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Special report from the
Policy Advice Division of Inland Revenue

Repeal of the research and development tax credit

As part of the recently enacted Taxation (Urgent Measures and Annual Rates) Act 2008, the research and development tax credit has been repealed from the 2009-10 income year. The tax credit remains in place for the 2008-09 income year. This special report is intended to help claimants who have early balance dates and their advisors to understand the legislative consequences of the repeal. A more detailed account of the legislation will be published in a *Tax Information Bulletin* to be published in 2008.

Background

A 15% tax credit for eligible expenditure on R&D activities was introduced in 2007, with effect from the 2008-09 income year.

The subsequent repeal of the tax credit was foreshadowed in the 2008 general election campaign. As the explanatory note of the Taxation (Urgent Measures and Annual Rates) Bill explained

“ . . . The Government’s objective in repealing the tax credit is to move towards a broad-based low-rate tax system, which will improve the quality of investment and reduce distortions.

Removing the R & D tax credit will also partially fund the reduction in personal tax rates. The Government considers the benefits of reducing tax rates are certain, whereas the benefits of the R&D tax credit are less certain.

The Government is concerned that much of the credit will fund R&D that would have occurred in any case, the compliance costs associated with claiming the credit are high and that the credit will be paid out on standard operating expenditure re-characterised as R & D related expenditure.”

Key features of the legislation

Main repeal (sections LH 1 to LH 6, LH 8 to LH 14, and LH 16, YA 1, YB 20(2)(ob) and schedule 21 of the Income Tax Act 2007)

The provisions that determine eligibility for the tax credit and that calculate the value of the tax credit have been repealed from the 2009-10 income year.

Expenditure on activities that take place in the 2009-10 or subsequent income years will not be eligible for the tax credit.

Example – Effect on research and development projects

F Co starts a two-year R&D venture in the 2008-09 income year that includes activities that meet the definition of eligible R&D activities in each year. The eligible expenditure and depreciation loss totals \$350,000 in the 2008-09 income year. In that year F Co incurs \$100,000 on activities carried out in New Zealand and \$250,000 on activities carried out in Australia. The activities continue into the 2009-10 income year, and the firm incurs \$300,000 of expenditure on activities carried out in New Zealand that would have been eligible for the tax credit had the credit not been repealed.

F Co can claim the R&D tax credit for the eligible New Zealand expenditure and depreciation loss for the 2008-09 income year, but not for any portion of the overseas expenditure or depreciation loss for that year (since more than half of the eligible expenditure or depreciation loss must be incurred in New Zealand). Expenditure in the 2009-10 income year is no longer eligible for a tax credit.

Consequential amendments repeal schedule 21 and the definitions of “district health board”, “industry research co-operative”, “listed research provider”, “overseas eligible expenditure”, “research and development project” and “tertiary institution” from section YA 1. For simplicity, the repeal date of the schedule and these definitions is aligned with the last possible date of the 2008-09 income year.

Deferred or carried forward expenditure (sections LH 2 and LH 6(5) of the Income Tax Act 2007)

Expenditure on activities carried out in the 2008-09 income year that would have been eligible for a tax credit only in a subsequent year will no longer be eligible.

Therefore an adjustment made in the 2008-09 income year, under section DB 50 of the Income Tax Act 2007, for unpaid expenditure on employment income will not be eligible when the deferred income is paid out in a subsequent period. Similarly, overseas eligible expenditure that has to be carried forward from the 2008-09 income year because the claimant has insufficient local expenditure on the same R&D project in that year will no longer be eligible for the tax credit.

Example – Eligible overseas expenditure

A New Zealand company, G Co, incurs eligible expenditure of \$1 million on R&D activities carried out in New Zealand in the 2008-09 income year. In the same year it also incurs eligible expenditure of \$400,000 on R&D conducted overseas on the same R&D project.

In the following year it incurs expenditure of \$500,000 on work in New Zealand as part of the same R&D project, which would have been eligible for a tax credit had the tax credit not been repealed.

G Co can claim the R&D tax credit for the local expenditure in the 2008-09 income year and on any overseas expenditure incurred that year that is equal to 10% of the New Zealand eligible amount, which in this case is \$100,000. The other \$300,000 of overseas expenditure is not eligible for a tax credit in the 2008-09 income year or in subsequent years.

Listed research providers (sections LH 15 of the Income Tax Act 2007)

The provisions that relate to a listed research provider (LRP) will be repealed from 1 October 2009. That will allow claimants, including those with late balance dates, to use the exception to the minimum threshold for eligible expenditure paid to a non-associated LRP.

Administration (sections 3(1), 33A(2), 43A(2), 91AAP, and 108(1B) of the Tax Administration Act 1994)

Consequent to the main repeal, provisions no longer necessary to administer the tax credit have been repealed. The definition of “response period” in section 3(1) has been amended because the time periods that relate to claims for the 2010-11 and subsequent income years are no longer necessary. A similar amendment has been made to section 108(1B). Sections 33A(2)(db) and 43A(2)(d)(iib) have been repealed from the 2009-10 income year. Section 91AAP is repealed from the date that the provision was initially enacted.

A number of administrative and definition provisions have been retained so that the tax credit can continue to be administered for the 2008-09 income year.

Future changes

Proposed remedial amendments to the R&D tax credit rules in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, introduced in July 2008, will be progressed where they are relevant for the year the tax credit is in force.

Tax policy officials are also working on possible changes to align the R&D tax credit rules with the policy intent of the concession for the year it is in place in the following areas:

- the eligibility of government agencies for the R&D tax credit;
- capitalised expenditure;
- the treatment of revenue account property; and
- administrative issues.