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Briefing note

Reference: BN2017/673

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To: Revenue Advisor, Minister of Revenue – s 9(2)(a) [redacted]
Private Secretary, Minister of Revenue – [redacted]

From: Keith Taylor

Subject: **Further information on the tax treatment of Research and Development**

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1. The Minister of Revenue, in a comment on report IR2017/596, has requested information on how research and development (R&D) is treated under the New Zealand tax system.

Allowable as a deduction

2. Research and development expenditure is deductible for tax purposes provided that:

    - The expenditure has been incurred in deriving income or in the course of carrying on a business for the purpose of deriving income; and
    - The taxpayer treats the amount as an expense for accounting purposes by applying the asset recognition criteria contained in financial reporting standard NZ IAS-38.

<u>NZ IAS-38</u>

3. Under NZ IAS-38, expenditure on "research" is expensed, while expenditure on "development" is expensed until the entity can establish that 6 criteria are met, in which case the expenditure is capitalised and depreciated. The recognition of an asset is a high threshold, resulting in the majority of development expenditure being expensed.

4. NZ IAS-38 defines "research" as "original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge or understanding." The term "development" is defined as "the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use."

Loss continuity

5. A person that has incurred R&D expenditure may choose to allocate all or part of the deduction to a later income year. This ensures that deductions for R&D are not lost under the shareholder continuity rules for carrying forward losses when companies bring in new equity investors.

Loss-cash out

6. Start-up companies are able to receive a payment up to 28 percent (the current company tax rate) of their tax losses from research and development expenditure in any given year, instead of carrying the losses forward to a future tax year.

7. A cashed-out loss is effectively an interest-free loan from the Government to be repaid from the taxpayer's future income.

8. To be eligible, a company must be a loss-making company resident in New Zealand, with a sufficient proportion of labour expenditure on research and development.

9. The amount of losses that can be cashed out has been capped as follows:

Tax year	Amount of loss	Cash-out value
2015-16	$500,000	$140,000
2016-17	$800,000	$224,000
2017-18	$1.1 million	$308,000
2018-29	$1.4 million	$392,000
2019-20	$1.7 million	$476,000
2020-2021 onwards	$2 million	$560,000

Previous R&D tax credit

10. A tax credit for research and development was enacted in 2008, but repealed in 2009.

Black hole expenditure

11. Black hole expenditure is business expenditure of a capital nature that is not immediately deductible for tax purposes and does not give rise to a depreciable asset, so cannot be deducted as tax depreciation over time.

12. Amendments were made in 2014 to allow deductions for certain black hole R&D expenditure, such as expenses incurred for the purpose of applying for a patent.

Capital gains tax and R&D

13. New Zealand does not have a comprehensive capital gains tax. This indirectly incentivises R&D as when a business ultimately decides to sell its idea, it is not subject to tax.

Implications of New Zealand's approach to R&D

14. As we do not have a tax credit for R&D expenditure, businesses have no incentive to separate out from other deductions the amount spent on R&D. This means that the amount spent on R&D may be under-reported to Statistics New Zealand.

Consultation with Treasury

15. Treasury was informed about this briefing note.

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9(2)(a) [redacted]