



WEEKLY COMMENT: FRIDAY 23 AUGUST 2013

1. This and next week I look at *R&D tax losses – An officials’ issues paper* (the “R&D IP”) released in July 2013. Submissions close on 30 August. The central proposal is to allow R&D-intensive start-up companies to cash out their tax losses, subject to a number of requirements and constraints.
2. This week I look at the current rules, and the types of R&D activities and expenditure that will be excluded when calculating the eligibility for the cash out concession.

The current rules

3. A person can choose to apply section DB 34 of the *Income Tax Act 2007*, which provides for a deduction for expenditure incurred on research and development by a person who:
 - (a) Recognises the expenditure as an expense for financial reporting purposes under paragraph 68(a) of NZIAS 38 applying paragraphs 54 to 67 of NZIAS 38; or
 - (b) Recognises the expenditure as an expense for financial reporting purposes under paragraph 5.1 or 5.2 of FRS 13 or because paragraph 5.4 of FRS 13 applies; or
 - (c) Recognises the expenditure as an expense for financial reporting purposes because it is an amount that is written off as immaterial, and would be required to recognise the expenditure as an expense for financial reporting purposes if it was not immaterial; or
 - (d) Incurs expenditure of \$10,000 or less, in total, on research and development in an income year and has written off the expenditure as immaterial for financial reporting purposes, and has recognised the expenditure as an expenses for financial reporting purposes.
4. Section DB 34 does not allow a deduction for expenditure incurred by a person on property to which all of the following apply:
 - (a) The property is used in carrying out research and development; and
 - (b) The property is not created from the research and development; and
 - (c) The property is one of the following kinds:
 - (i) Property for which the person is allowed a depreciation deduction; or
 - (ii) Property for which the cost can be amortised other than by depreciation; or
 - (iii) Land; or
 - (iv) Intangible property other than depreciable intangible property; or
 - (v) Property that the owner chooses under s. EE 8 to treat as not depreciable.

5. When a person has incurred expenditure to which s. DB 34 applies, the person may, instead of deducting the expenditure in the year in which it was incurred, choose to carry all or part the expenditure forward and deduct it in a later income year, subject to meeting the requirements in s. EJ 23, which also applies to depreciation on an asset used for research or development. Under s. EJ 23, a person must allocate the deduction to an income year:
 - (a) In which the person derives income that would not have been derived but for:
 - (i) The expenditure carried forward; or
 - (ii) The use of the asset in relation to which depreciation has been carried forward; or
 - (b) To which a loss balance could be carried forward from the year the expenditure or depreciation was incurred under the loss carry forward rules in Part I.
6. The minimum expenditure or depreciation that must be allocated to an income year is the lesser of:
 - (a) The income derived in the income year; and
 - (b) The remaining unallocated deductions or depreciation.
7. The maximum expenditure or depreciation that must be allocated to an income year cannot exceed the greater of:
 - (a) The income derived in the income year; and
 - (b) Losses able to be carried forward to the current year from other income years (income years other than the one in which the R&D expenditure or depreciation carried forward arose).
8. It is noted in paragraph 2.8 of the R&D IP that s. EJ 23 was introduced to recognise that many R&D firms introduce additional equity during the R&D process, as a result of which tax losses could be extinguished due to a failure to maintain the requisite shareholder continuity.
9. The expenditure that is deductible is related back to the relevant accounting standard. Paragraph 68 of NZIAS 38 requires expenditure on an intangible item to be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria (or was acquired as part of a business combination and cannot be recognised as an intangible asset). Under paragraph 18 of NZIAS 38, in order to be recognised as such, an intangible asset must meet the definition of an intangible asset in paragraphs 8 to 17, and also meet the recognition criteria.
10. The primary requirements for recognition, in paragraph 21 of NZIAS 38, are that: it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and the cost of the asset can be measured reliably.
11. Under paragraph 54 of NZIAS 38, no intangible asset arising from research (or from the research phase of an internal project) can be recognised. This is because in the research phase of an internal project an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred. Examples given of research activities are:
 - (a) Activities aimed at obtaining new knowledge;

- (b) The search for, evaluation and final selection of, applications of research findings or other knowledge;
 - (c) The search for alternatives for materials, devices, products, processes, systems or services; and
 - (d) The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.
12. Under paragraph 57, an intangible asset arising from development (or from the development phase of an internal project) can be recognised only if the entity can demonstrate all of the following:
- (a) The technical feasibility of completing the intangible asset, so that it will be available for use or sale.
 - (b) Its intention to complete the intangible asset and use or sell it.
 - (c) Its ability to use or sell the intangible asset.
 - (d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
 - (e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
 - (f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.
13. Examples given of development activities are:
- (a) The design, construction, and testing of pre-production or pre-use prototypes and models;
 - (b) The design of tools, jigs, moulds and dies involving new technology;
 - (c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
 - (d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.
14. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be recognised as intangible assets, because expenditure on such items cannot be distinguished from the cost of developing the business as a whole.
15. In addition, the following are specifically excluded, by paragraph 67 of NZIAS 38, from being part of the cost of an internally generated intangible asset:
- (a) Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;
 - (b) Identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and
 - (c) Expenditure on training staff to operate the asset.

16. It is noted in paragraph 2.9 of the R&D IP that profits from the sale of successful R&D are generally not taxed. The sale of companies which own the successful R&D is considered to be a sale of capital. The exceptions are income from royalties or income from the sale of patents which are taxable.

R&D expenditure for the purposes of the tax loss cash out rules

17. It is proposed that the existing definitions of research and development in paragraph 8 of NZIAS 38 are used:

- *Research* is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- *Development* is 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.

18. However, 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:

- (a) Prospecting and exploring for minerals, petroleum, natural gas or geothermal energy;
- (b) Research in social sciences, arts or humanities;
- (c) Market research, market testing, market development, or sales promotion including consumer surveys;
- (d) Quality control or routine testing of materials, products, devices, processes or services;
- (e) Making cosmetic or stylistic changes to materials, products, devices, processes or services;
- (f) Routine collection of information;
- (g) Commercial, legal and administrative aspects of patenting, licensing or other activities;
- (h) Activities involved in complying with statutory requirements or standards;
- (i) Management studies or efficiency surveys;
- (j) The reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information;
- (k) Pre-production activities such as a demonstration of commercial viability, tooling-up and trial runs;
- (l) Clinical trials; and
- (m) The late stages of software development (for example coding).

19. Officials have also specified, in paragraphs 5.29 to 5.32 of the R&D IP, some types of expenditure that should not be included as either qualifying R&D expenditure or as expenditure on wages on R&D activities:

- (a) Interest expenses related to R&D: officials are of the opinion that including interest expenses would encourage debt financing over equity financing;
- (b) Purchases of existing R&D assets: officials view is that R&D expenditure could be artificially inflated by buying and selling existing R&D assets;

- (c) R&D undertaken offshore: officials are concerned about potential re-characterisation risks;
- (d) Lease payments: Officials are concerned that leasing could be preferred over acquiring capital items with debt resulting in a type of “pseudo debt financing”;
- (e) Expenditure funded by government grants or research funding.



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