BUDDLE FINDLAY

Legal alert - Research and development tax incentive

Tony Wilkinson, Steve Nightingale, Philip Wood, Allan Yeoman, Amy Ryburn

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The Government released proposed legislation last week to encourage start-up companies to engage in research and development (R&D) by allowing them to 'cash-out' their tax losses arising from those activities from 1 April 2015. The proposed tax relief is targeted at start-up companies (particularly for those involved in software development).

Current loss regime

Typically, a company making losses in excess of income is able to carry these losses forward to reduce future taxable income. The ability to carry these losses forward is often of little immediate value for small start-up companies operating under substantial financial constraints (because these companies will not receive any actual savings until they are earning income and paying tax).

It is proposed that tax losses related to certain types of expenditure on R&D will be refundable in the income year they are incurred, rather than carried forward to future income years.

How does the proposed regime work?

Under the proposed rules, the tax relief will in general be made available for any New Zealand resident companies that make a tax loss in an income year (or part of a corporate group making an overall tax loss), and where at least 20% of the company or group's labour costs relate to certain types of R&D activities performed in New Zealand (note that different weight is given to contractors and employees costs in calculating whether the 20% threshold is met). Certain types of companies are excluded, including listed companies and look-through companies.

The total amount of any cash refund will be calculated as 28% of the eligible losses. The maximum amount of losses that may be cashed out in an income year will be determined by the lowest of:

- Company's total tax losses for the income year
- Company's R&D expenditure for the income year
- 1.5 times the company's eligible R&D labour costs in the income year.

The amount of losses that can be cashed out is to be capped at $500,000 initially, but rising incrementally to a maximum of $2 million over five years.

Under the proposal, the cashed-out loss is in effect an interest-free loan from the Government and must be repaid from the company's future taxable income. It is currently proposed that the cashed-out loss should be repaid and the tax losses will be reinstated in certain circumstances, including when:

- The company makes a return on their investment by disposing of or transferring R&D assets
- The company migrates
- If more than 90% of ownership in the company has changed since the company first cashed-out R&D tax losses.

In conjunction with the introduction of the R&D tax incentives, the Government is also revising the rules to allow deductions for certain types of black-hole R&D expenditure that is currently non-deductible.

Implications for business

It is encouraging to see that the Government is recognising the importance of innovation to help grow New Zealand's economy. We expect that the proposed rules will be welcomed by business.

The proposed legislation has remedied some of the deficiencies in the rules proposed in the Officials' Issues Paper, *R&D Tax Losses*, issued in July 2013. However, questions remain as to whether measuring the losses that may be cashed up by reference to labour costs may inadvertently deny worthy start-up companies from accessing the proposed tax relief (particularly given start-up companies generally pay employees at below-market rates in the first few years of the company's existence due to cash constraints). The exclusion of expenditure incurred at "late stage" software development activities also raises uncertainty as to the extent of the benefit that the proposed tax relief may actually deliver to start-up companies.

Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659