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WEEKLY COMMENT: FRIDAY 16 MAY 2014

1. The Government's 2014 Budget was announced yesterday and included two new tax measures to support business R&D. The Minister of Science and Innovation, Hon Steven Joyce, said:

   "The Government is targeting an increase in business R&D to 1 per cent of GDP to help build long-term growth and prosperity for New Zealand. As part of that we want to reduce tax hurdles that discourage R&D investment by innovative companies."

2. The tax initiatives are part of the Building Innovation stream of the Government's Business Growth Agenda, and will mean:

   (a) R&D-intensive start-up companies will have early access to all or part of their tax losses in the form of a cash receipt, rather than carrying these losses forward; and

   (b) All businesses will be allowed tax deductibility for R&D "black hole" expenditure that is currently neither deductible nor able to be depreciated:

      (i) Capitalised costs on depreciable, intangible assets (for example, patents) will be deductible over time whereas, at present, only the legal and administrative costs of registering the assets are treated as depreciable; and

      (ii) A one-off tax deduction will be allowed for capitalised development expenditure on intangible assets that are written-off for accounting purposes, thereby relieving "black hole" expenditure on R&D projects that ultimately turn out to be unsuccessful.

3. This week I look at the initiative to allow R&D-intensive companies to cash-out their tax losses. Next week I look at the initiatives relating to black hole R&D expenditure. The topics covered this week are:

   (a) Cashing out R&D tax losses;

   (b) Eligibility criteria;

   (c) Cap on cash-outs;

   (d) Claw-back of cash-outs;

   (e) Administration;

   (f) What has not yet been specified.

Cashing out R&D tax losses

4. Innovative start-up companies will be able to "cash-out" an amount of their tax losses arising from qualifying R&D expenditure. This means that instead of carrying the tax loss forward to apply against future assessable income, the company will receive a cash payment. The policy is to apply to income years beginning on or after 1 April 2015.

5. I reviewed *R&D tax losses – An officials' issues paper* (the "R&D IP") released in July 2013 in *Weekly Comment* 23 August 2013 and *Weekly Comment* 30 August 2013. The measures proposed in the Budget are largely as proposed in the R&D IP.

Eligibility criteria

6. The Budget measures apply only to companies. However, consistent with the R&D IP, the company cannot be a look-through or qualifying company, special corporate entity or publicly listed on a stock exchange.

7. There are several references to "innovative start-up companies" in the *Fact Sheet – Cashing-out research and development tax losses* ("the Fact Sheet") released by Inland Revenue in conjunction with the Budget. However, that term is not defined.

8. The Fact Sheet contains two main eligibility criteria:

   (a) 20% of a company's wage and salary expenditure must be on R&D (the wage intensity threshold). This includes expenditure on shareholder salaries, contracted labour and 66% of contracted R&D but does not include sweat equity (i.e. a party's contribution to a project in the form of effort, as opposed to financial equity, which is a contribution in the form of capital). Interestingly, shareholder salaries are included. In the R&D IP Officials prefer to exclude shareholder salaries unless they are subject to PAYE tax deductions, because Inland Revenue cannot monitor total expenditure on salaries and wages other then through the PAYE system.

   (b) A company must be carrying out eligible research and development, the definition for which will be consistent with that used by the relevant accounting standard (NZIAS 38 *Intangible Assets*). This is consistent with the proposals in the R&D IP.

9. If the company is in a group, the group must also meet the tax loss requirement and wage intensity threshold.

10. Consistent with the R&D IP, certain activities, that generally take place later in the R&D process, are excluded from being 'qualifying R&D' for the purposes of the tax loss cash out rules. Expenditure on interest and purchases of existing R&D assets will also not qualify. It is stated in the Fact Sheet that excluded activities and expenditure will be similar to those listed in the R&D IP, and will be confirmed shortly after the 2014 Budget. Refer to paragraphs 18 and 19 of *Weekly Comment* 23 August 2013 for a summary of excluded activities and expenditure in the R&D IP.

Cap on cash-outs

11. Innovative start-ups will be able to cash-out up to $500,000 of eligible tax losses in the first year of the initiative (under a company tax rate of 28% this is equivalent to a cash-out of $140,000). This cap will rise by $300,000 each year up to an eventual maximum of $2 million (a cash-out of $560,000 per year). The initial $500k cap and the eventual $2m cap are as

proposed in the R&D IP, although the annual increments of $300k were not previously specified.

Claw-back of cash-outs

12. Companies that eventually earn assessable income will return the value of the cashed-out loss through taxes paid on that income. This is because the tax losses that would otherwise have been available have already been used for the cash-out. It was noted in the R&D IP that there would be no further recovery unless the sale of the IP is taxable under some other provision – such as the sale of patents and the supply of know how.

13. Companies that make a successful return on their investment through a non-taxable capital gain will have their cashed-out losses reinstated as losses to carry forward by repaying the value of the cashed-out loss out of the gain made. It is stated in the Fact Sheet that the value of the cashed out loss would be reinstated as research and development expenditure to be allocated to subsequent years to align with the setting that allows R&D losses to survive a continuity breach.

14. Companies that make a capital return will trigger a "loss recovery event", where the value of the cashed-out loss is recovered. This would take place when:

    (a) The company sells intellectual property;

    (b) 90% of the company's shares are sold;

    (c) The company becomes non-resident (for tax purposes); or

    (d) The company is liquidated.

15. The proposal in the R&D IP that a sale of shares in excess of 5% would be a loss recovery event has apparently not been proceeded with. However, the company becoming non-resident and liquidation were not considered in the R&D IP.

Administration

16. It is stated in the Fact Sheet that:

    "The administration of the initiative is still under consideration. Officials are working to create a process that enables these innovative start-ups to easily comply with the requirements of the policy. How the initiative is administered will be determined shortly after the 2014 Budget."

17. In relation to the administration, it was noted in the R&D IP, and discussed in paragraphs 24 to 28 of *Weekly Comment* 30 August 2013, that:

    (a) Some new boxes would need to be added to the IR 4 company tax return to facilitate the claim for tax losses to be refunded;

    (b) Inland Revenue would require a new Statement of R&D Activity and Expenditure to be filed within 30 days of the income tax return being filed; and

    (c) The imputation rules and the IR 4J would need to be changed so that the tax refund would not result in penalties for debit balances;

    (d) Processing claims could involve an initial screening of the Statement of R&D followed by further investigation, if warranted.

What has not yet been specified

18. The R&D IP contained a number of other proposals to limit the amount that could be cashed out. Companies would be eligible to carry forward any losses in excess of the amount cashed out to future years.

19. There was a proposal to use a multiplier of 1.5 on eligible R&D salary and wage expenditure so as to effectively allow for other (non-salary and wage) R&D expenditure. In other words, eligible companies would be able to cash out tax losses up to the amount of 1.5 times their salary and wages expenses on R&D.

20. The total tax losses available to be cashed out would be limited to the company's tax loss for the year or its qualifying R&D expenditure.

21. In summary, the proposal in the R&D IP was that companies that qualify for the cash-out would be able to cash out the least of:

    (a) 1.5 times their eligible salary and wage expenditure in the relevant year;

    (b) Their total tax loss in the relevant year;

    (c) Their total qualifying R&D expenditure in the relevant year; and

    (d) The tax loss cap that applies for that year.

22. The R&D IP contained some fairly detailed information requirements to be provided in the Statement of R&D to establish eligibility by detailing the nature of the R&D activity and the amount of qualifying expenditure. The information required was to include:

    (a) Details of the R&D activity that show it meets the accounting definition of R&D;

    (b) Evidence that the R&D is being undertaken in New Zealand;

    (c) Salary and wage expenditure that relates to R&D activity; and

    (d) Details of the company grouping, ownership and shareholding.

23. It remains to be seen what limits, other than the cap, will apply to the cash-outs, and what the information requirements will be. It was recognised in the R&D IP that there would be additional compliance costs, but this was seen as acceptable in the light of the benefits to taxpayers as a result of the cash-outs.

Arun David, Director

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