the same type of tax arising from a corresponding tax position in an earlier return and does not take reasonable care to avoid the further tax shortfall"

Officials consider that the proposed amendment currently allows for such cases to be considered on a case by case basis. After a tax shortfall is identified, a reasonable person in the taxpayer's circumstances would identify that there is a risk in that area and would check in future periods that their tax position is correct.

Officials agree with the PricewaterhouseCoopers submission. We consider that over time the taxpayer may no longer be aware of the risk and the proposal should be amended to provide for a four-year time limit.

Recommendation

That the submission for a time limit be accepted in part in that a four-year time period be imposed.

That the second submission be declined.

REFINING THE SCOPE OF THE UNACCEPTABLE TAX POSITION SHORTFALL PENALTY

Issue: The unacceptable tax position shortfall penalty should be repealed

Submissions

(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

The not taking reasonable care shortfall penalty is imposed when a taxpayer has not exercised reasonable care. Where a taxpayer has exercised reasonable care, they should not be subject to an unacceptable tax position shortfall penalty. *(PricewaterhouseCoopers)*

The unacceptable tax position should be repealed and replaced by the former "unacceptable interpretation". *(New Zealand Institute of Chartered Accountants)*

Comment

The unacceptable tax position shortfall penalty is intended to ensure that taxpayers who take tax positions where there is a significant amount of tax at stake should take extra care and, when viewed objectively, their tax positions meet the standard of being about as likely as not to be correct.

Officials acknowledge that there have been problems in the past with the unacceptable tax position shortfall penalty. Last year, as a short-term solution, the Commissioner was given a discretion allowing him to reverse or not impose the penalty if certain criteria were met. The amendments in this bill form the long-term solution – limiting the scope of the penalty to income tax and substantially increasing the threshold at which the penalty is assessed. The amendments to the voluntary disclosure legislation also deal with some of the problems with this penalty.

Officials consider that this penalty is necessary to ensure that taxpayer's tax positions are "about as likely as not to be correct" in terms of the law. As noted in the discussion document, *Tax penalties, tax agents and disclosures,* the unacceptable tax position penalty:

> "… can be compared with the shortfall penalty for not taking reasonable care, which applies to a more general set of actions. When looking at whether a tax position is acceptable or not, the subjective elements, such as the effort the taxpayer went to, are not considered. In relation to the penalty for not taking reasonable care, taxpayers can argue that reasonable care has been taken by simply using a tax agent. This is not the case with the penalty for an unacceptable tax position – the penalty applies if the tax position taken fails to meet the required standard, irrespective of whether the taxpayer has engaged an agent."[1]

[1] Paragraph 4.3

In developing the amendments in this bill, the option of returning to the unacceptable interpretation penalty was considered. As noted in the discussion document, the change from unacceptable interpretation to unacceptable tax position was necessary because taxpayers could and did argue that because they had not made an interpretation the shortfall penalty could not be assessed. Officials remain of the view that if the penalty reverted to the unacceptable interpretation standard there would be cases where no shortfall penalty could be assessed, although a penalty would be warranted in the circumstances.

Recommendation

That the submissions be declined.

Issue: Meaning of "income tax"

Submission
(34 – Toovey Eaton & Macdonald Limited)

The amendment states that a taxpayer may be liable to an unacceptable tax position shortfall penalty in relation to income tax. The term "income tax" is not defined in the Tax Administration Act 1994. The term should be defined to provide clarity that withholding tax-types are not encompassed within this definition.

Comment

Officials agree. We recommend that section OB 6 of the Income Tax Act 2004 be amended to reflect this and to clarify that withholding-type taxes are excluded from the scope of the penalty.

Recommendation

That the submission be accepted.

Issue: Simple mistakes and oversights

Submission
(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

The Commissioner should be given a discretion to not impose a shortfall penalty for an unacceptable tax position when a taxpayer has exercised reasonable care but has made a simple mistake or oversight.

Comment

Officials agree that in many situations tax shortfalls should not be penalised – for a penalty to be imposed, the taxpayer's actions must fail to meet a required standard.

Under the proposed amendment, many of the cases where currently, the application of a shortfall penalty appears unfair will not be penalised. For example, a taxpayer who files a return, quickly realises there is a mistake in the return and contacts Inland Revenue to correct the mistake, will have made a voluntary disclosure and a shortfall penalty will not be assessed.

The proposed threshold for the penalty is substantial (more than both $50,000 and 1 percent of the taxpayer's total tax figure) and by implication covers most instances of clear mistake or simple oversight. Limiting the scope of the unacceptable tax position shortfall penalty to income tax will also help ensure that penalties are not imposed in most cases.

Recommendation

That the submission be declined.

Issue: Level of threshold

Submission
(91 – New Zealand Institute of Chartered Accountants)

The proposed minimum threshold of $50,000 should be increased to $100,000. The $50,000 limit is easy to breach for large corporate taxpayers and an increase will mean that larger taxpayers are not unfairly treated.

Comment

The bill proposes the tax shortfall must be both more than $50,000 in tax and 1 percent of the taxpayer's total tax figure for the relevant return period.

Officials consider that the 1 percent threshold already caters for large corporates because it will ensure that the penalty will not apply to what may be considered everyday transactions for those taxpayers.

Officials consider that the dollar increase of the threshold in the bill (from $20,000 to $50,000) is already significant and a further increase is unwarranted.

Recommendation

That the submission be declined.

Issue: Repeal of the discretion

Submission

(39 – Owens Tax Advisors Ltd, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

Section 141KB of the Tax Administration Act (which gives the Commissioner the discretion not to impose the unacceptable tax position penalty in certain circumstances) should be retained.

Comment

Section 141KB was enacted in 2006 to deal with concerns with the breadth of the application of the unacceptable tax position penalty. It provides the Commissioner with the discretion either to cancel or not impose the unacceptable tax position shortfall penalty. The discretion applies in cases when the Commissioner is satisfied that:

- the tax position taken is the result of a clear mistake or simple oversight;
- the shortfall arising from the tax position is or would be subject to a reduced penalty because the shortfall was voluntarily disclosed before notification of a pending tax audit or investigation, or is a temporary shortfall; and
- it is appropriate that the taxpayer not be liable to pay an unacceptable tax position shortfall penalty in relation to the tax position taken.

When introduced, the section was not considered to be a long-term solution to perceived problems in this area because:

- it increases administrative and compliance costs;
- does not fit well with the self-assessment environment; and
- using the words "clear mistake and simple oversight" in the penalties context is inherently uncertain and may create a revenue risk if the term becomes more broadly interpreted over time.

The amendments in the bill – namely increasing the thresholds for the application of the penalty and limiting its scope to income tax, will deal with the vast majority of concerns with its application, including the concerns intended to be addressed by section 141KB. The voluntary disclosure proposal will also help deal with other concerns.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(39 – Owens Tax Advisors Ltd, 91 – New Zealand Institute of Chartered Accountants)

The proposal should be backdated to 1 April 2003, the introduction of the unacceptable tax position shortfall penalty, or at a minimum 1 April 2006.

Comment

As noted earlier, an amendment was made last year, as a short-term measure, to deal with concerns about the breadth of application of the unacceptable tax position shortfall penalty.

In developing the discretion (the short-term solution) it was considered that if the penalty was reversed or not imposed, Inland Revenue should then be able to consider whether the taxpayer had taken reasonable care. Whether reasonable care has been taken is determined on a case by case basis.

The amendments to the unacceptable tax position penalty in the bill have not been made retrospective because the discretion enacted in 2006 (and repealed in this bill) was backdated to 1 April 2003 and therefore effectively dealt with cases where the imposition of that penalty was seen as unfair.

Cases where the Commissioner applied the discretion but which remained subject to a shortfall penalty were those to which the not taking reasonable care penalty could be applied. The proposed amendments are not intended to substantially change the application of this penalty and making the amendments to the unacceptable tax position penalty retrospective would not alter this position.

Recommendation

That the submission be declined.

Issue: Calculation and recording of numbers

Submission
(Matter raised by officials)

The exclusion from the unacceptable tax position penalty for tax shortfalls arising from mistakes in the calculation or recording of numbers in a return should be clarified to apply to working papers.

Comment

Currently, if a tax shortfall arises "merely by making a mistake in the calculation or recording of numbers in a return", the taxpayer is treated as not having taken an unacceptable tax position. Officials consider that the legislation should be clarified to also apply to working papers.

Recommendation

That the submission be accepted.

Issue: The threshold should not be removed

Submission

(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

The current threshold for the imposition of the shortfall penalty for an abusive tax position should not be repealed and the threshold should be at the same level as that for an unacceptable tax position shortfall penalty.

Comment

An abusive tax position is an unacceptable tax position (a tax position that is not "about as likely as not to be correct") that has a dominant purpose of reducing or removing tax liabilities or giving tax benefits.

As noted in the discussion document, *Tax penalties, tax agents and disclosures*:

> "While it is appropriate that the unacceptable tax position shortfall penalty has a threshold, as it would be overly onerous to apply this standard to all tax positions, this does not hold true for abusive tax positions. Although an abusive tax position is an unacceptable tax position, it is also at the more aggressive end of the non-compliance scale."[2]

The bill increases the threshold for the unacceptable tax position shortfall penalty from $20,000 to $50,000. Officials do not consider that it is appropriate for tax positions at the more aggressive end of the compliance scale, that fall below either $20,000 or $50,000, not to face shortfall penalties.

Recommendation

That the submission be declined.

[2] Paragraph 7.4

LATE PAYMENT OF PAYE

Issue: Issue should be removed from the bill

Submission
(91 – New Zealand Institute of Chartered Accountants)

NZICA has serious reservations about the PAYE proposals in the bill achieving a better or more equitable system. Taxpayers generally only fail to pay PAYE when they are in financial difficulties and adding penalties increases the debt, not the ability to pay.

The submission recommends that PAYE be withdrawn from the bill and further consultation undertaken with a view to including changes in the next available tax bill.

Comment

Currently, if an employer does not pay the PAYE deductions, the employer may face an evasion shortfall penalty of 150 percent. The bill proposes that a new graduated penalty replace the current shortfall penalty that applies when an employer files an employer monthly schedule but does not pay the PAYE. Under the proposal, Inland Revenue will contact the employer and if payment or an arrangement for payment is not made a penalty will be imposed. If payment is made or an instalment arrangement is entered into within a month of the penalty being imposed, the penalty will reduce by 50 percent. If the PAYE remains unpaid another penalty is imposed each month the PAYE remains unpaid.

This proposal has already been subject to consultation following the discussion document, *Tax penalties, tax agents and disclosures*. Several submissions supported the proposal, noting that it seemed fairer than the current penalty and would assist compliance with paying tax on time.

The proposal is aimed at encouraging employers to come forward and either pay the late PAYE or enter into an instalment arrangement. The proposal is intended to increase communication between the employer and Inland Revenue and we consider it should help employers to meet their obligations.

Recommendation

That the submission be declined.

Issue: Alignment with late payment penalty rules

Submission
(91 – New Zealand Institute of Chartered Accountants)

The PAYE penalty should be aligned with the general late payment penalty rules, thus treating PAYE debt no differently to other revenues when payment is made late. If the taxpayer ultimately does not pay, prosecution and/or liquidation action is the appropriate remedy.

Comment

Non-payment of PAYE is, and should be treated more seriously than failure to pay some of the other taxes, as PAYE places a special responsibility on the employer to effect payment on behalf of the employee. Currently, the non-payment of PAYE by an employer may be subject to a shortfall penalty of 150 percent for evasion. This bill replaces the shortfall penalty with a more graduated penalty system, aimed at increasing voluntary compliance by employers with the PAYE obligations. Inland Revenue still has the ability to prosecute and/or liquidate the employer if payment is not made.

Recommendation

That the submission be declined.

Issue: Level of penalty

Submissions
(91 – New Zealand Institute of Chartered Accountants)

The PAYE penalty should be limited to half that proposed, that is, 10 percent reduced to 5 percent if paid within 30 days and so on.

If the proposals proceed, any penalty should distinguish between small and large employers. The penalty for small taxpayers should be half that of large, more sophisticated, employers.

Comment

Officials agree with the submission that the PAYE penalty be reduced to half of that proposed. Reducing the penalty will, in our view, still assist voluntary compliance as the proposals intend.

In relation to the second submission, that the penalty should distinguish between small and large employers, the amount of the penalty assessed depends on the amount of PAYE not paid to Inland Revenue. Officials are not convinced that there is a strong case for imposing a lower penalty for one sector. Even so, the submission implies that a clear legislative distinction between small and large taxpayers would be needed. This definition would require more detailed consideration.

Recommendation

That the submissions be accepted in part, and the rate of the PAYE penalty be halved.

Issue: Application by receiver or liquidator

Submission
(61 – KPMG, 67 – McGrath Nicol Partners (NZ) Limited)

The new penalty should not apply if a receiver or liquidator files an employer monthly schedule showing PAYE payable for a pre-receivership/pre-liquidation period but cannot pay the PAYE because of insufficient funds.

Comment

Officials agree with the submission. One of the aims of the penalty is to encourage the employer to pay the PAYE and obtain more clarity about the consequences of not doing so. In the case of receivership or liquidation, imposing a penalty will not result in a change in taxpayer behaviour. Inland Revenue already has debt priority in relation to PAYE, which ensures that liquidators and receivers understand the importance of this obligation.

Recommendation

That the submission be accepted.

Issue: Circularity

Submission
(71 – PricewaterhouseCoopers)

It is not possible to apply the proposed section in its current form as the penalty is calculated by reference to the "due amount". However, the "due amount" includes the penalty amount.

Comment

As currently drafted, the proposal provides for subsequent impositions of the penalty to be based on the amount of PAYE not paid and any PAYE penalty imposed to date (the penalty compounds). As noted below, for reasons of simplicity and to ensure that the amount of the penalty does not accumulate too quickly, officials consider that the penalty should not compound. Officials therefore recommend the draft legislation no longer refer to "due amount".

Recommendation

That the submission be accepted in part, and no longer refer to "due amount".

Issue: Twice monthly PAYE threshold

Submission
(91 – New Zealand Institute of Chartered Accountants)

The thresholds for payment of twice-monthly PAYE should be lifted to better target larger taxpayers. While this is a simplification matter, it is also a penalty concern since PAYE and SSCWT obligations over $100,000 per year are required to be met 24 times a year, rather than 12.

Comment

This issue is outside of the scope of this bill, but is being considered by officials as part of work being undertaken in relation to compliance cost reduction for small and medium enterprises.

Recommendation

That the submission be noted.

Issue: Clarification of the provision

Submission
(Matter raised by officials)

The amendments should include further clarification of the process to be followed in administering the penalty.

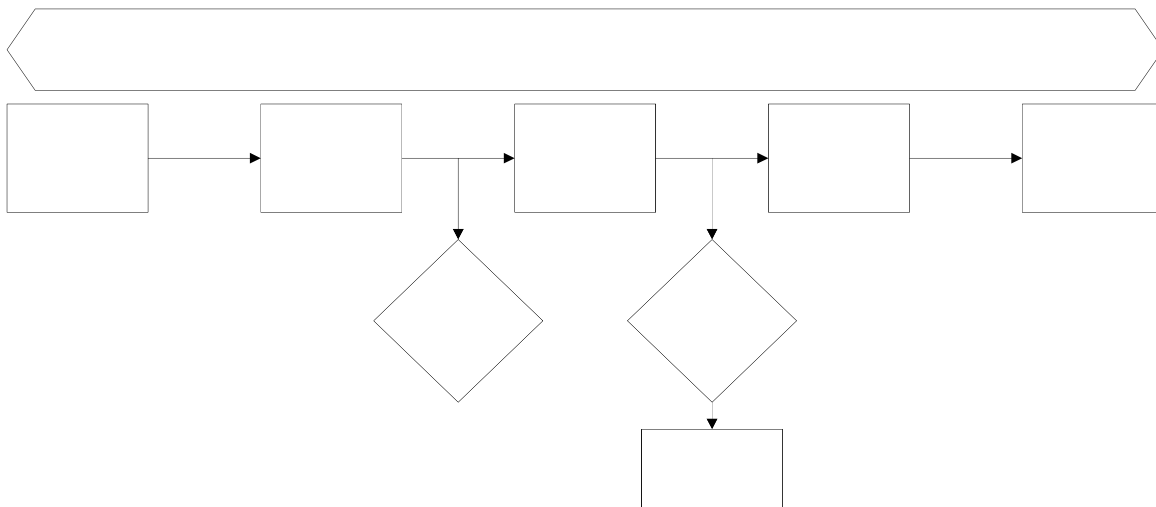
Comment

One of the basic tax obligations of employers is to withhold PAYE tax on behalf of their employees and pay the PAYE to Inland Revenue by specific dates. The current penalties that apply to defaulting PAYE obligations include late filing penalties, late payment penalties, shortfall penalties for evasion and prosecution.

This bill introduces a new penalty which will apply if an employer has filed an employer monthly schedule but not paid the PAYE. It is aimed at providing incentives to the employer to comply with their obligations.

Figure 1 illustrates how the penalty will apply:

FIGURE 1



Officials consider that the bill should be amended to clearly set out that:

- Inland Revenue will contact the employer two weeks after the PAYE was due, requesting payment (or that the employer enter an instalment arrangement) and set out the consequences in terms of the application of penalties if payment is not made;
- a month following the contact, the employer will be notified and the PAYE penalty will be imposed;

- the penalty apply to all amounts on the employer monthly schedule (not just PAYE); and
- another penalty will be imposed each month that the PAYE is not paid.

Currently, for the penalty to be imposed the employer monthly schedule must be filed on time. Officials consider that this requirement should be removed. To avoid the imposition of the penalty the employer only has to file the schedule a day late.

Under section 183F of the Tax Administration Act, penalties and interest do not apply to small amounts of tax. We consider that it should be made clear that this penalty also does not apply if the amount of the PAYE not paid is less than $100.

Under section 183A, certain penalties can be remitted if the penalty arises as a result of circumstances beyond the control of the taxpayer. In section 183D, certain penalties can be remitted if the Commissioner is satisfied that the remission is consistent with the Commissioner's duty to collect over time the highest net revenue. Officials consider that these remission provisions should also to apply this penalty.

Recommendation

That the submission be accepted.

VOLUNTARY DISCLOSURE REDUCTION

Issue: Proposal does not match publicity

Submission
(33 – Corporate Taxpayers Group, 54 – ASB, 74R – Deloitte)

The way the voluntary disclosure concession has been publicised does not match the way in which it has been implemented. The discussion document noted that "to increase the incentives for taxpayers to comply voluntarily, shortfall penalties payable when tax shortfalls are voluntarily disclosed before taxpayers are notified of pending audit or investigations will not be imposed". However, rather than ensuring the penalties are not imposed, the legislation still imposes the penalty but then reduces it by 100 percent.

Comment

Officials agree that the way the voluntary disclosure concession (which applies to the not taking reasonable care and the unacceptable tax position penalties) has been described does not exactly match the way it is being implemented. However, economically the result is the same.

By reducing the penalty by 100 percent, rather than not imposing it, the Commissioner has to first consider whether the taxpayer took reasonable care or an unacceptable tax position. If the Commissioner determines that the taxpayer has not taken reasonable care, there is then an opportunity to discuss with the taxpayer whether systems can be put in place to ensure that the same thing does not occur again.

It is also appropriate to first consider whether the penalty would apply, as it may indicate that there is a risk in that area which should be audited in the future.

In some cases, if a tax shortfall occurs repeatedly, it is possible that the taxpayer has been grossly careless. For the penalty for gross carelessness to apply it will be necessary for Inland Revenue to show that the taxpayer has "a complete or high level of disregard of the consequences".

Officials consider it important that filing a voluntary disclosure is not seen as a "rubber stamping" exercise and that taxpayers are still expected to take reasonable care when taking their tax positions.

Officials also consider that not imposing the penalty (rather than reducing it by 100 percent) gives the impression that there was no action of the taxpayer at fault, rather than giving the taxpayer credit for coming forward.

Recommendation

That the submission be declined.

Issue: Extension to other shortfall penalties

Submission
(39 – Owens Tax Advisors Ltd, 85 – Minter Ellison Rudd Watts)

The proposal regarding voluntary disclosures should also apply to "gross carelessness" or even all shortfall penalties. Inland Revenue will be more than compensated by use-of-money interest and it is inappropriate and counter-productive for any further penalty to apply.

Comment

The proposal in the bill is aimed at encouraging taxpayers to come forward and make voluntary disclosures. The proposal is aimed at the lower-end shortfall penalties and not the more serious gross carelessness, abusive tax position or evasion penalties. The current 75 percent reduction for shortfall penalties, which applies when taxpayers make voluntary disclosures before being notified of pending tax audits or investigation, will continue to apply to more serious penalties.

For a gross carelessness penalty to apply, the taxpayer must have a "complete or high level of disregard for the consequences" (of the actions in question). If the taxpayer takes tax positions that fall within the more serious categories it is appropriate that they be penalised for doing so.

Use-of-money interest compensates the Crown or the taxpayer for not having the use of their money and should not be regarded as a penalty.

Recommendation

That the submission be declined.

Issue: Reduction of abusive tax position shortfall penalty

Submission
(71 – PricewaterhouseCoopers)

The abusive tax position shortfall penalty of 100 percent of the tax shortfall should be reduced by, say, 50 percent where a taxpayer voluntarily discloses the tax shortfall amount. This would encourage the disclosure of these positions – for example, if a taxpayer has a change of staff or change of tax agent which triggers the identification of an abusive tax position.

Comment

As noted earlier, the legislation currently provides for a 75 percent reduction of all shortfall penalties if the taxpayer voluntarily discloses the tax shortfall before the taxpayer is notified of a pending tax audit or investigation.

The proposal in this bill increases the reduction to 100 percent if the tax shortfall arose because the taxpayer did not take reasonable care or took an unacceptable tax position. If the tax shortfall arose because the taxpayer was grossly careless, took an abusive tax position or evaded tax, the shortfall penalty would continue to be reduced by 75 percent. Given the more serious nature of the abusive tax position (having a dominant purpose of reducing or removing a tax liability or giving tax benefits), officials consider that this already provides the correct incentive for taxpayers to disclose these tax positions.

Recommendation

That the submission be declined.

Issue: Notification of audit

Submission
(91 – New Zealand Institute of Chartered Accountants)

The rules for pre-audit notification require an overhaul as there is no incentive for the Commissioner to give taxpayers a period of time within which to make a voluntary disclosure. A better way to express the rule may be to say that no shortfall penalty can be imposed at all unless a taxpayer is given a right of disclosure.

Comment

For a penalty to be assessed the taxpayer's actions must fail to meet a required standard.

Consistent with the self-assessment objective of the tax system, taxpayers' obligations are to take reasonable care when they take their tax positions – for example, when they file their returns, not when they have been warned by Inland Revenue that they may be audited.

Giving taxpayers a warning before notification of a pending audit greatly reduces the incentives for taxpayers to take reasonable care when taking a tax position.

Recommendation

That the submission be declined.

Issue: Use-of-money interest

Submission
(91 – New Zealand Institute of Chartered Accountants)

Use-of-money interest should be reduced to half the applicable rate for a tax shortfall that is voluntarily disclosed before notification of a pending tax audit or investigation.

Comment

This issue is outside of the scope of this bill.

Concerns in relation to use-of-money interest rates have already been raised with the Ministers of Finance and Revenue. Ministers have instructed officials to consider these matters further.

Recommendation

That the submission be noted.

Issue: Application date

Submission
(33 – Corporate Taxpayers Group, 34 – Toovey Eaton & Macdonald Limited, 39 – Owens Tax Advisors Ltd, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

Consideration should be given to going further in the retrospectivity of the voluntary disclosure rule to:

- 1 April 2003 (being the introduction of the unacceptable tax position shortfall penalty);
- 1 April 2006;
- 17 October 2006 (being the date the discussion document was released); or
- 7 March 2007 (being the date the Minister of Revenue made a media announcement acknowledging that the change would be included in the bill).

The Commentary on the bill states that the proposal once enacted will apply to voluntary disclosures made after the date that the bill was introduced, whereas the bill proposes that the reduction apply from 17 May 2007 (regardless of when the voluntary disclosure was made).

Comment

As mentioned earlier, an amendment (section 141KB) was enacted in 2006, giving the Commissioner discretion to reverse or not to impose the unacceptable tax position penalty in certain circumstances. This has addressed (from 1 April 2003) many cases where the imposition of the penalty for simple errors has been overly harsh. The discretion does not apply to the not taking reasonable care penalty, but given that this penalty is considered on a case by case basis, the issue of undue penalties does not arise to the same extent.

Since the Minister of Revenue's announcement on 7 March 2007, taxpayers have been aware that the rules were going to change. In some cases, taxpayers were prepared to risk the possibility of being audited before the bill was introduced and delayed making voluntary disclosures. If the proposal were backdated further, a number of cases where penalties have already been imposed would have to be re-examined.

Given this background and the fact that the law on voluntary disclosures has been clear, the case for further retrospectivity does not seem warranted.

However, officials agree that the legislation needs to be clarified. It was always intended that the proposal apply to voluntary disclosures made on or after the date the bill was introduced. The bill should be amended to make this clear.

Recommendation

That the submission for further retrospectivity be declined.

That the submission to clarify that the proposal apply to disclosures after introduction of the bill be accepted.

Issue: Consequential amendment

Submission
(91 – New Zealand Institute of Chartered Accountants)

The definition of "disqualifying penalty" should be amended to read:

> "(iii) is not reduced or eliminated for voluntary disclosure by the taxpayer; and"

It is unclear if the reference to "reduced" covers 100 percent reduction.

Comment

Officials disagree. If the proposal were amended to provide that the penalty was not imposed (as the submission has suggested), it might be appropriate to amend the legislation. However, the provision currently refers to "reduced" and officials consider that a 100 percent reduction of a penalty is a penalty that has been "reduced for voluntary disclosure by the taxpayer".

Recommendation

That the submission be declined.

Issue: Reduction for post-notification of audit voluntary disclosures

Submission
(91 – New Zealand Institute of Chartered Accountants)

The 40 percent reduction for "post-notification of audit" voluntary disclosures should be 75 percent for not taking reasonable care or unacceptable tax position shortfall penalties. The pre-audit notification process would be under less pressure if the post-audit notification reduction was 75 percent. Alternatively, the 75 percent reduction could apply instead of the 40 percent reduction when no pre-audit notification was made.

Comment

Officials consider that the 40 percent reduction given when a taxpayer voluntarily discloses a tax shortfall after being notified of a pending audit or investigation but before the audit begins, adequately reflects the administrative cost-saving of the disclosure. Voluntary disclosures at this time in general reflect a more moderate level of willingness to comply and the level of reduction needs to reflect this.

Recommendation

That the submission be declined.

Issue: Application to unacceptable interpretations

Submission
(Matter raised by officials)

The proposal to reduce the not taking reasonable care and unacceptable tax position shortfall penalties by 100 percent if the taxpayer makes a voluntary disclosure before notification of audit should be amended to also apply to the unacceptable interpretation shortfall penalty.

Comment

From 1 April 2003, the unacceptable interpretation shortfall penalty became the unacceptable tax position shortfall penalty. Officials consider that to encourage the voluntary disclosure of historical situations the legislation should be amended to cover the unacceptable interpretation penalty. This could be achieved by referring to the section numbers rather than the penalty names.

Recommendation

That the submission be accepted.

TEMPORARY SHORTFALLS

Issue: Time period

Submission
(91 – New Zealand Institute of Chartered Accountants)

The proposed two-year period for a shortfall to be considered temporary by being permanently reversed or corrected should be extended to four years.

Comment

Officials agree with the submission. Extending the time period to four years aligns the period with the period applicable to the previous behaviour reduction (section 141FB(4)) for taxes other than PAYE, FBT, GST and RWT.

Recommendation

That the submission be accepted.

Issue: Application date

Submission
(91 – New Zealand Institute of Chartered Accountants)

The amendment should be effective from 1 April 1997 (when the penalty rules were introduced). The amendment is taxpayer-friendly and is clarifying Inland Revenue practice. This would provide certainty for taxpayers.

Comment

The proposal is taxpayer-friendly. In part, it clarifies Inland Revenue practice. However, the requirement for the reversal to occur within a set period of two or four years may mean that taxpayers who had a shortfall penalty reduced would have their situations reviewed. This would also create unnecessary administration costs.

Recommendation

That the submission be declined.

Issue: Drafting of provision

Submission
(Matter raised by officials)

Section 141I(3) of the Tax Administration Act should be amended to clearly provide for instances when the shortfall has been corrected within the required period.

Comment

Sections 141I(3)(a) to (c) require that the shortfall be reversed, whereas section 141I(3)(d) anticipates that the shortfall has not yet been corrected. Officials consider that the section should be clarified to reflect that sections 141I(3) (a) to (c) apply when the reversal has taken place and section 141I(3)(d) when it has not.

Recommendation

That the submission be accepted.

Issue: Should apply to specific transactions

Submission
(91 – New Zealand Institute of Chartered Accountants)

The business group amnesty should be extended to specific transaction types, not just affected business groups.

Comment

The proposal is aimed at specific industries where tax evasion is a significant problem.

Basing the amnesty on a specific industry allows:

- the scope of the amnesty to be both limited and focussed on areas of concern;
- specific industries of concern to be "cleaned up";
- Inland Revenue to focus audit resources on that industry;
- all of the affected taxpayers to be identified;
- use of industry-based groups to facilitate education of their members.

These objectives are far less likely to be met if the proposal is focused on transaction types.

Officials are also concerned that if the proposal were extended to apply to specific transaction types there could be an unforeseen revenue risk to the government.

Recommendation

That the submission be declined.

Issue: Period in affected business

Submission
(91 – New Zealand Institute of Chartered Accountants)

The requirement for the person to be in the affected business throughout the period of three years before the end of the income year in which the amnesty becomes available should be replaced by the condition that the person has derived affected business income.

Comment

Under the proposal, a taxpayer who comes forward limits their exposure in terms of undisclosed income to the current year and the previous year.

By requiring that the taxpayer be in the affected business for the past three years the proposal will not apply to taxpayers who have exited the industry or to taxpayers who are new to the industry. The proposal is aimed at encouraging taxpayers to come forward, disclose income and then start complying – this will not be relevant if the taxpayer has left the industry and the taxpayer will not be part of an industry where evasion is a significant concern.

Officials consider that taxpayers who are new to the industry have limited need for an amnesty. The cost of coming forward is significantly less than for other taxpayers who have been in the industry for a long period.

Recommendation

That the submission be declined.

Issue: No need to disclose assets and liabilities

Submission
(91 – New Zealand Institute of Chartered Accountants)

The requirement for a person to provide a statement of assets and liabilities for the income year ending before the income year in which the amnesty becomes available is excessive and unnecessary for an amnesty disclosure. The requirement for an asset and liability statement is associated with a full Inland Revenue-instigated audit and is not a requirement for a person making a voluntary disclosure. Therefore it should not be a requirement of an amnesty disclosure.

Comment

It is appropriate that taxpayers who come forward provide the Commissioner with the information necessary to quantify their taxable income for the period in question. One method used to measure the amount of income not disclosed is asset accretion. Under this method the taxpayer's assets and liabilities at the beginning of the period being audited are compared with the assets and liabilities at the end of the period. The income disclosed is then subtracted and, allowing for certain factors such as the cost of living and inheritances, any increase in net assets is treated as undisclosed income.

Disclosing the taxpayer's assets and liabilities will also assist the Commissioner to determine the taxpayer's ability to pay tax on the undisclosed income. For example, the statement of assets and liabilities might set out bank account details or assets that could be sold.

Recommendation

That the submission be declined.

Issue: Information request too far-reaching

Submission
(91 – New Zealand Institute of Chartered Accountants)

The requirement to provide "any other information required by the Commissioner" is an excessive request and too far-reaching. The requirement should be restricted to the provision of information in respect of the amnesty the person is applying for, not an unfettered information requirement. Information requirements, other than those that relate directly to the amnesty, should be the domain of formal requests.

Comment

Officials disagree. The draft legislation follows the precedent of similar provisions in the Tax Administration Act 1994 which require information to be provided to the Commissioner.

Case law prevents Inland Revenue going on "fishing expeditions". Inland Revenue can only request information for the purpose of administering the Inland Revenue Acts.

Recommendation

That the submission be declined.

Issue: Debt repayment programme offered

Submission
(91 – New Zealand Institute of Chartered Accountants)

A debt repayment programme should be offered as part of the amnesty, so that it is clear to the tax evader at the outset what the payment arrangement will be. The ability to pay the debt assessed, under amnesty conditions, is an important consideration for a tax evader in deciding whether to come forward.

Comment

The amnesty proposal is aimed at encouraging taxpayers to come forward and disclose income from industries where tax evasion is a significant concern. The Commissioner has practices in place to provide payment arrangements that take into account the circumstances of the taxpayer. It is considered that this is the appropriate response to all debt, irrespective of whether it arises from an amnesty or otherwise.

Recommendation

That the submission be declined.

Issue: Application to taxpayers who have made disclosures before amnesty begins

Submission
(91 – New Zealand Institute of Chartered Accountants)

The amnesty should extend to taxpayers who belong to the targeted industry and make a voluntary disclosure, purely of their own accord, not long before a limited amnesty begins for their industry. Under section 226B(4)(d), the proposal is that anyone already being audited by Inland Revenue would not be eligible to participate. Although we understand that it is important to provide a clear boundary of eligibility, this may result in an unfair result in some circumstances.

Comment

Officials agree that it is necessary to have a clear boundary setting out the taxpayers who are eligible to come forward under an amnesty. While there may be situations where it would be possible for a taxpayer who has made a disclosure before an amnesty to be treated more harshly than a taxpayer who has the benefit of the amnesty, the legislation cannot sensibly address this without a substantial blurring of the boundary. Consistency of treatment is an issue that should be determined where possible by the Commissioner.

Recommendation

That the submission be declined.

Issue: Types of taxes covered

Submission
(91 – New Zealand Institute of Chartered Accountants)

The legislation should make it clear that all tax types are covered by the amnesty, including the social policy measures that are determined by income and administered through the tax system (family assistance, child support and student loans).

Comment

As previously noted, under the amnesty proposal, a taxpayer who comes forward limits their exposure in terms of undisclosed income to the current year and the previous year. The discussion documents, *Options for dealing with industry-wide tax evasion* and *Tax penalties, tax agents and disclosures* and the Commentary on this bill all commented on the effect coming forward under an amnesty would have in relation to social policy programmes.

As noted in the discussion document, *Options for dealing with industry-wide tax evasion*:

> "Similar considerations apply to social policy programmes based on assessed taxable income, such as family assistance, child support and student loans. Although a limit on the number of past years that are reassessed for income tax purposes means some assessments may never reflect an evader's real income, if an amnesty could bring the evader into the tax system it would mean that more accurate assessments could be made for the most recent years and would continue to be made in the future. Custodial parents who received underpaid child support from a tax evader over a number of years might be better off receiving the correct amount in future years – rather than waiting in vain for underpaid child support from the past that may not be collectible."[3]

And the Commentary on the bill noted:

> "Any consequential effects of disclosing income for family assistance, student loans and child support liabilities will also be included in the assessment."[4]

Officials therefore note that the current proposal already allows the Commissioner to extend the amnesty to all tax types, including social policy measures that are determined by income.

Recommendation

That the submission be declined.

Issue: Application of amnesty to all income

Submission
(91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

The requirement in section 226B(1) that the amnesty relates to a business group, where the type of activity is the person's "main business" should be amended to "significant part of their business". If the amnesty's scope only covers undisclosed income from the nominated industry, it will not be attractive to a person under-declaring tax in a variety of industries.

Comment

In developing this proposal officials considered the option of applying the amnesty to income from the specific industry or to all of the taxpayer's income. We consider that there is a revenue risk if the amnesty applies extensively to income from other sources. While we appreciate that applying the amnesty only to income from a particular source reduces the incentives for taxpayers to come forward but consider this to be a necessary trade-off in introducing the proposal.

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[3] Paragraph 1.10
[4] Page 89

Recommendation

That the submission be declined.

Issue: Commitment to audit activity

Submission
(91 – New Zealand Institute of Chartered Accountants)

Inland Revenue should commit to undertaking audit activity in the business group after the amnesty finishes. There will be little incentive to disclose errors if it is perceived there is no likelihood of discovery at a later date.

Comment

Officials agree with the submission. The discussion documents, *Options for dealing with industry-wide tax evasion* and *Tax penalties, tax agents and disclosures* and the Commentary on this bill all commented that following an amnesty the affected industry would be subject to increased audit and any tax shortfalls detected would face the full range of penalties and other sanctions provided in the legislation.

Officials agree with the submission but consider that including such a commitment in the legislation is unnecessary.

Recommendation

That the submission be noted.

Issue: Disclosure of the nature of the mistake

Submission
(91 – New Zealand Institute of Chartered Accountants)

Section 226B(5) should include a requirement for the person to state the nature of the mistake, non-disclosure or error. There needs to be a requirement for the person to disclose the nature of the mistake, otherwise the only way Inland Revenue can determine the adjustment required is through a tax audit. The mistake could be something as simple as rebates from a particular source not being declared, which should be able to be adjusted without an audit being carried out.

Comment

Officials agree with the submission, including a requirement for the person to disclose why the adjustment is necessary may result in the adjustment being made without a complete audit taking place.

Recommendation

That the submission be accepted.

Issue: Benefiting from more than one amnesty

Submission
(95 – New Zealand Law Society)

The requirement that a taxpayer not have benefited from a previous amnesty (proposed section 226B(4)(c)) should be removed. The Commissioner can ensure that taxpayers do not benefit from more than one amnesty by framing the terms of each amnesty so that there is no overlap.

Comment

Officials disagree with the submission. The taxpayer may change occupations and thus qualify under a subsequent amnesty for another industry with the overall concessional tax treatment becoming substantial.

Recommendation

That the submission be declined.

Issue: Prosecution by other Crown entities

Submission
(95 – New Zealand Law Society)

The proposal should be extended to prevent all Crown agencies (not just the Commissioner) from instituting a prosecution.

Comment

Under section 226B(9), the Commissioner must not prosecute the taxpayer (under the Tax Administration Act or any other Act). Officials consider that it is not appropriate to limit the Crown’s ability to take legal action under other statutes for non-tax related matters, merely because the taxpayer has come forward under a tax amnesty.

In addition, under the secrecy provisions, the Commissioner would be prevented from disclosing to other agencies information gathered under an amnesty. This would make the submission's proposal unworkable.

Recommendation

That the submission be declined.

Issue: Revenue-neutral transactions should not be subject to shortfall penalties

Submission

(39 – Owens Tax Advisors Ltd, 91 – New Zealand Institute of Chartered Accountants)

Revenue-neutral transactions, particularly between associated persons, should not be subject to shortfall penalties. When a transaction or event is revenue-neutral there is by definition no tax "shortfall". An example is the circumstance when a taxpayer identifies an error and discloses this to Inland Revenue before any tax credit or refund or other loss of revenue.

Comment

The aim of the shortfall penalties legislation is to encourage taxpayers to take correct tax positions, rather than to pay their tax on time which is covered by the late payment penalty.

There are a number of situations where there is no loss to the revenue yet it is appropriate to impose a shortfall penalty. For example, consider a company that is in a loss situation which does not take care in taking its tax positions. Because the company is carrying forward losses there is no loss to the revenue. It may, however, be appropriate to impose a shortfall penalty for not taking reasonable care. If the company's actions were able to be considered under the shortfall penalty rules, it would be treated differently from a company which is in a profit situation merely because the first company had accumulated losses.

The example noted in the submission will be dealt with by the voluntary disclosure proposal in the bill.

Recommendation

That the submission be declined.

Issue: Review of proposals

Submission

(39 – Owens Tax Advisors Ltd, 91 – New Zealand Institute of Chartered Accountants)

It is strongly recommended that the Finance and Expenditure Committee schedule a review of the shortfall penalty rules after a period of enactment of 12 or 18 months to ensure they are being applied as intended and that if there is any departure then appropriate amendments can be considered.

Comment

As part of the ongoing review of the compliance and penalties legislation, officials will monitor the amendments to ensure they meet their objectives and will respond to specific issues as they arise.

Recommendation

That the submission be noted.

Company tax rate consequentials

OVERVIEW

Clauses 9, 80, 92, 93, 97 to 99, 108(1), (2) and (4), 109, 110, 112 to 116, 117(2), 119(2), 121 to 128, 130, 134, 135(30) and (35) and 178 to 181

The Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007 reduced the company tax rate, the tax rate for widely held savings vehicles and the top rate for portfolio investment entities from 33% to 30%. The bill makes a number of consequential and transitional amendments relating to the tax rate reduction.

Currently, the maximum imputation and dividend withholding payment (DWP) credit ratio is 33/67. Without transitional provisions, a reduction in the company tax rate would cause the maximum ratio to fall to 30/70, thereby disadvantaging some taxpayers where the underlying company tax has been paid at the 33% rate. The bill introduces a transitional imputation period from the start of the 2008–09 income year to 31 March 2010. During this period companies will be able to allocate credits at the maximum 33/67 ratio as long as they have unused credits relating to tax paid at 33%.

Nine submissions discussed the transitional and consequential amendments. Most were supportive but considered that the period allowed for imputation and DWP credits to be imputed at 33/67 was too short. There were also strong representations that the RWT rate for dividends should be reduced to 30%, and a number of detailed submissions on other matters.

TAX RATES

Issue: Support for reduced company tax rate

Submissions
(23 – Investment Savings & Insurance Association of NZ Inc, 24 – AMP Financial Services & AMP Capital Investors (NZ) Ltd, 33 – Corporate Taxpayers Group, 49 – Contact Energy Ltd, 61 – KPMG, 71 – PricewaterhouseCoopers, 74R – Deloitte, 84 – New Zealand Chambers of Commerce, 91 – New Zealand Institute of Chartered Accountants)

The submissions are very supportive of the reduced company tax rate and the rates for savings vehicles.

Recommendation

That the submissions be noted.

Issue: Company, trust and individual tax rates generally

Submissions
(33 – Corporate Taxpayers Group, 61 – KPMG, 71 – PricewaterhouseCoopers, 84 – New Zealand Chambers of Commerce, 91 – New Zealand Institute of Chartered Accountants)

Further reductions to the company tax rate are required in the medium-term. *(Corporate Taxpayers Group, KPMG, PricewaterhouseCoopers, New Zealand Chambers of Commerce)*

Other tax rates, such as the individual and trust tax rates, should also be reviewed. *(Corporate Taxpayers Group, KPMG, PricewaterhouseCoopers, New Zealand Chambers of Commerce, New Zealand Institute of Chartered Accountants)*

A clear and early signal should be made by the government about the future of personal and trust tax rates. *(New Zealand Institute of Chartered Accountants)*

The government should signal very clearly its intentions in respect of personal tax rates. *(PricewaterhouseCoopers)*

The submission expresses disappointment that the 2005 decision to inflation-adjust income tax thresholds has been abandoned. *(New Zealand Chamber of Commerce)*

Comment

These submissions on further company tax cuts, and personal and trustee marginal tax rates are outside the scope of the bill.

Recommendation

That the submissions be noted.

Issue: Transitional period for imputation and DWP credits

Submission
(71 – PricewaterhouseCoopers)

The submission supports the transitional period, from the start of the 2008–09 income year to 31 March 2010, for allocating imputation and DWP credits up to a maximum ratio of 33/67.

Recommendation

That the submission be noted.

Submissions
(23 – Investment Savings and Insurance Association of NZ Inc, 24 – AMP Financial Services & AMP Capital Investors (NZ) Ltd, 33 – Corporate Taxpayers Group, 49/49B – Contact Energy Ltd, 61 – KPMG, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The transitional period for allocating imputation and DWP credits at a maximum ratio of 33/67 should be extended indefinitely, or for at least 5 or 10 years.

Comment

Generally, the submissions consider that companies should be able to decide when distributions of pre-2008–09 profits, which are represented by the 33/67 imputation credits, should be made, and that those decisions should be made in the interests of the company and its ongoing business, rather than for tax-driven reasons.

Submissions expressed concern about the two-year transitional period and its effect on companies' current plans to reinvest profits. They consider that the transitional period needs to be sufficient to allow investment and growth cycles to be worked through and that the two-year window is insufficient. They argue that the proposed transitional rules will create an incentive to distribute company profits earlier than would otherwise have happened to ensure that 33% credits will not be trapped within the company, or alternatively, that profits will not be available for distribution because of reinvestment plans.

Further, NZICA argues that the proposed legislation, in effect, requires two accounts to be maintained and tracked, and that therefore there is no compliance or audit reason for limiting the period over which the 33/67 credits can be used. They consider that because it creates additional compliance costs, a company would only continue with two separate imputation accounts if there were good commercial reasons for not distributing profits by way of dividends.

Officials understand that companies' dividend distribution decisions over the transitional period could impact on their reinvestment plans. There are three responses to this:

- The transitional period really begins in May 2007 so that the window for the use of the credits is really almost three years.
- Companies will have the option to distribute credits during the transitional period while still retaining the underlying cash, by making taxable bonus issues. While this is not a complete or totally satisfactory answer, it does provide a further alternative to paying cash dividends.
- The fact that pre-31 March 2008 profits are not distributed before the end of the transitional period does not necessarily mean that excess credits will be trapped. Any excess credits may still be able to be attached to distributable reserves that have not borne tax in the company's hands. However, officials acknowledge that in some cases if the 33/67 credits are not distributed by the end of the transitional period a portion may be trapped.

If relief was to be allowed for a significantly longer period, officials consider that a dual imputation system would be required, whereby tax paid at the 30% rate would need to be recorded in a separate account from that paid at the 33% rate. Credits paid at the 33% rate would have to be used before the 30% pool could be allocated. Such a system would have higher compliance and administration costs than the proposal included in the bill. Further, if there are subsequent company tax rate reductions, three or more different accounts may be required.

The government chose a two-year simplified transition for the 33/67 credits. This allows companies an option on whether they credit at 33/67 or the new standard ratio of 30/70. A number of companies will go straight to 30/70 because that will be in their shareholders' interests – in particular, this could happen when the company tax is effectively a final tax, as it will be for most savings vehicles.

The current proposals do not require dual accounts to be formally maintained, and officials do not consider that they should, because of the compliance and administration cost issues involved. However, officials note that if companies elect to impute at 33/67 in the transitional period they will need to keep sufficient extra records to be able to confirm they had not overdrawn their 33/67 credits as at 31 March 2010.

It is also noteworthy that Australia has had three company tax rate changes since it introduced its franking rules and has had different transitional arrangements for each change. There is no obvious right answer.

Officials consider that a transitional period that ends on 31 March 2010 provides the best balance between providing relief and minimising compliance and fiscal costs. We recommend that the transitional period should not be extended beyond 31 March 2010.

Recommendation

That the submissions be declined.

Issue: Transitional timeframe and balance dates

Submission
(33 – Corporate Taxpayers Group, 49 – Contact Energy Ltd)

For companies with September balance dates, the transitional period will be only 18 months. This is a reason why the transition period should be extended. *(Corporate Taxpayers Group)*

As a June balance date taxpayer, it should be noted that under the bill, Contact will have only 21 months to distribute imputation credits at the 33/67 ratio. *(Contact Energy Ltd)*

Comment

Companies have known since May 2007 (when the bill was introduced) that the transition period would end on 31 March 2010. Therefore, it is not correct to say that the transition period is less than two years. It is, however, correct that with regard to their last few 33% tax payments, later balance date companies will have this shorter period.

After discussions with submitters, officials believe that this late balance date effect does not seem to be the major problem. Rather, the problem is with companies that have a bank of credits because they have not fully distributed their past tax paid profits. This is dealt with in the preceding submission.

Recommendation

That the submissions be declined.

Issue: Technical complications with transition

Submission
(Matter raised with officials by Russell McVeagh)

That section ME 8, which sets the maximum imputation credit ratio, and proposed section MZ 10, which overrides this for the transitional period, do not achieve the desired outcome.

Comment

Where a company paying a dividend has a late balance date and a dividend is paid between 1 April 2008 and the company's balance date, the ratio is inappropriately limited to 30/70. We agree with the submission and recommend that the imputation year reference in section ME 8 (and similar sections MG 8 and 12) be removed.

Recommendation

That the submission be accepted.

Issue: Maximum credit ratios

Submission
(71 – PricewaterhouseCoopers)

The words “income” and expenditure” should be deleted from proposed sections MZ 10(1)(b) of the Income Tax Act 2004, and section 140BB(1)(a) of the Tax Administration Act 1994.

Comment

The submission argues that including the two words could cause confusion in circumstances where a company:

- has an imputation account credit balance as at 31 March 2008, but no retained earnings at that date; or
- receives a dividend with a 33/67 imputation credit attached to it, with the dividend being taxed at 30%.

A company referred to under the first bullet point should be able to retain the imputation credits, while in the second case, the full imputation credit should be available to be allocated to dividends paid to the underlying shareholders.

Officials will clarify the drafting.

Recommendation

That the submission be agreed in principle.

Issue: Clarification of policy

Submission
(74R – Deloitte)

The bill provides that tax paid in connection with the “old” company rate (33%) can give rise to imputation credits distributable at the 33/67 ratio. On the face of it because the rate of RWT is not connected with the rate of company tax, the fact that RWT will still be withheld at 33% will not give rise to imputation credits that can be allocated at the 33/67 ratio. We would appreciate clarification of this point.

Comment

We agree that the treatment of pre-and post- tax rate change RWT credits should be clarified. RWT deducted at 33% when the 33% tax rate applied, should result in 33/67 imputation credits.

However, where the 30% tax rate applies, RWT deducted at 33% should not be regarded as 33/67 credits, as the surplus 3 cents will be refundable.

Recommendation

That the submission be accepted.

Issue: Dividends received by companies and other 30% tax entities

Submission
(91 – New Zealand Institute of Chartered Accountants)

The formula in section MZ 13, which caps the imputation credit to 30% for taxpayers whose tax rate is 30%, should be modified or deleted.

Alternatively, if section MZ 13 is not deleted, it is inconsistent with New Zealand's imputation model to gross the dividend up by an amount greater than the credit that is ultimately allowed in respect of the dividend.

Comment

Section MZ 13 prevents an intermediate company, which pays tax at 30%, from being able to use the additional 3% credit to shelter other income that would be taxed at 30%.

Section MZ 13 correctly reflects the policy intent.

Recommendation

That the submission be declined.

QUALIFYING COMPANY ELECTION TAX (QCET)

Submission
(61 – KPMG, 91 – New Zealand Institute of Chartered Accountants)

The QCET change should apply from the beginning of the 2008–09 year.

Comment

The current application date is 17 May 2007, the date when the bill was introduced and the change was announced.

Tax avoidance measures, like the one subject to the submission, generally apply from the date when they are announced. If a later application date applied, taxpayers may be able to take actions that would negate the effect intended.

Officials consider, therefore, that the application date should not be deferred.

Recommendation

That the submission be declined.

RESIDENT WITHHOLDING TAX ON DIVIDENDS

Issue: Review of RWT

Submission
(33 – Corporate Taxpayers Group, 61 – KPMG, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The suggested review of RWT on dividends is supported.

Recommendation

That the submission be noted.

Issue: Rate of RWT on dividends

Submission
(33 – Corporate Taxpayers Group)

In time, a comprehensive RWT regime (similar to that applying to interest) should be introduced for dividends.

Comment

This submission will be considered as part of the review.

Recommendations

That the submission be noted.

Issue: Interim RWT rate on dividends

Submissions

(23 – Investment Savings & Insurance Association of NZ Incorporated, 24 – AMP Financial Services and AMP Capital Investors, 33 – Corporate Taxpayers Group, 49 – Contact, 54 – ASB, 61 – KPMG, 74R – Deloitte)

RWT on dividends should be reduced to 30%.

Comment

The submissions point out that retaining the 33% RWT rate for dividends means that all fully imputed dividends will now be subject to RWT, which may add compliance costs for companies.

Officials understand that listed companies will incur extra administration costs, but the present systems they use to pay their dividends will allow for the deduction of RWT at 33%. Also, small companies may have no RWT deduction systems in place, but their shareholders will often be 33% taxpayers and RWT at 33% is appropriate.

However, it seems that a number of unit trusts and group investment funds that pay dividends have no RWT systems in place because to date they have only paid fully imputed dividends and therefore have not needed to deduct RWT.

There seems to be agreement that no one RWT rate on dividends is appropriate. However, we agree with the savings industry that it seems inappropriate to require widely held unit trusts and group investment funds to implement systems to account for RWT at 33/67 when the RWT system will be reviewed. Other than this, we recommend that the rate stay at 33/67.

Recommendation

That the general RWT rate be 33/67, but that widely held unit trusts and group investment funds that have not previously accounted for RWT on dividends be allowed to account for it at 30/70.

GENERAL SUBMISSIONS

Issue: Excess imputation credits for individuals

Submission
(33 – Corporate Taxpayers Group)

An individual's excess imputation credits should be refunded.

Comment

In 1988, when the company imputation system was introduced, it was decided that excess imputation credits would not be refunded, because of the revenue cost of doing so.

The government is in the process of putting together its tax policy work programme for the coming year and the priority of the wider imputation credit review will be determined in that context. This submission should be considered as part of this review.

Recommendation

That the submission be noted.

Issue: Sole traders and partnerships

Submission
(61 – KPMG, 91 – New Zealand Institute of Chartered Accountants)

Sole traders and partnerships should be permitted to restructure as companies without this action being considered as "tax avoidance". *(KPMG)*

Parliament and Inland Revenue should make a clear statement that the change in the company tax rate is intended as an incentive to incorporation. *(New Zealand Institute of Chartered Accountants)*

Comment

These submissions appear to be making the same point – that it be stated that incorporation of a business is not tax avoidance per se.

In a very high portion of cases the restructuring of a business into a corporate form cannot be considered as "tax avoidance". However, applying the tax avoidance provisions may be considered if the restructuring results in the alienation of income that is essentially income from personal services. For example, medical professionals who corporatise their private practice and then appear to have a low taxable income may have to justify whether their use of this structure is appropriate from a taxation perspective.

We will clarify this issue in a subsequent *Tax Information Bulletin* following enactment of the legislation.

Recommendation

That the submission be declined, but the point be clarified.

Issue: Roll-over relief for re-structured businesses

Submission
(91 – New Zealand Institute of Chartered Accountants)

Statutory relief should be provided to allow unincorporated businesses to convert to companies without tax consequences.

Comment

Sole traders, trusts and partnerships of individuals and trusts, may wish to restructure their businesses as companies to benefit from the reduced company tax rate. By itself this is likely to be acceptable from a tax policy perspective (see officials' comment on the previous submission).

However, under normal tax rules, this type of restructuring could cause tax costs – for example, by way of income arising from depreciation recovery, profit on disposal of livestock or trading stock, disposal of growing trees, or income and expenditure from financial arrangements.

Livestock, trees and depreciable assets are likely to be the significant items from the taxpayers' perspective. The vendor (the individual or the trust) will have to dispose of these items at market value and often their tax book carrying value is significantly less, with the result being significant taxable income. Further, the company will either not get a corresponding tax write down, or that write down will happen over time.

These tax consequences could be avoided if there was a transitional period during which these assets could be transferred into a new company at tax book value. This is frequently called a "roll-over".

There could be a policy problem with the transfer of trees into companies – the individual has presumably taken the deductions by this stage at their marginal rates, and the corporatisation of the trees may result in the eventual income upon harvest not being taxed at the individual's marginal tax rate. However, this is a specific concern that could be dealt with separately if necessary.

The general policy concern with a roll-over approach is that it would set a precedent for business restructuring to be treated in this way in the future. Changes to entity-specific tax rules occur every so often and there appears little justification to provide roll-over relief in this situation and not others. Further, roll-over relief has the potential to be fiscally expensive. The corporatisation of a business is often part of the business's life cycle and generally the private sector is able to plan for this.

Recommendation

That the submission be declined.

Issue: Taxation of fully imputed dividends

Submission
(33 – Corporate Taxpayers Group)

Fully imputed dividends received by shareholders in widely held companies should be taxed at a maximum rate of 30%.

Comment

The submission points out that shareholders in widely held companies can achieve the maximum tax rate of 30% by investing in portfolio investment entities and certain other widely held collective investment vehicles. While officials acknowledge that this is technically correct, the reduction in the tax rate for those vehicles was made to encourage savings and introduce more neutral tax treatment of different savings and corporate entities.

Officials are concerned that there is a boundary issue in allowing fully imputed dividends received by shareholders of widely held companies to be taxed at 30%. The objective of the 30% tax rate for portfolio investment entity investors is to increase collective savings, which are generally longer term savings – taxing individuals' and trusts' dividends as final income at 30% will not necessarily achieve this.

In addition, the fiscal cost of the change in tax rate is likely to be high.

Recommendation

That the submission be declined.

Issue: Attribution rule for personal services

Submission
(74B – Deloitte)

Imputation credits under section ME 4(1)(ab), which provides for credits to arise when income is attributed from an intermediary company to the relevant individual under the attribution rule for personal services, should remain at 49.25% of the amount attributed, when the company is owned by a trust. Alternatively, dividends paid from income that has been attributed to shareholders could be exempt from tax.

Comment

The attribution rule is an anti-avoidance rule designed to ensure that wage earners cannot avoid the 39% tax rate by channelling their income through a company or a trust. It does this by treating, in defined circumstances, the person providing the personal services as deriving the income that would otherwise be derived by the intermediary company or trust.

Some double taxation can occur when the attribution rule is applied to income derived by a company because the cash still has to be extracted from the company as dividends. Section ME 4(1)(ab) partially or fully relieves, depending on the circumstances, the double taxation that could otherwise occur.

With the change in the company tax rate to 30% the imputation credit that arises under the section will be reduced to 42.86%, consistent with the new maximum imputation credit ratio of 30/70.

If the attribution applies to a year before the change in the company tax rate, the applicable rate should remain at 49.25%. This is achieved because the change to section ME 4(1)(ab) applies in relation to income attributed in the 2008–09 and later income years.

The submission asks that the deemed credit remain at 33/67 permanently. However, this will not, in the absence of other changes, achieve the submissions desired outcome as after 31 March 2010 dividends can only be imputed at 30/70. Officials do not support allowing the maximum imputation credit to be maintained at 33/67 indefinitely, because that rate is not consistent with the new company tax rate.

However, we consider that it would be possible to provide relief by exempting the dividends if a company paying a dividend meets certain criteria. Relief would be provided by ensuring that dividends paid by eligible companies were either fully imputed or exempt from tax. This proposal is consistent with the tax treatment of qualifying companies. Where a company elected to be subject to this treatment, a credit would not arise under section ME 4(1)(ab).

Relief would apply when a company's only activity was the one from which the income had been attributed. Also, it would be acceptable if it earned some incidental interest. However, if the company engaged in other activities, dividends would be subject to tax in the normal way, and a credit would arise under section ME 4(1)(ab). This would prevent the proposed treatment being manipulated to gain unintended benefits.

Recommendation

That the submission be accepted, and that relief be allowed by providing that dividends paid by eligible companies in relation to amounts attributed be exempt from tax using the qualifying company exemption mechanism.

Issue: Branch equivalent tax accounts (BETAs)

Submission
(33 – Corporate Taxpayers Group)

Notwithstanding the international tax review proposals, BETA credit balances should remain available to allow for future repatriation of profits taxed at 33%.

Comment

The future repatriation of profits will be taxed at 30% and the BETA amendment adjusts the BETA balances to reflect this.

Recommendation

That the submission be declined.

Issue: Drafting

Submission
(74R – Deloitte)

Doubling-up of numbering in new subpart MZ should be corrected.

Comment

This is simply a consequence of the fact that two tax bills were introduced at the same time. As part of the standard enactment process this will automatically be resolved.

Recommendation

That the submission be noted.