



**Inland Revenue**  
Te Tari Taake

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# Research and Development Tax Incentive: Guidance



# Introduction

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The Research and Development (R&D) Tax Incentive is part of the Government's strategy to increase the amount of R&D done in New Zealand. The R&D Tax Incentive operates as a tax credit and for clarity that is how we'll refer to it in this guidance material.

The key features of the R&D tax credit include:

- a 15% tax credit available from the beginning of a business' 2020 tax year
- a minimum R&D expenditure threshold of \$50,000 per year
- a \$120 million cap on eligible expenditure
- a definition of R&D intended to ensure accessibility across all sectors
- refundability for businesses in loss or with more R&D credits than income tax liability, capped at an amount based on the labour-related taxes they or other companies in the same group pay.

## What the guidance material in this document does

The R&D tax credit is available from the beginning of a business's 2019-20 income year. Our website will be progressively updated as R&D services become available. To find the latest information go to [ird.govt.nz/research-and-development](http://ird.govt.nz/research-and-development) or visit the R&D Hub website at [rdti.govt.nz](http://rdti.govt.nz)

The information you'll find in this document is intended to help you understand the intent and application of the R&D tax credit.

The situation of a taxpayer will always be fact specific and eligibility will depend on the detail of their situation. We have tried to cover a range of scenarios, but the following material is necessarily of a general nature and cannot cover all factual circumstances. If you are unclear on how the law applies to your circumstances, you are advised to seek specific advice from a qualified professional.

If you have reviewed the guidance and still have questions you can raise them with us on [R&DTIteam@ird.govt.nz](mailto:R&DTIteam@ird.govt.nz)

## Comment welcomed

Although the R&D tax credit regime has already been established, we intend to periodically update this document to reflect future legislative changes and lessons from implementing the scheme.

The main feature of this update is the inclusion of new material in response to questions we've received from stakeholders on various topics, including the interaction between the tax credit and the wage subsidy, clarification on claiming overhead expenditure, and further guidance on how to claim the credit as a joint venture. It also contains some updates to the operational sections on claiming the tax credit, to reflect further progress on operational design.

We welcome feedback from users to improve the next update. You can provide feedback on the Loomio forum at [govt.loomio.nz/rdtaxcredit](http://govt.loomio.nz/rdtaxcredit) or by email to [R&DTIteam@ird.govt.nz](mailto:R&DTIteam@ird.govt.nz)

## Policy intent

The Government has set a target of raising the total amount of R&D performed in New Zealand to 2% of gross domestic product (GDP) by 2028. To meet this goal, there needs to be a significant increase in the amount of business R&D performed in New Zealand.

By providing a tax incentive in the form of a tax credit, the Government will lower the cost to businesses of performing R&D. This will create an incentive for firms already performing R&D to do more, and for other firms to start undertaking R&D.

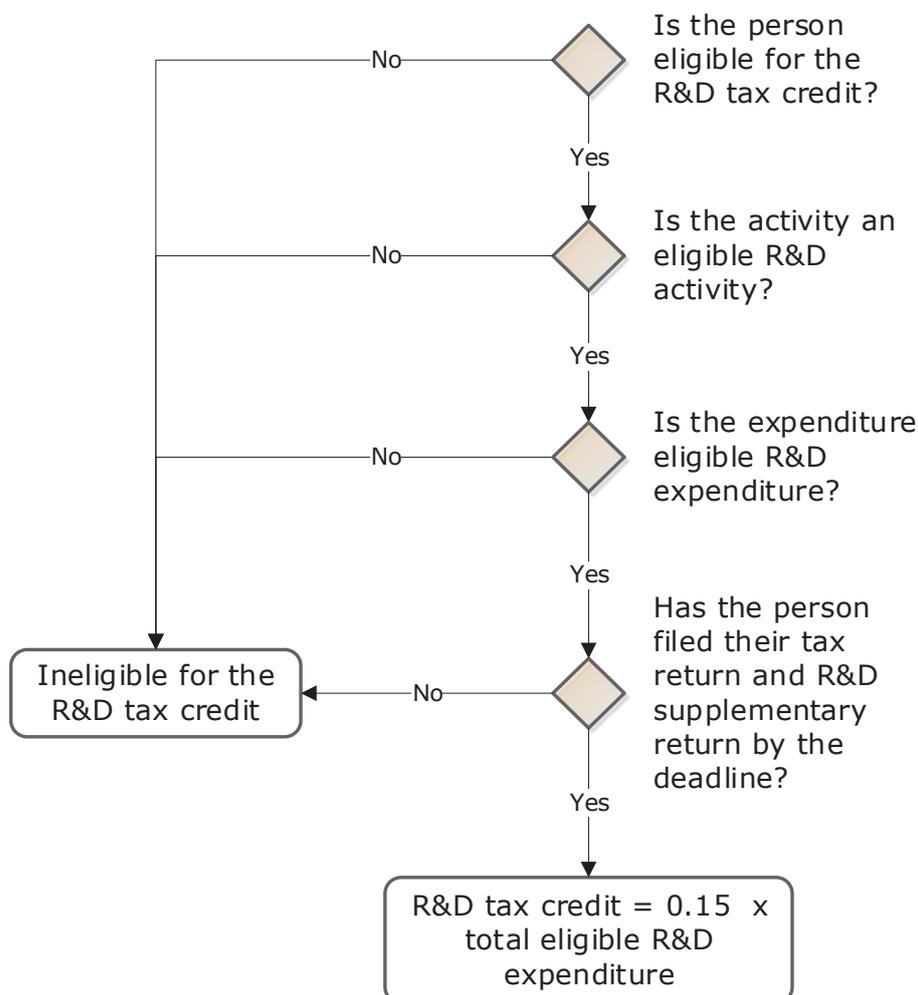
The rationale for providing R&D tax credits to businesses is that there is under-investment by businesses in R&D because the investing firm does not capture all the benefits of the investment. Some of the benefit is captured by other businesses or consumers, rather than by the investing firm. The tax credit is intended to provide an offset for the likely spill-over benefits to other firms and individuals in New Zealand. This is expected to help transform the New Zealand economy into a high-skill, knowledge-based, and productive economy. The tax credit will be evaluated in 5 years to determine its effectiveness in meeting these objectives.

A tax credit has been selected as the instrument for providing the subsidy because of the wide reach of the tax system. The tax system also provides greater certainty than a grant-based approach because firms can access support based on predefined rules.

## Quick overview of eligibility

The flowchart below provides a quick overview of eligibility requirements for the tax credit. Or go to **Research and development not supported by the tax credit** on the next page.

### Outline of R and D incentive policy



# Research and development not supported by the tax credit

This section covers some key situations where R&D is **not** eligible for the tax credit.

## R&D activity

Just because it is called R&D does not mean it meets the definition of an eligible R&D activity. The tax credit is intended to encourage development which goes beyond what is known can be achieved with existing knowledge. As well as creating something new, your development must involve a plan to push beyond what is currently known.

Some situations where an activity will not meet the definition are listed below.

## Development based on existing knowledge

A critical part of the definition of an R&D activity is the requirement that it must seek to resolve scientific or technological uncertainty.

You must be trying to do something that a competent professional in that field is uncertain can be done. If others have successfully done what you are trying to do, your work will not be eligible for the tax credit - unless the knowledge of how to do it was still a trade secret.

The test is not merely that no-one in your business knows how to achieve your goal, or no one in New Zealand has done it before, but that the knowledge is not publicly available anywhere (in the world). You must be able to show that you searched for an existing solution before you claim for your R&D activity.

The development of a new product, system or process (even if that is novel and innovative) is ineligible if someone who knows how to do those sorts of things (a competent professional) could use existing knowledge to identify, in advance, an approach which can be used to successfully develop it. It is only where a competent professional is uncertain whether existing knowledge/technology can achieve the goal, and a systematic process must be undertaken to evaluate possible solution(s), that work can qualify for the tax credit.

For more information go to the section on **Research and development (R&D) activity** (starting on page 33).

## Research in some fields is excluded

Research into some fields, including the following, is automatically an excluded activity:

- social sciences (including economics)
- arts
- humanities (for example historical or psychological research)
- investigating the market for your product or service.

For more information go to the **Activities excluded from being a research and development (R&D) activity** section on page 51.

## Business structure

Most private businesses based in New Zealand will be eligible for the tax credit. However, you will not be able to claim the tax credit if any of the following apply.

- The R&D is performed for other parties.
- You received a Callaghan Growth Grant in the same income year (there is a limited exception for businesses with a late balance date in the 2020-21 income year).
- You're associated with or controlled by a Crown Research Institute, district health board, or tertiary education organisation (including those based overseas), or Callaghan Innovation.
- You derive certain sorts of exempt income. Find out more about eligible entities on page 21.

For more information on what to do if you want to move from the Growth Grant to the tax credit refer to page 24.

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# Overview of the research and development tax credit

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## Eligible entities

You must be an eligible entity to claim the research and development (R&D) tax credit. Private sector businesses are generally eligible. Other entities such as industry levy bodies may also qualify for the R&D tax credit. Some restrictions apply to entities that are owned or funded by the Crown.

## General eligible entity criteria

You are an eligible entity if you both:

- perform a core R&D activity in New Zealand yourself or through an R&D contractor in New Zealand
- carry on a business through a fixed establishment in New Zealand.

You must also either:

- own the results of your R&D activities (or a member of your corporate group, who is a resident in New Zealand or located in a jurisdiction New Zealand has a double tax agreement with, owns the results)
- be able to use the results of your R&D activities for no extra cost.

Partnerships, look-through companies and joint ventures are eligible for the tax credit if they meet certain conditions (pages 31 and 32).

## Filing requirements

To make a claim you need to meet filing requirements. You must file both your:

- **Research and development (R&D) supplementary return** within 30 days of the latest filing due date for your income tax return
- income tax return within 1 year of the latest filing due date for your return.

## Minimum threshold

You must also satisfy the minimum expenditure threshold. This requires you to have eligible R&D expenditure of at least \$50,000.

Expenditure incurred with an approved research provider is not subject to the minimum threshold.

## Ineligible entities

You cannot claim the R&D tax credit if any of the following apply to you.

- You are an entity which derives tax-exempt income under any of the following sections of the Income Tax Act 2007: CW 38 (public authorities), CW 39 (local authorities), CW 40 (local and regional promotion bodies), CW 41 or 42 (charities), or CW 55BA (tertiary education institutions), and you are not a levy body researcher.
- You receive, or are directly or indirectly controlled by, or associated with a person receiving a Callaghan Innovation Growth Grant for the same income year. There is a limited exception for businesses with a late balance date in the 2020-21 income year.
- You are, or are associated with or controlled by, a Crown Research Institute, a district health board, a tertiary education organisation (including overseas tertiary education organisations), or Callaghan Innovation.
- You are an R&D contractor in relation to the relevant R&D activity for a person who carries on a business through a fixed establishment in New Zealand.
- You are a member of a joint venture, a partner in a partnership, or an owner of a look-through company, and are not a New Zealand tax resident in the tax year.

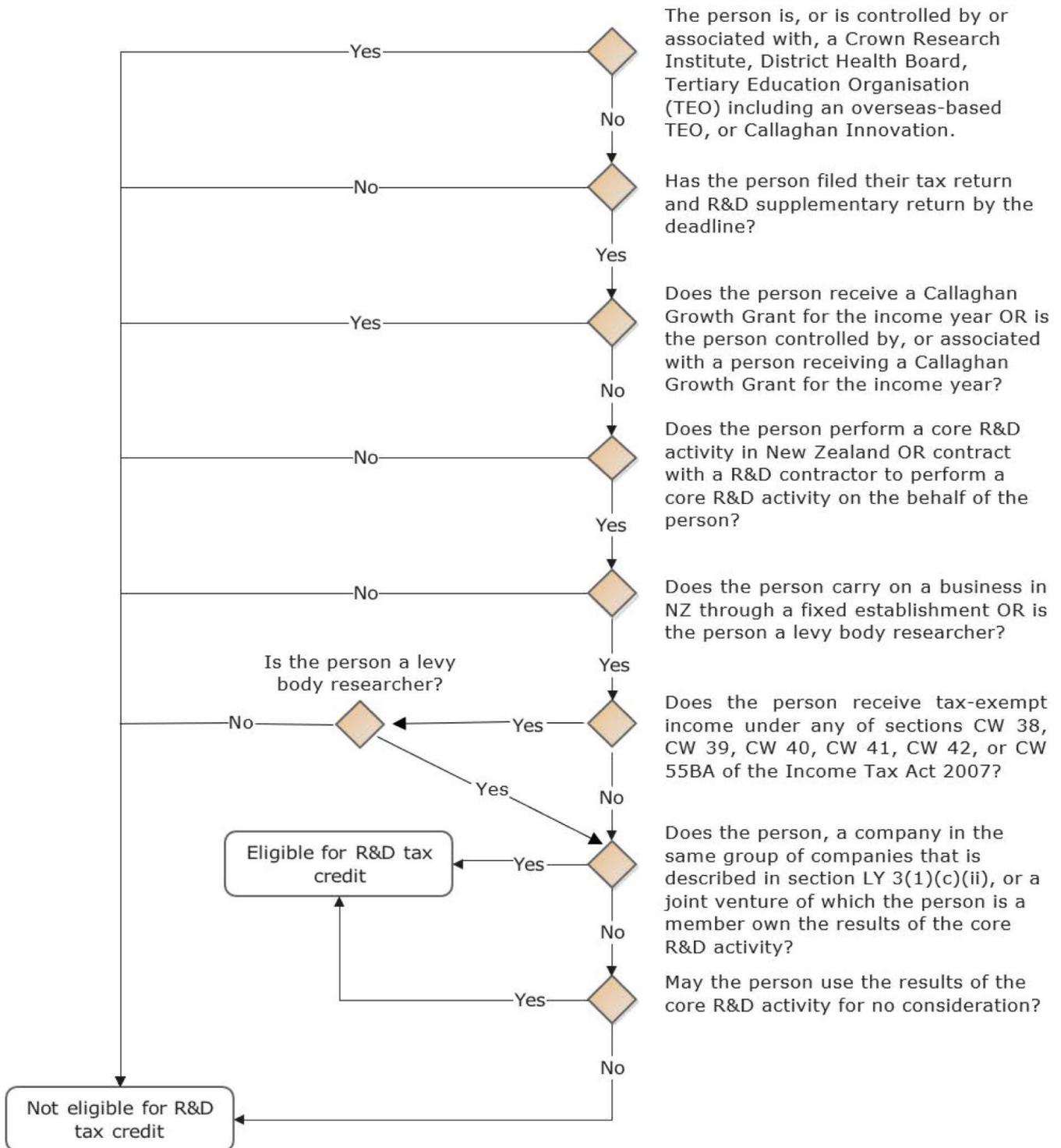
Find out more about eligible entities on page 21.

For more information on what to do if you want to move from the Growth Grant to the tax credit refer to page 24.

## Eligible entity rules flowchart

The flowchart provides a high-level overview of the eligible entity rules.

### Is a person eligible for the R&D tax credit?



## Research and development (R&D) activities

The Government has introduced a research and development (R&D) tax credit for businesses that intend to create new knowledge, or new and improved processes, services or goods.

To qualify for the tax credit, you must use a systematic approach which has the purpose of resolving scientific or technological uncertainty.

To claim the tax credit, you must have a core R&D activity. If you have a core R&D activity, you may also have supporting R&D activity for which you can claim the tax credit.

In a commercial project it is unlikely all the work will meet the definitions of core or supporting R&D activities. A system must be in place to identify and record expenditure on activities that qualify for the tax credit.

Find out more about record keeping for the R&D tax credit on page 90.

### Core R&D activity

A core R&D activity is an activity that:

- is carried out with the purpose of creating new knowledge, or new or improved processes, services or goods
- uses a systematic approach
- most of all, has the purpose of resolving scientific or technological uncertainty.

A systematic approach is a methodical (organised and planned) approach to formulate and test possible solution(s) to the identified uncertainty. How this looks will be different in different sectors and will depend on the nature of the uncertainty. Find out more about systematic approach on page 38.

Scientific or technological uncertainty exists if there is a gap in knowledge of a scientific or technological nature, and the knowledge required to resolve that uncertainty is both:

- not publicly available
- unable to be worked out by a competent professional in that field, without undertaking a systematic process to generate new knowledge or test a possible solution.

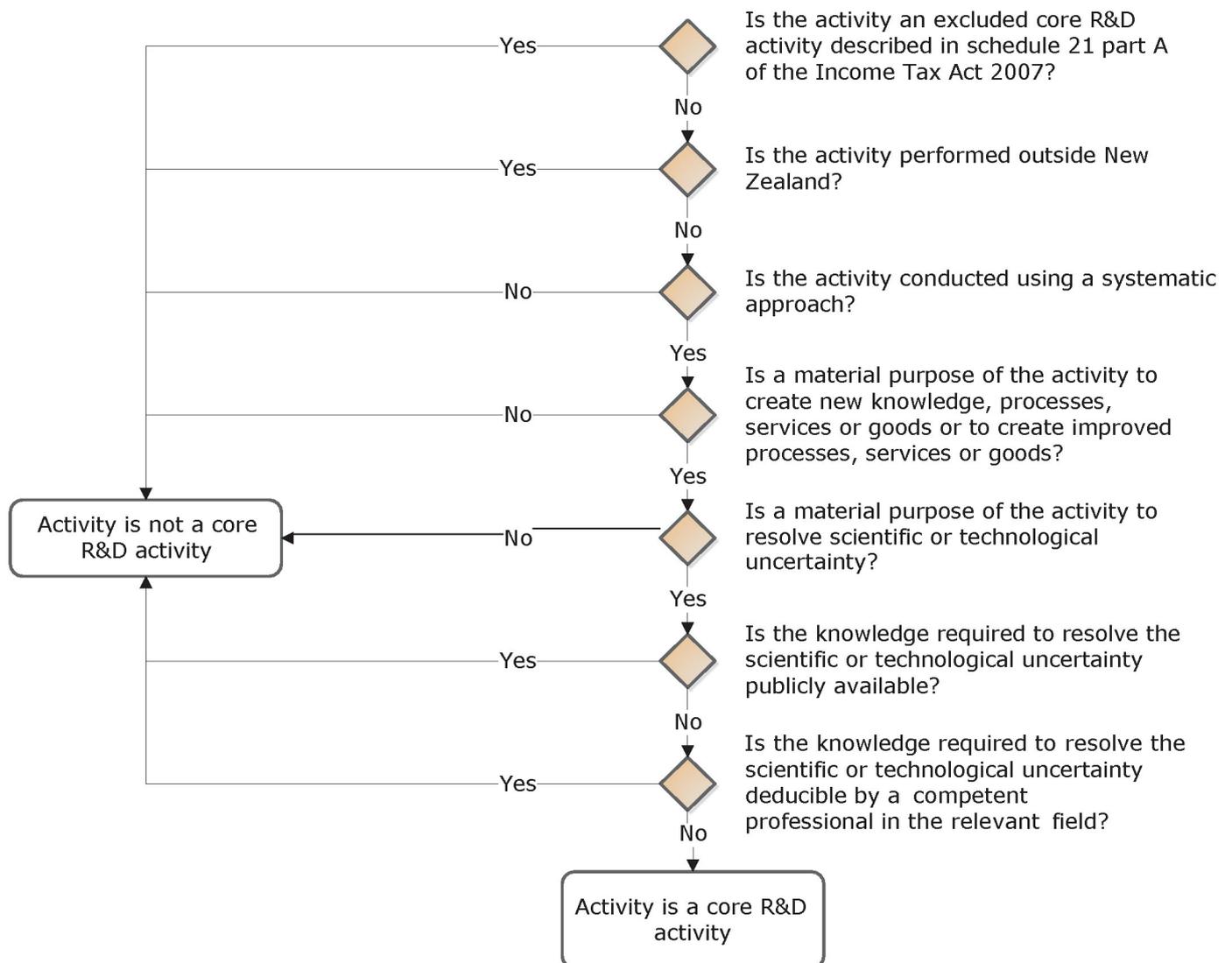
Even if those tests are met, to claim the tax credit your activity cannot be on the list of excluded core research and development (R&D) activities (page 51).

Additionally, an activity must be performed in New Zealand to qualify as a core R&D activity. Activities which meet the criteria for a core R&D activity but which are not performed in New Zealand can be claimed as a supporting R&D activity if they meet the criteria.

The flowchart on the next page will help you determine if your activity is a core R&D activity.

## Core R&D activity flowchart

### Is an activity a core R&D activity?



From year 2, the 2020-21 income year, R&D activities will require approval under either section 68CB or 68CC of the Tax Administration Act 1994.

## Supporting R&D activity

An activity which does not meet the definition of a **core R&D activity** but which is required for your core R&D activity may also qualify for the tax credit. A supporting R&D activity is an activity that both:

- supports the core R&D activity as its only or main purpose
- is required for and integral to the core R&D activity.

If your activities support commercial production as well as the core R&D, it is unlikely you will be able to claim the tax credit. This is because the only or main purpose is not to support the core R&D activity.

Unlike core R&D activities, a supporting R&D activity can be performed outside New Zealand. Expenditure on supporting R&D activities outside New Zealand can form up to 10% of your claim. Find out more about overseas expenditure on page 70.

## Activities excluded from being a research and development (R&D) activity

Certain activities are excluded from being a core R&D activity and a smaller number are also excluded from being a supporting R&D activity.

Some activities are excluded to clarify that, although they may involve testing or other systematic processes, these activities do not meet the requirement of attempting to resolve scientific or technological uncertainty.

While activities may occur within an overall project involving R&D activities, they may occur before the scientific or technological uncertainty is identified or after it has been resolved. These activities are excluded because they relate to commercial or administrative objectives rather than to the resolution of scientific or technological uncertainty.

Other activities are excluded because there are generally other mechanisms for funding them or because the spill-over benefits are unlikely to justify the cost to the taxpayer.

Find out more about activities excluded from being research and development activity on page 51.

## Eligible expenditure

To have eligible research and development (R&D) expenditure, you must have both:

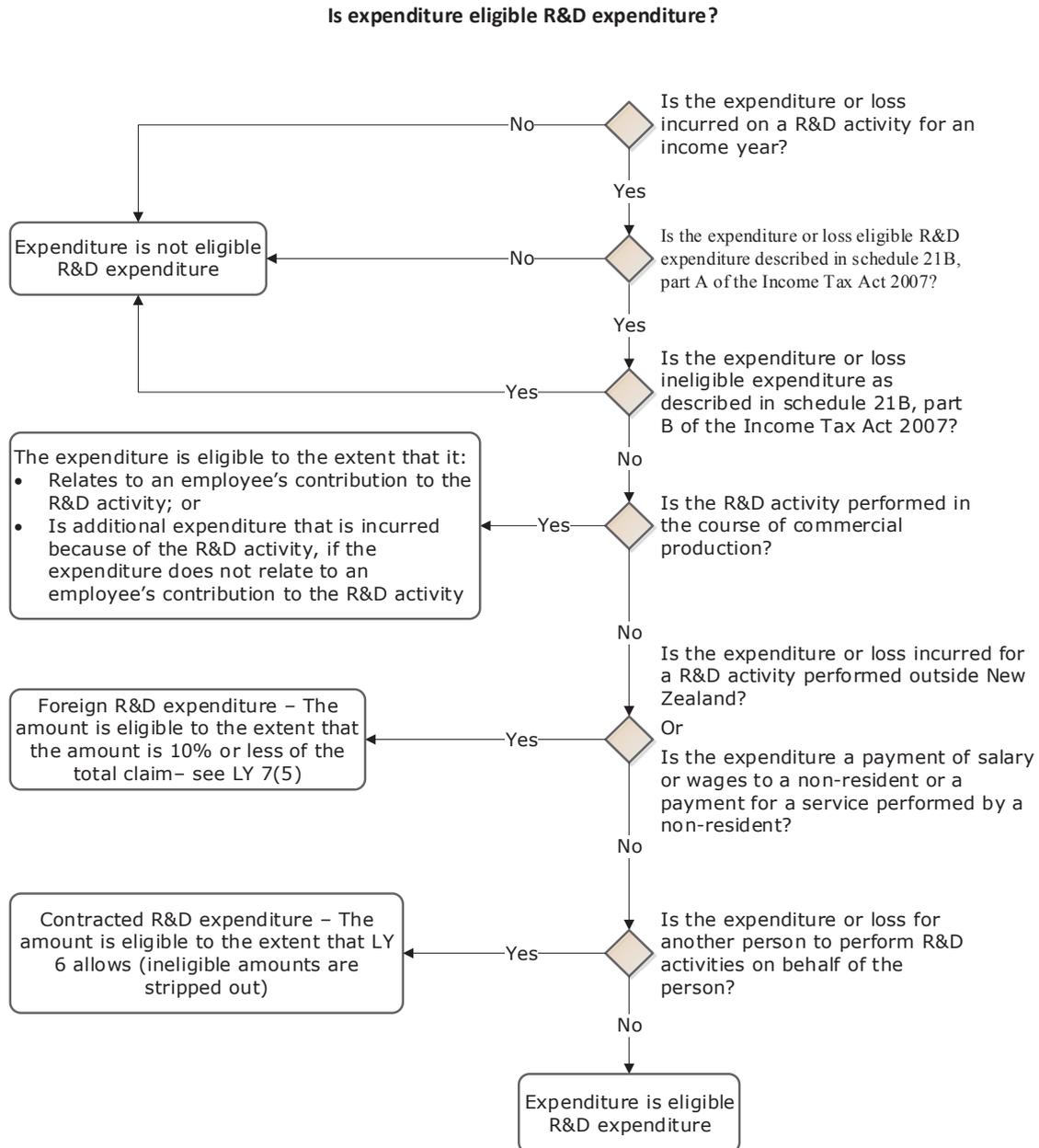
- incurred expenditure on an eligible R&D activity
- expenditure included on the list of eligible expenditure, and not included on the list of ineligible expenditure. Specific rules apply for R&D in a commercial production environment, contracted R&D and foreign R&D.

A tax credit is only available on expenditure of \$50,000 or more, unless you use an approved research provider. There is a cap on eligible expenditure of \$120 million in an income year, unless you obtain approval to exceed the cap.

Find out more about eligible expenditure on page 64.

## Is the expenditure eligible for the R&D tax credit? flowchart

The following flow-chart provides a high-level overview of the expenditure rules:



### Points to note:

- Eligible R&D expenditure is subject to the \$50,000 minimum total spend threshold (section LY 4(1)(a)) and the \$120,000,000 maximum total spend cap (section LY 4(3)9a)).
- A person who does not meet the \$50,000 minimum total spend threshold may still claim a R&D tax credit for eligible R&D expenditure that is for an approved research provider performing a research and development activity on their behalf.
- Expenditure that is incurred in the course of commercial production may also be considered foreign R&D expenditure and/or contracted R&D expenditure.

## Expenditure incurred on an R&D activity

To determine if you have eligible expenditure, you need to consider the extent to which the expenditure is incurred on an eligible R&D activity.

### Apportionment

A tax credit is allowed **to the extent** that expenditure is incurred on an eligible R&D activity. **To the extent** allows you to apportion expenditure between R&D and non-R&D activities.

If your eligible R&D activity is done in a separate or self-contained area, so the expenditure incurred only

There are no specific rules for how the apportionment must be applied. It is up to you to apportion the expenditure in a way that is fair and reasonable, by reference to the advantages you have gained from the expenditure.

Your apportionment method could be based on any of the following:

- a percentage of time
- floor area used for the R&D
- days/units of usage
- volume used
- unit sales
- dollar value
- activity-based costing principles.

Your apportionment does not need to be made with absolute precision. You must however be able to point to an appropriate basis upon which your apportionment has been made, or you will not be able to claim any of the expenditure. This apportionment method must be supported by an audit trail of source documents and working papers.

#### **Example: Apportionment of expenditure**

A company leases a building in which they perform both eligible and ineligible R&D. This means they cannot claim the full lease amount for the R&D tax credit.

The company determines the R&D activities occupy 15% of the building by floor area for the first half of the year. Eligible R&D is carried out full-time during that period. 15% of the lease payments for the first half of the year can be claimed as eligible expenditure.

## **Relationship between the R&D activity and the expenditure**

There must be a sufficient relationship between the expenditure incurred, and the R&D activity. This will depend on the circumstances. Expenditure that does not have a direct connection to the R&D activity will not qualify.

#### **Example: Expenditure with insufficient connection to the R&D activity**

Alison's Armoury produces fencing gear. The company has an area of the building dedicated to R&D.

An apportionment of overheads related to this area would be eligible - for example cleaning costs and management staff salaries to the extent management staff spend time dealing with issues related to the staff performing R&D. An example of a cost that is not sufficiently connected with the R&D and therefore not claimable is the cleaning costs related to the manager's office.

## **Meaning of incurred**

Expenditure is incurred where you are definitively committed to the expenditure and it can be reliably estimated.

#### **Example: Incurred expenditure**

Aco has a contract with Bco to purchase consumables for use in its R&D process for \$50,000. Despite Aco not having paid for the consumables, the expenditure has been incurred because Aco has a contractual liability to pay for them, and the price is known.

## **Types of eligible expenditure**

Expenditure must be included on the list of eligible expenditure to be eligible for the tax credit. The following expenditure is eligible:

- depreciation loss for items used in performing R&D
- expenditure or loss on acquiring goods and services used in performing R&D
- amounts for employees performing R&D.

## Ineligible expenditure

The types of expenditure and depreciation loss not eligible for the R&D tax credit are listed below.

- The GST input portion of expenditure.
- Expenditure which is eligible expenditure of someone else.
- Amounts incurred by a person and their associates on R&D to the extent the amounts exceed \$120 million or the person's approved research and development cap.
- Expenditure incurred in acquiring depreciable property.
- Expenditure that contributes to the cost of depreciable tangible property.
- Depreciation on property, to the extent the cost of the property is eligible R&D expenditure.
- Depreciation on pooled property where an item in the pool is not used solely in performing R&D.
- Depreciation from an asset being written off or sold below its adjusted tax value.
- Certain amounts of depreciation on property acquired from associates.
- Profits on R&D services and property provided by associates.
- Amounts in excess of market value for leasing property from associates.
- Expenditure to purchase land.
- Interest and other financing costs.
- Professional fees in determining a person's entitlement to an R&D tax credit.
- Expenditure on acquiring an interest in intangible property other than software.
- Expenditure on bespoke software.
- Internal software development expenditure incurred by a person and any associates, for purposes other than internal administration (an ineligible activity), to the extent that it exceeds \$25 million.
- Expenditure on goods or services to the extent it exceeds the market value of the goods or services.
- Gifts.
- The cost of acquiring technology that is used as a basis for further R&D activities.
- Expenditure to commercialise the results of an R&D activity.
- Expenditure that relates to a government or local authority grant.
- Expenditure on inputs used, or subject to a process or transformation, to the extent the expenditure does not exceed the value of the output from that expenditure (feedstock rule).
- Expenditure for which a person has received an R&D tax credit for from another country.
- If a person's eligible expenditure is less than \$50,000, expenditure or loss under \$50,000 that is not for an approved research provider to perform an R&D activity on behalf of the person.

Find out more about ineligible expenditure on page 74.

## Internal software development

Software development for the purpose of internal administration of a business ineligible for the research and development (R&D) tax credit. This does not include software development for non-administrative internal purposes which is subject to a \$25 million cap.

Software developed for the main purpose of sale or as an integral part of goods that are sold (external software development), is not subject to the \$25 million cap.

Find out more about internal software development on page 83.

## Approved research providers

An approved research provider is a research provider approved by us. They provide R&D services under contract to other businesses in New Zealand.

If you are carrying out your own R&D activities, you cannot claim the tax credit unless you have more than \$50,000 of eligible expenditure in a tax year.

However, if you have less than \$50,000 of eligible R&D expenditure, you may be able to claim the R&D tax credit if your R&D is performed by an approved research provider on your behalf. This exception helps make the R&D tax credit accessible to businesses of all sizes.

### Becoming an approved research provider

If you currently provide research and development (R&D) services to businesses in New Zealand, or plan to provide such services, you may be eligible to apply to be an approved research provider.

Being an approved research provider would allow your clients to claim the R&D tax credit with respect to eligible R&D activities you perform on their behalf. This is regardless of whether the minimum expenditure threshold of \$50,000 is met or not.

Find out more about approved research providers on page 86.

## Record keeping requirements for R&D tax credits

Inland Revenue has standard record keeping requirements.

The records required to support a claim for a research and development (R&D) tax credit will go beyond the financial records normally required to be kept for tax purposes. Records need to be available to support that:

- your business is eligible to claim the R&D tax credit
- the R&D activity is eligible
- your R&D expenditure or depreciation loss is eligible.

You are not required to send us your R&D records with your application for the tax credit. Your records will help you complete your R&D supplementary return (and from the 2021 income year your application for in-year approval) and they must be available if we ask to see them. Records for your R&D do not need to be kept on paper but as for all other tax records you are required to retain records, in an accessible state, for 7 years.

For more detail about general record keeping requirements at [ird.govt.nz/records](https://ird.govt.nz/records)

### Entity eligibility

Normal business records will often be enough to confirm you are in business in New Zealand and that you own the R&D. In most cases these will be the key tests to establish that your business is eligible to claim the R&D tax credit.

If you are in any of the following situations, you should make sure you have records which demonstrate you meet the relevant criteria which are set out in the more detailed information:

- contracting with someone else to perform the R&D
- a levy body researcher
- an overseas owned company conducting the R&D through a fixed establishment in New Zealand
- performing the R&D on behalf of a company in the same group which owns the R&D
- conducting the R&D in a partnership or joint venture, or in a structure with a government owned organisation such as a Crown Research Institute, or university within a group of companies.

## Eligible research and development activity

To claim the tax credit, you must have records which demonstrate that your activities meet the definition of eligible R&D activities. The following information must be recorded and kept.

- The purpose of the R&D - it must be for new knowledge or a new or improved process, product or service.
- The scientific or technological uncertainty (the question) that the systematic approach is intended to resolve.
- How you know the uncertainty could not be resolved based on publicly available information or deduced by a competent professional.
- The systematic approach that was undertaken in an attempt to resolve the uncertainty (these are the core R&D activities). The activities must be described in enough detail to show that they are not on the list of excluded activities.
- The nature of any supporting activities that are only, or mainly, for the purpose of supporting the core R&D activity.

Once you have identified that you are dealing with a scientific or technological uncertainty our recommendation is that your standard project documentation should be used as much as possible to capture the required information.

## Eligible expenditure

Claims for the tax credit will be based on information about the staff time and other resources that were spent on each eligible R&D activity. The records must be sufficiently detailed to show the:

- connection between the expenditure and the eligible R&D activity
- claimed expenditure is on the list of eligible expenditure types
- claimed expenditure is not on the list of ineligible expenditure.

Salary and wages paid to employees are eligible expenditure to the extent the employees worked on eligible R&D activities. This might be recorded in a time recording system where eligible R&D is coded separately from other activities, or it might be assessed and recorded in project documentation on a regular (for example daily or weekly) basis.

Other inputs such as ingredients, materials and depreciation on capital equipment used in the eligible R&D activities should be recorded through stock control/usage tracking systems which have codes for eligible R&D, or by apportionment. If you are conducting R&D in the course of commercial production, you should make sure you have had regard to the relevant rules and that your records correctly capture expenditure information.

Overheads are eligible for the tax credit to the extent they were incurred in direct support of the eligible R&D activity. These overheads need to be assigned in a discernible way to directly support the R&D activity. This will normally require apportionment as overhead expenditure is often shared between R&D and non-R&D activities.

Where apportionment is used it must be on a reasonable basis, supported by an audit trail, and capable of being substantiated.

When determining if an overhead expense directly supports the R&D activity, you should also consider:

- whether or not the expense would exist in the absence of the R&D
- if there would be a direct impact on the R&D if the overhead did not exist.

## Contemporaneous record keeping

The legislation requires anyone who claims the tax credit to keep sufficient records to allow us to readily ascertain the amount of the tax credit.

For us to be able to readily ascertain the amount of the tax credit, the claim should be based on records kept at the time the R&D was done (contemporaneous records). The credibility of your records will be improved if they identify the author/creator and date of creation.

There is no absolute standard for how frequently a record must be kept for it to be seen as contemporaneous, but the records must be timely and not backdated or created at the end of the year. Find out more about contemporaneous record keeping on page 97.

Find out detailed information on record keeping for R&D tax credit purposes starting on page 90.

## Claiming the R&D tax credit

### How to claim the R&D tax credit in the 2019-20 income year

To claim the research and development (R&D) tax credit, you need to enrol for the tax credit through myIR and file both:

- your income tax return, make sure you complete the R&D tax credit field which is only available in the electronic version of the income tax return
- an R&D supplementary return.

There is a time limit to claim the R&D tax credit. If you make a claim outside of this timeframe, it will be declined. To make a claim you need to file both:

- your income tax return (preferably on time - you can file your return up to a year late for tax credit purposes, but this may result in penalties/interest)
- an R&D supplementary return within 30 days after the due date of your income tax return.

The R&D supplementary return will ask you to describe your R&D activities and your expenditure on those activities. This return must be filed online.

### Changes in 2020-21 income year: general approval and significant performer regimes

From your 2020-2021 income year, you will be required to get your R&D activities approved by the Commissioner before you will be eligible to claim for an R&D tax credit. This is known as general approval. You should apply for and obtain general approval before you file your income tax return and R&D supplementary return.

If you have or expect to have more than \$2 million of eligible R&D expenditure in a tax year, then you must either:

- obtain general approval for each R&D activity, or
- seek recognition as a significant performer, which will require you to provide Inland Revenue with an estimate of your R&D expenditure, obtain criteria and methodologies approval, and then provide an R&D certificate with your supplementary return, confirming that your R&D expenditure was reviewed by an R&D certifier and calculated in accordance with the approved criteria and methodologies. . This alternative is known as the significant performer regime.

If you have not applied for general approval or been recognised as a significant performer by the relevant deadline, which is 7 May for businesses with a standard balance date, you will not be able to claim R&D tax credits for that year.

No fee is charged for general approval applications or criteria and methodologies approvals.

If you receive criteria and methodology approval you can also apply for general approval of specific R&D activities if they fall outside the criteria and methodologies approval or if you want certainty about those activities.

Find out more about claiming the R&D tax credit on page 100.

## Receiving your R&D tax credit

When applying tax credits against your income tax liability, your R&D tax credits apply 4th. That is, they apply after imputation credits but before refundable tax credits.

Your tax credits are used in the following order:

- Non-refundable tax credits (which are extinguished if you do not use them in the income year they arise).
- Tax credits for supplementary dividends.
- Imputation credits.
- R&D tax credits from a previous tax year
- R&D tax credits from the current tax year
- Refundable tax credits.

Any R&D tax credits you have leftover can be carried forward to your next income year. If you are a company, you may only carry your R&D tax credits forward if you meet the shareholder continuity requirements, although if continuity of ownership is met for part of a year you may be able to carry forward a portion of your tax credits.

You may be able to receive R&D tax credit refunds if you meet certain criteria, as explained in the section on R&D tax credit refunds on page 116.

Your R&D tax credits are subtracted from your residual income tax figure. You can choose to factor your anticipated R&D tax credits into your provisional tax calculations for the relevant income year.

If you are a company or Māori authority, you will receive imputation credits or Māori authority credits equal to your R&D tax credits. You will need to include the imputation credits you expect to receive (as a result of your R&D tax credit claim) in your imputation return.

Find out detailed information on receiving the R&D tax credit on page 115.

## Managing disputes and reassessments, anti-avoidance, penalties, binding rulings and Orders in Council, secrecy, publication, and evaluation

### Disputes and reassessments

To make an upward adjustment to your R&D tax credit claim, you must satisfy both of the following:

- you filed an R&D supplementary return by its due date
- the request for the adjustment must be made within the required time frames which are detailed on page 130.

Note that only 1 upward adjustment is allowed for any income year, whether it is made by way of issuing a notice of proposed adjustment or requesting an amendment by the Commissioner.

Find out more about disputes and reassessments on page 130.

### Anti-avoidance rules

We may reduce your R&D tax credit claim if you apply the R&D tax credit rules in a way that was not intended by the R&D tax credit legislation. This includes an arrangement with a purpose or effect of treating ineligible expenditure as eligible expenditure or claiming inflated expenditure.

Find out more about anti-avoidance on page 131.

### Penalties and interest

Penalties and use-of-money interest may apply to over-claimed amounts of the R&D tax credit.

Find out more about penalties and interest on page 132.

## Promoter penalties

If you are a promoter of an arrangement involving R&D tax credits, you may be subject to a promoter penalty if the arrangement results in a shortfall penalty for an abusive tax position being imposed on a party to the arrangement.

For R&D tax purposes, note that this includes an arrangement where you provide services on a contingency fee basis in relation to R&D tax credit claims.

Find out more about promoter penalties on page 132.

## Binding rulings

You cannot obtain a binding ruling on matters related to the R&D tax credit. Find out more on page 134.

## Orders in Council

The Governor-General may, by Order in Council, amend the lists of ineligible R&D activities and eligible and ineligible R&D expenditure, on the joint recommendation of the Minister of Revenue and the Minister of Research, Science, and Innovation.

In making the joint recommendation, the Ministers will consult appropriately and have regard to the following:

- maintaining the R&D activity and eligible R&D expenditure definitions in accordance with the purpose of the R&D tax credit legislation
- the effect of their recommendation on the creation of new scientific or technological knowledge
- the fiscal impact of their recommendation.

A change made by Order in Council in a tax year will apply for 4 years from the start of the following tax year.

## Secrecy

Inland Revenue can share information related to your claim with other state sector entities for the purposes of policy formation, administration, evaluation and statistical reporting. It can also share information with Callaghan Innovation and the Ministry of Business, Innovation and Employment that is reasonably necessary for them to offer R&D advice and incentives.

Find out more about taxpayer secrecy provisions for the R&D tax credit on page 136.

## Publication

Inland Revenue will publish the name of those who have received R&D tax credits and the amount of the tax credit (in dollar bands), 2 years after the end of the tax year to which the claim related.

Publication will provide transparency about how the tax credit regime is operating.

Find out more about publication on page 137.

## Evaluation

The Minister of Research, Science and Innovation is required to conduct an independent and objective evaluation of the R&D tax credit regime every 5 years and report the results to Parliament.

Find out more about the evaluation of the R&D tax credit regime on page 138.

# Eligible entities

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## Legislative reference and intent

Income Tax Act 2007 subpart CW: sections LA 5, LY 3, LY 4, LY 8, LZ 13, FM 2, and YA 1 Tax Administration Act 1994 33E

The aim of the research and development (R&D) tax credit is to increase the amount of business R&D performed in New Zealand.

The key eligibility criteria are that a person carries out business in New Zealand and performs a core R&D activity in New Zealand.

In comparison to other jurisdictions, the New Zealand regime involves less of a focus on where the intellectual property from the R&D is held. Instead, the key focus is on where the R&D is being performed so that the benefits of the R&D spill-over to the New Zealand economy - for example through an increased number of high-skill jobs for New Zealanders.

The R&D tax credit regime is intended to encourage business R&D. Consequently, Crown research institutes, district health boards, tertiary education organisations (as well as their associates, and any entities they control), are excluded from the regime.

Callaghan Innovation is a Government agency and is helping Inland Revenue administer the R&D tax credit. For the avoidance of doubt, Callaghan Innovation, entities it controls, and any of its associates are excluded from claiming the R&D tax credit.

The rationale behind the exclusion of certain tax-exempt entities is that entities which wholly or mainly derive tax exempt income sit outside the tax system, so should not benefit from incentives provided from within the tax system. Charities, which come within the tax-exempt entity exclusion, do not pay income tax, and receive additional Government support in the form of GST concessions, exemption from FBT, and the donor tax credit regime. Broader association rules have not been included in this exclusion, allowing taxpaying subsidiaries of affected entities to claim the credit.

## Eligible entity criteria

Private sector businesses in New Zealand are eligible, whether they are incorporated or not. This includes sole traders, partnerships, companies, joint ventures, and trusts. Other entities such as industry levy bodies which are not in business may also qualify for the R&D tax credit.

To be eligible, you must both:

- perform a core R&D activity in New Zealand yourself or through an R&D contractor in New Zealand
- carry on a business through a fixed establishment in New Zealand.

You must also either:

- own the results of your R&D activities (or a member of your corporate group, who is resident in New Zealand or in a country New Zealand has a double tax agreement with, owns the results)
- be able to use the results of your R&D activities for no extra cost.

You must file an R&D supplementary return for the year the R&D tax credit relates to within 30 days after your filing due date for the income tax return. The income tax return must also be filed within 1 year of the latest filing due date for your return.

The rules relating to filing dates limit a claimant's ability to retrospectively reclassify their expenditure (which is where R&D expenditure is only identified after the end of an income year, rather than being identified when it is performed). The rationale behind these rules is that the intention of the R&D tax credits is that they should incentivise people to do more R&D. If a claimant does not realise they have done R&D until after they end of the income year, it is unlikely the R&D tax credit regime has incentivised the claimant to perform those R&D activities.

If you do not file the returns by the due dates, you will not be eligible to claim the R&D tax credit.

Find out detailed information on the R&D supplementary return on page 101.

#### Example: Filing requirements with no extension of time

For the 2019-20 income year, ACo has a standard balance date ending 31 March. ACo's due date for filing its income tax return is 7 July 2020.

To be eligible for the R&D tax credit, ACo must have its R&D supplementary and income tax returns filed by 6 August 2020 and 7 July 2021, respectively.

#### Example: Filing requirements with an extension of time

For the 2019-20 income year, BCo has an extension of time to file their income tax return by 31 March 2021. To claim the R&D tax credit, BCo has to file its R&D supplementary return by 30 April 2021 and the income tax return by 31 March 2022.

#### Note

In both examples above, if the income tax returns are not filed by their respective original due dates a late filing penalty may apply.

Your eligible R&D expenditure must also be at least \$50,000. An exception to the minimum expenditure threshold exists if you incur expenditure with an approved research provider.

#### Important

The above eligible entity criteria and requirements apply to a consolidated tax group of companies at the group level. This means if a member within your consolidated tax group satisfies the eligible entity criteria and requirements, the group as a whole will be eligible to claim the R&D tax credit unless an exclusion applies.

For more information go to our **Eligible expenditure** (page 64) and **Approved research providers** (page 86) guidelines.

## Core R&D activity in New Zealand

There must be a core R&D activity performed in New Zealand, whether it is performed by you or by an R&D contractor on your behalf.

Where you have 1 or more R&D activities performed overseas, they do not affect your eligibility to claim the R&D tax credit. It is however important to note that:

- only 10% of the total expenditure you claim can be for overseas R&D activity
- any activity performed overseas does not qualify as a core R&D activity.

Find out if your activity is a core R&D activity on page 33 and more about overseas expenditure on page 70.

## Carry on a business through a fixed establishment in New Zealand

You must carry on a business through a fixed establishment in New Zealand. Where an R&D contractor performs a core R&D activity on your behalf, the contractor must carry on a business through a fixed establishment in New Zealand.

The term **fixed establishment** is defined in section YA 1 of the Income Tax Act 2007 and means a fixed place of business in which substantial business is carried on by a person.

Carrying on a business has the same meaning as for other tax purposes and essentially means you must operate with the intention of making a profit.

An exception exists for levy body researchers which are industry organisations to which a levy is payable under New Zealand law. For R&D tax purposes, levy body researchers are treated as carrying on a business in New Zealand regardless of whether they intend to make any profit.

Your R&D activities do not have to relate to your existing New Zealand business. It is sufficient if you carry on a business through a fixed establishment in New Zealand.

#### **Example: R&D does not relate to existing New Zealand business**

PCo is a New Zealand-based company with clothing manufacturing facilities in Hamilton. It has been asked by its Australian parent company, which owns other companies that sell parachutes, to branch out into making parachutes. PCo needs to do some R&D before producing parachutes because it needs to make sure its parachutes have an **edge** to distinguish them from other parachutes already on the market.

PCo satisfies the **in business** and fixed establishment requirements. It does not matter that PCo's R&D does not relate to its existing clothing manufacturing business.

## Ownership of R&D results

To claim the R&D tax credit you must satisfy the ownership requirements, which require that at least 1 of the following apply.

- You own the results of your R&D activities.
- A company in your corporate group owns the results of your R&D activities, provided the company is resident in New Zealand or a country New Zealand has a double tax agreement with (DTA jurisdiction).
- You are able to use the results of your R&D activities for no extra cost above your R&D expenditure for the activities.

Find the list of DTA jurisdictions at [ird.govt.nz/dta](http://ird.govt.nz/dta)

#### **Example: Ownership of results by company in DTA jurisdiction**

NZ Co is part of a corporate group owned by Aus Co, an Australian tax resident company. A technological uncertainty arises in the group's manufacturing operations, so it decides to undertake R&D to resolve the uncertainty.

The core R&D activity is carried out in New Zealand by NZ Co. Both NZ Co and Aus Co analyse the results of the R&D to determine whether the uncertainty has been resolved. The results of the R&D are owned by Aus Co, which plans to adapt the results for commercial use in Australia.

The results of the core R&D activity are owned by Aus Co. Aus Co is a member of NZ Co's corporate group and is a tax resident of a DTA jurisdiction. NZ Co satisfies the ownership requirements. For R&D tax purposes, it is irrelevant whether NZ Co has to pay to use the results of its R&D at a future date.

#### **Variation of facts: ownership of results by company in non-DTA jurisdiction**

If Aus Co was a tax resident of a non-DTA jurisdiction, NZ Co would not satisfy the ownership requirements unless it was able to use the results for no further cost.

The ownership requirements are satisfied where you own (or have the right to use for no further cost) the intellectual property such as a copyright, a patent or a registered design arising from the R&D.

The right to use can be shared with others or available in limited ways or for limited purposes. The ownership requirements are not satisfied where you own or have the right to use the physical output of the R&D, but not the intellectual property.

If no intellectual property protection was taken out to protect the results, **ownership** of the results means that you must have the right to reuse the knowledge without further payment.

It is also possible that there is no intellectual property because the R&D activity is unsuccessful and there is no exploitable result from it. This does not mean that you do not satisfy the ownership requirement.

## Ineligible entities

You are an ineligible entity and excluded from claiming the R&D tax credit for an income year if any of the following apply.

- You receive, or are directly or indirectly controlled by, or associated with a person receiving, a Callaghan Innovation Growth Grant for the same income year.
- You are an entity which derives tax-exempt income under any of the following sections of the Income Tax Act 2007: CW 38 (public authorities), CW 39 (local authorities), CW 40 (local and regional promotion bodies), CW 41 or 42 (charities), or CW 55BA (tertiary education institutions), and you are not a levy body researcher.
- You are, or are associated with or controlled by a Crown Research Institute, district health board, tertiary education organisation (including overseas-based tertiary education organisations), or Callaghan Innovation.
- You are an R&D contractor in relation to the relevant R&D activity for a person who carries on a business through a fixed establishment in New Zealand.
- You are a member of a joint venture, a partner in a partnership or an owner of a look-through-company and are not a New Zealand tax resident in the tax year.

## Callaghan Innovation Growth Grant

This section provides guidance on:

- how receiving a Growth Grant affects your eligibility for the tax credit
- special rules that apply if you have a late balance date (that is, one that starts after 1 April), and receive a Growth Grant for only part of your 2020-21 income year (year 2 of the scheme).

## Growth Grant recipients are generally ineligible for the R&D tax credit

The R&D tax credit serves as a replacement to (but in many cases is not equivalent to) the Callaghan Innovation Growth Grant. The exclusion from eligibility for Growth Grant recipients is intended to prevent a person from picking and choosing between the best aspects of each scheme, if they were eligible for both.

If you receive a Callaghan Innovation Growth Grant for the whole, or a part, of an income year, you are excluded from claiming the R&D tax credit for that income year. The exclusion also applies where you are directly or indirectly controlled by or associated with a person receiving a Growth Grant.

If the exclusion applies, it applies even to R&D activity and expenditure for which you have not received a Growth Grant.

### Example: Exclusion for a Growth Grant recipient

GG Co is a Growth Grant recipient with a balance date ending 31 December.

On 1 February 2020, GG Co makes the last Growth Grant claim after its Growth Grant contract ends on 31 December 2019.

GG Co is excluded from claiming the R&D tax credit for all its R&D expenditure incurred for the 2019-20 income year ending 31 December 2019.

For the 2020-21 income year, GG Co is not excluded from claiming the R&D tax credit for its eligible R&D expenditure incurred for that income year. The fact that GG Co makes the last Growth Grant claim in the 2020-21 income year is not relevant.

## Special rule for Growth Grant recipients with late balance dates in the 2020-21, income year (year 2 of the tax credit scheme)

For the 2020-21 income year (year 2 of the tax credit scheme), the exclusion may not apply for the entire income year if you satisfy both the following.

- Your income year starts after 1 April 2020 (you have a late balance date).
- You receive a Growth Grant for a part of the 2020-21 income year.

If both statements apply, you may be eligible to claim your eligible R&D expenditure for the part of the income year after your Growth Grant contract ends. Find out how to apportion your eligible R&D expenditure for the R&D tax credit on page 64.

## Entities which derive excluded tax-exempt income

From year 2 of the regime (the 2020-21 income year), you will be ineligible for the R&D tax credit regime if you are an entity which derives tax exempt income under certain sections of the Income Tax Act 2007. These entities are:

- Public authorities (section CW 38)
- Local authorities (section CW 39)
- Local and regional promotion bodies (section CW 40)
- Charities (sections CW 41 and CW 42)
- Tertiary education institutions and their subsidiaries (section CW 55BA).

An exception to this rule exists for levy body researchers, which can still claim the credit even if they receive tax exempt income under any of the above sections.

Any R&D tax credits received in year 1 (the 2019-20 income year) by an entity which is ineligible on these grounds cannot be refunded in year 2 (the 2020-21 income year), nor can these be carried forward to year 2.

These credits will be extinguished from the beginning of year 2.

### Example: Charity's year 1 credits extinguished

In the year ended 31 March 2020, Charity X claims \$100,000 of R&D tax credits. As Charity X does not pay income tax, it has no income tax liability to offset its R&D tax credits against. It is not eligible for refundability, because Charity X receives exempt income.

Charity X has a standard 31 March balance date. Its \$100,000 of R&D tax credits from year 1 cannot be refunded in year 1 and cannot be brought forward to year 2. They are extinguished from 1 April 2020. Charity X also ceases to be eligible for the R&D tax credit from this date.

This exclusion does not include broader association rules. Therefore, a subsidiary taxpaying business can still be eligible for the credit even if it is owned by an entity that would be excluded because it derives tax exempt income under the sections specified above.

### Example: Subsidiary not ineligible because its parent derives exempt income

Charitech is a charity which performs R&D to support its charitable work. It performs R&D on adapting traditional plant medicines so that they can be used alongside modern medicine to achieve better health outcomes. Charitech would like to claim the R&D tax credit for its R&D in the 2020-21 income year, but because it derives exempt income it is ineligible to claim the credit in its own right.

Charitech establishes a subsidiary company to undertake its R&D work. The subsidiary is taxpaying and does not derive any exempt income, so is not excluded from the credit through the exempt income exclusion.

Assuming the subsidiary satisfies the other R&D tax credit eligibility criteria, it will be able to claim the credit, even though its parent organisation receives exempt income.

## Crown Research Institutes, district health boards, tertiary education organisations, and Callaghan Innovation

The R&D tax credit is designed to encourage private sector business R&D.

Crown Research Institutes (CRIs), district health boards (DHBs), tertiary education organisations (including overseas tertiary organisations, which are specifically excluded for the avoidance of doubt), Callaghan Innovation, their associates, and entities controlled by them are not eligible for the R&D tax credit. Control by CRIs, DHBs, tertiary education organisations, Callaghan Innovation, or their associates means either majority ownership or effective control.

### Example: Ownership by an ineligible business

ZXZ Co is 25% owned by a CRI, 26% owned by a trust whose beneficiary is a university, and 49% is owned by a private firm, Y Co.

For R&D tax purposes, ZXZ Co is an ineligible entity because a CRI and a university that is a tertiary education organisation control it.

There are some circumstances in which a business and an ineligible entity might do R&D together. Depending on the specific agreement between the business and ineligible entity, the business may or may not be eligible to claim R&D tax credits for the R&D performed. For example, a business contracting out its R&D to an ineligible entity may be eligible for the credit, provided the business satisfies the entity, activity, and expenditure eligibility criteria.

### Example: Ineligible entity as R&D contractor

E&E Co contracts a CRI to do eligible R&D activities on their behalf. E&E Co pays the CRI \$300,000 to do the R&D.

The contract sets out that E&E Co owns the results of the R&D activities once full and final payment is made for them. The R&D activities are completed by 31 March 2020, and E&E Co claims R&D tax credits in relation to the \$300,000 expenditure incurred for that year.

For R&D tax purposes, E&E Co may claim R&D tax credits for the \$300,000. This is because:

- the CRI is an R&D contractor
- only E&E Co is able to claim the credit in respect of the \$300,000 (so the anti-double dip rule, which prevents parties from claiming the credit if more than 1 person is able to claim the same amount of expenditure, does not apply)
- E&E Co satisfies the entity eligibility criteria, including the requirement that you must own the results of your R&D activities, or be able to use the results of your R&D activities for no further consideration.

On the other hand, a business will not be eligible for the credit if it does not own the results of the R&D activities (or cannot use the results for no further consideration), even where it is paying an ineligible entity for the R&D.

### Example: Royalty payments in respect of ineligible entity's R&D

ASW Co and a tertiary education organisation (TEO) enter into an arrangement regarding some R&D performed by the TEO.

TEO has completed some initial R&D on a new plant growth stimulant aimed at encouraging plants to flower earlier and more prolifically, which if successful would help increase fruit production of orchards throughout New Zealand. The market value of the R&D TEO has completed to date would be worth \$150,000.

TEO agrees to allow ASW to use the results of initial R&D (original IP), in exchange for a lump sum payment of \$50,000. The parties also agree that if ASW develops the original IP into a product that is subsequently commercialised, then TEO will receive 5% of all profits made from the sale of the product (royalty payment). Any new IP created by ASW (new IP), resulting from further R&D conducted by ASW using the original IP, also vests in TEO. The contract specifies that the 5% royalty payment forms part of ASW's consideration to TEO for use of the IP resulting from ASW's R&D.

ASW takes TEO's original IP, spends a further \$350,000 on R&D that results in new IP, and then successfully commercialises the product. The product is successful and generates significant amounts of revenue for ASW. In accordance with ASW's agreement with TEO, the IP vests in TEO and ASW pays TEO 5% of all its profits generated from the sale of the product.

The \$50,000 ASW pays TEO for original IP is ineligible for the credit, because that \$50,000 is considered ineligible technology expenditure. Ineligible technology expenditure is essentially expenditure on acquiring technology produced by someone else's R&D, where that technology is then used as a base for further R&D undertaken by a claimant.

The \$350,000 spent by ASW on additional R&D, and the royalty payments ASW makes to TEO, are also ineligible. ASW does not own the results of the R&D and cannot use the results for no further consideration.

## R&D contractors

If you perform an R&D activity on behalf of another person (the principal) who carries on a business through a fixed establishment in New Zealand, you are an R&D contractor and are not eligible to claim the R&D tax credit in relation to that activity.

However, you may be eligible to claim the R&D tax credit if your principal does not carry on a business through a fixed establishment in New Zealand. To be eligible, you have to satisfy the eligible entity criteria in relation to the relevant R&D activity, in your own right.

The rationale for the exclusion of the R&D contractor is that the principal to the contract should claim the credit as they make the decision to invest in R&D. However, in order to encourage R&D to be performed in New Zealand, where the principal is based offshore and cannot claim the credit the contractor may be eligible provided they can use the results of the R&D for no further consideration.

### Are you an R&D contractor?

In determining whether you are an R&D contractor, you need to consider the facts surrounding your relationship with the principal, including the contract itself.

Key factors to consider include:

#### **Contract for R&D or contract for outcome.**

Does the contract provide for you to perform R&D on behalf of the principal or are you being contracted to deliver an outcome, for example a product or process? If you are being contracted to deliver an outcome, then it is likely you are not an **R&D contractor** in relation to the activity.

#### **Control, ownership and financial risk.**

If you fund, control and own the results of an R&D activity, you are not likely to be an **R&D contractor** in respect of the R&D activity.

- **Control over the activity**

Do you have control over the R&D activity? This means you must have the ability to make decisions to start or stop the R&D activity or change its direction. The day-to-day management of the R&D activity would not suffice by itself.

- **Ownership or right to use**

Do you own or have the right to use for no further cost, the results arising from the R&D activity? Find out if you have the ownership of the R&D activity on page 23.

- **Financial risk**

Do you bear the financial risk of the R&D activity? If your fee for the R&D activity is payable depending on the outcome of the activity being successful or acceptable by the principal, you are likely to be bearing the financial risk of the R&D activity.

#### **Example: Acting as an R&D Contractor**

A Co and C Co are both R&D businesses based in New Zealand. They enter into a contract under which C Co is to carry out specified services that qualify as eligible R&D activities.

A Co has no expertise in that particular R&D field but has given broad direction in the contract to C Co about the specifications it wants achieved by the services. A Co is obliged to pay C Co for the cost of those services, regardless of the results.

Although A Co owns intellectual property arising from the R&D activities, C Co can use the intellectual property for its own commercial purposes for no extra cost.

C Co conducts the R&D activities on behalf of A Co. C Co is an R&D contractor and is not eligible to claim the R&D tax credits in relation to those activities.

#### **Variation of facts: principal not based in New Zealand**

The facts are as above except A Co is based in Australia and does not carry on business through a fixed establishment in New Zealand. C Co may be eligible to claim the R&D tax credit with respect to the R&D activities since it satisfies the eligible entity criteria in its own right.

#### **Example: Not acting as an R&D contractor**

F Co is a New Zealand-based company that develops innovative construction techniques and provides design services. G Co contracts F Co to design a high-rise building with an earthquake rating of over 100% at the waterfront in Wellington. The contract does not require F Co to undertake any R&D.

F Co has existing knowledge and techniques to meet the seismic requirement, but it decides to undertake eligible R&D activities to develop new construction techniques that could make the building more resistant to damage during natural disasters.

F Co designs the building with an earthquake rating of 120% with its new construction techniques. F Co had the control over the R&D and owns the IP for the new construction techniques.

The fact G Co paid for and owns the building does not prevent F Co from satisfying the eligible entity criteria. F Co may claim the R&D tax credits for its R&D expenditure.

**Note:** The amount claimed must meet the commercial production rules, see page 66.

## Partnerships and look-through companies

### Legislative reference

Income Tax Act 2007 ss HB 1, HG 2, LY 3 and LY 4  
Tax Administration Act 1994 ss 22(4), 33E, 42, 42B

Rules apply to partnerships and look-through companies (LTCs).

The following eligible entity criteria are applied at a partnership or LTC level, with the partnership or LTC treated as the entity performing the R&D activities:

- performing R&D in New Zealand
- carrying on business in New Zealand
- owning or having the right to use the results of the R&D
- the \$50,000 a year minimum eligible expenditure threshold.

Partners or LTC owners will be taken to have met the criteria in relation to the R&D activity if the partnership or LTC (treated as the entity carrying out the R&D activities) would meet those criteria.

### Example: Eligible entity criteria assessed at the partnership level

Mike and Sarah are both tax residents of New Zealand and have equal interests in a partnership based in New Zealand.

During the year, Mike undertakes eligible core R&D activities for the partnership business. Sarah does not have any knowledge or skill to perform the R&D activities, but she will be marketing the results of those R&D activities the following year.

The partnership satisfies the eligible entity criteria with respect to R&D activities performed by Mike during the year. Both Mike and Sarah are taken to have met the criteria and will be eligible to claim the R&D tax credit relative to their share in the partnership.

The minimum threshold for eligible expenditure is assessed based on the total eligible expenditure of the partnership or LTC. Partners or LTC owners claim the tax credit in proportion to their share in the partnership or LTC.

The following ineligible entity provisions however apply at the partner or individual LTC owner level:

- failure to file on time
- receiving a Callaghan Growth Grant in the same income year. There is a limited exception for businesses with a late balance date in the 2020-21 income year.
- being, or being controlled by or associated with a Crown research institute, district health board, tertiary education organisation (including overseas tertiary education organisations), or Callaghan Innovation.

In addition, a partner or an owner of an LTC who is not a tax resident of New Zealand for the whole of the income year is excluded from claiming the R&D tax credit. This rule ensures that only persons with sufficient presence in New Zealand receive R&D tax credits.

### Example: Partnership meets the eligible R&D business criteria and minimum threshold

James and Alison have equal interests in a partnership which is carrying on a business in New Zealand. Alison lives in Australia and is not a tax resident of New Zealand for the year.

The partnership undertakes R&D in New Zealand to develop a new type of recording device using James' scientific expertise and Alison's manufacturing skills. If the development is successful, the partnership intends to exploit the product commercially in New Zealand.

The development meets the eligible R&D activity criteria and incurs \$60,000 of eligible R&D expenditure. The general eligible entity criteria are satisfied at the partnership level which has ownership of the results from the development. The partnership has met the minimum threshold of \$50,000.

James can claim the tax credit in relation to \$30,000, his share of the partnership's eligible R&D expenditure. Alison cannot claim the credit since she is not a tax resident of New Zealand for the income year a claim is made.

## Joint ventures

### Legislative reference

Income Tax Act 2007 ss LY 3 and LY 4 Tax Administration Act 1994 ss 33E, 42

Parties performing R&D as part of an unincorporated joint venture can apply the following eligible entity criteria at the joint venture level:

- performing R&D in New Zealand
- carrying on business in New Zealand
- owning or having the right to use the results of the R&D
- the \$50,000 a year minimum eligible expenditure threshold.

If the joint venture, treated as an entity performing the R&D activities, meets these criteria, then the parties to the joint venture will be treated as meeting those criteria. Each member will be eligible to claim the R&D tax credit in accordance with their interest in the joint venture.

The onus is on joint venture members to use an appropriate methodology to determine their interests in the joint venture for the relevant income year.

Filing requirements and ineligible entity exclusions apply at an individual party's level. This would for example exclude a joint venture member who is controlled by a CRI or who is not a tax resident of New Zealand for the whole of the income year.

### Example: R&D undertaken through a joint venture

An iwi owned business wants to undertake R&D to see if they can commercially farm a species that has not been previously used in aquaculture. The proposed R&D meets the eligible core R&D activity criteria.

The iwi knows that to succeed it will need to collaborate with an established aquaculture business as well as a local engineering firm which has the capability to prototype the structures they will require. This work is likely to be a supporting activity.

The iwi entity, the aquaculture business and the engineering firm (the joint venture) jointly agree on the objectives for the project and on their responsibilities within it. After the parties decide to jointly sponsor the research, a contract is developed which identifies their responsibilities and commitments. They agree that they can jointly exploit the results of the R&D.

The parties to the joint venture (the iwi entity, the aquaculture business and the engineering firm) are taken to satisfy the eligible entity criteria as the joint venture (as the entity carrying out the R&D activities) meets the criteria.

Each party can claim the tax credit in proportion to their share in the joint venture, subject to filing requirements and ineligible entity exclusions applied at an individual party's level.

**Important**

In claiming the R&D tax credit, you must make sure the joint venture retains appropriate records to support your claim and that you can access them. This includes records of R&D activity and expenditure that are relevant to your claim in any respect, whether or not they are performed and funded by you under the joint venture agreement. Find more information on record keeping requirements on page 90.

# Research and development (R&D) activity

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## Core R&D activities

### Legislative reference and intent

Income Tax Act 2007 LY2

The definitions of R&D activity are based on the **Frascati Manual**, an OECD publication which defines research and development for statistical purposes. The Frascati definition has been modified for the purposes of the tax credit and the enacted definitions reflect elements of the R&D tax credit definitions used in Australia, Canada and the United Kingdom.

The definitions identify as eligible for the tax credit expenditure on R&D which is considered most likely to generate spill-over benefits in New Zealand. The amendment defines core R&D activity as activity which is conducted in New Zealand using a systematic approach and which has the material purposes of both:

- creating new knowledge, or new or improved processes, services or goods
- resolving scientific or technological uncertainty (this requirement is not satisfied if the knowledge to resolve the uncertainty is publicly available or is deducible by a competent professional in the relevant field of science or technology).

The amendments define core research and development activity in a way that is expected to apply to a wide range of R&D activities in a variety of industries. It is, however, accepted that expenditure on some activities, which businesses refer to as R&D, will not be eligible for the tax credit.

Activities intended to improve business efficiency or to develop something new, but which do not seek to resolve scientific or technological uncertainty, are not eligible for the tax credit. Unlike in the 2008 R&D definition of eligible R&D, there is no entitlement for a tax credit for an activity which involves an appreciable element of novelty, but which does not seek to resolve scientific or technological uncertainty. This is because novel developments are considered less likely to generate spill-over benefits than those which resolve scientific or technological uncertainty.

To be eligible for the research and development (R&D) tax credit, you must have a core R&D activity. Your core R&D activity must meet all of the following:

- be performed in New Zealand
- have a material purpose of creating new knowledge or new or improved processes, services or goods
- have a material purpose of resolving scientific or technological uncertainty (scientific or technological uncertainty exists if knowledge is not publicly available or deducible by a competent professional)
- use a systematic approach.

In addition, the activity cannot be on the list of excluded core research and development (R&D) activities.

## Performed in New Zealand

The R&D tax credit's purpose is to encourage research and development in New Zealand. This means core R&D activities must be performed in New Zealand.

Under the overseas expenditure rules, up to 10% of your total eligible expenditure can be for supporting activities performed overseas, provided the supporting activity is in support of a core R&D activity in New Zealand.

Find out more about the overseas expenditure rules on page 70.

## Purpose of creating something new or improved

To be eligible for the R&D tax credit a core R&D activity must have a material purpose of seeking to create new knowledge, or new or improved processes, services or goods. The test of **new** is a comparison with information that is publicly available on a worldwide basis or not being deducible by a competent professional in the research field. It is not enough that it is new to your business or new for New Zealand, if the knowledge is available elsewhere.

Having a material purpose means that the required objective must be significant or important. This requirement is intended to disqualify new knowledge or applications that are discovered by accident.

It is not a requirement that the R&D is ultimately successful in creating something new or improved, so long as the activity has that purpose (and meets the other criteria). Unsuccessful R&D also increases knowledge, and activities that are unsuccessful potentially qualify.

You may be undertaking work which may result in a new product or service and which is innovative or substantially novel, but that is not enough. Nor is a mere redesign or development of an existing product. What matters for eligibility in New Zealand is that your activities have a material purpose of resolving scientific or technological uncertainty.

## Resolution of scientific or technological uncertainty

To qualify for the tax credit your activity must have a material purpose of resolving scientific or technological uncertainty.

A material purpose is a significant or important purpose but showing scientific or technological uncertainty does not require you to undertake fundamental scientific research. It is enough to be trying to extend the practical application of such knowledge, in a way that could not be predicted in advance.

Technology is **the application of scientific knowledge for practical purposes**. A technological uncertainty exists if there is uncertainty about whether existing technology can achieve your goal(s).

The research and development tax credit is intended to encourage development which goes beyond what can be achieved with existing knowledge. It is not enough to be creating something new. To be eligible for the tax credit your development needs to involve pushing beyond (developing) what is currently known. This does not need to be a major or fundamental advance, it can be incremental. The uncertainty to be resolved can still qualify.

Scientific or technological uncertainty meets the standard required by the tax credit when a competent professional, with access to the publicly available information on the topic, does not know whether something is achievable. In these circumstances there is an uncertainty, or a knowledge gap, in the available scientific or technological knowledge.

If a competent professional does not know whether something is possible or not, or how to achieve it, and must use a systematic approach to discover knowledge to bridge the gap (for example through a process of testing, experimentation or prototyping), the activity involved in the systematic approach could qualify for the tax credit.

## Situations in which scientific or technological uncertainty can arise

If the knowledge of how to do something has been kept secret scientific or technological uncertainty can arise even though you know something is possible. For example if another firm has already created something but kept the knowledge secret, your activity may involve the resolution of scientific or technological uncertainty provided:

- a competent professional in that field could not deduce how to create the same product or service (without undertaking a systematic process of for example prototyping or experimentation to test possible approaches, as opposed to simply applying known engineering or design principles knowing that they will produce the outcome which is sought)
- there is no publicly available information that would enable a competent professional to resolve the uncertainty.

Scientific or technological uncertainty can arise in several situations, for example:

- it may be uncertain whether a goal can be achieved
- you may be confident that the goal can be achieved but do not know how to achieve it. There is scientific or technological uncertainty if a competent professional cannot simply apply known engineering or design principles knowing that they will produce the outcome which is sought, but would need to undertake an investigative process to test, analyse or prototype possible approaches to achieving your goal
- there may be uncertainty (from a scientific or technological perspective) in relation to whether the output will meet specifications which are not currently known to be achievable, or overcome known technological constraints or limits such as response time, reliability, reproducibility or cost.

#### **Example: Technological uncertainty arising from a cost constraint**

DelCo are a niche manufacturer using rare earth metals in their components. The technology is well understood, but DelCo wants to reduce the costs of manufacturing the components so that they can remain competitive. Specifically, DelCo wants to reduce their reliance on the expensive rare earth metals enabling them to produce the same functionality but at lower cost.

Papers, based on theoretical models and laboratory experimentation, have been published suggesting cheaper materials should be substitutable up to a threshold. DelCo makes enquiries with professionals in the relevant field. The responses to their enquiries indicate that there is no publicly available or deducible knowledge about how to successfully incorporate these insights into a manufacturing process. An R&D process involving prototyping and experimentation will be required.

Although the component DelCo wishes to produce will be functionally identical to its current offering there is a technological uncertainty about how to produce the component at a significantly cheaper price point with reduced reliance on rare earth metals.

DelCo undertakes prototyping and testing to redevelop the process and determine whether the components can be reliably manufactured despite using less expensive materials. This R&D project may be eligible for the tax credit.

Achieving your desired outcome, whether it is knowing something, creating something or making something work, may be complex and technically challenging and require a systematic approach without seeking to resolve scientific or technological uncertainty. If the desired outcome can be seen to be possible from the outset, without requiring an investigative process to test, analyse or prototype possible solutions, it does not involve a scientific or technological uncertainty.

Many projects have uncertainties that are not scientific or technological. For example, your staff may not know how to achieve something because they do not have the appropriate skills or experience. Or it may be uncertain whether the project can be completed within the budgeted costs, or whether it will be commercially viable.

You, or a competent professional assisting you, may be facing a novel situation and be confident but not certain that an existing approach, which has worked in similar circumstances, will be successful. Testing or prototyping to confirm that the existing approach works would not be eligible for the tax credit. The testing or prototyping is for the purpose of confirmation that an existing approach works, not for the purpose of resolving a scientific or technological uncertainty.

Similarly applying known engineering solutions to achieve redesign of a product would not reach the standard of uncertainty which is required. These are not scenarios involving scientific or technological uncertainties and do not give rise to eligibility for the tax credit.

## Who is a competent professional?

A competent professional is a person who meets all of the following:

- is knowledgeable about and experienced in the relevant field of science or technology
- possesses the relevant qualifications and/or experience to participate in the relevant field with a reasonable level of skill
- is aware of the current state of knowledge in the field
- has access to knowledge from around the world, including access to publicly and generally available resources, for example the internet, relevant industry journals and other professionals.

The test does not require that a competent professional can resolve the uncertainty off the top of their head. If a competent professional knows that an existing methodology or established development path will achieve your goal, there is no scientific or technological uncertainty.

However, if what you are trying to achieve goes beyond what is currently known to be achievable and a competent professional needs to investigate possible solution(s) then the systematic process of investigation could be core R&D.

### Example: A competent professional can deduce the solution

A client wishes to build a house on a challenging site with extensive glass. The structural engineer does not know, off the top of their head, the detail of the required structural elements but they know how to work the options out.

There are existing proven methodologies for the resolution of this type of question. In this situation a competent structural engineer could deduce the answer based on existing knowledge. There is no scientific or technological uncertainty that meets the requirement for the tax credit.

### Example: A competent professional cannot deduce the solution

A construction business is developing a niche specialising in sustainable buildings with a low carbon footprint. It is interested in using wool composite panels as a construction material. A review of the international material science literature and conversations with the Wool Research Organisation indicates that wool is widely used as insulation and that there is some use of wool fibres as an addition to clay in brick making. Although there are academic articles on the qualities of wool reinforced composites there is no publicly available information on the design or suitability of panels, made from biodegradable polymers reinforced with wool fibre, as a construction material.

The suitability of such materials for use in construction is not deducible by a competent professional with knowledge of publicly available information. Work to systematically investigate and analyse the properties of wool composite construction panels could be eligible for the R&D tax credit.

On the other hand, a competent professional may consider that there are relevant differences between the situation she is facing and the situations the standard approach is designed for and be unable to find publicly available information that resolves the issue. In this situation, a programme of testing an alternative approach or approaches may be eligible for the R&D tax credit.

Although the competent professional test is an objective one it does not require the standard of a world leading expert. In a rapidly developing field there may be very few people who understand the very latest research. In this context, if you are dealing with a question of what the technology can do, the test is whether an average and competent professional in that field would understand how existing knowledge is normally applied in the relevant area and would be able to access publicly available information.

The test does not require that you actually consult a competent professional. While you have no obligation to consult a competent professional in the relevant field, if we review or audit your claim for an R&D tax credit, the standard we will adopt is whether a competent professional would consider that there is uncertainty. If you do not involve a competent professional and follow a process that reviews what is publicly available on a world-wide basis, you cannot assume that the activities you undertake will be eligible for the tax credit.

You may be a competent professional in the field in which you are considering undertaking R&D, or your business may employ them on its staff. The test does not require independence, but it does require an objective judgement. If you are unsure where to find a competent professional you should contact a relevant industry organisation, an independent research organisation or research institute, university or government agency such as Callaghan Innovation for advice.

## **What publicly available means**

The test requires that the information you need to resolve your uncertainty is not already publicly available. Public availability includes information available from the following sources:

- in patents
- on the internet
- by purchasing a licence or right to use
- in trade or professional journals
- from other professionals.

Public availability means accessible where New Zealand based professionals in that field could be expected to look. Publicly available does not mean that the information must be available for free. It means available to the claimant from anywhere in the world, on commercial terms.

Your business may choose not to look for or pay for available expertise or purchase the right to use available information because you prefer to come up with your own solutions or cannot afford to pay for the right to use existing knowledge. In such cases, any work you undertake on the problem will not qualify for the tax credit; the information required to solve the problem is already available, so there is no relevant uncertainty. An exception for this would be where the existing knowledge is still a trade secret (though working to reverse engineer an existing product will not qualify for the credit).

Any evidence that you submit supporting that your research is covering a knowledge gap will reinforce your claim and will assist the assessment of your application.

## **Confirming that the answer is not already known**

It must be clear that the scientific or technological uncertainty could not be resolved using publicly available knowledge or resolved through knowledge deduced by a competent professional or by applying known engineering or design principles. This would include undertaking analysis or searches to research the current state of knowledge and why the existing knowledge fails to provide an answer to the problem or a methodology/established development path for resolving it.

## **Systematic approach**

If you use a systematic approach to test (analyse, prototype, or experiment with) possible solution(s) to see if you can resolve a scientific or technological uncertainty you may have core R&D activity that qualifies for the tax credit.

A systematic approach is a methodical (planned and structured) approach to test possible solution(s) to an uncertainty. The solution is the idea, proposal or hypothesis that is being investigated using the systematic approach. The test for a systematic approach in research contexts is whether the methodology is sufficiently structured and documented that it can be reproduced.

For your approach to be systematic you must keep records of the process followed and the outcome. You should know and document all of the following:

- what the scientific or technological uncertainty is. The uncertainty must be stated in sufficient detail for a competent professional to make a judgement about whether a systematic approach was required to assess (test, prototype or analyse) possible solution(s)
- what possible solution(s) your systematic approach is testing
- the actual activities that were undertaken to test the possible solution(s)
- what the result of the test(s) or experimentation was.

Once a scientific or technological uncertainty is identified, work will be considered systematic if it is sufficiently planned and structured to test the possible solution(s) and generate valid results. As far as possible you should base your record keeping for the tax credit on the documentation you already keep to manage your R&D. Find out more about record keeping for the R&D tax credit on page 90.

The systematic approach requirement is intended to exclude work carried out on a random, or unplanned trial and error, basis regardless of whether anything useful was discovered.

The systematic approach need not however involve detailed scientific experimentation with a formal hypothesis so long as there is an identifiable plan with a testable outcome. A planned iterative sequence of tested approaches is not the same as random trial and error.

Systematic approaches used to resolve scientific or technological uncertainty will typically vary from sector to sector. An engineering workshop may build and test a prototype, a food manufacturer may experiment with a new production process in a test kitchen and a software development company may run a range of data sets through a new algorithm to test if it will work.

Most businesses also systematically undertake work which would not qualify as an R&D activity, for example to modify an existing product for a new client, to design for a new site or to develop new goods or services in ways that do not require the resolution of scientific or technological uncertainty. The key to distinguishing eligible R&D activity from ineligible activities is the presence of scientific or technological uncertainty.

## Beginning and end of core activities

Core R&D activity generally begins once you have a testable idea, or proposition (hypothesis) which could resolve your scientific or technological uncertainty. A testable proposition is one that can be tested and seen to be supported (it works) or not (it does not). Core R&D can include:

- designing the systematic approach of testing, analysis or experimentation
- conducting the tests, analysis or experiments
- evaluating the results and feeding them back to modify the original proposition(s)
- running the modified testing process to test the modified proposition(s).

Core activities do not include work to research the state of existing knowledge or to formulate your testable idea or proposition. These activities typically occur before the core R&D begins. Provided you continue to the point of undertaking core R&D the work you did to determine the state of knowledge and formulate testable propositions may be eligible as supporting R&D activity. The description of supporting activity is in the following section.

If there are scientific or technological uncertainties around whether a process, service or product can be reliably produced at scale and the testing, measurement and evaluation continues in a production environment these activities may also qualify as core R&D activities. You should however be familiar with what is required for an activity to be a supporting activity on page 38, and with the expenditure rules that surround R&D in a commercial production environment on page 66.

Core R&D activity is expected to end when you cease to measure and evaluate the extent to which your activities have resolved the scientific or technological uncertainty.

In a large commercial project, you may be confident that you can achieve the overall goal but if technological uncertainty arises about how to resolve a particular issue the core R&D will both:

- start when you have a testable idea to overcome the problematic issue
- expect to end when you cease measuring and evaluating whether your activities have resolved the uncertainty.

## Important

There will often be a boundary between measuring and evaluating to resolve the uncertainty and testing for preproduction or quality control purposes. The commercial production rule on page 66 and the exclusions of routine testing on page 61, and preproduction activities page 51, are intended to ensure that such activities do not inappropriately qualify for the tax credit. You should be familiar with these provisions when you determine the end point of your R&D.

Systematic approaches used to resolve technological uncertainty will typically vary from sector to sector. An engineering workshop may build and test a prototype, a food manufacturer may experiment with a new production process in a test kitchen and a software development company may run a range of data sets through a new algorithm to test if it will work.

Check out our specific advice and examples from different sectors on pages 41 to 50. Advice is provided in the section on Claiming the R&D tax credit (page 95) about how tests, evaluations or experiments can be grouped together as a core activity. In summary you can group a series of tests, investigations or experiments together as 1 core activity provided they are aimed at testing the same solution or related solutions.

## Supporting research and development (R&D) activity

### Legislative reference and intent

Income Tax Act 2007 LY 2

The amendments define supporting research and development activities in a way that is intended to create a close nexus between the core and supporting activity.

If you have core R&D activity there may be related activities which, although they do not meet the definition of a core R&D activity are directly related to it and required for the conduct of the core R&D activity.

To qualify for the tax credit, a supporting R&D activity must both:

- support the core R&D activity as its only or main purpose
- be required for and integral to the core R&D activity.

In addition, the supporting R&D activity cannot be on the schedule of excluded supporting research and development (R&D) activities (page 51).

A core R&D activity may have a number of supporting R&D activities. Supporting activities can take place before, during or after the relevant core R&D activities

Activities which could qualify as supporting activities include:

- literature searches to determine if there is an existing successful approach or technological solution
- work undertaken to formulate your idea, proposition or hypothesis, so that it can be tested
- planning a series of tests, prototypes, or the necessary analysis
- writing specialised software to monitor R&D results
- designing and producing equipment to be used in testing or analysis
- routine crop management of plants required for core R&D activity
- documenting the R&D results to meet an internal stage gate or approval process
- disassembling testing equipment or prototype and/or disposing of waste material.

Supporting activities can precede the core R&D activity. For example, work you undertake to review the state of knowledge and develop your idea to the point where it can be tested can qualify as supporting activity provided the systematic approach (the core activity) goes ahead.

However, if there is a change of direction and the R&D does not go ahead or you discover the knowledge is already available, the expenditure related to the knowledge review and design work cannot be claimed for the tax credit. This is because there is no core R&D activity.

## Important

Although you can claim supporting activities that precede a core activity, you must have a core activity in an income year in order to claim the tax credit for that year. You cannot claim the credit in a year in which you have only supporting activities.

### Only or main purpose test

Supporting activities must only be performed for the relevant core activity or must have supporting the core activity as its main purpose.

If your activity supports a core R&D activity but also supports another purpose, you must assess what the main purpose of the activity is.

#### Example: Activity which has R&D as its only or main purpose

A business which develops new fruit cultivars is running a trial which seeks to resolve technological uncertainty and qualifies as core R&D. Work to tend and manage the trial crops is eligible as a supporting R&D activity. Because the uncertainty has not yet been resolved and the business has not decided which cultivar to commercialise, commercial arrangements are not in place to market the fruit. However, to recover some costs the easily harvestable crop is sold for stock food.

The main purpose of tending and managing the crop is to support the research and this activity is not disqualified from being a supporting activity because some costs are recovered. You should note however that under the feedstock rule the expenditure on growing the crops which can be claimed for the tax credit must be reduced by the market value of the output. For more information on the feedstock rule see Market value related exclusions including feedstock on page 80.

It is unlikely that an activity which is routinely undertaken for a non-R&D purpose will have a main purpose of supporting the R&D.

#### Example: Activity that is not for the only or main purpose

Company K is planning a series of tests to resolve a technological uncertainty related to its emissions.

It uses data drawn from its regular environmental monitoring in its planning of the testing process. The cost of the regular environmental monitoring process cannot be claimed for the tax credit as the activity does not meet the only or main purpose test.

### Required for and integral to core R&D activities

To be eligible as a supporting activity, an activity must be required for and integral to the core R&D activity. A required activity is a necessary part of the systematic approach you are using to resolve the scientific or technological uncertainty.

The provision that a supporting activity must be required for and integral to the core activity does not obligate a business to adopt the cheapest possible approach to its R&D. One business may seek a 99% confidence level for its activities, and another may be satisfied with 95%. In both cases the supporting activity required for and integral to the chosen objective would be eligible.

Similarly, business may go about their research in different ways. Activities that are required for the systematic approach that the business has chosen will not be disqualified simply because another business might have chosen a cheaper option.

### Example: Required support activity

Company M has found that requiring its staff to wear ear protection when working in its research facility is inefficient. It curtails valuable communication and staff can respond by removing the ear protection risking their hearing. Wherever possible Company M shields its staff from noise through the use of acoustic panels and other noise dampening technologies.

Company M is doing eligible R&D on a prototype of a new production process.

The installation of noise absorbing materials to shield staff from noise during testing would not be disqualified from being eligible as a supporting activity simply because another business might have issued ear muffs.

In this case the company is required to protect employee's hearing when conducting noisy activities and the choice of method is for the company to make. In order to be eligible as a supporting activity the activity would have to also meet the tests of being for the only or main purpose of supporting the core R&D and be integral to it.

Required support activity is eligible only as much as necessary to support the core R&D activity.

### Example: Activities that exceed what is required for core R&D

To resolve a technological uncertainty a seed company plans to conduct trials of a new cultivar on a farm. They are doing some initial soil testing work to inform the design of the trial. If the trial proceeds this will be an eligible supporting activity.

The farmer recognises that he would benefit if the soil testing is done over a wider area than is necessary for the trial. He arranges with the seed company that it conducts testing beyond that required to inform the design of the trial. The wider testing is not required for the core R&D and the expenditure on it is not eligible for the tax credit.

**Integral to** means that the supporting activity must be directly related to the core R&D activity and necessary for it.

### Example: Support activity that meets the definition and further activity that does not meet it

The staff involved with the core R&D have completed a series of tests and analysed the results and are satisfied that their work has resolved the technological uncertainty and that the desired technical specifications have been met.

The business manages its R&D through a structured governance approach. Documenting the results of the testing, to establish for the business's project governance committee that the technical specifications related to the uncertainty have been met, would be an eligible support activity.

However, further work to ready the written material for publication in an industry journal would fail the tests of being **required for** and **integral to** the core R&D activity.

# Sector specific guidance and examples

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The following sections address issues which typically arise in different sectors.

## Digital technology

The definition of R&D in digital services and products is the same as for other sectors. You should be familiar with the general guidance on core R&D activity (page 33). In summary, to be eligible for the R&D tax credit your core R&D activity must have a material purpose of both:

- creating new knowledge, or new or improved processes, services, or goods
- resolving scientific or technological uncertainty which cannot be resolved using knowledge that is, publicly available or deducible by a competent professional and therefore requires a systematic approach that creates new knowledge.

The research and development tax credit is intended to encourage development which goes beyond what competent professionals in that field know can be achieved with existing knowledge. It is not enough to be creating something new. To be eligible for the tax credit your development needs to involve pushing beyond (developing) what is currently known. This does not need to be a major or fundamental advance, it can be incremental. The uncertainty to be resolved can still qualify.

As in all other sectors, to be eligible for the tax credit you will need to be able to identify both the scientific or technological uncertainty you are seeking to resolve and the systematic approach that is being undertaken to resolve it.

Key issues in correctly identifying eligible R&D activity include the following (which are detailed below):

- identifying scientific or technological uncertainty in digital services and products
- the superficial similarity between the software development lifecycle and the requirement for a systematic approach that aims at resolving a scientific or technological uncertainty in an eligible R&D activity
- distinguishing activities eligible for the R&D tax credit from ineligible activities within the same overall project.

## Identifying technological uncertainty

Technology is the application of scientific knowledge for practical purposes. Scientific or technological uncertainty meets the standard required for the tax credit when a competent professional with access to publicly available information on the topic does not know whether something is achievable.

As set out in the guidance on the resolution of scientific or technological uncertainty (page 34) the uncertainty does not need to be absolute. It might arise because of a constraint, for example it is uncertain whether something can be done within a response time constraint or with high enough resolution to exceed what is currently known to be possible with existing technology/knowledge.

To identify technological uncertainty, it is recommended that you identify the technological challenge.

- It may be that you have tried the usual methods (deducible by a competent professional) and they have not worked.
- You may know that you are developing new architectures, frameworks or applications where the knowledge on how to achieve your objective cannot be worked out in advance (is not publicly available or deducible).
- You may be attempting to solve known uncertainties where there are current articles or discussions on that specific issue.

To identify **why** you are uncertain that you can achieve your objective using existing knowledge you should explain the process you used. How did you determine that existing products, methodologies, technological information and expertise were insufficient to bridge the knowledge gap and allow you to complete your objective?

### Example: Identifying technological uncertainty for a digital service

Marketplace are a company building a 2-sided market place with the purpose of bringing buyers and sellers of grain together locally and globally. In technical terms the stack is c#, .NET with Angular JS/React. There is a body of competent professionals in the market with these skills. Although such a market place for grain would be a **new service** simply building the marketplace is not eligible for the tax credit because there is no technological uncertainty. A competent professional in that field would know how to develop it.

In a subsequent phase Marketplace wishes to extend the marketplace to integrate a lot of publicly available data feeds that capture rainfall, sunshine hours, planting information and fertiliser sales as well as satellite images so that they can predict crop yields, providing users of the platform with more visibility of the likely future costs of products traded on the market place.

The work on the predictive analytics engine could be core R&D activity as none of the competent professionals with whom they have consulted are confident that the available feeds can be combined to predict crop yields to a stated accuracy level and that the result can be delivered to users in near real time.

Developing the integrations/interfaces to capture the data feeds could be supporting R&D activity if these are required to verify the results of the R&D and are only for the purpose of supporting the core R&D.

A development project may include business or market-related uncertainty. Market or commercial uncertainty does not give rise to eligibility for the R&D tax credit and for the avoidance of doubt market research and related activities (page 57) are specifically excluded from the definition of core R&D activities.

### Example: Product development where there is no technological uncertainty

Borer-R-US, a pest control company, wants to develop a product that predicts pest infestation. The product effectively re-packages known algorithms used to predict pest infestation, into a new product with a user interface built in well proven technology.

They have confidence that the product can be built and embark on a study of their potential market, researching how to market a digital product to their typical customer who normally buys cans of pest spray, and what model for monetisation might work.

None of the activity is eligible for the R&D tax credit. Market research is excluded as a core R&D activity and there is no scientific or technological uncertainty. The infestation algorithm is known to work, and the user interface is being built in a technology that a competent professional could derive a known path to a successful outcome.

Digital technology is everywhere, supporting developments in many fields including mathematics, physics and astronomy and the development of a wide range of consumer goods and services. Examples of where such developments may be a core R&D activity include the analysis required to develop and test new and improved algorithms such as those needed for:

- predictive modelling
- interrogating large data sets
- new functionality in firmware.

Or, in a typical IT development process, if you identify an issue that a competent professional in your field does not know how to resolve using existing technology or methods, there may be scientific and technological uncertainty. These issues might arise, for example, in your proof of concept work or during systems analysis.

On the other hand, if the path to the desired outcome can be identified and seen to be achievable from the outset, with the appropriate technical skills and expertise, it does not involve a scientific or technological uncertainty.

### Example: Technological uncertainty in a digital development

ManfSense manufactures ruggedised electronic sensor units that can be deployed outside in harsh conditions. As part of their manufacturing business they want to develop a product that will utilise component test data to understand what combination of variances from specification of the component parts will constitute a failed complete unit. This would lower their overall manufacturing yield.

The product will initially capture large amount of component test results and then over time use machine learning to **understand** whether a variation in specification, or combination of variances will or will not cause a failed product at the end-of-line test.

In this case the work to build the machine learning algorithms could be core R&D and the activity involving the capture, storage, indexing, retrieval of data, as well as the visualisation/exposure of the outcomes could be supporting R&D activity as those activities are required to prove that the product achieves its technical objectives.

ManfSense are also, as part of the product, building a report to show manufacturing cost savings from their ability to increase yield by knowing the impacts of spec variances in components. This would not be a supporting R&D activity as the report is simply tabulating cost savings and is not **required** for the purpose of the R&D.

### Software development lifecycle is superficially similar to the required systematic approach

Software development activities are systematic and may seek to develop new products or services. Because software development is systematic and iterative and almost always involves testing, businesses may wrongly assume that such software development activities are by their nature, eligible R&D activities.

However, the application of a software development lifecycle, does not mean that eligible R&D is taking place or that the issues being resolved are not being resolved on the basis of existing knowledge, information and expertise.

Unless there is a scientific or technological uncertainty which a competent professional would need to undertake a systematic approach to resolve, there is no basis for a claim for the R&D tax credit.

### Distinguishing activities eligible for the tax credit from ineligible activities

Core R&D in digital developments (and elsewhere) is usually only a subset of the activities on a larger commercial project. It is therefore important to establish and document when the activities that are eligible for the tax credit start and finish and to have systems in place that can identify and record the costs associated with those activities.

Core R&D activity begins when you have a testable proposition to overcome your scientific or technological uncertainty and ends when work to measure or evaluate the results of your work to overcome the uncertainty ceases. Eligible R&D in digital applications can include the design, development and testing activities directly required to resolve the scientific or technological uncertainty.

### Example: Eligible R&D ends when the technological uncertainty is resolved

PeopleBank needs an open application programming interface (API) for Open Banking. To meet the New Zealand legislative criteria and security audit requirements, they need to implement cryptography and key management that has never been implemented before.

None of the current cryptography and key management approaches will pass the criteria set by the testing organisations. They engage a university and get well-qualified researchers working on new cryptographical algorithms, a key management scheme and new protocols. The work is further constrained by having to run on low power devices like tablets and cell phones.

PeopleBank needs to resolve technological uncertainty in that they may not be able to achieve encryption and key management on low power devices sufficient to meet the constraints of the protocols that must be observed (such as timeouts). The work to develop, code and test the new algorithms and protocols could be R&D activity. As part of the process they **dry run** through the certifying lab to verify their implementation - this could also be eligible as R&D activity as it is required to confirm that the R&D has met the target specifications.

When going through the certification process Peoplebank ends up doing 3 runs through the certifying lab, due to some last-minute changes which made the solution non-compliant. These issues were corrected by reversing the last-minute changes. None of these additional cycles through the certifying lab are eligible as R&D activity as this testing occurred after the technological uncertainty had been resolved (this work would also be excluded as an activity involved in complying with statutory requirements or standards (page 58)).

## Record keeping

Record keeping for the tax credit should not require additional systems but will require both:

- project staff and/or managers to be alert to the possibility that their work involves the resolution of technological or scientific uncertainty
- an additional layer of detail to identify the activities that qualify for the tax credit and to record the associated expenditure. For example, the resolution of a technological uncertainty within a larger R&D project might be established and tracked as a project deliverable, or within an Agile approach as an Epic. General advice on record keeping appears in the section on record keeping on page 90.

Because of the speed at which digital technology moves it is particularly important that you keep contemporaneous records demonstrating your investigation of the state of knowledge at the time you undertook the activities for which you are claiming the R&D tax credit. Even if information that resolves the uncertainty subsequently becomes publicly available such records should enable you to demonstrate that the required information was not available when you began your work.

## Supporting activities in digital development

Expenditure on requirement gathering where no technological uncertainty exists is not in support of core R&D activity and would not qualify for the tax credit.

Planning activities such as estimating, scheduling and planning for the core and supporting R&D activities of the project could qualify as supporting activity.

There will be testing continuously through the entire project. To be a supporting R&D activity the purpose of the testing work must be to feed back into the core R&D. If the testing process simultaneously tests the core R&D and other aspects, you should apportion the time involved on a reasonable basis.

If user acceptance testing focuses on testing functionality (rather than the core R&D issues which have been resolved) or focuses on the look and feel of the solution it does not qualify as a supporting activity. If, however the user acceptance testing is intended to feed back into the resolution to the scientific or technological uncertainty then those activities may qualify as a supporting activity.

## Digital technology related activities excluded from being R&D activities

For the avoidance of doubt several digital technology related activities have been excluded as R&D activities (pages 54 to 56). By themselves these activities do not amount to R&D activities.

In addition, despite the possibility that there may be research and development activities which meet the definition of core R&D activities internal software development intended for the sole or main purpose of improving the internal administration of your business, or your associates' business, is considered, ineligible internal software development so an excluded core R&D activity (page 56).

Eligible internal software development, where the software is not for sale or license, is subject to an internal software development expenditure cap of \$25 million (page 84).

This means that a maximum of \$25 million of expenditure may be claimed in respect of eligible internal software development, where you:

- have eligible R&D activities
- develop software intended for internal use unrelated to administration or to improve non-digital services to customers.

## Primary production

The R&D tax credit intends to incentivise activities where the outcome of those activities cannot be known or determined in advance. Where there is scientific or technological uncertainty, systematic activities to resolve the uncertainty may be eligible for the tax credit across a wide range of products and processes in primary production.

For example, this includes new knowledge or new or improved:

- cultivars
- irrigation systems
- pest management approaches
- environmental mitigations
- harvesting technologies.

The key requirement for eligibility in primary production is the same as in other sectors. You must be able to identify a technological uncertainty that a competent professional could not resolve using existing knowledge. You must also undertake systematic activities designed to resolve that uncertainty.

In primary production key issues in the application of the tax credit arise in several areas including:

- the use of trials to test existing products, processes or systems
- what it means to be resolving scientific and technological uncertainty.

## Production trials

Trials are a systematic approach that may be used in eligible core R&D activities and for other purposes.

If a process, system, or product has already been tested and proven in one context and is known to work, trials you undertake to test it in your context (for example in a new location or to test it with a new crop or soil type) are unlikely to be regarded as an eligible core R&D activity. This is because the underlying technology is likely to be well understood by a competent professional even if the specific test results in the new context cannot be predicted in advance they are more likely to be regarded as demonstration of commercial viability (an excluded activity) than as trials to resolve scientific or technological uncertainty.

If you are assessing the productivity of existing cultivars on a specific site, or testing which existing system (for example production, irrigation or harvesting), best meets your needs, it is unlikely that your activities would be seen as seeking to resolve scientific and technological uncertainty.

### Example: Ineligible trial in primary production

A horticulture business imports a variety of commercially available cultivars and establishes a trial to evaluate the relative productivity of the new cultivars over several growing seasons. The purpose of this trial is to evaluate the different cultivars against one another.

Those managing the trial know that they will gather data that answers their question of which cultivar is the most productive in their environment. There is no scientific or technological uncertainty. The trial would not be eligible as an R&D activity.

### Scientific or technological uncertainty

For a trial to be eligible it needs to have been established to test a scientific or technological uncertainty.

For you to show that you have been seeking to resolve scientific or technological uncertainty you will need to record how you determined that publicly available information could not resolve your uncertainty (bridge your knowledge gap). You will also need to provide evidence that your systematic activities were sufficiently planned and structured to have a material purpose of resolving the uncertainty.

In a primary production context identifying a scientific or technological uncertainty could include sourcing information from suppliers, research organisation, industry journals or university departments.

For trials to be sufficiently structured to resolve uncertainty it is likely that they will have identified and controlled for as many variables as possible. To be eligible, trials must be testing solution(s) to an identified uncertainty. The test must be designed to observe, measure and evaluate the effect, while controlling as much as possible for other factors which might interfere.

### Example: Eligible trial to test possible solutions

A farmer wishes to reduce the incidence of animal parasites resistant to available drenches. He commissions research from a Crown Research Institute (CRI) to better understand the effects of farm management practices on reducing the incidence of drench resistance.

The CRI develops some hypotheses about the likely issues that cause disease resistance. It runs appropriately designed farm trials to test these hypotheses, combining different drenching regimes and farm practices. The trials also control for other variables. This may be an eligible core R&D activity.

If trials are taking place across a larger area than is necessary to provide valid results the excess area would not be regarded as having a material purpose of resolving scientific or technological uncertainty.

## Food and beverage

New Zealand has a significant number of different sized businesses in the food and beverage sector. As in other sectors, the key requirement for eligibility is that the business uses a systematic process to resolve a scientific or technological uncertainty which could not be resolved using existing knowledge.

If your business spends money to experimentally develop new products or services, or to solve technical problems, you may be undertaking activities that qualify for the tax credit.

Important distinctions for the food industry include distinguishing between eligible core R&D activities and:

- activities undertaken to confirm expected results or make minor adaptations to existing products based on existing knowledge
- activities around scaling up from a test facility to mass production where there is no technological or scientific uncertainty
- analysis and experimentation required to comply with statutory requirements or standards.

## Eligible R&D activities compared with minor adaptation

The development of new products and recipes may be based on existing knowledge where testing and trialling is required to fine tune the outcome. In these circumstances a competent professional would know from the outset that with the appropriate skills and expertise the desired outcome is possible and how to achieve it.

Where a competent professional knows that it is possible to successfully develop a product or adapt a recipe, and testing is only required to confirm or optimise the results, the activities would not be eligible for the tax credit.

### Example: Ineligible experimentation in product development

Julia's company produces ice blocks using different flavourings. She employs a food technologist (Leila) to manage the quality control and recipe development process. Leila also oversees the work necessary to develop new flavours and scale up from the test kitchen to production.

The product range is based around citrus flavours and Leila knows the parameters within which a new juice can be successfully introduced to the base recipes. She also knows how to vary the base recipe to accommodate seasonal variations, provided the characteristics of a juice fall within a defined range of the preferred parameters. These changes are made based on existing knowledge.

In these circumstances testing undertaken by the food technologist to analyse the characteristics of a new juice, to incorporate it into the base recipe and to finalise and document the details of the recipe for use with Julia's production equipment, is not carried out with the purpose of resolving scientific or technological uncertainty. As such Julia would not be able to claim the tax credit for these activities.

Ideas for product or process development can however go beyond what competent professionals know how to do based on existing knowledge. In these cases, a systematic process will need to be designed to test whether it is possible to create a new product that meets defined technical requirements. Such activities may be eligible core R&D activities.

### Example: Eligible R&D in developing a new food product

Julia wants to enlarge her ice block product range beyond citrus flavours to incorporate alcoholic spirits. Leila does not know whether it is possible to develop a product with the desired taste and shelf life characteristics.

After a web search and consultation with a university food technology department, she finds that several companies are active in this segment overseas, but the information on their processes is not publicly available and none are using the spirits Julia wants to incorporate.

Julia's objective is to make ice blocks with a defined shelf life and which taste like the cocktails they are based on. Following the consultation process outlined above, there is technological uncertainty around how to incorporate tequila and vodka alongside lime and grapefruit juices. Because the addition of alcohol changes the way the ingredients freeze and there is no information about the processes that are used overseas to produce alcoholic ice blocks at scale, the uncertainty continues beyond the test kitchen until the alcoholic ice block has been successfully produced at scale.

It is likely that Julia could claim the test kitchen experimentation and trials in the production facility as core R&D activities. The eligible activities could include the taste testing undertaken by a sensory panel and work to test the shelf life of the new products.

Once the shelf life testing has resolved the uncertainty about whether the flavour persists over the desired shelf life any ongoing testing would be regarded as undertaken for the purpose of quality control or routine testing and would be ineligible for the tax credit.

## Scaling up

Where a new product or process has been developed trials may be required to determine how the outcome, which has been achieved at a small scale, can be scaled up and reproduced using mass production techniques.

Provided scientific or technological uncertainty remains, trials to determine whether the outcome can be reproduced at scale will be eligible as core R&D activities. Eligible R&D around scaling up is illustrated in the **trials** section of the Manufacturing guidance (page 48).

## Complying with statutory standards

Food companies typically undertake analysis and testing to complete nutrition panels and to make sure their products are produced to the desired standards. Such testing is not undertaken to resolve scientific or technological uncertainty and is specifically excluded by the exclusion of activities involved in complying with statutory requirements or standards (page 58) and it is not eligible for the tax credit.

## Manufacturing

The development of new products and processes in manufacturing may involve the resolution of scientific or technological uncertainty. Key issues in understanding the tax credit in a manufacturing context include:

- recognising technological uncertainty in a manufacturing environment
- determining when the R&D process is finished, and ineligible pre-production activities have begun
- determining whether a trial is eligible as a core R&D activity
- determining whether activities are eligible as supporting R&D activities.

## Technological uncertainty in a manufacturing environment

To take full advantage of the tax credit staff considering the development or improvement of a product or process need to ask what is required to succeed.

- If the project involves the application of existing knowledge with prototyping and testing (including customer testing) required to confirm and fine tune results and to iterate towards the best outcome, the activities are unlikely to qualify for the tax credit.
- Alternatively, if competent professionals in the field do not know whether the desired outcome is possible, or how to achieve it, and a programme of prototyping and testing is required to test possible solutions to the uncertainty, there may be eligible core R&D activities. The example on page 32 (Technological uncertainty arising from a cost constraint) illustrates R&D in a manufacturing context.

Eligible R&D activities may be recognised at the beginning of the project or may emerge when something that was thought to be straightforward proves difficult. When a problem arises during a project the test is essentially the same: could a competent professional familiar with the field, and who has access to publicly available information, solve this problem. If standard diagnostic approaches fail and a systematic approach is required to research the problem, there may be eligible core R&D activities.

It may be necessary to trial prototypes with customers to determine whether your R&D will meet its technical objectives in a commercial environment. Provided these trials are undertaken to resolve technological rather than commercial uncertainty they may be eligible for the tax credit.

Once the scientific or technological uncertainty has been resolved eligibility for the tax credit ends.

## Pre-production activities

Trials and demonstrations undertaken to influence potential customers are ineligible for the tax credit as are activities such as tooling up and planning the commercial production process.

As explained in the exclusion relating to pre-production activities, including demonstrations of commercial viability and tooling up, on page 51, pre-production activities are explicitly excluded from being core or supporting R&D activities. It is however recognised that eligible R&D can arise during the pre-production process and that eligible R&D and ineligible pre-production activities can be going on at the same time. More information is provided in the following section on trials and in the discussion of the pre-production exclusion.

## Trials

Tests to commission equipment, calibrate, fine-tune, or optimise processes or production systems are not eligible as core R&D activities unless there is scientific or technological uncertainty to resolve.

Many production systems and processes, such as the commissioning of equipment in a new environment, require or benefit from fine-tuning or calibration to optimise performance. These processes may involve running tests and recording and evaluating the results.

These trials are part of standard processes used and understood by competent professionals in those fields and are directed towards confirming a result within an expected range. These trials themselves do not seek to resolve scientific or technological uncertainty.

If, however, these processes throw up unexpected problems requiring the resolution of scientific or technological uncertainty, there may be an eligible R&D activity.

#### **Example: Ineligible trial to commission new equipment**

Clarke and Co are installing a machine that is new to them, but which has been successfully used in other sites. The vendor supplies information and an engineer to oversee the installation and calibration process. The process is complex but understood by the vendor's representative, and the problems that arise are resolved through the application of a routine diagnostic process. There is no scientific or technological uncertainty. These activities are pre-production activities and are not core, nor supporting R&D activities.

Where a new product or process has been developed trials may be required to determine whether the outcome which has been achieved at a small scale can be scaled up and reproduced using mass production techniques.

Provided scientific or technological uncertainty remains, trials to determine whether the outcome can be reproduced at scale may be eligible as core R&D activities.

#### **Example: Eligible trial at scale**

Apgar is testing whether its proposed new consumer product which it has successfully prototyped in a pilot, can be manufactured at scale. The proposed manufacturing process has not previously been used for this type of product and although the design engineers have proposed solutions to the technological challenges they are uncertain how the process will perform at full scale and whether the product will meet specifications. The programme of production trials meets the requirements for seeking to resolve technological uncertainty.

To conduct the tests Apgar takes 1 production line out of commercial production to accommodate the R&D. The early output from the production trials is not for sale but if Apgar's production trials succeed a number of units will be released to a few customers at discounted prices, with the intention that the customer's feedback contributes to the assessment of whether the product meets durability requirements.

The programme of testing at scale may be eligible for the R&D tax credit. Expenditure on the testing is not subject to the commercial production rules because the output is not widely offered for sale, see more detail on commercial production on page 66. The cost of the units that are sold will however be subject to the feedstock rules, see page 80.

## **Support activities in a production environment**

Supporting R&D activities must have the only or main purpose of supporting 1 or more core R&D activities. In addition, they must be required for and integral to the core R&D activities.

In a production environment it is possible that some activities that contribute to core R&D activities also support the normal production process. In this context, the work of the staff supporting the normal production process is unlikely to meet the test of having the only or main purpose of supporting the core R&D activities.

The work performed by these staff would not be eligible as a supporting R&D activity.

### Example: Ineligible supporting activities in a production environment

Zeanith and Co is testing a proposed change to its production system which is designed to significantly reduce a certain type of wastage. Whether the proposed modification will be successful is unknown, and the testing is for the purpose of resolving technological uncertainty.

The testing is taking place at the same time goods are being produced for sale.

Although the required testing could not be done in the absence of the production process, the duties of the production staff cannot be counted as support activities. The staff are not involved in the testing, so they are not undertaking core R&D and their main purpose is to produce goods for sale. Their duties do not have the only or main purpose of supporting Zeanith and Co's core R&D activity.

**Note:** The costs of the production staff would also be excluded by the rules relating to expenditure in the course of commercial production which only permit the additional costs to be claimed.

# Activities excluded from being a research and development (R&D) activity

## Legislative reference and intent

Income Tax Act 2007 Schedule 21

Activities have been excluded from being an R&D activity for several reasons, including:

- to clarify that the activity does not amount to R&D because the knowledge required to resolve the uncertainty is publicly available or is deductible by a competent professional
- to clarify that the activity does not amount to R&D because it occurs before any scientific or technological uncertainty is identified, or after the uncertainty has been resolved
- there are inadequate spill-over benefits
- the fiscal cost associated with the activity is too high
- the Government may not want to incentivise the activity through an R&D tax credit regime
- incentives other than an R&D tax credit regime may be better suited to supporting the activity.

The 2008 excluded activity list only applied to core activities. New schedule 21 also contains a list, in part B, of supporting activity exclusions. Excluding activities from the supporting activity definition clarifies which activities are completely excluded from the R&D tax credit regime. This clarification is intended to reduce compliance and administrative costs.

Please note that all activities must first meet the relevant tests for a core or supporting activity, before consideration is given to whether the following exclusions apply. In other words, if your activity is not excluded by Schedule 21, that does not by itself mean that it is eligible.

## Pre-production activities and reverse engineering

### Preproduction activities, including demonstration of commercial viability and tooling up (Schedule 21 Part A Clause 1 and Part B Clause 1)

Pre-production activities are excluded from being core R&D activities. This excludes any activities that occur before production but after scientific or technological uncertainty has been resolved. The excluded activities include:

- demonstrations of commercial viability
- tooling-up for commercial production
- planning the production process
- developing control systems
- undertaking start-up procedures
- commissioning new equipment (an example illustrating the exclusion is included in the manufacturing industry guidance on page 48).

If scientific or technological uncertainty arises during pre-production activities, which a competent professional cannot resolve on the basis of publicly available information, including using known methods for resolving that sort of problem, it may give rise to core R&D activities. The tests for an eligible core R&D activity must however be applied and met. Standalone pre-production activities, or pre-production activities which form part of an overall R&D project cannot be assumed to be eligible simply because they are systematic or because they provide feedback or data required to confirm commercial viability or to optimise the production set-up.

If eligible R&D is still being conducted alongside pre-production activities the pre-production activities are ineligible, but the activity directed towards resolving the remaining uncertainty may be eligible for the tax credit.

### Example: R&D occurring alongside preproduction activities

Aparar has resolved many of the technological uncertainties around a new consumer product. The company is fine tuning the control systems for the commercial production process and is tooling up for commercial production.

At the same time technological uncertainty, around whether a component can perform to the desired specification, remains. Aparar plan to test methods of resolving this uncertainty on the commercial line using the production tools. At the same time feedback from **trial runs** on the line is being used to fine tune the production process.

The costs of developing the control systems, tooling up for commercial production and fine tuning the production process are excluded as pre-production activities.

The costs, relating to testing the component where technological uncertainty remains, may be eligible for the tax credit. Depending on how the component testing is undertaken the commercial production rules may apply (page 66).

Pre-production activities are also ineligible as supporting R&D activities. These activities occur after the scientific or technological uncertainty has been resolved and are not for the only or main purpose of supporting core R&D activities.

The exclusion of preproduction activities also applies where an existing product or process is being adapted to a customer's need or site. In these instances, standard engineering approaches will be deployed including for problem solving. The presence of a systematic approach to optimise or fine tune a set-up does not imply a scientific or technological uncertainty. If a scientific or technological uncertainty arises during such a process, there may however be eligible R&D activities.

### **Reproduction of a commercial product or process by a physical examination of an existing product or system, or from plans, blueprints, detailed specifications, or publicly available information (Schedule 21 Part A Clause 22)**

Reproduction of a commercial product or process is excluded from being a core R&D activity. Excluded activities are copying or reproducing a product, system or process from:

- a physical examination of the product, process or system
- plans
- blueprints
- detailed specifications
- publicly available information.

This type of reproduction (sometimes called reverse engineering) is excluded because the product, system or process can by definition be reproduced from available industry knowledge and information and therefore without requiring the resolution of scientific or technological uncertainty.

### **Minor adaptations, cosmetic or stylistic changes or improvements, including to software**

#### **Minor adaptation of, or improvement to, existing processes, services, or goods (Schedule 21 Part A Clause 15)**

There is no entitlement to the R&D tax credit because a systematic approach has been used to make a minor change or improvement to an existing process, service or good.

**Existing** has the dictionary definition and is used to describe something which is already present, available, or in operation. A process, service or good is not existing if it is being developed for the first time.

For an activity to be eligible as an R&D activity, your desired change or improvement must seek to resolve scientific or technological uncertainty.

### Example: Minor adaption as an excluded activity

Mike and Fulia are in a partnership which designs and builds houses. In response to market demand they are improving their designs to achieve **passive house** energy efficient standards.

Their designs are new and Mike and Fulia are very systematic in checking each stage of design and construction complies with the performance standards. In addition, they are uncertain about whether the project will be commercially successful.

The principles for passive house design are however well understood and there is no scientific or technological uncertainty in what Mike and Fulia are doing. Because of the absence of scientific or technological uncertainty this type of adaption or improvement does not qualify as a core R&D activity.

If an existing product, service or process is being developed in a way that requires a core R&D activity and minor adaptations or improvements are being made at the same time, the eligibility of the work to improve or adapt will depend on whether this aspect of the work meets the definition of a supporting R&D activity.

## Making cosmetic or stylistic changes to processes, services, or goods (Schedule 21 Part A Clause 21)

This exclusion means that an activity which alters the appearance or shape of something, but which does not seek to resolve scientific or technological uncertainty is excluded from being a core R&D activity.

### Example: Stylistic changes that do not qualify as R&D

Company A wants to refresh its product range and decides to move into acid colours and to incorporate curved surfaces.

This work produces a new product range but does not involve the resolution of scientific or technological uncertainty. These activities are cosmetic or stylistic changes and are ineligible for the R&D tax credit as core R&D activities.

Provided the core R&D activity definition is satisfied, R&D on new stylistic or cosmetic products or processes such as paints, glazes, cosmetics, or means of achieving visual effects in software are not affected by this exclusion.

### Example: Eligible R&D in a cosmetic process

Company B is developing a new process to dye nylon for use in 3D printing. The work will seek to resolve uncertainties with the technology and will improve their current product.

A competent professional cannot deduce, based on publicly available information, whether the new process will resolve the uncertainty and achieve the desired effect. Company B's activities are not disqualified from being core R&D activities because they relate to a dye process which affects the appearance of the finished article.

An activity that involves making cosmetic or stylistic changes may be eligible as a supporting R&D activity if the work meets the supporting activity definition. That is, if the cosmetic or stylistic activities have the only or main purpose of supporting the core activity and is required for and integral to the core R&D activity.

### Example: Stylistic changes eligible as support activity

A business is upgrading a vacuum cleaner. The eligible R&D involves redeveloping the motor to be significantly more energy efficient and smaller.

Redesigning the motor results in a need to also redesign the vacuum cleaner casing, because the casing does not fit the redesigned motor. The upgraded motor cannot be fully tested unless it has a suitably shaped casing that fits.

The changes to the casing have the main purpose of supporting the core R&D activity and are required for the core R&D activity. As such, the changes may be eligible as supporting activities.

Stylistic or cosmetic changes that are made for commercial reasons, instead of being for the purpose of supporting a core R&D activity, are not eligible. This is because the supporting activity definition requires activities to be for the only or main purpose of, required for, and integral to a relevant core R&D activity.

### **Example: Stylistic change which is ineligible as a supporting activity**

A business is redeveloping a product, so it can be voice activated. The eligible activities involve changes to the existing activation module and require a technological advance which meets the definition of a core R&D activity.

At the same time, the casing for the product is being redesigned to give it a more contemporary look. These changes are independent of the voice activation module and are not eligible as a support activity as they are not for the only or main purpose of supporting the core R&D and are not required to support the core R&D activity.

### **Supporting or making minor improvements to existing computer software, using known methods (Schedule 21 Part A Clause 3 and Part B Clause 3)**

No entitlement to the tax credit arises where minor improvements are made to existing computer software using known methods. Known methods are methods that a competent professional familiar with that type of software, knows could achieve that improvement.

**Existing** has the dictionary definition and is used to describe something which is already present, available, or in operation. A process service or good is not existing if it is being developed for the first time.

These activities are excluded because they do not seek to resolve scientific or technological uncertainty.

Making minor improvements to existing computer software, or supporting users in the use of such software, is also excluded as a supporting R&D activity.

For completeness major improvements to existing computer software are eligible for the R&D tax credit if they meet the definitions of core or supporting R&D activity.

### **Software testing, debugging, maintenance and conversion related exclusions**

#### **Routine de-bugging of existing computer software (Schedule 21 Part A Clause 2 and Part B Clause 2)**

Routine de-bugging is the process of fixing errors or faults in software. De-bugging may be systematic, but it does not seek to resolve scientific or technological uncertainty and does not qualify as a core R&D activity.

Where the creation of new software is an R&D activity, debugging that new software may be eligible as a supporting R&D activity.

Routine debugging of existing software is however excluded as a supporting R&D activity.

#### **Routine software and computer maintenance (Schedule 21 Part A Clause 4 and Part B Clause 4)**

Routine computer and software maintenance include regular tasks such as updating security patches, installing software updates, backing up data and uninstalling unused programmes. It is good practice to undertake these tasks systematically, but they are excluded from qualifying for the tax credit because they do not seek to resolve scientific or technological uncertainty.

Routine software and computer maintenance is also excluded from being a supporting R&D activity.

## **Bug testing, beta testing, system requirement testing, user acceptance testing, and data integrity testing (Schedule 21 Part A Clause 16)**

- Bug testing is the process of finding errors or faults in software.
- Beta testing is the 2nd phase of software testing in which a sample of the intended audience tries the product out.
- System testing is testing conducted on a complete integrated system to evaluate the system's compliance with its specified requirements.
- User acceptance testing (UAT) is the last phase of the software testing process. During UAT, actual software users test the software to make sure it can handle required tasks in real-world scenarios, according to specifications.
- Data integrity test techniques verify that data is being stored by the system in a manner where the data is not compromised by updating, restoration, or retrieval processing.

Although these activities may use a systematic process, they themselves do not seek to resolve scientific or technological uncertainty.

Where there is an eligible core R&D activity, testing may be eligible as R&D activity. There is further discussion of testing in the section on digital technology from page 41.

### **Example: Ineligible beta testing**

A company has released an innovative new software product for beta testing. Although the product is new and innovative, and the testing uses a systematic process there was no scientific or technological uncertainty in the development of the new product.

Because the testing is not testing whether scientific or technological uncertainty has been resolved it does not qualify as a core R&D activity.

### **Example: Testing which may be eligible as a support activity**

A company which specialises in driverless vehicle design is developing its product in a way that requires the resolution of technological uncertainty. Bug testing, of the software in the control module while not directly related to the resolution of the technological uncertainty, may qualify as a supporting R&D activity.

Expenditure on testing undertaken after the technological uncertainty has been resolved will not be eligible for the tax credit.

## **Data mapping and data migration testing (Schedule 21 Part A Clause 17)**

In computing and data management, data mapping is the process of creating data element mappings between 2 distinct data models. Data mapping is used as a first step for a wide variety of data integration tasks.

Data migration testing is required when data is being moved from 1 system, often a legacy system, to another system.

Although these activities may use a systematic process, they do not themselves seek to resolve scientific or technological uncertainty. These activities do not qualify as a core R&D activity.

## **Testing, or comparing the efficiency, of algorithms that are already known to work (Schedule 21 Part A Clause 18)**

Tests that simply compare efficiency of existing products, processes, systems or algorithms are not eligible for the tax credit. Although these tests may use a systematic process they do not seek to resolve scientific or technological uncertainty.

It is possible that taking existing algorithms that are known to work in one context and applying them in a new context may be eligible as a core R&D activity. Testing or comparing the algorithms in the new context would however only be eligible if it involved resolving scientific or technological uncertainty.

## **Testing security protocols or arrangements (Schedule 21 Part A Clause 19)**

Security testing and security protocol testing are processes intended to reveal flaws in the security mechanisms of an information system. These terms generally refer to tests of existing systems and links. Such tests do not seek to resolve scientific or technological uncertainty and do not qualify as R&D activities.

Where there is a core R&D activity, testing the security arrangements and protocols may be eligible as a supporting activity if it meets the supporting activity requirements (page 38).

## **Converting existing systems to, or integrating existing systems with, new software platforms (Schedule 21 Part A Clause 20)**

Activities where the purpose is to extend the life of, improve or renew a product or service by establishing it on a new software platform are excluded. Such activities are ineligible for the tax credit.

**Existing** has the dictionary definition and is used to describe something which is already present, available, or in operation. A system is not an **existing system** if it is being developed for the first time.

The reason activities related to converting systems or integrating systems with new software platforms have been excluded from the tax credit is because such activities are usually specific to the business. Therefore, the spill over benefits from resolving technological uncertainties related to such work were considered insufficient to justify the fiscal risk to the Government of including such activities.

If such activities meet the definition of a supporting R&D activity they could be eligible for the tax credit.

## **Ineligible internal software development (Schedule 21 Part A Clause 11 and Part B Clause 11)**

This exclusion covers software development undertaken for the only or main purpose of the internal administration of your business, or the business of your associate(s). The purposes of internal administration include but are not limited to:

- payroll systems
- accounting systems
- executive or management information systems
- human resources systems
- enterprise resource planning systems
- purchasing
- invoicing systems
- inventory systems.

This exclusion covers both core and supporting activities and applies because the spill over benefits of the excluded activities are considered to be insufficient to warrant the provision of a government subsidy.

Find more information on internal software development that enhances services to customers and external software development on page 83.

## **Prospecting for, exploring for, or drilling for, minerals, petroleum, natural gas, or geothermal energy (Schedule 21 Part A Clause 5 and Part B Clause 5)**

Prospecting and exploring are not activities the tax credit is intended to encourage. Such activities resolve uncertainty relating to geography or location, rather than technological or scientific uncertainty.

Prospecting, exploring and drilling for minerals, petroleum, natural gas or geothermal energy are therefore excluded from both from being core or supporting R&D activities.

It is possible to have an eligible R&D activity in extractive industries. Examples that may meet the tests for an eligible core R&D activity include the development of improved conceptual generic mineralisation models or devices, provided the models or devices have general application (if the model was site specific it would be assumed to be for the purpose of prospecting or exploring and caught by the exclusion).

There may be also be scientific or technological uncertainty relating to drilling methods. If you are undertaking a systematic approach to resolve such uncertainty your activity may be eligible for the tax credit and drilling may be eligible as a supporting R&D activity. You should be aware however that if the drilling is also for the purpose of prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal energy you will need to demonstrate that it was for the main purpose of supporting the core R&D activity. Further it is likely that in such a situation the rules related to commercial production would apply, see page 66.

To be eligible as a supporting R&D activity, drilling would need to be all the following:

- only or mainly for the purpose of the supporting the core R&D activity
- required for the core R&D activity
- integral to the core R&D activities.

#### **Example: Drilling as a support activity**

A mining company is seeking to develop a new drill bit and to resolve technological uncertainty the bit must be tested in field trials.

Drilling that is wholly or mainly for the purpose of, required for and integral to the experimental phase of the development of the new drill bit may qualify as a supporting R&D activity.

## **Market research, market testing, market development, or sales promotion, including consumer surveys (Schedule 21 Part A Clause 6 and Part B Clause 6)**

This exclusion targets all activities:

- conducted to investigate consumers' preferences and/or potential interest in a product or service
- conducted to investigate the characteristics or features of a product or service which appeal or might appeal to a customer segment
- designed to encourage the consumption of products or services.

These types of activities do not have the purpose of resolving scientific or technological uncertainty.

#### **Example: Ineligible market research**

Company C is designing a new product, and this work involves some eligible R&D activities. It undertakes an investigation into whether it will be viable to launch the new product in a new market.

While Company C's design of the new product includes some eligible R&D activities, its market research is not an eligible core or supporting activity. The market research has a commercial purpose and does not have a material purpose of resolving scientific or technological uncertainty. Nor is the activity required to resolve the technological uncertainty associated with the design of the new product. Company C's market research is ineligible as a core or supporting R&D activity.

If an R&D project has a technological objective that can only be measured through testing (sensory evaluation) that involves consumers, that testing is not affected by this exclusion. That is, the activities may be eligible despite this exclusion.

### Example: Consumer testing may be an eligible R&D activity

Company D is developing a new preservative ingredient for use in tomato sauce. This work requires the resolution of technological uncertainty.

A panel is convened to test whether the new ingredient is detectable at various levels. Whether the taste profile is affected, and to what degree, will determine whether the required flavour specifications can be met. In this case expenditure on the sensory panel may be eligible for the tax credit.

Market research, market testing, market development or sales promotion including consumer surveys (Schedule 21 Part B Clause 6) are also excluded from being supporting R&D activities. This exclusion exists because even where such activities may occur within the same overall project as core R&D activity they support commercial objectives rather than the resolution of scientific or technological uncertainty.

## Patenting and complying with statutory requirements and standards

### Commercial, legal, or administrative aspects of patenting, licensing, or other similar activities (Schedule 21 Part A Clause 7 and Part B Clause 7)

This exclusion is concerned with the commercial, legal and administrative activity associated with both:

- taking steps to protect your own intellectual property
- granting rights to another party to use or access your intellectual property.

The scope of the exclusion covers all types of intellectual property including patents, trademarks, designs and plant breeders' rights.

Examples of activities excluded by this section include:

- researching, preparing and filing applications for intellectual property registrations
- licensing (which includes the cost of any fees paid for those rights, any legal activities associated with negotiating the licence, and the administrative costs of all associated paperwork).

Commercial, legal and administrative activities such as those identified above are not seeking to resolve scientific or technological uncertainty and typically take place after any scientific or technological uncertainty has been resolved.

The commercial, legal and administrative aspects of patenting and licensing are not essential (required for and integral to) the core activity which seeks to resolve scientific or technological uncertainty. Accordingly, these activities are also excluded from being support activities.

This exclusion does not exclude patent searches that are undertaken to discover the existing state of knowledge. These types of searches may be eligible as supporting activities if they satisfy the supporting activity definition.

### Activities involved in complying with statutory requirements or standards

#### (Schedule 21 Part A Clause 8 and Part B Clause 8)

Activity involved in demonstrating compliance with statutory requirements or standards is excluded from being a core R&D activity. This exclusion will cover any activity carried out to meet a requirement in any:

- legislation
- regulations
- standards - for example those developed by Standards New Zealand or joint Australia-New Zealand or international standards.

This exclusion targets both:

- routine testing and analysis of materials, products and processes to check that they comply with statutory requirements or standards
- activities such as the analysis required to complete nutrition panels to comply with market requirements. These activities are excluded when they are undertaken to test compliance and support entry to a market rather than to resolve technological uncertainty.

R&D activities that are a condition of a statutory consent or concession are also excluded from being an eligible activity. This for example excludes R&D you are required to undertake to research the environmental impact of your activities.

Activity involved in complying with statutory requirements or standards for **pre-existing** processes, services or products is also excluded from being a supporting R&D activity. Pre-existing means something which is present, available, or in operation before the R&D began. A process, service or good is not pre-existing if it is being developed for the first time.

Testing to determine whether a **new** product, service or process meets the technical requirements of relevant statutory or other standards may be an eligible R&D activity. If there is scientific or technological uncertainty about whether a new or improved product, service or process can be developed, which meets the statutory requirements or standards, work to resolve the uncertainty may qualify for the tax credit.

For example, where there are core R&D activities in the development of pharmaceuticals this exclusion is not intended to exclude conducting Phase I, II and III clinical trials. If there is scientific or technological uncertainty it does not matter that these trials are necessary to gain subsequent regulatory approvals.

If a standard changes, or a new standard is introduced, routine testing of an existing product or process to determine whether it meets the requirements is caught by this exclusion. If the change to the standard requires the product or process to be reformulated or redesigned, which in turn, requires the resolution of scientific or technological uncertainty there may be an eligible R&D activity.

#### **Example: Ineligible activities to meet a new standard**

Noggin produces hard hats. A new international standard for hard hats has been introduced into New Zealand. Noggin tests their existing range against the new standard. This testing activity is excluded from eligibility for the tax credit.

#### **Example: R&D activities required as a result of a new standard**

Some of Noggin's hard hat range fails to meet the new standard. Noggin's product designers are unsure whether they can meet the new impact resistance requirements while retaining their trademark air flow capability. After reviewing the state of knowledge and consulting materials engineers, they conclude that there is technological uncertainty about whether this range can be redesigned to meet the new standard. The activities undertaken by Noggin to resolve the uncertainty may qualify for the tax credit.

## Social sciences, arts, humanities, organisational design and management studies

### Research in social sciences, arts, or humanities (Schedule 21 Part A Clause 12)

Regardless of whether or not there is scientific or technological uncertainty research in the social sciences, arts or humanities is not eligible as a core R&D activity. The legislation does not define the scope of the exclusion but without providing an exhaustive list, the commonly accepted meanings of the terms social sciences, arts and humanities includes:

- economics
- classics
- communication studies
- education
- finance
- business studies
- geography
- languages
- literature
- music
- philosophy
- sociology
- anthropology
- psychology
- history
- religion
- visual and performing arts.

#### Example: Excluded social science research

A business selling educational products researches how children respond to their products. The research involves studying how their clients learn and interact with the company's resources. As the activity is research in educational psychology, it is ineligible for the tax credit.

Research in these fields is only excluded as a core R&D activity. If you are developing a new product or process, and your core R&D activity requires social science, arts, or humanities research, your research may be eligible as a supporting R&D activity.

To be eligible as a support activity, an activity would need to be all of the following:

- only or mainly for the purpose of the core activities
- required for the core activities
- integral to the core activities.

#### Example: Social science research as a supporting activity

A company is developing an immersive game technology which aims to overcome several previously unresolved technological challenges.

Testing the new game requires research into human behaviour when engaged with the game. If the research satisfies the supporting R&D activity definition, expenditure on it may qualify for the tax credit.

## **Management studies (Schedule 21 Part A Clause 9 and Part B Clause 9)**

This exclusion focuses on activities that are conducted to provide information to assist management decision making about efficient and effective business operations. Management studies include but are not limited to:

- studies of energy efficiency
- time and motion studies
- analyses of productivity

Even without this exclusion, many management studies would be ineligible because their subject area is the social sciences (and so would be ineligible under the social science exclusion).

Management studies are excluded from being core and supporting R&D activities.

A core R&D activity might occur if a new tool, for example for the analysis of energy efficiency, was being developed for use in a management study or studies of efficiency.

Where eligible R&D activities are taking place, for example to design a new system or process, tests of cycle time or speed are not excluded by this provision.

## **Activities relating to organisational design (Schedule 21A Part A Clause 10 and Part B Clause 10)**

This exclusion focuses on the analysis of work flow, procedures, structures and systems, and efforts to realign these things to fit business realities or goals.

Consideration of organisational design may involve a systematic approach. It may also be necessitated by the development of new processes or systems. Activities related to organisational design are, however, expressly excluded from the tax credit. They can never be eligible as core or supporting R&D activities.

Even without this exclusion, many activities related to organisational design would be ineligible because their subject area is the social sciences (and so would be ineligible under the social science exclusion).

## **Quality control, routine testing, routine collection of information and routine operations on data**

### **Quality control or routine testing of processes, services, or goods (Schedule 21 Part A Clause 13)**

Routine testing is regular testing, unrelated to R&D activities that meet the legislative definition for the tax credit.

Quality control testing is conducted to maintain standards and includes testing to establish whether the characteristics of a product, process or service are within acceptable boundaries for example monitoring for:

- the characteristics of natural products such as milk, as they enter the commercial production process
- service response times and quality characteristics
- production processes
- medical diagnostic purposes.

Routine testing and testing for quality control purposes are excluded as a core R&D activity because they do not test possible solutions to a technological or scientific uncertainty.

### **Example: Routine testing excluded from being a core R&D activity**

Farmer A is not confident that industry-accepted software he is using to guide on farm practices to manage nitrogen run-off is right for his situation. He is also concerned that nitrogen run-off from his farm into the local stream is above acceptable environmental levels set by the regional council.

He places meters at locations that are most likely to detect the impact of his farm management systems on nitrogen run-off. From these, he collects data both to validate the software for his own situation, and to compare it with the council's environmental requirements and assess his own compliance. These activities are routine testing activities to guide farm management decisions. Because they do not seek to resolve scientific or technological uncertainty they do not qualify for the tax credit.

### **Example: Quality control testing excluded from being a core R&D activity**

A juice manufacturer conducts regular shelf-life testing in its quality and research facility. This is part of on-going quality control tests to monitor product longevity and packaging integrity over time. These activities are not testing possible solutions to a scientific or technological uncertainty and do not qualify as R&D activities.

Where there is scientific or technological uncertainty and core R&D activities exist, testing to determine whether the scientific or technological uncertainty has been resolved is not for routine testing or quality control and is not caught by this exclusion.

### **Example: Testing that meets the R&D activity definition**

A food manufacturer is undertaking R&D into whether natural ingredients can extend the shelf life of their product range. Technological uncertainty that meets the requirements for the tax credit exists.

The core R&D activity includes testing to make sure the product's characteristics are not adversely affected by the additional ingredients and testing the quality of the products over time to see if the shelf life has been extended. This testing is a core R&D activity as it occurs in the context of seeking to resolve a technological uncertainty.

## **Routine collection of information (Schedule 21 Part A Clause 14)**

Routine collection of information is regular information gathering unrelated to a core R&D activity. The routine collection of information does not seek to resolve scientific or technological uncertainty.

The purpose of the exclusion of routine collection of information is to exclude information gathering as an R&D activity for any of the following and similar purposes:

- to provide a baseline against which to monitor naturally occurring change
- for the purposes of inventory control
- to evaluate the yield or effectiveness of a commercially available product or system in your environment
- to monitor change resulting from routine engineering or other technical procedures.

### **Example: Routine collection of information that is excluded from being a core R&D activity**

Every time JK manufacturing changes the product that they are manufacturing they collect more information than normal about the production process and the product, when production recommences This is the routine collection of information. It is unrelated to resolving a scientific or technological uncertainty and does not qualify as a core R&D activity.

Routine collection of information is not excluded as a supporting R&D activity however information collection that would have occurred in the absence of the R&D is unlikely to meet the test of being for the only or main purpose of supporting the core R&D activity. This test is illustrated in the example of activity that is not for the only or main purpose of supporting core R&D (page 39).

## **Carrying out routine operations on data, including presentation of data (Schedule 21 Part A Clause 23)**

Routine operations on data are the regular or customary ways data is handled or manipulated or presented unrelated to an R&D activity. Although routine operations on data may be systematic they do not seek to resolve scientific or technological uncertainty. Where there is an eligible core R&D activity the manipulation or presentation of data relating to the systematic approach of testing or prototyping may be eligible as a supporting R&D activity.

# Eligible expenditure

## Legislative reference and intent

Income Tax Act 2007 Schedule 21B Part A

The rules are aimed at ensuring expenditure with a direct connection to an R&D activity conducted in New Zealand is eligible, and that non-R&D expenditure or expenditure tangentially connected with R&D is not. The R&D tax credit regime aims to primarily incentivise R&D activities performed in New Zealand because the wider benefits are more likely to be gained by New Zealand. There is a 10% allowance for expenditure conducted overseas to recognise that experts in certain fields may only be available overseas, or the type of R&D the claimant needs to undertake is not able to be performed in New Zealand or it would be cost prohibitive to perform it here.

For R&D activities performed in a commercial production environment, only employee costs and any additional costs of the R&D are eligible. This rule is aimed at ensuring that business as usual expenditure does not qualify for the R&D tax credit.

Expenditure must be included on the list of eligible expenditure to be eligible for the tax credit. The following expenditure is all eligible:

- depreciation loss for items used in performing R&D
- expenditure or loss on acquiring goods and services used in performing R&D
- amounts for employees performing R&D.

## Types of eligible expenditure

### Depreciation (Schedule 21B Part A Clause 1)

Depreciation on assets used in performing R&D is eligible for the tax credit. The calculation is based on the time the asset is used for R&D as a proportion of total use. Availability for use does not factor into the calculation.

Depreciation attracts the tax credit on 2 types of assets:

- facilitative assets
- end-result assets.

### Facilitative assets

Facilitative assets are used in the R&D process, but are not the object of the R&D. For example, test equipment used to analyse results such as a spectrograph.

#### Example: Facilitative asset

A Co has a computer that is used 20% of the time on eligible R&D, 60% on other activities, and available for use the other 20% of the time.

An R&D tax credit may be claimed on 25% of the annual depreciation deduction (ie R&D use as a proportion of total use  $20 \div 80 = 25\%$ ).

### End-result assets

End-result assets are:

- the object of the R&D
- used in the R&D process (for example a prototype)
- also used in the business's other activities.

### Example: End-result tangible asset

Piped Ltd is a utility company experimenting with a new material for its underground pipes. It constructs a small area of pipes for testing before rolling them out in the region. In this case, the construction of that part of the network is an eligible R&D activity.

The test pipes supply gas to a neighbourhood and will remain in place following the test if they are satisfactory. The salaries and materials spent on the construction of the pipe network are not eligible for the tax credit when they are incurred<sup>1</sup>, but depreciation on them is eligible while they are being tested.

Expenditure incurred in creating an asset that is used solely in R&D is eligible for the credit. Any depreciation relating to the subsequent use of that asset in R&D is not eligible for the credit.

## Expenditure or loss to acquire goods and services used in performing R&D (Schedule 21B Part A Clause 2)

Expenditure on non-depreciable goods and services used in performing R&D is eligible, such as:

- the cost of goods consumed in R&D activities (refer to the feedstock rule, as this reduces the amount you may claim)
- overheads, to the extent they relate to R&D activities
- the cost of materials incorporated into prototypes used solely for R&D. Overheads cover any expenditure directly related to the R&D activity, such as:
  - rates
  - utilities
  - insurance
  - lease payments
  - security costs
  - cleaning
  - repairs and maintenance
  - corporate services, such as human resources.

Expenses must have a direct relationship with the R&D activity to be eligible.

An apportionment is required where the goods or services are also used in non-R&D activities.

### Unexpired amounts

Expenditure you have incurred on a good that has not been used at the end of the income year (and has not been destroyed) or on a service that has not been performed, is not eligible for the R&D tax credit. The amount is eligible once the relevant good or service has been used or performed.

## Amounts paid to employees (Schedule 21B Part A Clause 3)

Amounts for employees are eligible, to the extent they relate to performing R&D.

This includes:

- salary and wages including allowances
- bonuses
- employee share schemes when an entitlement arises
- employee recruitment and relocation costs
- overtime
- holiday pay
- long-service pay
- superannuation contributions.

**Shareholder employee salaries**, often paid at the end of the year rather than regularly, are not normally treated as payments to employees, and may therefore instead be considered as being for services (see above concerning Schedule 21B Part A Clause 2).

If an employee works on eligible R&D for part of their time, only the portion of the employee's pay that relates to their time spent on R&D is eligible. You must demonstrate that you have used an appropriate apportionment method to identify the employee's time spent on R&D.

### Important

Expenditure on employees that is supported by the COVID-19 wage subsidy is not eligible for the R&D tax credit. However, the rest of an employee's wages (i.e. the part of the wages not covered by the subsidy) remains eligible expenditure and can be claimed for the tax credit. See the **Ineligible expenditure - Tax credits from another country, gifts and grants** section on page 95 for more information.

Appropriate methods might be based on the dates when eligible activities were done, or on records such as timesheets, project reporting, or other time recording data.

If you can provide supporting evidence that work patterns were consistent over a period, apportionment might be based on information derived from a sample period.

### Example: Apportionment of employee's time

Zach works on eligible R&D full-time for 23 weeks of the year. He also attends a 2-week project management course which is applicable to all his work. He spends 4 weeks on annual leave, and the remaining 23 weeks doing other work.

Zach's employer can claim 50% of Zach's salary as eligible expenditure, calculated as follows:

- The first step is to determine what proportion of Zach's time is spent on R&D. Anything which relates to both R&D and non-R&D must be removed from the calculation initially - ie since you are trying to determine what proportion of Zach's salary while he was on leave and at the project management course relate to R&D, they must be removed from the calculation. Zach's time spent on R&D is therefore 50% ( $23 \div 46$ ).
- The next step is to use this fraction to apportion Zach's time spent on tasks which have an R&D and a non-R&D purpose. This means that 1 week of the project management course, and 2 weeks of annual leave are considered eligible.
- The weeks of his time that relate to R&D must be added up and divided by the total to determine what proportion of Zach's salary is eligible, ie  $23 + 1 + 2 = 26$  weeks.  $26 \div 52 = 50\%$ .

As this training relates to all his work, it must be apportioned to the extent his time relates to R&D. As half of the year Zach works fulltime on R&D, his employer can claim half of his salary cost for the time he attends the training course. Half of the cost of the training course would also be eligible.

If you or anyone else has contributed unpaid time to your R&D, you cannot attribute a value to those hours and include it in your claim. Remuneration must have actually been paid to be eligible expenditure.

## Commercial production environment - the commercial production rule

### Legislative reference

Income Tax Act 2007 Section LY 5(1)(c)

Where an R&D activity is performed in the course of commercial production, the amount you can claim is limited to both the:

- expenditure in relation to your employee's contribution to the R&D
- additional expenditure you incur because of the R&D.

## What in the course of commercial production means

Commercial production means producing products or services for sale.

**In the course of** refers to time and location.

If you perform your R&D in conjunction with a commercial activity, that R&D will have been performed in the course of commercial production. Examples of a commercial production environment include:

- R&D performed on a production line that at the same time was producing products for sale
- R&D performed as part of the process of designing, developing or building something where there is a contract in place for the result or it is for sale.

It is unlikely that an R&D activity would be considered as having been performed in the course of commercial production if any of the:

- items produced will not be sold or incorporated into another product that will be sold (the fact that the knowledge gained from the R&D is subsequently incorporated into items for sale does not mean that the original R&D was in the course of commercial production)
- R&D activity is performed in a separate space (or on a separate production line) dedicated to R&D
- R&D activity is not performed at the same time as the commercial production activities
- good or service produced by the activity is not widely offered for sale. For example, selling the product produced by your R&D to a select market for the purposes of field testing and further improvement will not be considered in the course of commercial production.

### Example: Activity in the course of commercial production

JJ Co produces spa baths. The company makes improvements to its production line to try and make its water jets more energy efficient. The improved water jets are produced alongside the company's regular water jets, and all of them are sold.

JJ Co's R&D activity occurs in the course of commercial production, because the more energy efficient jets are produced alongside its normal production.

### Example: Activity not in the course of commercial production

WindFuel produces sails for yachts. WindFuel is seeking to produce the world's lightest and strongest sail for use in the America's Cup.

Between 9am and 5pm WindFuel produces its regular sails. From 5pm to 7pm the production line is dedicated to producing the new sails. These new sails will not be sold.

WindFuel's R&D activity is separate from its regular production line and the R&D activity itself is not commercial production because the sails will not be sold. The R&D activity does not take place in the course of commercial production, so the normal expenditure rules apply.

### Example: Service in the course of commercial production

Tunnels Ltd has been commissioned by A co to build a tunnel. As part of this work, Tunnels Ltd does some R&D to improve the effectiveness of its Tunnel boring machine (TBM). The company wants to know whether it can claim some of the cost of digging the tunnel whilst the upgrades to the TBM were being tested.

The work is done in the context of a commercial contract and therefore is considered to be in the course of commercial production. Only the additional cost of the R&D can be claimed. Tunnels Ltd were digging the tunnel anyway absent the R&D so cannot claim for any of its cost. If Tunnels Ltd need to dig another tunnel to test the equipment in another soil structure then the digging costs may be eligible provided the supporting R&D activity requirements are met, and the commercial production rule does not apply.

### Example: Service not in the course of commercial production

DD Ltd designs and builds bridges. The company wants to tender for work on larger more complicated bridges. To give itself a competitive edge, DD Ltd undertakes some R&D to create suspension cables that are stronger and lighter than what is currently available. This R&D is not considered to be in the course of commercial production as it was done independently of a commercial contract.

## What expenditure in relation to your employee's contribution to the R&D means

**Expenditure in relation to your employee's contribution to the R&D** means the remuneration you pay to that employee to perform R&D, such as:

- salary and wages
- bonuses
- employee share schemes
- superannuation contributions
- overtime
- holiday pay or long service leave.

It does not cover the cost of contractors you engage to perform the R&D.

It is expected that the time employees spend on eligible R&D is recorded on a contemporaneous (timely) basis. Time recording which distinguishes between eligible R&D and other duties is an example of how this might be done but time sheets are not essential.

Find out more about contemporaneous record keeping on page 97.

## Additional expenditure

Additional expenditure on the R&D activity is any expenditure that would not have been incurred in absence of the activity. In other words, the eligible amount is the extra cost a business incurs as a result of undertaking the R&D.

### Example: Additional expenditure

Bert's Biscuits Ltd is seeking to produce its best-selling product, the lettuce cracker (lettuce cracker 1.0), more efficiently, while still maintaining the same taste and shelf-life (lettuce cracker 2.0).

#### Activity not in course of commercial production - to the extent test

In January, lettuce cracker 2.0 is developed in the firm's test kitchen by a food technologist. Because this activity did not occur in the course of commercial production, expenditure is apportioned to the extent it is incurred on R&D. The following costs are eligible.

- Lease on building = \$2,000 (this is 20% of the total lease cost, as the test kitchen is 20% of the floor area.
- Food technologist's salary = \$4,000
- Raw materials = \$5,000
- Electricity = \$150 (this is 15% of the total monthly bill for the factory. Because the test kitchen is not separately metered, it was apportioned based on a reasonable estimate of appliance use and energy consumption use from manufacturers).

#### Activity in the course of commercial production - additionality test

In February, Bert's Biscuits needed to determine whether lettuce cracker 2.0 was able to be replicated at scale so began production on 1 of its commercial production lines. This relies on adjusting production settings to ensure ingredients are combined in the right way and at the correct proportions. The firm is unsure what impact this will have on the production failure rate.

Over the course of the month, the average failure rate was 10% (compared to a 2% failure rate for the lettuce cracker 1.0). The successful lettuce crackers were sold, which means the commercial production rule applies.

The cost assessment is as follows:

- Lease on building = \$0 (Bert's Biscuits would have incurred this cost anyway in the absence of the R&D).
- Production staff salary = \$2,000 (this is 20% of the staff cost and relates to the time staff spent supervising the trials, adjusting the production settings, hypothesising and investigating possible solutions to produce the lettuce cracker. The time the staff spent doing business-as-usual activities related to the production of the cracker is not eligible).
- Raw materials = \$800 (8% of total cost of \$10,000, which is the additional wastage from the R&D).
- Electricity = \$80 (for the first half of the month, the electricity cost was not separately metered, and therefore Bert's Biscuits is not able to claim any of the cost as it cannot show the additional cost. For the 2nd half of the month, electricity meters were installed on all production lines. This shows the electricity costs on the R&D production line are 20% higher than regular production lines. Apportioning the electricity using this figure, and taking into account floor area and the energy consumption of the other appliances in the building, gives a figure of \$80).

## Contracted R&D

### Legislative reference

Income Tax Act 2007 Section LY 6, Schedule 21B Part B Clause 7

Where you engage a contractor to perform R&D on your behalf, your payment for the R&D to the contractor is eligible expenditure, however the payment must be reduced by any ineligible expenditure the contractor incurs in relation to the activity.

### Calculating eligible contracted research and development expenditure

Your eligible expenditure for engaging a contractor to perform R&D on your behalf is calculated as:

contract amount – ineligible expenditure

This formula applies to independent contractors, including approved research providers.

The **contract amount** is the amount you pay to the person to perform R&D activities on your behalf.

**Ineligible expenditure** means the contractor's expenditure that is not eligible for the tax credit - for example, because the expenditure is on the list of expenditure that is excluded from the tax credit. The expenditure incurred by the contractor is subject to the same exclusions as expenditure you incur yourself.

### Example: Contracted R&D

AXC Ltd engages a contractor to perform R&D on their behalf. AXC pays the contractor \$1 million. The contractor incurs the following ineligible expenditure:

- \$200,000 on acquiring depreciable property
- \$70,000 of expenditure taken out by the feedstock rule. AXC Ltd's eligible expenditure is calculated as follows:

$$1,000,000 - \$200,000 - \$70,000 = \$730,000$$

### R&D outsourced to an associate

Where you engage a contractor associated to you, you can only claim for the lesser of what you paid the contractor and the contractor's costs. All the profit margin is removed.

### Separation of costs

It is your responsibility to make sure your claimed expenditure includes only expenditure on eligible activities and excludes any ineligible expenditure. You may want to consider imposing contractual requirements on your contractors to identify total eligible expenditure for each eligible project. For further information see the **Record keeping** section on page 90.

## R&D conducted overseas

### Legislative reference

Income Tax Act 2007 Section LY 7

Expenditure on an R&D activity conducted outside New Zealand is generally ineligible.

However, where you incur expenditure on an R&D activity conducted overseas, and that activity is integral to a core R&D activity conducted in New Zealand, your eligible expenditure is the lesser of your actual expenditure incurred on the activity overseas, and 10% of your total eligible expenditure. Note that while the legislation only allows for a supporting activity to be performed overseas, the activity can still be a **core** activity in the sense that it seeks to resolve scientific or technological uncertainty. Using the supporting activity definition simply ensures that the activity must be integral to a core R&D activity conducted in New Zealand.

### Foreign research and development expenditure

Foreign R&D expenditure can only be up to 10% of your total eligible expenditure.

Foreign R&D expenditure is made up of both:

- expenditure on overseas activities - expenditure incurred on an R&D activity performed outside New Zealand, that is integral to a core R&D activity conducted in New Zealand
- expenditure for services performed by non-residents - salary and wage payments and payments for services to non-residents performing R&D in New Zealand.

### Expenditure on overseas activities

The limit applies to activities performed outside New Zealand. Therefore, it is where the good or service is consumed that determines whether it is foreign expenditure, not where it was purchased. An exception to this rule applies where non-residents perform services in New Zealand (see below).

#### Example: New Zealand expenditure - imports

Lirene imports chemicals from the USA to be consumed in experiments conducted in her R&D facility in Wellington.

The expenditure on the chemicals is New Zealand expenditure.

#### Example: Overseas expenditure

Alison purchased some consumables in New Zealand, which were used in her R&D activity in Australia. This is overseas expenditure because the goods were consumed in an R&D activity conducted outside New Zealand.

#### Example: Overseas expenditure

Mia travels to Los Angeles to attend a conference relevant to the R&D she is undertaking. The cost of the airfare and conference are overseas expenditure as they are consumed overseas, despite the fact that the tickets were purchased from a retailer in New Zealand.

### Expenditure for services performed by non-residents

Payments for non-residents to perform services forms part of the 10% cap.

A non-resident is a person who is not New Zealand resident for tax purposes. Generally speaking, a person will be resident in New Zealand if they have been in New Zealand for more than 183 days in a 12-month period, or have a permanent place of abode in New Zealand. A company will be resident in New Zealand if it meets 1 of the following conditions:

- is incorporated in New Zealand
- has its centre of management in New Zealand
- has its head office in New Zealand
- the directors of the company exercise control of the company in New Zealand.

Note that for the purposes of this test, only New Zealand domestic law is relevant, not double tax agreements.

#### Example: Resident for R&D tax credit purposes

A Co is incorporated in New Zealand but has its centre of management in Australia. Under the New Zealand-Australia double tax agreement A Co is resident in Australia, but for R&D tax credit purposes the company is resident in New Zealand.

Therefore, if you engaged A Co to perform services on your behalf, your payments A Co would not fall under the 10% cap.

Find out more about tax residency in New Zealand at [ird.govt.nz/tax-residency](http://ird.govt.nz/tax-residency)

#### Example: Service payments subject to the 10% cap

Stephanie hires an American expert, Xavier, to assist her team in developing a cure for a cancer. Xavier spends 3 months in New Zealand and then heads back to America.

Xavier is non-resident for tax purposes, which means Stephanie's payments to him are subject to the 10% cap.

## How foreign research and development expenditure is calculated

Where you incur foreign R&D expenditure, the amount you may claim is the lesser of either:

- the actual amount you spend on foreign R&D
- 10% of your total eligible expenditure.

**Amount spent** - The actual amount you incur on foreign R&D is made up of both:

- payments to non-residents working in New Zealand
- your eligible expenditure to perform R&D activities overseas. This is subject to all the R&D expenditure rules. For example, the list of ineligible expenditure as well as the rules for contractors and commercial production.

**Capped amount** - 10% of total eligible expenditure. This is calculated as:

$$0.1 \times \text{total New Zealand R\&D expenditure} \div 0.9$$

The above calculation is equivalent to 10% of total eligible expenditure. Because we are trying to determine the amount of foreign expenditure that can be claimed, it cannot form part of the calculation. Therefore, the New Zealand expenditure needs to be grossed up to determine the foreign amount (11.1% of 90 is the same as 10% of 100).

Your total New Zealand R&D expenditure is not confined to the specific project, but rather is calculated by adding up all your eligible New Zealand R&D expenditure across all projects for the year. For example, half your expenditure for a project could be foreign R&D expenditure, provided that the amount was no more than 10% of your total eligible expenditure across all projects in the year.

#### Example: How foreign research and development expenditure is calculated

SA Co, a pharmaceutical company developing a cure for atrial fibrillation, incurs the following expenditure:

- \$500,000 on researchers in New Zealand
- \$100,000 on a non-resident researcher helping the team in New Zealand
- \$200,000 conducting clinical trials overseas. \$50,000 of this expense is ineligible as it relates to purchasing depreciable property.

Amount spent on foreign R&D = \$250,000 (made up of the expenses on the non-resident researcher, and the eligible portion of the expenses relating to the clinical trials).

The firm's capped expenditure =  $0.1 \times 500,000 \div 0.9 = \$55,556$ . This equates to 10% of their total eligible expenditure i.e.  $\$55,556 \div 555,556 = 0.1$

The firm's eligible foreign expenditure = \$55,556, which is the lesser of the amount the firm spent on foreign R&D (\$250,000) and the capped amount (\$55,556).

## Stand-alone overseas R&D

If you carry out R&D activities outside New Zealand which are not integral to a core R&D activity conducted in New Zealand, the expenditure incurred on these activities is not eligible for the tax credit.

## Minimum threshold

### Legislative reference

Income Tax Act 2007 Section LY 4, Schedule 21B Part B Clause 24

Your eligible expenditure must exceed \$50,000 in the income year to qualify for the R&D tax credit. There is an exception where you are using an approved research provider to perform R&D on your behalf.

### How the minimum threshold applies

#### Expenditure threshold

Where you have more than \$50,000 of eligible expenditure in a year, the full amount will be eligible for the tax credit.

If you are in a partnership, joint venture, or are an owner of a look-through company, the minimum threshold can be satisfied by assessing the total eligible expenditure of the partnership, joint venture or look-through company.

#### Example: Partners with less than \$50,000 of eligible expenditure

Alison and Jane are in partnership together. The partnership has \$55,000 of eligible expenditure (\$20,000 is attributed to Alison, and \$35,000 attributed to Jane. Individually, Alison and Jane are unable to satisfy the minimum threshold. Since they are in partnership, their expenditure can be grouped. As a result, Alison and Jane satisfy the \$50,000 minimum threshold.

### Approved research providers

If your total eligible expenditure is under \$50,000, you will only be able to claim your eligible expenditure in relation to an approved research provider performing R&D on your behalf.

Approved research providers are research providers that have been approved by us. They provide R&D services under contract to other businesses. For more information see the section on approved research providers on page 86.

#### Example: Approved research provider expenditure

Hannah spends \$10,000 on R&D. She also spends \$25,000 for an approved research provider to undertake R&D on her behalf. Only \$20,000 of this expenditure is eligible, once the ineligible expenditure of the approved research provider is taken out.

Hannah may claim the \$20,000 expenditure in relation to the approved research provider performing R&D on her behalf, but not the \$10,000 on performing R&D herself, as her total eligible expenditure is only \$30,000, which is under \$50,000.

## Maximum threshold

### Legislative reference

Income Tax Act 2007 Section LY 4, 68CD

You cannot claim a tax credit on more than \$120 million of expenditure, unless you have obtained our approval.

The cap includes expenditure claimed by your associates. This means your claim combined with the claims of your associates is limited to \$120 million total or your approved R&D cap. It does not matter if the R&D you and your associate do are on different projects, it is total expenditure on R&D across all projects that is relevant.

You will be required to tick a box on your supplementary return indicating that an associate is intending to, or has, made a claim for the tax credit. This will trigger personal contact from us. If you and your associate are claiming for the same R&D, you will need to set out what part each associate is claiming for and ensure no expenditure has been claimed twice. Refer to the contracted R&D section for guidance on who has the entitlement to claim (page 69).

### **Approval to exceed the maximum threshold**

If you expect to incur more than \$120 million of eligible expenditure in an income year, you may apply to us to exceed the maximum threshold.

We may approve a threshold greater than \$120 million, but only if satisfied that your R&D activities will result in a substantial net benefit for New Zealand. In reaching a decision, we must consult with the Chief Executive of the Ministry of Business, Innovation and Employment.

Your application to exceed the cap must be made by the 7th day of the 2nd month after the end of the relevant income year. For example, if your income year ended 31 March 2021, your application would need to be filed by 7 May 2021.

Decisions made by the Commissioner regarding applications for approval to exceed the maximum threshold cannot be challenged.

# Ineligible expenditure

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## Legislative reference

Income Tax Act 2007 LY 1(6), Schedule 21B Part B

Certain expenditure is excluded from being R&D expenditure, to:

- clarify when expenditure will have insufficient connection with an R&D activity
- reduce compliance and administrative costs
- prevent double dipping
- prevent abuse of the R&D tax credit regime
- limit fiscal risk.

The types of expenditure and depreciation loss not eligible for the R&D tax credit are listed and explained below.

- The GST input portion of expenditure.
- Expenditure which is eligible expenditure of someone else.
- Amounts under the \$50,000 or over the \$120 million thresholds
  - Amounts incurred by a person and their associates on R&D to the extent the amounts exceed \$120 million or the person's approved cap
  - If a person's eligible expenditure is less than \$50,000, expenditure or loss under \$50,000 that is not for an approved research provider to perform an R&D activity on behalf of the person.
- Depreciation related exclusions
  - Expenditure incurred in acquiring depreciable property
  - Expenditure that contributes to the cost of depreciable tangible property
  - Depreciation on property, to the extent the cost of the assets are eligible R&D expenditure
  - Depreciation on pooled property where an item in the pool is not used solely in performing R&D
  - Depreciation arising from an asset being written off or sold below its adjusted tax value.
- Exclusions related to associated persons
  - Certain amounts of depreciation on property acquired from associates
  - Profits on R&D services and property provided by associates
  - Amounts in excess of market value for leasing property from associates.
- Exclusions for the cost of land, financing costs, professional fees, and expenditure to commercialise the results of R&D
  - Expenditure to purchase land
  - Interest and other financing costs
  - Professional fees in determining a person's entitlement to an R&D tax credit
  - Expenditure to commercialise the results of an R&D activity.
- Intangible property (other than software), software related exclusions and ineligible technology
  - Expenditure on acquiring an interest in intangible property other than software
  - Expenditure on bespoke software
  - Internal software development expenditure incurred by a person and their associates, to the extent it exceeds \$25 million
  - The cost of acquiring technology that is used as a basis for further R&D activities.

- Market value related exclusions including feedstock
  - Expenditure on goods or services to the extent it exceeds the market value of the goods or services
  - Expenditure on inputs used, or subject to a process or transformation, to the extent the expenditure does not exceed the value of the output from that expenditure (feedstock rule).
- Tax credits from another country, gifts and grants
  - Expenditure for which a person has received an R&D tax credit from another country
  - Gifts
  - Expenditure that relates to a government or local authority grant, including the COVID-19 wage subsidy.

## GST adjustments (Section LY 1(6))

If you are a GST registered person and claim a GST input credit on your expenditure, the amount of your GST input credit claimed must be deducted from your expenditure when determining your eligible expenditure for the R&D tax credit. This rule ensures that an R&D tax credit is not given for the portion of the cost which is reimbursed through the tax system.

### Example: GST excluded from eligible expenditure

Alison purchased \$10,000 of oil for use in her R&D activities. As Alison is GST registered, she claims a GST input tax credit of \$1,304.34, which is refunded to her by Inland Revenue. Alison's eligible R&D expenditure is \$8,695.66.

The rules are the same as the rules that apply to deductions for tax purposes under section DB 2 of the Income Tax Act 2007. Therefore, you must also deduct any adjustments made to GST from your eligible expenditure (such as adjustments on disposal or for change of use).

### Example: Deducting GST adjustments from eligible expenditure

James purchased \$20,000 worth of oil. He intended to only use  $\frac{2}{3}$  of the oil in his R&D process and take  $\frac{1}{3}$  home for private use. In the end, James used all the oil in his R&D process.

James originally claimed GST of \$1,739 ( $\frac{2}{3}$  of \$2,609). Because James used all the oil, he makes an adjustment to claim the remaining GST of \$870.

When James files his tax return and claims his R&D tax credit, the extra \$870 must be deducted off his eligible expenditure to reflect that the true cost of the oil to his R&D was \$17,391.

## Expenditure which is eligible expenditure of someone else

### No double dip for contractors and others (Section LY 5(3))

Your expenditure or loss will not be eligible if it is also eligible research and development expenditure of someone else.

### Example: Two parties claiming eligible expenditure

A contracts B to build a bridge. As part of building that bridge, B does some R&D. A believes he is entitled to claim the R&D tax credit on the cost of the R&D, as he paid B to build the bridge. B believes he can claim the credit, as whilst he is contracted by A, his R&D on the bridge is independent of the work which he was contracted to perform.

The above rule makes sure that where there is a dispute whether a person is a contractor for the purposes of the R&D rules, both parties cannot claim the credit for the same expenditure - which is the expenditure related to the R&D on the bridge.

## Amounts under the \$50,000 or over the \$120 million thresholds

### Amounts exceeding \$120 million (Schedule 21B Part B Clause 1)

Expenditure you have incurred above \$120 million or above your approved research and development cap for the income year is not eligible for the R&D tax credit.

The cap includes expenditure incurred by people associated to you. This means your eligible expenditure may be reduced even when you spend less than \$120 million/your approved cap, if the combined expenditure incurred by you and an associate exceeds \$120 million/your approved cap.

Find out more about the Expenditure cap on page 72.

### Expenditure or loss under \$50,000 (Schedule 21B Part B Clause 24)

If your total eligible expenditure is \$50,000 or less you may only claim the eligible portion that was paid to an approved research provider to perform R&D on your behalf.

Find out more about approved research providers on page 86.

## Depreciation related exclusions

### Expenditure incurred in acquiring depreciable property (Schedule 21B Part B Clause 2)

The cost of depreciable property is not eligible for the tax credit. The cost includes the cost of getting the property in place and ready for use.

Depreciation loss is the better measure of cost to a person as the property could later be sold or used for another purpose.

Depreciable property is property that cost more than \$500, and that might reasonably be expected to decline in value.

#### Example: Expenditure to acquire depreciable property

A Co spends \$25,000 on a machine for use in its R&D process. They also spend \$3,000 on getting the machine installed. The \$28,000 cost is not eligible expenditure.

The company instead may claim as eligible expenditure the amount of depreciation loss on the asset to the extent the asset it is used in R&D.

### Expenditure contributing to the cost of depreciable tangible property (Schedule 21B Part B Clause 3)

Where you are creating depreciable tangible property, expenditure that contributes to the cost of that property is not eligible, unless the property is used solely in performing R&D. For example, expenditure on producing a prototype used solely in R&D would be eligible.

#### Example: Expenditure contributing to the cost of depreciable tangible property

Zb3 Ltd is producing a long range customisable electric engine which can be installed into production cars. The company incurs the following costs:

- \$2 million on research
- \$40,000 on parts for the engine
- \$20,000 on labour to put the engine together.

The \$2 million on research is eligible expenditure as it does not form part of the cost of the asset.

The \$40,000 on parts and \$20,000 labour form part of the cost of the engine, so will only be eligible if the engine was solely used in R&D (a prototype).

If the engine was used for a non-R&D activity, or sold (or expected to be sold), these costs would not be eligible.

The focus is on whether the property is depreciable tangible property for tax purposes. This involves looking at, among other things, whether the property might reasonably be expected to decline in value while used in deriving assessable income. Just because the costs have been capitalised to a work in progress account for financial reporting purposes will not necessarily mean that they form part of the cost of the property for the purposes of this exclusion.

## **Depreciation loss where cost of depreciable property was eligible expenditure** (Schedule 21B Part B Clause 4)

Expenditure on R&D that creates depreciable intangible property, or depreciable tangible property used solely in R&D, is eligible for the tax credit.

You cannot claim the tax credit for depreciation where these assets are subsequently used in R&D because the cost of the asset has already attracted the credit.

### **Example: Depreciable property**

A Co, a car manufacturer, did some R&D to create a specialised welding robot, for use on high-tech materials. The firm is also seeking to create the world's fastest car, and solely uses the specialised welding robot in this process. The depreciation on the welding robot is not eligible for the tax credit since the cost of creating the welding robot attracted the credit.

## **Pooled property** (Schedule 21B Part B Clause 5)

The R&D tax credit does not apply to depreciable property in a tax depreciation pool unless the pool consists solely of assets used wholly in conducting the eligible R&D.

## **Depreciation arising from an asset being written off or sold below its adjusted tax value** (Schedule 21B part B clause 6)

To minimise compliance and administrative costs, there is no claw-back of R&D tax credits when depreciable property used in R&D is sold for more than its adjusted tax value.

### **Example: No clawback where depreciable property used in R&D sold above ATV**

Everly paid \$50,000 for an asset in 2020 and used it in her R&D process. Over the 5 years she used it in R&D, she claimed an R&D tax credit on \$30,000 worth of depreciation. She sold it in 2026 for \$40,000 which means she depreciated the asset by \$20,000 too much. Everly does not need to repay the R&D tax credit she claimed on this \$20,000.

To ensure symmetry of treatment, you cannot claim an R&D tax credit for where an asset is written off or sold below its adjusted tax value.

### **Example: No tax credit for loss on disposal**

Sticks Ltd buys an asset for \$1 million which is used wholly in eligible R&D. The company depreciates the asset down to \$600,000 but sells the asset for \$500,000. No tax credit is available for the \$100,000 loss.

## Exclusions related to associated persons

### Certain depreciation deductions on assets acquired from an associate (Schedule 21B Part B Clause 7)

You cannot claim a tax credit for depreciation on an asset acquired from an associate, to the extent:

- you purchase the asset for more than the adjusted tax value in the hands of the associate
- the asset was used in the associate's R&D activities.

#### Example: Depreciable property acquired from associate for more than the adjusted tax value

Webb Ltd sells an asset that was used in R&D, which cost \$200 and has an adjusted tax value of \$100, to its associate, Wood Ltd, for \$130. Wood Ltd's depreciation can only be claimed on the asset's adjusted tax value of \$100. The \$30 above the adjusted tax value is excluded from this calculation as ineligible expenditure).

In other words, when an associate has claimed a tax credit for depreciation on the asset in relation to the same decline in value, you cannot also claim the credit.

### Profits on R&D services and property provided by associates (Schedule 21B Part B Clause 8)

When you acquire goods or services from an associated person for use in your R&D, you cannot claim a tax credit for any profit margin that the associate gains in supplying the goods or services.

#### Example: Profits on R&D goods and services provided by associates

A Co buys some consumables for \$5,000 and immediately sells them to its associate B Co for \$7,000 for use in B Co's R&D. B Co may only claim a tax credit on \$5,000, not \$7,000.

### Property leased from an associate (Schedule 21B Part B Clause 9)

When property is leased directly or indirectly from an associated person at more than market value, the excess paid over market value is not eligible for the R&D tax credit.

#### Example: Property leased from an associate

A Co leases a plant to be used in eligible R&D activities from an associate, B Co, for \$100,000 for the year. The market value of the lease is \$75,000. The additional \$25,000 is not eligible for the tax credit.

## Exclusions for the cost of land, financing costs, professional fees, and expenditure to commercialise the results of R&D

### Expenditure to purchase land (Schedule 21B Part B Clause 10)

The cost of land used in your R&D process is not eligible for the R&D tax credit. Lease or rent payments are eligible to the extent the land is used in your R&D process. Note that you cannot attribute a rent value to land you have purchased for use in your R&D. Your rent must have been paid or payable for you to claim the credit.

### Interest and other financing costs (Schedule 21B Part B Clause 11 and 12)

Interest, or amounts in the nature of interest, relating to the financing of R&D activities are ineligible for the tax credit.

### Professional fees (Schedule 21B Part B Clause 13)

Fees paid to professionals (such as accountants or lawyers) to determine whether claimants, activities and expenditure are eligible, or for calculating the amount of the claim, are not eligible for the R&D tax credit. Fees paid to a tax agent to prepare your R&D claim are also excluded.

The costs of professional research to determine the state of knowledge at the start of the project may be eligible expenditure.

## **Expenditure to commercialise the results of an R&D activity (Schedule 21B Part B Clause 20)**

Expenditure you incur to commercialise the results of an R&D activity will not be eligible. If during commercialisation new scientific or technological uncertainty arises that requires resolution, a new R&D activity may arise.

### **Example: Expenditure to commercialise results**

Boffita Bovine Ltd has created an enzyme which significantly extends the shelf life of beef. The company has conducted sufficient testing and has established that the enzyme works.

BB Ltd purchases machinery, raw materials, and hires staff to begin commercial production of the enzyme.

Depreciation on the machinery, as well as expenditure on the raw materials and staff salaries are not eligible for the R&D tax credit, as the firm has resolved the scientific or technological uncertainty and is now commercialising the results.

If a scientific or technological uncertainty arose during commercial production, for example, if a chemical reaction to create the enzyme was not occurring correctly on the manufacturing line, expenditure incurred to resolve that uncertainty may be eligible.

## **Intangible property (other than software), software related exclusions and ineligible technology**

### **Expenditure on acquiring an interest in intangible property (Schedule 21B Part B Clause 14)**

The R&D tax credit is not available for expenditure to acquire an interest in intangible property - such as purchasing, leasing or obtaining a right to use. This includes royalty payments and lump sum capital costs.

This exclusion does not apply to software.

Costs associated with creating intangible assets from R&D activities, such as plant variety rights, may be eligible.

### **Expenditure on bespoke software (Schedule 21B Part B Clause 15)**

Expenditure incurred on purchasing, leasing or otherwise acquiring bespoke software, or software that is not widely commercially available, is ineligible. Bespoke software has been excluded because of fiscal risk.

Expenditure on software that is widely available, such as Microsoft Excel or project management software, may be eligible expenditure.

### **Internal software development expenditure exceeding \$25 million (Schedule 21B Part B Clause 16)**

Expenditure you incur on internal software development, for purposes other than internal administration (which is completely excluded), is subject to a \$25 million cap. Expenditure on this kind of software development that exceeds \$25 million is therefore not eligible. The rationale for imposing a \$25 million cap on this kind of internal software development is due to the reduced spill-over benefits when compared with external software development, as well as fiscal risk.

All other software development undertaken for the purpose of internal administration of a business is totally excluded. Find out more in the **Internal software development** section on page 83.

### **Ineligible technology expenditure (Schedule 21B Part B Clause 19, Section YA 1 definition)**

The cost of technology upon which your R&D activity is based is not eligible for the credit, nor is the depreciation on the technology. This includes technology that your R&D activities seek to extend, continue, develop or complete. Modifications you make to this technology may be eligible.

This exclusion is intended to prevent a person from obtaining an R&D tax credit for someone else's R&D.

### **Example: Ineligible technology expenditure**

Pink Fish runs a salmon farm and is developing an automated aquaculture system which uses tidal power to automate functions such as feeding. Some of the aquaculture system development activities meet the criteria as an eligible R&D activity. The company has sourced a tidal generator to power the system. The control module of the generator requires some modifications for the R&D.

Expenditure on the control module is ineligible as it is ineligible technology expenditure (it would also likely be ineligible as it is depreciable property).

## **Market value related exclusions including feedstock**

### **Above market value goods or services (Schedule 21B Part B Clause 17)**

Where you pay (or have a liability to pay) above market value for goods or services, the portion of your expenditure that exceeds the market value is not eligible for the tax credit. This applies even when the person you buy the goods or services from is not associated to you.

Goods or services purchased in an arm's length transaction are at market value. You should keep appropriate records of your transactions.

This provision is intended to apply broadly, the amount paid which exceeds the market value is not an eligible expense.

### **Feedstock rule (Schedule 21B Part B Clause 22)**

For items used in, processed, or transformed as part of your R&D activities, only the net expenditure is eligible. What this means is costs of inputs which are recouped through the value of the output are ineligible. The feedstock rule ensures a business only gets a tax credit for the extra costs associated with their R&D.

#### **Cost of inputs**

The net cost of the inputs is the excess of the cost over the value of the output. Inputs include anything that is used in, or subject to, a process or transformation. It includes both:

- the physical good subject to or used in the process or transformation
- expenditure on energy, such as electricity or gas.

It does not include staff costs, depreciation on assets used in the process, or other overheads such as cleaning costs. Catalysts, accelerants or reactants which are used up in the process but do not form part of the output are also not included.

#### **Value of outputs**

The value of the output is the sale proceeds when the output is sold in an arm's length transaction, or if it is not sold, the value is the market value of the output at the end of the relevant income year.

The market value of the output should reflect the price that buyers in an arm's length transaction would be willing to pay for it. This can be obtained by engaging a commercially credible independent professional to value the output. Where you have sold numerous identical outputs in the income year, you may take the average selling price for that year as the value of the output.

### Example: Feedstock rule

Mike's Paints is developing a new coating for bike frames which will be more durable than paint. The company has painted some frames to test the coating, and incurs the following costs:

Expenditure on inputs	Amount
Cost of inputs (value of steel frames and coating)	\$2,000
Electricity used in the process	\$500
<b>Total cost of inputs</b>	<b>\$2,500</b>

Once Mike's Paints completes its R&D activities, they find that Scott's Mountain Bikes wants to purchase the test frames. They establish the market value of the coated frames is \$2,500. Therefore, they need to work out feedstock expenditure.

The total cost of Mike's Paints inputs is \$2,500, which is made up of the cost of the steel frames and the electricity used in the R&D process. The company incurred \$1,000 on other production costs, like labour and overhead costs, but these costs are not considered inputs for the feedstock rule.

The cost of the company's inputs and the value of its outputs net out at zero, so none of Mike's Paints' input costs are eligible. The \$1,000 incurred on other production costs is, however, eligible expenditure despite the application of the feedstock rule.

## Tax credits from another country, gifts and grants

### Gifts (Schedule 21B Part B Clause 18)

If you donate or gift something to another person's R&D, the value of the gift is not eligible expenditure.

If you are the recipient of a gift, you may not claim an R&D tax credit on the value of that gift if you choose to use it in your R&D process.

The cost of a gift given to a person to get them to participate in your R&D process, such as a gift voucher given to a participant in a medical trial, does not fall within this exclusion. It is consideration for a service and therefore eligible for the R&D tax credit.

### Expenditure that relates to a government or local authority grant (Schedule 21B Part B Clause 21)

This exclusion includes both:

- expenditure funded by a government or local authority grant - for example if you receive a grant and spend it on what would otherwise be eligible expenditure, that expenditure is ineligible
- co-funding - This is where you or a third party contributes funds as a condition of obtaining a grant. Expenditure paid for by these funds is ineligible.

This exclusion covers expenditure on employees that is funded through the COVID-19 wage subsidy. The wage subsidy is considered a grant for the purposes of the R&D tax credit, which means that payments made to an employee are ineligible R&D expenditure to the extent to which they are funded through the wage subsidy. However, any part of an employee's wages not funded through the subsidy remains eligible expenditure and can be claimed for the R&D tax credit.

Note that, if you receive a Callaghan Innovation Growth Grant in the income year, you are not eligible for the R&D tax credit at all. A limited exception applies in the 2021 income year if you are a late balance date taxpayer. In this case, you may receive the Growth Grant up until 31 March 2021, and then receive the R&D tax credit for the remainder of your income year.

Find out more about eligible entities on page 21. For more information on what to do if you want to move from the Growth Grant to the tax credit refer to page 24.

### Example: Government grant

ZEQ Ltd receives a government R&D grant of \$100,000. ZEQ uses this money to pay for R&D salaries. While this expenditure would normally be eligible, it is excluded because it was paid for by the grant.

### Example: Co-funding

ZoomBoom receives a government R&D grant of \$500,000 to subsidise its R&D salary costs. As a condition of the grant, ZoomBoom is required to contribute \$500,000 of its own funds towards the project.

ZoomBoom uses the \$1 million to fund its R&D activities. This includes paying for R&D salaries and constructing prototypes used solely in R&D activities. While this expenditure would normally be eligible, it is ineligible expenditure because of the grant and co-funding exclusions.

### Example: Third-party co-funding

B Ltd receives a \$500k government grant, on the condition it arranges matching funding from businesses. T Ltd agrees to contribute \$500k to B Ltd's R&D.

Neither company can claim a tax credit on the funding as it is required co-funding, even where it is spent on what would otherwise be eligible expenditure.

If the contract does not specify which expenses within the project the grant or required co-funding is to be applied to, you can choose to apply the grant and/or the required co-funding to ineligible expenditure related to your R&D project.

### Example: Applying funding

L Co receives a government grant of \$200,000 towards its R&D. In the year the grant was received the firm had the following expenses:

- Staff salaries - \$200,000
- Consumables - \$500,000
- Right to use patent - \$200,000

The right to use the patent (being an interest in intangible property) is ineligible expenditure. L Co chooses to use the government grant to fund this expenditure. This leaves L Co with \$700,000 of eligible expenditure to claim the tax credit.

## Expenditure for which a person has received an R&D tax credit from another country (Schedule 21B Part B Clause 23)

If you have received a tax credit for your R&D expenditure in another country, you cannot get a credit for the same expenditure in New Zealand. It is not appropriate to give 2 credits for the same expenditure.

### Example: Tax credit in another jurisdiction

Michael is doing R&D. He does some of his R&D in Australia and can claim \$50,000 of that expenditure in New Zealand under the foreign R&D rules (page 65). However, if he has also received an R&D tax credit for that \$50,000 in Australia, then he will not be able to claim a tax credit on that expenditure in New Zealand.

# Internal software development

## Legislative reference and intent

Income Tax Act 2007 Section YA 1 (definition of internal software development expenditure and ineligible internal software development), Schedule 21 Parts A and B Clause 11 and Schedule 21B Part B Clause 16

The policy intent is for there to be 3 categories of software development under the R&D tax credit rules, with different treatment for each of the categories.

Type of software development	Policy intent
Internal software development undertaken for the purpose of internal administration	Ineligible for the tax credit
Other internal software development	Capped limit at \$25 million of eligible expenditure
External software development (software developed for the main purpose of sale, or as an integral part of goods that are sold)	Eligible for the tax credit and uncapped limit

The rationale for excluding or limiting claims for internal software development is the fiscal risk and limited spill-over benefits associated with internal software development activities.

### Internal administration exclusion

Internal software development undertaken for the purpose of internal administration is ineligible for the R&D tax credit. This is because there is likely to be limited public benefit from such activities. An example of software development this exclusion would apply to is a firm upgrading its internal HR system.

### Other internal software development

All other internal software development, such as software development that enhances non-digital services to customers or enhances a business's manufacturing capability, is subject to an expenditure cap of \$25 million. This kind of software development is not excluded, because it has an external focus or element. Therefore, the spill-over benefits associated with this type of software development are wider than the benefits associated with activities subject to the internal administration exclusion.

Projects to upgrade internal business processes can be very expensive in some industries. The Government is cautious about the fiscal consequences of including these activities within the scope of the R&D tax credit regimes. The internal administration exclusion and the \$25 million cap are both aimed at reducing this potential fiscal risk.

Association rules apply to the \$25 million cap, grouping a business's expenditure on eligible internal software development together with that of any associated businesses. This is to prevent businesses from artificially their internal software development activities to get around the cap.

Software development for the purpose of internal administration of a business is ineligible for the research and development (R&D) tax credit.

This does not include internal software development for purposes unrelated to administration, which is subject to a \$25 million cap, rather than excluded outright.

Software developed for the main purpose of sale or as an integral part of goods that are sold (external software development), is not subject to the \$25 million cap.

## Excluded internal software development

If you develop software for the purpose of the internal administration of your business (or an associate's business, as defined in the Income Tax Act 2007 subpart YB), any expenditure you incur that relates to that development is not eligible for the R&D tax credit.

The purposes of internal administration include but are not limited to:

- payroll
- accounting
- executive or management information
- human resources
- customer relationship management
- enterprise resource planning
- purchasing
- invoicing
- inventory systems.

This exclusion covers both core and supporting activities. However, software development in excluded areas may still be eligible for the tax credit, if the software is developed with an external focus (and would therefore be considered external software development instead).

#### **Example: Software developed for internal administrative use**

GeneriCo is working on improving its inventory processes in its warehouses around the country. It develops new software which resolves technological uncertainty in managing its inventory. Because this software was developed entirely for internal administrative purposes, it is excluded from eligibility for the tax credit.

#### **Variation of facts: Developed for sale**

If GeneriCo were developing its inventory software primarily for sale to other companies, rather than for internal use, it may be eligible for the tax credit (as this expenditure could be considered external software development expenditure instead).

## **Software development subject to the \$25 million cap**

A \$25 million cap applies to all other software developed for internal purposes. This means that you can only claim \$25 million of expenditure on this kind of software development per year, regardless of how much you have actually spent. This equals a maximum tax credit of \$3.75 million.

The cap applies to software developed for internal purposes unrelated to administration. This includes such purposes as manufacturing, testing, quality control, or enhancing non-digital services to customers.

You will be required to tick a box on your supplementary return indicating if an associate is intending to or has made a claim for the tax credit. This will trigger personal contact from us. If you and your associate are claiming for the same R&D, you will need to set out what part each associate is claiming for and ensure no expenditure has been claimed twice. Refer to the contracted R&D section for guidance on who has the entitlement to claim (page 69).

### **Software that enhances non-digital services to customers**

A service is a non-digital service if the main reason why your customers use it is to obtain a service other than the use of your software (even though that service may be enabled, supported or facilitated by computer or software technology). Software which is not being developed for sale or licence, but which is intended to enhance non-digital services to customers, is considered internal software and is covered by the \$25 million cap.

#### **Example: Software that enhances non-computer services to customers**

Mohammed runs a courier business and develops software that enables his customers to pinpoint the exact location and condition of their packages.

This satisfies the definition of internal software development expenditure, because Mohammed's customers are using his services to receive the goods he delivers (a non-digital service), not to use the software Mohammed has developed. The expenditure Mohammed's business incurred to develop the software is subject to the \$25 million cap.

## Association rules and internal software development expenditure

The cap groups your expenditure with internal software development amounts claimed by your associates. Therefore, the maximum amount of internal software development expenditure you can claim, combined with your associates, is limited to \$25 million.

This is to prevent businesses from artificially splitting up their internal software development activities to get around the cap.

For partnerships and look-through companies, the cap is applied at the partnership or look-through company level (rather than the partner or individual owner level). Refer to the contracted R&D section for guidance on who has the entitlement to claim (page 69).

You will be required to tick a box on your supplementary return indicating if an associate is intending to, or has, made a claim for the tax credit. This will trigger personal contact from us to ensure that together your claimed expenditure on internal software development does not exceed \$25 million.

If you and your associate are claiming for different parts of the same R&D project, you will need to set out what part each associate is claiming for, and ensure no expenditure has been claimed twice.

### Example: Associated persons with internal software development expenditure

SL Ltd incurs \$20 million of internal software development expenditure and XW Ltd incurs \$11.5 million. SL Ltd and XW Ltd are wholly owned by NB Ltd.

As XW Ltd and SL Ltd are associated persons for tax purposes, their combined claim may not exceed \$25 million. This means that \$6.5 million of their combined expenditure (which totals \$31.5 million) is not eligible because it exceeds the internal software development cap.

## External software development

External software development is not subject to the \$25 million cap. Instead, it is subject to the same cap as all other eligible R&D expenditure, which is \$120 million. Refer to the maximum threshold section on page 72.

There are 2 types of external software development.

### Software that is sold

If you develop software with the main purpose of disposing of it to someone not associated to you, then it is considered external software development and not subject to the \$25 million cap.

You can still use this software internally without being subject to the \$25 million cap, provided your main purpose behind developing the software was to sell it.

### Software that is an integral part of goods that are sold

Software you develop that forms an integral part of goods that you sell in your business is also considered to be external software development, and not subject to the \$25 million cap.

This exception is targeted at firmware - such as software that runs inside a washing machine or TV remote.

## Purpose behind your software development

Your purpose at the time you develop your software determines what test you fall under. For example, if you develop your software for the purpose of internal administration and then later decide to sell it, this software would still be classified as internal software development and therefore excluded.

If you develop software with the purpose of both internal use and sale, the eligibility of the expenditure will depend on your main purpose at the time you developed it. If your main purpose was to develop software for internal purposes other than administration the expenditure will be eligible, subject to the \$25 million cap.

Alternatively, if it was intended for internal administration purposes, it will be ineligible. If your main purpose was to sell the software, it will be external software development and not subject to the \$25 million cap.

# Approved research providers

## Legislative reference

Income Tax Act 2007 Section LY 4, LY 6 and Schedule 21B Part B Clause 24 Tax Administration Act 1994 Section 124ZH

Claimants who use approved research providers are not subject to the \$50,000 minimum expenditure threshold for that expenditure. Additionally, expenditure on approved research providers is not subject to the refundability cap and is therefore fully refundable regardless of the amount of labour-related taxes a claimant has paid. This exception helps make the R&D tax credit accessible to businesses of all sizes.

To ensure that these concessions cannot be accessed improperly, a person must be able to perform core R&D activities to become an approved research provider. These are activities that involve attempting to resolve scientific or technological uncertainty.

## What is an approved research provider?

An approved research provider is a research provider approved by us. They provide R&D services under contract to other businesses in New Zealand.

## When you might choose to engage an approved research provider

If you are carrying out your own R&D activities, you cannot claim the tax credit unless you have more than \$50,000 of eligible expenditure in your income tax year.

If you have less than \$50,000 of eligible R&D expenditure, you may be able to claim the R&D tax credit if your R&D is performed by an approved research provider on your behalf. This exception helps make the R&D tax credit accessible to businesses of all sizes.

## Eligibility of claimants who contract work out to approved research providers

To claim the R&D tax credit with respect to R&D activities performed by approved research providers on your behalf you must satisfy the eligible entity criteria.

Find out more about the eligible entities on page 21.

## Eligible activities

Activities you outsource to an approved research provider must be eligible R&D activities. The same activity exclusions apply whether you contract out your R&D activities or perform them yourself.

Find out more about eligible activities on page 33.

## Calculating eligible approved research provider expenditure

Payments you make to an approved research provider are only eligible if they are included in the list of eligible expenditure and are not included in the list of ineligible expenditure.

Your eligible approved research provider expenditure is calculated using the formula:

$$\text{contract amount} - \text{ineligible expenditure}$$

Explanation of formula terms:

- **Contract amount:** the amount you have paid to an approved research provider for performing R&D activities on your behalf
- **Ineligible expenditure:** expenditure incurred by an approved research provider to perform R&D activities on your behalf, where that expenditure is included in the list of ineligible expenditure.

### Example: Calculating eligible approved research provider expenditure

B Co engages an approved research provider to perform R&D on its behalf. B Co pays them \$45,000. Of this, \$15,000 was paid for expenditure on the ineligible expenditure list.

B Co's eligible approved research provider expenditure is calculated as follows:

$$45,000 - 15,000 = \$30,000$$

Your eligible R&D expenditure may be a mixture of approved research provider and non-approved research provider expenditure. If so, your combined total eligible R&D expenditure must be \$50,000 or more for the non-approved research provider expenditure to qualify for the R&D tax credit.

### Example: Mixture of approved research provider and non-approved research provider expenditure

A Co has \$15,000 of eligible expenditure with an approved research provider. A Co also spends \$20,000 on R&D it performs itself in-house.

A Co's total R&D expenditure	
Approved research provider expenditure	\$15,000
In-house expenditure	\$20,000
<b>Total</b>	<b>\$35,000</b>

A Co's total R&D expenditure is \$35,000. Because the total expenditure is under \$50,000, A Co can only claim the tax credit on the \$15,000 spent on the R&D from the approved research provider.

### Important

Approved research providers have no duty to help you with your claim. It is your responsibility to make sure the details of your claim are correct and your approved research provider expenditure only includes eligible R&D expenditure. You should make sure your contracts with approved research providers accurately identify the R&D activity and a method for identifying your total eligible R&D expenditure.

## Choosing an approved research provider

In choosing an approved research provider, it's your responsibility to make sure they have the capability to perform the specific R&D you need for your business. We will only approve people as approved research providers on the basis that they meet all of the following:

- they are capable of performing core R&D on behalf of other people
- they have facilities in New Zealand to perform core R&D on behalf of other people
- they are available to perform core R&D on behalf of third-parties
- they perform, or will perform, core R&D on behalf of other people at market rates.

## What happens if my approved research provider's approved status is revoked?

Approved research providers may request to have their approved status revoked. We may also revoke their approved status if they cease to meet the above criteria.

If you already have a contract with an approved research provider when its approval is revoked, payments you made to them under your existing contract (entered into prior to revocation) will still be eligible for the tax credit.

If an approved research provider's approval is revoked and you then enter into a new contract for R&D activities with them, any payments you make to them under the contract may not be eligible for the tax credit. This is the case even if the new contract is for the continuation of activities first contracted for when the approved research provider still had approved status. Your payments under this new contract would only be considered eligible if your total R&D expenditure is \$50,000 or more.

# Becoming an approved research provider

## Legislative reference

Tax Administration Act 1994 Section 124ZH

## Why you might want to become an approved research provider

If you currently provide research and development (R&D) services to businesses in New Zealand, or plan to provide such services, you may be eligible to apply to be an approved research provider.

Being an approved research provider would allow your clients to claim the R&D tax credit with respect to eligible R&D activities you perform on their behalf. This is regardless of whether the minimum expenditure threshold of \$50,000 is met or not.

## Important

Approved research providers perform services as an R&D contractor and are not eligible to claim the R&D tax credit with respect to R&D activities they perform for others. They may be eligible to claim the credit if they are not acting as an R&D contractor and satisfy the eligible entity criteria in their own right.

## How to become an approved research provider

To become an approved research provider, you must:

- be capable of performing core R&D activities on behalf of other people
- have facilities to perform core R&D activities in New Zealand
- be available to perform core R&D activities on behalf of third-parties
- perform, now or in the future, core R&D activities for other people for market value consideration. Approved research providers must also keep adequate records. More information on approved research providers and record-keeping requirements follows.

## Important

You do not become an approved research provider automatically if you meet the criteria. You must complete the **Approved research provider application form - IR1203**. Download the IR1203 from [ird.govt.nz/forms-guides](http://ird.govt.nz/forms-guides)

## Capable of performing R&D activities on behalf of others

You must have the capability (skills and knowledge) to perform core R&D activities on behalf of other people. This may be demonstrated by records of past work, employee qualifications, and/or industry experience.

Find out more about core R&D activities on page 33.

## Facilities in New Zealand

You must have facilities to provide R&D services in New Zealand. It does not matter if you own, rent or lease the facilities.

## Available to perform R&D on behalf of third parties

You must be available (that is, you must have the time and resources) to provide R&D services to others not associated with you. While this does not mean that all of your clients must be third parties, you cannot be an approved research provider if you only intend to provide R&D services to your associates (for example, to other businesses within your corporate group).

For more information download our **Associated persons definitions for income tax purposes - IR620** booklet from [ird.govt.nz/forms-guides](http://ird.govt.nz/forms-guides)

## Market value consideration

You must charge fees for R&D services on commercial (arm's length) terms.

## Your information on our website

Some of the information you provide will be published online in the list of approved research providers. We will publish details including your name, a link to your website, and information on the research services you offer.

We take no responsibility for any use the public may have of this information, or any other unforeseen consequences of this information being available from our website.

## Obligations of an approved research provider

As an approved research provider, you have an obligation to maintain records that show both:

- you continue to satisfy the approved research provider requirements
- the amounts you derive and incur performing R&D activities on behalf of others claiming the R&D tax credits.

These record-keeping requirements are additional to the business records you will need to keep to support your business's audit and/or tax requirements.

Expenditure records must be sufficiently detailed to enable a judgement to be made about whether the expenditure is eligible. This requires that expenditure records contain or are able to be linked to a record with a description of the R&D activities to which the expenditure related.

You have no obligation to keep records of the **amounts you derive or incur in performing R&D activities on behalf of others claiming the R&D tax credit** if you do not know that they are intending to claim the tax credit.

While you have no obligation to do so, it would be helpful to clarify with your clients up front whether they plan to claim the R&D tax credit.

If the work includes activities that are not eligible for the tax credit, or there is ineligible expenditure, you should agree with your client how you will present information that will enable them to exclude ineligible amounts from their tax credit claim. More information on how this can be achieved is provided in the section on Record keeping when you use a contractor on page 95.

Note that the legal responsibility to only include eligible R&D expenditure in a claim for the R&D tax credit remains with your client, but if you are acting as an approved research provider you have an obligation to keep and make available records which enable your client to make a compliant claim.

## Revocation

We may revoke your approval as an approved research provider if you either:

- apply for a revocation of approval
- cease to satisfy any of the requirements of an approved research provider.

If your approval is revoked, we will send you a notice of revocation with reasons for the revocation and date from which the revocation will take effect. Any decision made by the Commissioner on a person's status as an approved research provider cannot be challenged.

# Record keeping requirements

## Legislative reference

Tax Administration Act 1994 Section 22 (2)(eb), 22(2)(kc) - general record keeping requirements

Tax Administration Act 1994 Section 22(2)(ec) - and 22(2)(kd) - approved research provider

It is important for the fiscal sustainability of the scheme that the R&D tax credit is only provided for legitimate R&D. Therefore, to ensure a person substantiates their claim for the credit, the person must keep sufficient records.

The record keeping obligations set out below apply to anyone claiming the research and development (R&D) tax credit. The material relating to keeping records of R&D activities and expenditure also apply to approved research providers.

If you have contracted your R&D out to an R&D contractor, you should read and understand the following requirements and make sure your contractor is keeping adequate records and that you can access them to support your claim.

## Records to demonstrate you have an eligible business

To claim the tax credit:

- you need to be in business in New Zealand, or be a levy body researcher
- you, or a company in the same group which is resident in a country New Zealand has a double tax agreement with, must own the R&D or, if not you must be able to use the results of the R&D for no consideration
- the core R&D must be performed in New Zealand.

Find out more about eligible entities on page 21, and core R&D activities on page 33.

In most cases your normal business records should demonstrate you are in business in New Zealand or that you are a levy-body researcher. If you are in any doubt we recommend you review the requirements at the above links, to make sure you have records which can demonstrate your eligibility.

Non-resident claimants who carry out R&D activity in New Zealand must have records that show they carry on business through a fixed establishment in New Zealand, or that they have been using an R&D contractor who has a fixed establishment in New Zealand.

Crown Research Institutes, universities and other tertiary education organisations, district health boards, and businesses directly or indirectly controlled by or associated with any of them are not eligible for the tax credit.

If you are in a structure which involves an ineligible entity, for example as a shareholder, you should make sure your records demonstrate that you are nonetheless eligible, for example, the ineligible entity is a minority shareholder and not otherwise associated with you.

You must also be able to show that either:

- you, or a joint venture to which you belong owns the results of the R&D activity
- a company in the same group as you, which is resident in New Zealand or in a country New Zealand has a double tax agreement with, owns the results of the R&D activity.

If the company which owns the R&D does not meet this requirement, your business may still be eligible if it can use the results of the R&D activity for no additional cost.

Ownership of the R&D activity might be recorded in initiation or commissioning reports, in a joint venture agreement, in project documentation or minutes of meetings. If ownership information is implicit you should make it explicit.

If you are contracting someone else to perform the R&D on your behalf, your contract should make it clear that you own the R&D activity and can commercially exploit the results without further payment.

The above tests can be satisfied within a partnership, a joint venture or a group of companies (pages 31 and 32). In all cases records must be retained which demonstrate that the claimant for the tax credit was in a structure or collaboration which met the tests at the required level.

You are also ineligible for the tax credit if you have received a Callaghan Innovation Growth Grant in the same income year. There is a limited exception for the 2020-21 income year for claimants who have a late balance date.

Find out more about eligible entities on page xx. For more information on what to do if you want to move from the Growth Grant to the tax credit refer to page xx.

## Records to demonstrate you have R&D activity that meets the definition

### Core research and development activities

To claim the R&D tax credit you must be undertaking a core R&D activity. This activity must:

- be performed for the material purpose of acquiring new knowledge, or creating new or improved processes, services or goods
- have the material purpose of resolving a scientific or technological uncertainty
- conducted using a systematic approach.

Further, an activity is not a core R&D activity if either:

- the knowledge required to resolve the uncertainty is publicly available
- it is deducible by a competent professional in the relevant scientific or technological field.

To demonstrate that your activities are eligible you should have records from the time the R&D was undertaken which meet the following requirements.

### Purpose

You must record the purpose of the R&D. What new knowledge, or new or improved product, process or service are the core R&D activities directed towards?

Evidence that supports the requirement that the knowledge, product, process or service is new or improved should also be documented. The test is not that it is new or improved for your business or in New Zealand, but on a worldwide basis.

This information might be recorded in work done to assess the state of the market or in patent or web searches or from discussions with industry colleagues. This information should be documented and retained.

### Scientific or technological uncertainty

One of the material purposes of your core research and development activity must be to resolve scientific or technological uncertainty otherwise your expenditure may not qualify for the tax credit.

You must document the scientific or technological uncertainty that your core R&D activity is seeking to resolve. This is the question(s) that the systematic approach is undertaken to answer.

Project commissioning and initiation reports often focus more on the commercial uncertainties than the technological and we recognise that commissioning documents are often written stressing the prospects of success rather than the scale of scientific or technological challenge. However, if there is scientific or technological uncertainty in the project you should include a section somewhere in your core project documentation identifying it.

To document the uncertainty, you should identify the issue(s) that you do not know whether you can resolve (the uncertainty or uncertainties) focusing on the scientific or technological dimensions and what it is that makes the issues difficult. If this information is included in your project documentation you will have simplified the subsequent process of completing your research and development (R&D) supplementary return (and from the 2021 income year your application for general approval. Find guidance on how to complete the supplementary return and application for general approval on page 101.

Experience with the 2008 R&D tax credit and from overseas jurisdictions suggests that the key to effectively describing scientific and technological uncertainties is early involvement of the research or technical staff.

Identification of the uncertainty should allow you to track the activity to resolve it, and the related expenditure, through an additional layer in your existing project management system(s). This will reduce your compliance costs.

If the scientific or technological uncertainty was not recognised when the project began but emerged subsequently you should document the uncertainty as soon as you recognise it. This might be in a standalone document. However, you will simplify and improve the process of tracking the eligible activity, and the related expenditure, if you add it to your normal project management system and track it from there.

### **State of knowledge**

You should record the state of knowledge which existed when the R&D was undertaken. This information is required to demonstrate that the knowledge to resolve the uncertainty was not publicly available or deducible by a competent professional when you began your core R&D activity. This is particularly important in fast moving fields where others may be working on the same problems.

Many businesses undertake this work in scoping the situation and looking for solutions before undertaking R&D activity. The state of knowledge might be recorded in the results of literature reviews or in patent or other searches, in articles in trade or professional journals or in advice from competent professionals who know the state of knowledge in the relevant field. You should document and retain this information, or a summary of it.

### **Systematic activity**

You must record the start and end date of the core R&D activity and the systematic approach undertaken to resolve the uncertainty.

This will require a description of the investigations, tests, analysis or experiments undertaken and whether the results resolved the uncertainty.

A single business project may be made up of both eligible activities and activities that are not directed towards resolving scientific or technological uncertainty. In addition, there may be activities which are on the schedule of excluded research and development (R&D) activities (page 51).

To support a claim for the tax credit your record keeping should be sufficiently detailed to differentiate between eligible activities and those which are ineligible because they serve another purpose or because they are excluded activities.

As noted above you should if possible capture this information by establishing the core R&D activity as a deliverable (or other appropriate artefact) in your project management system.

Different industries and sectors will have different approaches to documenting their R&D activities. Record keeping for the tax credit should largely derive from standard project documentation such as project plans, test results, sprint documentation or stage gate reports. Further discussion of appropriate record keeping in different environments appears in the section on Records to demonstrate you have R&D activity that meets the definition on page 91.

### **Eligible support activities**

If you have a core R&D activity that meets the definition, there may also be eligible supporting R&D activity (page 38).

If you claim for supporting activity, you must be able to show that the supporting activity or activities, were required for and integral to the core R&D activity and had the only or main purpose of supporting the core R&D activity. In addition, there must be enough detail so that the claimed activity can be seen to not be on the list of activities excluded as supporting activities (page 51).

### Example: Documentation to support a claim for supporting activity

Planning the testing or experimentation required to resolve a technological uncertainty is an eligible support activity.

Where costs related to planning are claimed for the tax credit, the documentation should include enough detail to make it clear the planning costs that have been included are those that were for the purpose of resolving the uncertainty and not for the wider project.

This might be done by creating a separate work item for this subset of the overall plan, naming it appropriately and assigning time and any other eligible expenditure to this work item.

Alternatively, if the planning activities to resolve the uncertainty were entwined with those for some other aspects of the project, the planning activity might be apportioned on a reasonable basis between the eligible R&D activity and the other work. The basis for apportionment as well as the results should be recorded.

## Eligible expenditure records

You must be able to show that the amounts you are claiming for the R&D tax credit have been incurred on core and where relevant, supporting R&D activity. In addition, the expenditure must be of a type that is on the schedule of eligible expenditure (page 64) and not on the schedule of ineligible expenditure (page 74).

Expenditure records required to support a claim for the R&D tax credit are the same as those required for other tax purposes, but additional detail will be required to demonstrate the connection with eligible R&D activity.

Your records must allow you to attribute expenditure to each core and supporting activity included in your claim. More detail on expenditure record keeping including the records we would expect to see if your **Research and development (R&D) supplementary return** is selected for audit or review, appears in the **Records showing eligible expenditure** section on page 97.

## Apportionment

Expenditure is only eligible for the R&D tax credit to the extent that it was incurred on core or supporting R&D activities. In some circumstances it will not be practicable to examine each expenditure item and calculate the extent to which it was applied to an eligible R&D activity. In these cases, a method of apportionment will be required. More detail is provided in the Eligible expenditure section on page 64.

Where apportionment is used, it must be:

- on a reasonable basis
- supported by an audit trail of source documents and working papers
- capable of being substantiated.

## R&D performed overseas (foreign R&D)

A maximum of 10% of the total eligible expenditure can relate to R&D activity performed overseas. The 10% cap does not apply to material or depreciation on equipment imported to New Zealand to be used in R&D conducted in New Zealand.

Your activity and expenditure records must clearly identify where services were provided outside of New Zealand.

## Contemporaneous records required

The records used to relate expenditure to the R&D activities and record keeping should be contemporaneous with (occurring at the same time as) the eligible activities and not retrospectively created, for example at the end of the tax year or at the end of the project.

## Employee costs

Expenditure on employee time on eligible activities should be recorded either through a time recording system or other project documentation such as log sheets or project reporting. This documentation should be contemporaneous with (created at the same time as) the R&D activity.

If employees are involved with R&D in the course of commercial production (page 66) your records will need to identify how this test was met, for example that you only claimed the time for the additional duties related to R&D and not the time spent on standard production duties.

Where a business project is comprised of both R&D activities and other activities which do not meet the legislative definition the time recording system, or other documentation, will need to be sufficiently detailed to identify or support a reasonable apportionment of the time spent on eligible R&D activities.

## **Depreciation**

To the extent that depreciable assets are used in performing R&D activities, depreciation loss is generally an eligible expense for the tax credit.

Records should identify the asset(s) used in the R&D activity and when it was used. If the asset was not exclusively used for eligible R&D activities, apportionment based on usage should determine the actual depreciation applied to the R&D activities.

If the R&D is performed in the course of commercial production depreciation will only be an eligible expenditure if it is additional to the costs that would have been incurred in the absence of the R&D activity. To be eligible expenditure the depreciation loss must be additional to that incurred in the production process and your records should demonstrate this.

## **Other expenditure**

Expenditure on items that are not depreciable property assets is eligible for the tax credit to the extent that the expenditure:

- is of a type that is included on the list of eligible expenditure
- was incurred on eligible R&D activities
- is not of a type listed as ineligible expenditure.

Expenditure on consumable items, such as materials and components which are used in R&D activity, is eligible for the tax credit. Records should document the usage. This might be through a stock control system or apportionment on a reasonable basis.

There are rules for feedstock (page 80) which relate to materials and energy inputs that are transformed or used in the R&D process and the output is then sold. These rules provide that the cost of the materials is only eligible to the extent that the expenditure exceeds the sale price, or the market value if the item is not sold or is sold to an associate. If your claim includes expenditure relating to feedstock, you must retain records which identify the value of the output.

Expenditure on overheads such as rent, insurance, administration personnel and cleaning costs are eligible expenditure to the extent they were incurred to support eligible R&D activities and are not of a type listed in the schedule of ineligible expenditure. A key requirement for overheads is that your records demonstrate how reasonable apportionment methods have been applied.

If the R&D activity was in the course of commercial production your records relating to overheads should demonstrate that the eligible expenditure was additional to that incurred in the production process. For example, if the R&D took place after normal hours when the facility was not producing goods for sale, this fact should be noted to support the claim for a portion of the overhead cost to be allocated to the R&D.

## **Record keeping when you use a contractor**

Where you use a contractor (including an approved research provider) to undertake R&D on your behalf you remain responsible for the content of your supplementary return/request for general approval, and for the tax position you take in your income tax return.

To enable you to make and support your claim you should make sure the contractor keeps appropriate records and that you can access them.

What this will look like will vary depending on the work you have contracted but if your contractor has been involved in your R&D from the beginning it will include being able to access records that document the investigation of the state of knowledge and which identify the scientific and technological uncertainty.

The information you should require your contractor to keep will include both the information you need to file your supplementary return (from year 2 the information you need to apply for general approval) and additional information to support the claim should we have questions.

If your contract includes work that does not meet the definition of an R&D activity (page 33), you will need to make sure the records are sufficiently detailed to separate the payments made for the core and supporting R&D activity, from the other work.

You might do this by making sure the eligible and ineligible activities are separately categorised in the schedule of work and agreeing that you will be invoiced on the basis of these categories with enough description of the eligible activities to allow you to complete the supplementary return. Alternatively, you might agree to an itemisation of the activities that you will be charged for, sufficient to enable you to classify them as eligible R&D activities or as ineligible.

In addition to ensuring that you only claim for contractor expenditure on eligible R&D activity you will be required to confirm that the expenditure for which you claim the tax credit was both:

- of a type included in the schedule as eligible expenditure (page 64)
- not on the schedule of ineligible expenditure (page 74).

You might satisfy this requirement by requiring your contractor to advise you of the subtotal spent or incurred on ineligible expenditure types, or alternatively to confirm in writing that all of the expenditure on eligible R&D activity was eligible expenditure as defined in Schedule 21B part A.

It is possible that we may follow up with you to seek further information about the claimed activity or expenditure and you should have an arrangement in place whereby you can access this information from your contractor if it is required to support your claim.

#### Note

We will not follow up directly with your R&D contractor without your knowledge but if you cannot source or arrange for us to access the required information for your claim, or request for in year approval, we may not be able to progress your application.

## Record keeping by approved research providers

Approved research providers have the same obligations as businesses to keep records relating to R&D activities and expenditure.

In addition, approved research providers must be able to show that they continue to meet the requirements for being listed as an approved research provider. These requirements are set out in the section on approved research providers (page 86) and require an R&D contractor to be in the business of providing contract R&D services in New Zealand, to other businesses they are not associated with. Normal business records which indicate the nature of the services an approved research provider provides should be enough to meet this obligation.

## Record keeping approaches to record R&D activity

You will need to plan for how you are going to record your R&D activities and expenditure. If you have not already, you will need to implement a suitable project management or record keeping system to keep track of your R&D project and supporting information.

Having a system will assist you to complete the research and development (R&D) supplementary return and calculate the expenditure claim. It will also help you have the relevant project and expenditure information to hand in case your claim is selected for review.

## Projects using project governance methodologies

Projects using formal project governance methodologies identify and report on deliverables in each phase. In such projects much of the information required to support a claim for the R&D tax credit can be captured in the standard project management documentation.

The key requirement is to make sure that where a scientific or technological uncertainty is known to exist, or emerges, the activities required to resolve it are captured as a deliverable or deliverables in their own right and that expenditure is appropriately recorded or apportioned against those deliverables. This will often require the use of additional project costing codes to capture the expenditure or provide a basis for apportionment.

A description of the scientific or technological uncertainty should be included in the description of the deliverable and routine reporting on progress with deliverables should include information that demonstrates that systematic activities were undertaken to resolve the uncertainty.

## Less formal projects

Smaller scale projects may have less formal governance and reporting methodologies but if a systematic approach is employed there should be a standard investigative or experimental process or a project brief that structures the work.

Where there is scientific or technological uncertainty the standard process or project brief may provide a suitable basis around which record keeping supporting the claim can be structured.

The project may be composed of elements which involve scientific or technological uncertainty and other elements that do not, or which involve ineligible activities. You should structure your project brief or process to separately identify the issue(s) involving scientific or technological uncertainty and put systems in place to document the activities and record or apportion the expenditure involved in attempting to resolve the uncertainties.

## Agile development methodologies

You should build deliberate consideration of whether there are qualifying R&D activities into sprint planning and review meetings. R&D activity once recognised, might be organised as an Epic or as (a collection of) user stories.

Where eligible R&D activities are identified an indicator denoting eligible R&D status could provide a mechanism for cost allocation and traceability. A pile of post-it notes is unlikely to meet the requirement to demonstrate a systematic approach but photos of dated scrum-boards which clearly show the progression of tickets related to the eligible R&D might.

In addition to recording the activities undertaken to resolve the uncertainty, the record keeping for a project being managed by an agile team must also identify the question that was scientifically or technologically uncertain, how your business knew it was uncertain and whether that activity was successful.

Where eligible and other activities take place simultaneously in a manner that makes them difficult to separate you should apportion staffing and other costs in a manner that reflects the balance of effort expended on eligible R&D activity.

## Contemporaneous record keeping

For records to be sufficient to support a claim for the R&D tax credit they should be kept on a contemporaneous or timely basis. Records which are created after the R&D is finished or at year end are not likely to meet this requirement.

There is no absolute standard for how frequently a record must be kept for it to be **contemporaneous**. The test is whether the frequency is sufficient to provide confidence that the record is based on reliable information.

Where employees are not engaged full time on eligible R&D activities a time recording system could be used to apportion their costs between eligible and other activities. If time recording is not used, you should be able to show that you have a credible and timely process for apportioning expenditure. This might be demonstrated if time allocated to qualifying R&D activities is regularly estimated and reported in project documentation, for example on a weekly or fortnightly basis.

Where staff are allocated to eligible R&D activities on a full-time basis the requirement for timely records could be met if there is monthly documentation which identified the staff involved with the work and the dates during the month when staff commenced or ceased working on eligible R&D activities.

Where expenditure on materials or depreciation is being allocated to eligible R&D activities, usage should be recorded at the time through a stock control system or cost allocation process. If the expenditure on eligible activities is apportioned, the basis for apportionment must be reasonable and be supported by an audit trail.

If your records are insufficient your R&D tax credit, or a portion of it, may be disallowed should we audit you.

## Records showing eligible expenditure

It is expected that businesses applying for R&D tax credit will meet financial and record keeping requirements<sup>2</sup>. The administrative records of your R&D will need to be produced in the event that your claim for a tax credit is selected for audit. Therefore, the records must contain clear and explicit information about the costs incurred and expenditure claimed for R&D tax credit.

Knowledge management is an essential feature of commercially-driven R&D. Good R&D record keeping has other associated benefits, including to:

- record new knowledge and lessons
- track risks and successes
- review objectives and milestones
- track progress and stages
- record the specific costs of the R&D programme
- meet compliance and reporting requirements
- accurately record and calculate eligible expenditure
- support a claim for a tax credit.

If your research and development (R&D) supplementary return is selected for audit or review, it is essential that you have retained sufficient documentation to support the expenditure claimed as eligible for the tax credit.

The level of documentation should be appropriate to the scale of the project.

If there is little or no documentation or record keeping this is an indicator the business has not followed a systematic approach, or the original intention of the project has diverted away from R&D, for example quickly evolved to a commercial stage.

A research and development supplementary return is required to be filed to claim the R&D tax credit for the relevant year. Therefore, expenditure documentation must be applicable to the year of the claim.

You must be able to provide any information reasonably required to determine eligibility and entitlement to the R&D tax credit. This may also include reasonable access to your staff, third parties and third-party research contractors, premises, and equipment where applicable.

You will be given reasonable notice if an audit is to be undertaken. Additional information may be requested during the audit. It is your responsibility to retain relevant and contemporaneous documentation.

The general record keeping requirements for business records apply for the R&D tax credit. For example, every person undertaking business in New Zealand must:

- record income, expenses, assets and liabilities
- keep records for 7 years after the end of the tax year they relate to
- keep records in English or Te Reo Māori, unless we approve you using another language
- keep electronic records in a format that allows us to readily work out the amount of tax payable.

## Common source documents

- Invoices
- Worksheets
- Journals
- Financial statements
- Management accounts
- Tax reconciliation
- General ledger and ledger accounts
- Directors', management, shareholder meeting minutes
- Ledgers and relevant source documents
- Bank statements
- Business contracts
- Meeting minutes
- Personnel files
- Wages and shareholder salary records
- Asset registers
- Private use records

## R&D source documentation, R&D expenditure evidence, and other supporting material

The following list outlines some of the types of records that will help you prepare your R&D tax credit application.

- R&D project plans
- R&D resources and their allocation
- R&D work papers
- Progress and status reports
- R&D project financial reports, including asset registers and R&D depreciation calculations
- Testing protocols, analysis, conclusions
- Testing and trial records, the results, and follow-up actions
- Separate project or activity details that show how many hours each employee has worked on the project, which part of the project the employee worked on and their hourly cost
- A worksheet that shows how you calculated the claim expenditure for each line item - this must reconcile against the amount you have claimed
- Activity initiation or commencement documents
- Records showing the date when commercialisation of the R&D results has begun
- Activity proposal agreed to by internal stakeholders
- Documents identifying the new knowledge sought by the R&D project
- Documents recording the scientific or technological uncertainties
- Documents relating to the state of knowledge and technology at the start of the project
- Details on research into publicly available information
- Advice or research documents that show how it was determined that the knowledge being sought was not readily deducible by a competent professional, and why this conclusion was reached
- Research commissioning documents
- Contractual agreements with approved research providers or other R&D contractors
- Worksheet showing the calculation of any feedstock inputs and how the net cost was calculated
- Full details of any R&D activities for which the associated expenditure is being claimed as foreign research and development expenditure - including the currency exchange rate conversion calculations where applicable

- Registration of patents as a result of R&D activities
- Documentation describing IP strategies, for example advice on how to effectively protect IP
- Correspondence with us regarding application and eligibility
- Wage reconciliation, journals, and provision records

In the event of an audit or review the documents must be provided in a form that clearly shows how your claim was prepared. Additional information and help on record keeping is provided in the record keeping section on our website at [ird.govt.nz/records](http://ird.govt.nz/records)

In summary, to support a claim for R&D tax credit you must keep sufficient documentation to support your expenditure claimed for the R&D tax credit.

R&D expenditure is only eligible for the R&D tax credit to the extent the time, goods or services relate to R&D activities. Where expenditure has more than 1 purpose it is necessary to identify that portion of your expenditure relating to eligible R&D activities as opposed to other business activities. This will generally be required for overheads, or utility expenditure where there is an area used for R&D and non-R&D activities.

Where you have apportioned expenditure, records should clearly show how you have done this. Be prepared to explain the basis, the reasons why that basis will provide reasonably accurate results, and the calculation method. The method must be reasonable, supportable and understandable.

If record keeping and the standard of documentation retention is inadequate this may result in corrections to your tax credit where its accuracy cannot be supported.

# Claiming the R&D tax credit

## Legislative reference

Tax Administration Act 1994 Sections 33E, 36BE, and 36C  
Income Tax Act 2007 Sections LY 1 to 7

## Enrolment

If you intend to claim the R&D tax credit your first step is to enrol in myIR under the business tab. This will give you access to the supplementary return and from the 2021 income year, the application for general approval.

You will need to provide some basic information about your business and contact details when you enrol. There will also be some general R&D questions.

Following enrolment, we may contact you to confirm your details and provide links to further guidance and information about next steps. Inland Revenue is working with Callaghan Innovation to administer the tax credit and your contact information may be shared with them for this purpose.

We encourage you to enrol as early as possible as it will enable us to provide you tailored support.

## How to claim the R&D tax credit in the 2019-20 income year

To claim the R&D tax credit, you need to enrol for the R&D tax credit. In addition to enrolling for the credit, you must file your:

- Research and development (R&D) supplementary return within 30 days after the due date of your income tax return
- income tax return on time (although note you can file your return up to a year late, but doing so may result in penalties and interest).

## Important

If your claim for the R&D tax credit is to be considered your income tax return must be filed within 1 year after your due date for filing.

This is not an extension of time to the original due date of the income tax return. Instead, it is a final absolute date for when the Commissioner can accept a late claim for a research and development (R&D) tax credit in an income tax return. Penalties and interest will apply in the usual way to late filed income tax returns.

## Example: Due dates for filing

ABC is wanting to claim a research and development (R&D) tax credit for the 2019-20 income year. ABC's due date for filing an income tax return is 31 March 2021 due to having an extension of time through their tax agent.

To be eligible, ABC must file their research and development (R&D) supplementary return by the 30 April 2021 (being 30 days after the due date of their income tax return). Their income tax return must be filed no later than 31 March 2022. Penalties and interest will apply to ABC's income tax return if filed after the 31 March 2021 due date.

When you complete your income tax return, a new field will ask you to enter the amount of the tax credit you are claiming.

To support your claim, you will provide information about your R&D activities and expenditure in the **R&D supplementary return**. This will help us understand the R&D you have done, and how it meets the definitions for R&D activity and eligible expenses. In addition, there will be an additional field in your income tax return for the amount of the R&D tax credit you are claiming.

## Important

If you file either return outside of the required timeframes, your claim will be declined.

The **R&D supplementary return** must be filed electronically. Our intention is this will be available to be filed in your myIR account.

To claim the R&D tax credit your income tax return must also be filed electronically, this is because the field for the R&D tax credit will only appear in the electronic versions of the income tax return.

## Important

Important

To claim the R&D tax credit you must file both your R&D supplementary return and your income tax return electronically.

The claim process will change from the 2020-21 income year. Information about the changed process is included in the **Changes in year 2 (2020-21 income year)** section on page 106.

## Research and development (R&D) supplementary return

The R&D supplementary return will ask you to provide some background information about your business and provide the following types of information about the R&D. Guidance on how to complete the R&D supplementary return and, from 2021, the application for general approval is included in the following section.

A PDF of screenshots from the R&D supplementary return is available from the Research and development tax incentive page Research and development tax incentive ([ird.govt.nz](http://ird.govt.nz))

### Purpose and uncertainty

- What new knowledge, process, service or good did the R&D aim to produce?
- What scientific or technological uncertainty, or uncertainties, did the R&D activity seek to resolve?
- Why could the scientific or technological uncertainty not be resolved using publicly available knowledge or knowledge deducible by a competent professional working in the relevant scientific or technological field?

### Core and supporting activities

- What core R&D activities did you undertake to resolve the scientific or technological uncertainty? For each core activity identify any associated supporting R&D activities which are included in your claim.
- What systematic approach was used to resolve the uncertainty? A systematic approach is a planned and structured approach. You should describe the approach and the process of testing, experimentation or analysis that was used to evaluate the possible solution(s) to the scientific or technological uncertainty.
- You should identify any work you have claimed for which was not part of the core R&D (the prototyping, experimentation, testing or analysis), but which you consider meets the requirements for being a supporting activity and note why those activities were required for the core R&D.

### Expenditure

Expenditure information will be collected at the R&D project level. An R&D project is a group of related core and supporting activities. More information about R&D projects is in the How to complete the R&D supplementary return/application for general approval section.

Expenditure will be broken down into:

- materials, consumables and overheads
- R&D tax depreciation
- employee related costs
- contract expenditure (there is a separate category for expenditure on an approved research provider. Expenditure on an approved research provider should only be included once).

You will also be asked to advise how much of your claim relates to expenditure incurred:

- on R&D activities conducted outside New Zealand
- on internal software development
- on items used in, or subject to, a process or transformation as part of your R&D activities (feedstock). If so, the extent this expenditure exceeds the market value of any goods resulting from the process or transformation
- in the course of commercial production.

## Additional Information

We may also ask you to provide the following information:

- whether an associated person is also claiming the tax credit (find out more in **Associated persons definitions for income tax purposes - IR620**)
- if you are claiming for work done through a joint venture structure.

You have the same obligations to supply information in your supplementary R&D return for R&D done on your behalf by a contractor (including an approved research provider) as you do when you are doing the R&D yourself.

If you use a contractor, you should discuss record keeping obligations with them to make sure you have the appropriate information to complete your R&D supplementary return to support your claim.

Find out more about the records you need to keep to support an R&D tax credit claim on page 90.

A section in the R&D return is for evaluation purposes. It asks a number of questions about your business's involvement with R&D..

## Claiming the tax credit in a consolidated group

If you are doing R&D as a member of a consolidated group, the consolidated group should enrol for the R&D tax credit and should file an R&D supplementary return. From 2020-21 tax year it is the consolidated group that should seek general approval or recognition as a significant performer.

## Claiming the tax credit as a joint venture or partnership

Incorporated joint ventures established as a company will claim the tax credit in the same way as any other company. This section is about unincorporated joint ventures and partnerships.

The R&D activity criteria and the minimum threshold for eligible expenditure apply at the joint venture or partnership level. Ineligible entity exclusions and filing requirements apply at the level of the individual party to the joint venture or partner (party) level.

To be eligible, each individual party that intends to claim a share of eligible joint venture or partnership R&D expenditure must be a New Zealand tax resident for the whole of the relevant income year.

## Process for joint ventures and partnerships in 2019-20 income year

The joint venture or partnership does not enrol for, or claim, the tax credit at the joint venture or partnership level. Instead, each of the individual parties (to the joint venture or partnership) intending to claim the tax credit must:

- enrol for the R&D tax credit
- complete an R&D supplementary return (R&D return). Each individual party's R&D return should include any R&D they do themselves (outside of the joint venture or partnership), plus any R&D done by the joint venture or partnership
- claim R&D tax credits in their income tax return. The amount claimed should include eligible expenditure on their own R&D (done outside of the joint venture or partnership), plus any eligible expenditure of the joint venture or partnership that the individual party wishes to claim.

## R&D supplementary return

The R&D supplementary return asks claimants to identify projects which are joint venture or partnership projects. Because the eligible R&D activity criteria apply at the level of the joint venture or partnership (rather than at the individual party level) it is important that each party describes the eligible activities of the joint venture or partnership as a whole and does not simply describe what they have done by themselves.

### Important

Parties should use a common name for the joint venture or partnership R&D project and develop common responses to the activity questions for use by all parties claiming the credit. This will assist us to accurately and consistently process claims arising from joint venture or partnership R&D.

Where you are an individual party in a joint venture or partnership R&D project you will be asked to identify:

- the other parties in the joint venture or partnership and their percentage share of the joint venture or partnership
- your percentage share
- the value of your share of eligible expenditure.

The R&D supplementary return asks for expenditure to be broken down into several categories including employee costs, contractor costs, depreciation and materials, consumables and overheads. You should provide details of your share of the joint venture or partnership expenditure in response to these questions.

If you have a different balance date from other parties you will need to ensure that you have activity and expenditure information available in time to support you to lodge your R&D supplementary return.

Where the parties have different balance dates you should retain the same name for the project but if necessary, activity information should be updated to reflect the situation when the R&D return is submitted. The expenditure information provided by each party should reflect their share of the joint venture's expenditure during their income year.

The following example illustrates the situation for a joint venture, but the same principles would apply to a partnership.

### Example: Joint venture R&D claimed

Electra Co, LBP Engineering and Frieda Farmer have formed a joint venture to develop an electrically powered piece of farm equipment which satisfies the tests for technological uncertainty. Electra Co has a 31 December balance date - LBP Engineering's income year ends on 31 March and Frieda Farmer's on 30 June. None of the parties have any other eligible R&D. Each party enrolls for the tax credit and completes an R&D return.

Each party claims for their expenditure in the joint venture which spends a total of \$400,000 on eligible R&D activity between 1 January 2019 and 30 June 2020.

The table below identifies what each party can claim in their 2019-20 income tax return.

Joint venture showing eligible expenditure claimable in 2019-20 income year							
	1 Jan to 31 Mar 2019	1 Apr to 30 Jun 2019	1 Jul to 30 Sep 2019	1 Oct to 30 Dec 2019	1 Jan to 31 Mar 2020	1 Apr to 30 Jun 2020	Total R&D exp claimed in 2019-20
JV Spend	\$50,000	\$70,000	\$80,000	\$70,000	\$80,000	\$50,000	-
Electra	\$10,000	\$20,000	\$20,000	\$40,000	Note 2	Note 2	\$90,000
LBP Eng.	Note 1	\$40,000	\$40,000	\$20,000	\$20,000	Note 2	\$120,000
Freida F	Note 1	Note 1	\$20,000	\$10,000	\$10,000	\$10,000	\$50,000

The JV spend identified is on eligible R&D activity and is eligible expenditure in terms of Schedule 21B Part A and is not ineligible expenditure in terms of Schedule 21B Part to the Income Tax Act 2007.

**Note 1:** The parties are only able to claim eligible expenditure from the beginning of their 2019-20 income year.

**Note 2:** Electra Co and LBP Engineering can claim their portion of this expenditure in their 2020-21 income year.

## Income tax return

Your income tax return must reflect your total R&D tax credit claim.

## Claiming the tax credit as a look-through company

The eligibility criteria are applied at the look-through company (LTC) level with the LTC treated as the entity performing the R&D activities. The LTC owner is taken to meet the R&D activity requirements if the LTC would meet the criteria. The LTC owner must however be a tax resident of New Zealand for whole of the relevant income year to be able to claim the tax credit.

It is the LTC owner who must enrol for the tax credit, file an R&D return and claim the tax credit in their income tax return.

## How to complete the R&D supplementary return/the application for general approval

In your R&D supplementary return, you will be asked to provide background information. This includes a name and reference for the **project** within which your R&D activities are occurring.

**Project** is not a term used in the R&D tax credit rules, but we recognise that businesses typically organise and manage their R&D through projects. The project reference is intended to help you, and us, logically group and assess your core and supporting R&D activities.

If the concept of a project or projects does not resonate with you (for example, you are a start-up, and everything is directed towards 1 purpose) simply create 1 project and give your R&D a meaningful name in the project space. Alternatively, you could make each core R&D activity a separate project.

Within each project you will be asked for the information outlined below. From year 2 (the 2020-21 income year) the information about R&D activities will be required in your application for general approval and the supplementary return will largely focus on expenditure information.

### Purpose of R&D

Your R&D must have a material purpose of creating new knowledge or new or improved processes, services or goods.

You will be asked to briefly describe what new knowledge, or new or improved product, good or service you are seeking to develop. Your answer must identify what is new or improved in what you are seeking to achieve.

### Explaining your scientific or technological uncertainty or uncertainties

The identification of the uncertainty or uncertainties is critical to your claim for the tax credit as it is the basis for the identification of eligible R&D activity.

It is not acceptable to state the uncertainty in general terms such as "we don't know how to do x". Such statements provide an insufficient link to a set of core activities which have a material purpose of resolving the uncertainty.

The uncertainty should be described as a gap in knowledge which can only be resolved using a systematic approach (testing, experimentation prototyping or similar) to evaluating possible answers. We are not seeking the detail of every proposition your process will test but we want to know the key questions that your R&D is investigating and which you believe have not already been answered.

In any R&D project there may be more than 1 scientific or technological uncertainty. You should exercise judgement in determining whether they are described as 1 or are separated out.

Where the uncertainties are in the same field and efforts to resolve them will form part of set of linked activities you could describe them as a single uncertainty. For example, in the food and beverage example on page 42 there may be technological uncertainty both about whether it is possible to make cocktail ice blocks that taste like the original cocktails and also about whether the ice blocks retain the cocktail taste and other required characteristics for the desired shelf life. These uncertainties are closely linked and could be combined into a single statement.

However, where the uncertainties in an R&D project relate to different technological fields and/or different stages of an R&D project they should generally be separated out.

This is because an uncertainty in one area does not determine whether there is scientific or technological uncertainty in a separate aspect or subsequent stage of the project. In the alcoholic ice block example whether the cocktail flavoured blocks could be manufactured at scale was also identified as a technological uncertainty. This uncertainty should be described separately from the one(s) relating to product formulation.

### **Substantiating that the answer is not already known**

You will be asked how you know that the uncertainty could not be resolved using publicly available knowledge or resolved through knowledge deduced by a competent professional.

Here your answer should briefly detail the analysis or searches you undertook to research the current state of knowledge and why the existing knowledge fails to provide an answer to the problem or a methodology/ established development path for resolving it.

In answering this question, you could be providing information based on work your staff have previously undertaken, or drawn from suppliers, industry associations, research organisations, research articles, blogs, wikis etc.

### **Core R&D activity**

Core R&D activity starts once you have formulated a possible solution or solutions to the scientific or technological uncertainty.

In deciding how to categorise and describe your core activity it is important to avoid being too detailed.

You should describe the process of testing, experimentation or analysis that you used or are proposing to use to evaluate the possible solution(s) to the scientific or technological uncertainty.

**One core activity** can describe an iterative series of investigations, analysis or experiments provided they test related aspects of your proposed solution(s) to the scientific and technological uncertainty.

In the example on page 36 a construction business is prototyping, and testing construction panels made of a wool composite. The prototyping and testing process could be described as a single core R&D activity.

### **Supporting R&D activity**

Supporting activities while not part of the immediate process of testing, experimentation or analysis are nonetheless undertaken for that purpose and are both required for and integral to it.

Each supporting activity needs to be described separately in your supplementary return or (from the 2020-21 income year) your request for general approval, but you should avoid pitching your description at an excessively detailed level.

For example, if your core R&D involves a horticultural trial of new cultivars and your support activity could reasonably be described as **crop management** you should describe it at this level rather than describing the preparation of the beds, weed management and irrigation as separate supporting activities. As noted in the section on record keeping requirements in page 85 you must however be able to provide further information about the work undertaken and the related expenditure should we seek it.

## Does the R&D Loan scheme impact my Research and Development Tax Incentive (RDTI) claim?

When assessing RDTI claims, the R&D Loan scheme is exempt from being a government grant for tax purposes, so does not impact on the claim.

However, if the loan or part of it is written off (e.g. because a business goes into liquidation) any tax liabilities that would normally arise from the write off, such as GST liability, remain.

## Changes in year 2 (2020-21 income year) - General approval and significant performer regime

### Legislative reference and intent

**Pilot provisions (in force for the 2019-20 income year)** Tax Administration Act 1994 Sections 68CB, 68CC  
Income Tax Act 2007 Section LY 3(1)(d)

**Year 2 approval provisions (in force from the 2020-21 income year)**

Tax Administration Act 1994 Sections 3 (definition of research and development certificate) 68CB, 68CC, 124ZI and 138E

Income Tax Act 2007 Section LY 3(1)(d)

### General approval

General approval is designed to do the following.

- Provide assurance/certainty - customers will be able to obtain approval of their activities while they are undertaking them. To that end, once granted, approval by the Commissioner is binding provided all the conditions of the general approval legislation are met.
- Act as an integrity measure - requiring approval closer to when the activity is being performed increases the likelihood that R&D tax credits are only being paid out to those who are aware that they are performing R&D. It also makes it easier to identify that there is scientific or technological uncertainty as opposed to if the assessment occurred 1 or 2 years after the R&D activity was performed.
- Shift the timing and burden of compliance and administrative costs so that it is easier on both government and people making R&D tax credit claims.

### The significant performer regime

The significant performer regime is intended to provide large R&D performers with an alternative to the general approval regime, because the compliance and administrative costs associated with obtaining general approval for large amounts of R&D activities may outweigh the benefit of the R&D tax credit for these businesses.

Criteria and methodologies approval is mandatory for all businesses in the significant performer regime.

### Criteria and methodologies approval

Criteria and methodologies approval (CAM) is mandatory for significant performers. CAM is intended to do the following.

- Provide businesses that opt out of general approval (which is mandatory for businesses that are not in the significant performer regime) with more comfort regarding the eligibility of their activities and expenditure.
- Ensure businesses engage with officials regarding their R&D tax credit claims earlier in the claims process. This should reduce the need for later scrutiny, and reduce the likelihood of claims being reassessed (and penalties and interest later being imposed).

## General approval

### The general approval process and deadlines

Under the general approval process, you will be required to obtain approval of your core and supporting R&D activities. If your R&D project is expected to take longer than a year you can obtain general approval for your activities for up to 3 years.

General approval is intended to provide certainty for taxpayers, before they incur significant expenditure on R&D, that their R&D activity is eligible for the tax credit.

The general approval application form will require you to set out the activities you are seeking approval for and the income years you want your approval to apply for. It will also ask for information about your project to assist Inland Revenue with the management of the R&D tax credit. We provide further guidance on how to identify and describe your R&D activities.

General approval applications are due by the 7th day of the 2nd month following the end of your income year. So, if you are a standard balance date (31 March) taxpayer, your general approval application will be due on 7 May (of the next income year).

We encourage you to submit applications for general approval as soon as you have sufficient detail to apply. Once approved you can be assured that your R&D activities are eligible for a claim at the end of the year. You can submit new projects throughout the year.

A PDF of screenshots from the General approval is available from the Research and development tax incentive page Research and development tax incentive ([ird.govt.nz](http://ird.govt.nz))

### Approval binding on the Commissioner

Once granted, general approval is binding on the Commissioner as long as:

- your application is accurate
- there have not been any material changes to the R&D activities that were approved
- you satisfy any conditions of the approval (these will be made clear in any approval you receive)
- there have not been any significant changes to the law that would affect your approval.

If any law changes do occur that could affect you, we will contact you to discuss your approval and any variation that may be required. We anticipate that in most circumstances, any law change would not take effect in your current income year but rather from a future income year.

#### Important

It is a requirement of general approval that you are required to notify us if your R&D activities or the conditions of your approval materially change. Where your R&D activities have materially changed during the income year, you must get in touch with us to inform us of these changes and seek a variation, otherwise you risk not being able to claim the credit for any R&D activities that have changed materially since you received the approval.

### Varying an existing approval

If your circumstances change you can apply to add to or vary your existing approval. Variation applications need to be made by the due date for approval for that year. You can vary multi-year and single-year approvals.

You can use this feature to:

- add new projects and, therefore, new R&D activities
- amend the information you have already provided about a project containing R&D (before it received general approval)
- seek a variation to the details of a project for which you have received general approval.

To add new projects or add or vary R&D activities in projects you have already created you will go back into your R&D workspace and chose the appropriate action (add project or edit project) from the **I want to** menu in myIR.

If you are adding a new project or seeking to vary a project where activities have already been approved when you submit the information, a new approval request will be generated.

### **No material change**

You do not need to seek a variation of your approval application if the previously provided descriptions of the following continue to be accurate.

- The purpose of your R&D.
- The scientific or technological uncertainty you are seeking to resolve.
- The proposed R&D activity or activities.

It is not material that progress has been slower (or faster) than originally anticipated, or that the results obtained require iterative changes within the core R&D activity (the testing, prototyping, analysis or experimentation that is your core R&D activity). These changes are to be expected in R&D.

### **Material change**

You should however seek a variation to an approved project if there is, or you expect there will be a material change to any of the:

- The scientific or technological uncertainty that is being investigated
- The core activities you are carrying out
- The nature of your supporting activities, or an increase in the number of support activities that you will be including in your claim.

A material change is one that is significant. In the context of in-year approval, the key issue for assessing materiality is whether the changes could affect the eligibility of activities for the tax credit. For example, has the:

- scientific and technological uncertainty that you are investigating changed such that the evidence you provided for it being a scientific or technological uncertainty is no longer directly relevant?
- nature of your core activity changed such that it calls into question whether it is directed towards resolving scientific or technological uncertainty - for example if you change your approach from developing a prototype to testing something which is already on the market.

You must also seek a variation if you propose to claim for any new support activity or if there is any change in the nature of an activity such that it might no longer meet the supporting activity tests.

#### **Example: Applying to vary a single year approval**

A Co has general approval in respect of the year ended 31 March 2021, which it obtained on 5 June 2020 so that it would have certainty regarding the eligibility of its R&D activities. A Co completes its R&D sooner than expected, and in December 2020 it starts performing R&D activities directed at resolving another technological uncertainty that it does not have approval for. A Co would have to submit a variation to its existing general approval by 7 May 2021 if it intends to claim R&D tax credits in relation to its additional activities.

#### **Example: Applying to vary a multi-year approval**

A Co, a standard balance date taxpayer, has obtained general approval for 3 income years: 2020-21, 2021-22, and 2021-23. In the 2021-22 income year, A Co decides to change the focus of its R&D. A Co would need to apply to vary its general approval by 7 May 2022.

### **Challenging approval decisions**

Decisions made by the Commissioner regarding general approval applications cannot be challenged. We will contact you if we think your approval application may be unsuccessful or where we need further information to assess your eligibility. We will only decline your application once we have contacted you to discuss it (and provided you with an opportunity to supply additional information, if appropriate).

## R&D supplementary return

From the 2020-21 income year you will be required in your R&D supplementary return to provide information on the expenditure you have incurred on your R&D, allocated to each project. Because you will have already provided information on your R&D activity as part of the general approval process, you will not have to provide that information again and it will pre-populate into your supplementary return. You will however be asked for a declaration that your activities have not materially changed from how you described them in your general approval application.

If your activities have materially changed from how you described them in your general approval application, they will only be eligible if you have applied to vary your approval application within the specified timeframes (by 7 May of the following income year for most businesses).

## Significant performer regime

From year 2 (the 2020-21 income year), if you expect to have more than \$2 million of eligible R&D expenditure in an income year, you can opt out of the general approval regime into the significant performer regime. To opt into the significant performer regime, you need to notify Inland Revenue by the 7th day of the 2nd month after the end of your income year, which is 7 May for most businesses (with a 31 March balance date). For the 2022 and later years it is proposed that the last day for applying for criteria and methodologies approval will be 6 months before the end of your income year.

The significant performer regime is intended to reduce compliance costs for businesses that conduct a significant amount of R&D and which would otherwise have to apply for general approval for each individual R&D activity. If you opt into the significant performer regime, instead of applying for general approval for each activity, you are required to apply for and receive approval of your criteria and methodologies for determining whether R&D activities and expenditure are eligible for the tax credit.

### Example: Significant performer opts into the regime

BruceCo is a large R&D performer with 150 different R&D projects, each involving multiple R&D activities. Most of its R&D activities are performed at a dedicated R&D facility in New Zealand. The compliance costs associated with submitting details on each individual R&D activity are high because of the number of activities BruceCo performs, and these costs could outweigh the benefit to BruceCo of receiving R&D tax credits for its expenditure on the R&D activities. To reduce its compliance costs, BruceCo opts into the significant performer regime and therefore must apply for criteria and methodologies approval, so that it can develop and have approval for a consistent, compliant approach to identifying eligible R&D activities and expenditure.

BruceCo meets with Inland Revenue and develops criteria and methodologies that enable it to reduce its compliance costs while nevertheless satisfying the Commissioner that it has complied with the requirements of the R&D tax credit rules. It expects to continue doing R&D for at least the next 3 years, so it receives criteria and methodologies approval for the 2020-21, 2021-22 and 2022-23 income years.

Your criteria and methodologies approval does not have to cover all of your R&D activities. You may still apply for general approval in relation to an activity if the activity is not covered by the criteria and methodologies approval, or if you want to ensure that activity meets the eligibility criteria. Note, however, that any R&D activities neither covered by your criteria and methodologies approval nor approved under general approval will not be eligible.

## Application to be a significant performer

If you choose to opt into the significant performer regime, you must apply for and receive approval of your criteria and methodologies for determining whether your R&D activities and expenditure are eligible.

To apply for criteria and methodologies approval you must provide:

- an estimate of your eligible R&D expenditure for each year covered by the approval
- a detailed description of the systems and processes you rely on to identify eligible R&D activities and expenditure.

In addition, before you submit your supplementary return you must engage an approved R&D certifier to review your compliance with the approved criteria and methodologies and to provide an R&D certificate to support your supplementary return.

### **Expenditure estimate**

You must provide Inland Revenue with an estimate of your R&D expenditure for the income year when you notify Inland Revenue of your intention to opt-in to the significant performer regime. You will only be able to elect into the significant performer regime if you have, or reasonably expect to have, more than \$2 million of eligible R&D expenditure in the relevant year. You can satisfy the expenditure threshold in your own right, or you can group your expenditure with other members of your corporate group. For partnerships or joint ventures, you may use the total eligible expenditure incurred (or that you reasonably expect will be incurred) by the partnership or joint venture, rather than your respective share.

If you have multi-year criteria and methodologies approval you must have or reasonably expect to have eligible R&D expenditure of more than \$2 million for each of the years covered by the approval. If unforeseen circumstances arise and the eligible expenditure drops below \$2 million, this doesn't automatically mean the criteria and methodologies approval won't apply. However, if there has been a change in circumstances and you no longer reasonably expect to have more than \$2 million in eligible R&D expenditure for a year, you will cease to be eligible for criteria and methodologies approval from the beginning of that year, and you will have to obtain general approval of your R&D activities. If you have criteria and methodologies approval but are concerned you may not meet the \$2 million threshold in a given year, please contact Inland Revenue to discuss your situation.

#### **Example: Criteria and methodologies approval - ending multi-year approval early**

Steph's Engineering has criteria and methodologies approval for the 2020-21, 2021-22, and 2022-23 income years. The company decides to do less R&D in the 2022-23 income year and realises it will not satisfy the \$2 million threshold requirement because it only expects to spend \$1 million on eligible R&D in that year. Steph's Engineering advises Inland Revenue that it will not be eligible for criteria and methodologies approval for the 2022-23 income year. The company then makes a general approval application for its core and supporting activities by the relevant due date for the 2022-23 income year.

#### **Example: Criteria and methodologies approval - unexpected and temporary reduction in expenditure**

Steph's Engineering has criteria and methodologies approval for the 2020-21, 2021-22, and 2022-23 income years. Late in the 2021-22 year it loses a major client and the reduction in cash flow forces it to scale back its R&D activities.

After a few months a new client is found, and the company resumes its normal level of R&D activities. Expenditure for the 2021-22 year was originally expected to be \$2.2 million but fell to \$1.9 million.

Because there was a reasonable expectation that eligible expenditure for the 2021-22 year would be more than \$2 million, the criteria and methodologies approval will remain in force.

### **R&D certificates**

If you opt into the significant performer regime, in addition to criteria and methodologies approval, you must obtain an R&D certificate from an approved R&D certifier and supply this with your R&D supplementary return.

It is expected that your R&D certificate will confirm that an R&D certifier has reviewed your R&D supplementary return, including a sample of your expense claims, to confirm that you have followed the approved criteria and methodologies for identifying eligible and ineligible expenditure.

R&D certificates are intended to provide us with reasonable assurance that you have complied with the requirements. We are finalising what R&D certifiers will do and will provide more guidance as soon as possible.

In addition to engaging an approved R&D certifier to certify your R&D expenditure, Callaghan Innovation may undertake a periodic review of your approved criteria and methodologies relating to R&D activities.

Find out more about R&D certifiers on page 114.

## Criteria and methodologies approval

Criteria and methodologies approval is a systems-based approach which looks at the systems, processes and controls a company has in place to help it determine whether R&D activities and expenditure are eligible for the tax credit. It looks at how decisions are made and recorded, rather than at specific R&D activities or expenditure, although as part of the approval process we will want to test that the processes are producing the right outcomes.

A PDF of screenshots from the Criteria and methodologies approval is available from the Research and development tax incentive page Research and development tax incentive ([ird.govt.nz](http://ird.govt.nz))

### Description of systems and processes

We expect an applicant for criteria and methodologies approval to provide a detailed description of how it goes about deciding whether R&D activities and expenditure are eligible for the tax credit. This would include a detailed description of the following.

#### R&D activities

- What is the nature of your business and the type of R&D typically performed? This provides the context in which systems and processes are evaluated.
- What is your typical development process? This could include:
  - Project Documentation Plan or Project Identification Document
  - Business case
  - Feasibility/basic research
  - Approval
  - Development and testing
  - Design transfer
  - Verification and validation
  - Production/Manufacturing
- How you determine whether an activity is a core R&D activity, including:
  - Who is involved in making decisions on whether activities are eligible, and what is their role?
  - How do you decide there is a scientific or technological uncertainty?
  - How do you confirm the knowledge to resolve any uncertainty is not currently available?
  - How do you determine when an R&D activity starts and ends?
  - How do you monitor R&D activities to identify when scientific or technological uncertainties have been resolved?
- Is your R&D performed in a commercial production environment?
- What are your usual supporting activities and how do these relate to your core activities?
- How are decisions on eligibility documented?
- How are time, materials and other inputs to R&D activities recorded and attributed to eligible or ineligible R&D activities (for example cost centres, project codes, time sheets)?
- What governance and control processes do you follow to ensure processes are being followed and decisions are correct (for example, do you undertake periodic reviews, and how frequently?)

#### R&D expenditure

- Where does your information on R&D expenditure come from? This could include details of cost centres, ledger accounts and other sources.
- How are decisions made on what expenditure is eligible, and who makes those decisions?
- How is expenditure attributed to projects or activities?
- What assets are used in your R&D activities?
- Where expenditure is apportioned between eligible R&D activities and other ineligible purposes, what is the method of apportionment and the rationale for using that method?

- What overheads do you intend to include in your eligible expenditure and how do these relate to your eligible R&D activities?
- How is ineligible expenditure (see Schedule 21B Part B) identified and excluded from your R&D claim?
- What documents are being maintained to record eligible expenditure?
- What governance and control processes do you follow to ensure that processes are being followed and decisions are correct?
- If any of the following apply, how you will identify relevant revenue and expenditure?
  - R&D performed overseas
  - R&D performed in commercial production environment
  - Feedstock rule
  - Internal software development.

### Criteria and methodologies application deadlines

For the 2020-21 income year (year 2 of the tax credit regime), if you opt into the significant performer regime, you must also apply for criteria and methodologies approval by the 7th day of the 2nd month after the end of the first income year to which the application relates (7 May for taxpayers with a 31 March balance date).

The criteria and methodologies approval process requires Inland Revenue and Callaghan Innovation to work closely with the applicant to get a detailed understanding of the applicant's systems and processes.

#### Example: Obligations under significant performer regime

Prahm Industries is a standard balance date (31 March) taxpayer, with an extension of time to file its income tax return. It has incurred more than \$2 million of eligible R&D expenditure and determines that it does not need general approval of its R&D activities. Prahm Industries decides to opt into the significant performer regime for the year ended 31 March 2021. The company must notify Inland Revenue by 7 May 2021 of its election to opt-into the significant performer regime and must provide an expenditure estimate with its election. It must also apply for criteria and methodologies approval by 7 May 2021.

Prahm Industries opts into the significant performer regime on 20 April 2021, which is after the end of Prahm Industries' income year (31 March 2021) and before the deadline for notifying the Commissioner. Prahm Industries is able to provide an exact account of its eligible R&D expenditure, which is \$2,548,000, alongside its election to opt-into the significant performer regime. It has an extension of time, so its income tax return is due on 31 March 2022. Prahm Industries files its return by this date and claims \$382,200 of R&D tax credits (15% of \$2,548,000 eligible R&D expenditure) in its income tax return. Prahm Industries' supplementary return (which must contain details of Prahm Industries' R&D expenditure) and R&D certificate are due on 30 April 2022.

Criteria and methodologies approval can be granted for up to 3 years. No fees will be charged for criteria and methodologies approval. This process is designed to increase certainty for significant R&D performers. It is expected that criteria and methodologies approval will vary on a case by case basis.

#### Important

It is highly recommended that you apply for criteria and methodologies approval as early as possible, to allow time for the process to be completed. Applications at year end run the risk of not being approved in time for the year to which they relate. If left too late, it could also be impractical for general approval applications to be approved.

For the 2022 and later years it is proposed that applications for criteria and methodologies approval must be received no later than 6 months before the end of your income year.

## Approval is not binding

Criteria and methodologies approval is intended to provide assurance to significant performers that if they follow the approved procedures, they will correctly determine the eligibility of activities and expenditure. However, unlike general approval, criteria and methodologies approval is not binding on the Commissioner. This is because criteria and methodologies approval looks at a company's systems and processes and relies on companies to make the correct decision on whether R&D activities and expenditure are eligible.

If you are unsure about any particular activity, you can request general approval for that activity.

Criteria and methodologies approval will not apply if:

- Your application contained a material omission or misrepresentation
- You fail to comply with any conditions on the approval
- There has been a material change to the RDTI legislation
- You do not provide an R&D certificate with your supplementary return.

## Varying an existing approval

Like general approvals, if your circumstances do materially change, you can contact us to vary your criteria and methodologies approval application. Variation applications need to be made by the due date for approval for that year. You can vary multi-year and single-year approvals.

### Example: Criteria and methodologies approval - dedicated R&D facility experiencing a material change in circumstances

Graham Labs is a large R&D performer with 150 different R&D projects which each involve multiple R&D activities. Graham Labs' R&D activities are performed at two dedicated R&D facilities in New Zealand. The compliance costs associated with submitting details on each individual R&D activity are high because of the number of activities it performs. Graham Labs decides to apply for criteria and methodologies approval so that it can develop a streamlined approach to identifying eligible R&D activities and expenditure.

Graham Labs meets with Inland Revenue and develops criteria and methodologies for identifying eligible R&D expenditure that enable it to assure the Commissioner that it has satisfied the requirements of the R&D tax credit rules. It expects to continue doing R&D for at least the next 3 years, so it receives criteria and methodologies approval for the 2020-21, 2021-22, and 2022-23 income years.

In the 2022-23 income year, Graham Labs shuts down one of its dedicated R&D facilities and now conducts some R&D at its manufacturing sites. Graham Labs' circumstances have materially changed, because it will now be doing some of its R&D in the course of commercial production. It will need to contact Inland Revenue and seek to vary its criteria and methodologies approval. Graham Labs is a standard balance date taxpayer, so it will need to contact Inland Revenue to vary its approval by 7 May 2023.

## Challenging approval decisions

Decisions made by the Commissioner regarding criteria and methodologies approval applications cannot be challenged. We will contact you if we think your approval application may be unsuccessful. We will only make a final decision to decline your application after we have contacted you to discuss it (and provided you with an opportunity to supply additional information, if appropriate).

## Revoking criteria and methodologies approvals

Criteria and methodologies approval can be revoked if we consider you have classified your activities or expenditure in a way that defeats the intent and purpose of the R&D tax credit. If your approval is revoked, we will provide you with reasons for the revocation. Similar to approval decisions more generally, decisions to revoke criteria and methodologies approvals cannot be challenged.

## Approved R&D certifiers

Approved R&D certifiers can supply R&D certificates to significant performers. Having an R&D certificate and filing this with your supplementary R&D return is a requirement for claimants in the significant performer regime.

## **Applying to be an approved R&D certifier**

To become an approved R&D certifier, you will need to apply using the approved application form. The form will require you to list any licenced auditors you employ, as well as the names of any partners, directors, or principals authorised to provide R&D certificates.

You are also required to make a statutory declaration on the application form stating that you are competent in applying the appropriate legal and accounting standards that relate to R&D tax credits and provide any other information the Commissioner considers necessary.

If we approve your application, we'll let you know and will also publish your approval on the Inland Revenue website. Your approved R&D certifier status takes effect from the date of your application.

You will not be approved if:

- your approval would adversely affect the integrity of the tax system
- your approval has been revoked in the last 2 years, or
- you surrendered your approval in the last 2 years in anticipation of revocation.

## **Firms or individuals**

It is envisaged that accounting firms as a whole will apply to be approved R&D certifiers, rather than individuals within each firm being certifiers in their own right. Where a firm is approved as an R&D certifier, the firm will be required to provide us with the names of individuals with delegated authority to issue R&D certificates on behalf of the firm.

## **Licenced auditors**

To be approved as an R&D certifier, it is proposed that a firm must declare that they include or employ one or more licenced auditors (as approved by the Financial Markets Authority). Where a firm is approved as an R&D certifier, the firm will be required to provide us with the names of licenced auditors in its employ.

## **What will the certifier certify?**

It is expected that an approved R&D certifier will review aspects of your supplementary return to confirm that you have followed the approved criteria and methodologies relating to how you determine whether R&D expenditure is eligible expenditure.

This process is still being developed and we will provide more details as soon as possible.

## **Revoking approved R&D certifier status**

Your approved R&D certifier status will be revoked if:

- you provide an R&D certificate to a person who is liable for shortfall penalties in relation to R&D tax credits, if the person took an abusive tax position or committed tax avoidance or tax evasion
- you receive a promoter penalty
- your approval would adversely affect the integrity of the tax system.

If your approved R&D certifier status is revoked, we will provide you with reasons for the revocation. Once revoked, you cannot have your R&D certifier status reinstated for 2 years. This also applies if you surrender your R&D certifier status in anticipation of having it revoked. Revocation takes effect from the date it is published online.

## **Challenging decisions**

Decisions made by the Commissioner regarding approved R&D certifier applications and revocations cannot be challenged.

# Receiving your R&D tax credit

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## Ordering rules

### Legislative reference

Income Tax Act 2007 Section LA 4

When applying tax credits against your income tax liability, your R&D tax credits from the current tax year apply 5th. Your R&D tax credits that have been carried forward from a previous year are offset against your income tax liability before R&D tax credits from the current year.

Your tax credits are used in the following order:

1. Non-refundable tax credits (which are extinguished if you do not use them in the income year they arise).
2. Tax credits for supplementary dividends.
3. Imputation credits.
4. R&D tax credits from a previous tax year.
5. R&D tax credits from the current tax year.
6. Refundable tax credits.

## How the R&D tax credit is applied

### Legislative reference

Income Tax Act 2007 Sections LA 5 and LA 6

Your R&D tax credits are first used to satisfy your income tax liability, if any, for the income year your credits relate to.

Once your credit has been used to satisfy your income tax liability for the year your credit relates to, different rules apply depending on whether your R&D tax credit is refundable or not.

### Refundable R&D tax credits

Where you meet the eligibility criteria, you may elect to receive a refund of your tax credits. You may be eligible for refundability if you are in a tax loss position, or if you have insufficient income tax to pay to offset all of your R&D tax credits against (that is, you have surplus R&D tax credits). The total amount of R&D tax credits you can get refunded is subject to a cap based on labour-related taxes.

Special rules can also apply in the 2019-20 income year, to allow you to use the old limited refundability rules instead, if this is your preference.

To learn more about refundability, see the Refunding R&D Tax Credits section on page 118.

### Ordering rules

Before being refunded, your tax credits must first be applied to any other liabilities, in the following order.

1. An income tax liability for a previous year.
2. A current income tax liability for a future tax year.
3. A current provisional tax liability for a future tax year.
4. A different tax period or type (as requested by you, or as applied by us if you have other tax outstanding).

The remaining amount may be refunded. A key difference between refundable and non-refundable R&D tax credits is that the refundable portion must first be offset against outstanding liabilities from other tax years, as outlined in the above order. The amount of the refundable credit that is left can be refunded. Non-refundable tax credits are only offset against tax liabilities in the current year, and then carried forward. They cannot be used to satisfy tax liabilities from other tax years.

### Example: Application of ordering rules

In the year ended 31 March 2021, Kimmie's Lab Ltd (KLL) incurred \$50,000 of eligible R&D expenditure. Of the \$50,000 of eligible R&D expenditure, \$30,000 was incurred on eligible R&D activities performed by an approved research provider. KLL had \$2,000 of income tax payable for the year and did not pay any labour-related taxes.

KLL is eligible for \$7,500 of R&D tax credits:

- \$4,500 of refundable R&D tax credits (\$30,000 of approved research provider expenditure × 15%), and
- \$3,000 of non-refundable R&D tax credits (\$20,000 of other eligible R&D expenditure).

Before receiving an R&D tax credit refund, KLL's R&D tax credits must first be offset against its income tax liability for the year. KLL offsets \$2,000 of its non-refundable R&D credits against its income tax liability of \$2,000. KLL receives an R&D tax credit refund of \$4,500 for the income year. Its \$1,000 of surplus non-refundable R&D tax credits can be carried forward to the 2021-22 income year provided KLL satisfies the R&D tax credit shareholder continuity requirements.

## Non-refundable R&D tax credits

Non-refundable R&D tax credits are not applied to tax liabilities from previous tax years. Any credits left over after applying them against your current year's tax liability may be carried forward to a future income year. For companies, the credit may only be carried forward where shareholder continuity requirements are met.

### Example: How refundable tax credits are applied

Vicki is entitled to \$500,000 of R&D tax credits in the 2019-20 income year. She has a \$50,000 tax liability in the current year, and an outstanding liability of \$200,000 from the previous tax year. She meets the criteria to have R&D tax credits refunded. Vicki has \$255,000 of refundable R&D tax credits, and \$245,000 of non-refundable R&D tax credits to be applied. They are applied as follows:

1. The \$245,000 of non-refundable tax credits are applied against her \$50,000 liability for the current year. The remaining \$195,000 is carried forward to the next tax year.
2. The \$255,000 of refundable credits must first be applied to the \$200,000 liability outstanding from the previous tax year.
3. The final result is Vicki gets \$55,000 R&D tax credits refunded, \$195,000 carried forward, and all outstanding tax liabilities are satisfied.

### Example: How non-refundable tax credits are applied

Same facts as above, except assume that Vicki does not meet the criteria for refundability.

The full \$500,000 of R&D tax credits is non-refundable and can only be applied against her \$50,000 liability for the current year. The remaining \$450,000 is carried forward to the next tax year.

## R&D tax credit refunds and cashed-out losses

You may be able to claim both the R&D loss tax credit and the R&D tax credit. Note that the R&D loss tax credit is currently under review by the Government. Further information on this review will be added to this guidance as it becomes available.

### Example: Company eligible for both R&D loss tax credit and R&D tax credit

Taranaki Seismic Sensors Limited (TSSL) is a NZ resident start-up company in year 2 of its operations. It does not derive exempt income and has no outstanding tax to pay.

TSSL is developing seismic sensors to help predict volcanic eruptions. The R&D project is expected to take 5 years before commercialisation of its product.

The company will remain in a tax loss situation until commercialisation.

#### R&D loss tax credit - year ended 31 March 2020

TSSL meets the corporate eligibility tests for the R&D loss tax credit. The company has 2 projects under way.

1. R&D of the physical seismic sensors (the firmware).
2. Development of software to support the sensors.

Under the R&D loss tax credit, TSSL applies the NZ IAS 38 definition of R&D expenditure. TSSL determines that it has \$365,000 of eligible R&D expenditure:

- \$305,000 relating to R&D on the firmware and developing an initial prototype
- \$60,000 relating to developing the software for the sensors.

TSSL has \$205,000 of R&D labour expenditure (calculated under NZ IAS 38) and its total labour expenditure is \$389,000. TSSL satisfies the wage intensity requirements, because it has an R&D wage intensity of 53% (which exceeds the required 20%).

When TSSL files its tax return for the 2019-2020 year, it cashes out \$102,200, which is 28% of its eligible R&D expenditure ( $\$365,000 \times 28\%$ ). TSSL will have to repay the \$102,200 when it becomes profitable (or if another trigger event occurs).

#### R&D tax credit - year ended 31 March 2020

TSSL also plans to apply for R&D tax credits and wants to have its R&D tax credits refunded. TSSL already knows that it meets the R&D tax loss credit corporate eligibility and wage intensity tests.

At the beginning of the income year, TSSL applies the R&D tax credit definitions to its planned R&D activities (the R&D tax credit definitions are different to the NZ IAS 38 definitions).

TSSL identifies technological uncertainty in the activities required to develop the sensor firmware. None of the activities TSSL undertakes are excluded activities, so the \$305,000 of expenditure that was eligible for the R&D loss tax credit is also eligible for the R&D tax credit.

TSSL concludes however that the software development does not require it to resolve scientific or technological uncertainty. The software development project also does not satisfy the supporting activity definition (in relation to the sensor firmware project). Since the software development project does not satisfy the R&D tax credit core or supporting activity definitions, the \$60,000 incurred by TSSL on this project is not eligible for the R&D tax credit.

When TSSL files its 2020 income tax return, it claims R&D tax credits on \$305,000 of its expenditure. TSSL receives an R&D tax credit refund of \$45,750, because it satisfies the refundability requirements.

Project	Eligible expenditure	
	R&D loss tax credit	R&D tax credit
R&D on sensor firmware	\$305,000	\$305,000
Software development	\$60,000	\$0
<b>Total</b>	<b>\$365,000</b>	<b>\$305,000</b>
Rate	28%	15%
<b>Cashed-out/credit amount</b>	<b>\$102,200</b>	<b>\$45,750</b>

## Note

If you are not eligible for refundability, you may be able to carry your R&D tax credits forward to the next income year.

## Refunding R&D tax credits

### Legislative reference and intent

Income Tax Act 2007 Sections LA 5, LA 6 and LZ 14; Subpart MX; and Section YA 1

Refundability is intended to ensure that all claimants doing R&D are able to benefit from their R&D tax credits soon after the year their R&D takes place in. Without refundability, some claimants may not be able to benefit from their credits until a much later date (if at all, depending on the circumstances of each claimant).

You may be able to get an R&D tax credit refund, subject to the new refundability cap, if your R&D tax credits exceed your income tax liability for the relevant income year. If you want to receive refundable credits, you must also make sure you do not have any other outstanding tax to pay.

The total amount of R&D tax credits you can receive as a refund is limited to a cap based on the amount of labour-related taxes paid by your business. The cap includes any PAYE (which includes withholding tax on schedular payments), FBT (fringe benefit tax), and employer superannuation contribution tax (ESCT) you pay for the relevant income year.

Any surplus credits you have can be refunded, up to your refundability cap for the relevant income year. If your credits exceed your refundability cap, then any credits in excess of your cap cannot be refunded in that year but can be carried forward to the next income year provided you meet the shareholder continuity requirements (refer to page 123).

### Example: Refunding credits under the refundability cap

In the year ended 31 March 2020, EmmaCorp has eligible R&D expenditure of \$1 million, so it is eligible for \$150,000 of R&D tax credits. The company has 12 employees and pays a total of \$200,000 in labour-related taxes (this amount is EmmaCorp's refundability cap). EmmaCorp has no income tax to pay in the 2019-20 income year.

Because its R&D tax credits (\$150,000) are less than its refundability cap (\$200,000) for the year, EmmaCorp can receive a refund of all its R&D tax credits.

#### Variation of facts: Insufficient labour-related taxes paid to refund all claimed credits

If EmmaCorp had only 6 employees and paid a total of \$100,000 in labour-related taxes for the year, it would have a refundability cap of \$100,000. Only \$100,000 of its R&D tax credits would be refundable. EmmaCorp meets the shareholder continuity requirements, so the remaining \$50,000 of R&D tax credits can be carried forward to the 2020-21 income year.

## Refundability cap can include taxes paid by controller or group companies

The refundability cap has grouping rules, which allow certain companies to allocate labour-related taxes they have paid to other companies they control or that sit within the same wholly-owned group.

The formula for calculating the refundability cap is:

own tax + other wholly-owned tax + other controller tax - double-dip allocation

Term	Definition
Own tax	The labour-related taxes paid by a claimant for the relevant tax year.
Other wholly-owned tax	The total labour-related taxes allocated to the claimant that have been paid by a member of the claimant's wholly-owned group for the relevant tax year.
Other controller tax	The total labour-related taxes allocated to the claimant that have been paid by a company that directly or indirectly controls the claimant for the relevant tax year.
Double-dip allocation	Any amounts allocated to a claimant that have already been allocated to another person are stripped out of the refundability cap. This prevents the same taxes going towards more than one claimant's refundability cap.

### Example: Grouping rules

Misto Labs is an R&D-intensive firm eligible for \$400,000 of R&D tax credits this year. It is in a tax loss position. Its refundability cap is made up of the following amounts.

Misto's refundability cap for the 2019-20 income year		
Formula component	Amount	Explanation
Own tax	\$75,000	PAYE, ESCT and FBT paid by Misto this year.
Other wholly-owned tax	\$100,000	PAYE, ESCT and FBT paid by Zeus Industries this year. Zeus is a company in the same wholly-owned group as Misto. Zeus has \$200,000 of its own labour-related taxes but allocates \$100,000 to Misto.
Other controller tax	\$100,000	Total PAYE, ESCT and FBT paid by ZigCo this year. ZigCo controls Misto and holds 65% of the shares in Misto.
Double-dip allocation	(\$0)	No amounts allocated to Misto by Zeus or ZigCo have been used by, or allocated to, other businesses for the purposes of calculating a refundability cap.
<b>Misto's total cap</b>	<b>\$275,000</b>	

Since Misto has a refundability cap of \$275,000, it can obtain an R&D tax credit refund for \$275,000 of its credits. Its remaining \$125,000 of R&D tax credits are non-refundable this year. Misto can carry these non-refundable credits forward to the next income year provided it satisfies the R&D tax credit shareholder continuity requirements.

### Example: Grouping rules with double-dip allocation

Same facts as the previous example, except ZigCo claims \$100,000 of R&D tax credits, half of which it offsets against its income tax payable. As with the previous example, ZigCo has paid \$100,000 of PAYE, ESCT and FBT for the year. ZigCo indicates in its supplementary return that it has a refundability cap of \$50,000, and so receives an R&D tax credit refund of its remaining \$50,000 of credits. Despite this, ZigCo informs Misto that it will allocate \$100,000 of labour-related taxes to Misto. Because ZigCo has already used \$50,000 of its own labour-related taxes for its refundability cap, the double-dip allocation rules apply.

#### Misto's refundability cap for the 2019-20 income year

Formula component	Amount	Explanation
Own tax	\$75,000	PAYE, ESCT and FBT paid by Misto this year.
Other wholly-owned tax	\$100,000	PAYE, ESCT and FBT paid by Zeus Industries this year. Zeus is a company in the same wholly-owned group as Misto. Zeus has \$200,000 of its own labour-related taxes but allocates \$100,000 to Misto.
Other controller tax	\$100,000	Total PAYE, ESCT and FBT by ZigCo this year. ZigCo controls Misto and holds 65% of the shares in Misto.
Double-dip allocation	(\$50,000)	ZigCo has allocated \$100,000 to Misto, of which it has already used \$50,000 for its own refundability cap. The same amount of tax can only go towards one person's refundability cap, so the \$50,000 already used by ZigCo must not be included in Misto's cap.
<b>Misto's total cap</b>	<b>\$225,000</b>	

\$50,000 is subtracted from Misto's refundability cap, because this amount has already been included in ZigCo's cap. As a result, after deducting the double-dip allocation amount, Misto's refundability cap is 225,000.

## Levy bodies and expenditure on approved research providers

There are 2 exceptions to the refundability cap. The cap does not restrict refunds for either:

- eligible expenditure on approved research providers
- claims made by levy bodies.

### Example: Credits paid to levy bodies fully refundable

Levy Body A (LBA) is an industry organisation to which levies are payable under the Commodity Levies Act 1990. LBA incurred \$1 million of eligible R&D expenditure this year. It has no income tax liability and pays \$50,000 of labour-related taxes for the year. LBA receives a full refund of its \$150,000 R&D tax credits, because the refundability cap does not apply to levy body researchers.

#### Levy Body A - 31 March 2020-21

Eligible R&D expenditure	\$1 million
	× 15%
R&D tax credits claimed	\$150,000
Income tax liability	\$0
<b>R&amp;D tax credits refunded</b>	<b>\$150,000</b>

### Example: Expenditure on approved research providers fully refundable

In the 2020-21 income year, Bagsy's Backpacks contracts an approved research provider to conduct research into lighter, stronger, and more weather-resistant textiles for use in a planned new range of lightweight but heavy-duty backpacks. All of its R&D is done through this approved research provider - Bagsy's Backpacks does not do any R&D in-house or through non-ARP contractors. It incurs \$400,000 of eligible R&D expenditure on the project and claims \$60,000 of R&D tax credits (15% of \$400,000). Bagsy's Backpacks has no income tax liability in the 2020-21 income year, because it has brought forward losses from previous income years.

Although Bagsy's Backpacks only paid \$10,000 of labour-related taxes (PAYE, FBT, and ESCT) for the year, because it used an approved research provider for all its R&D, it can claim a full refund of its R&D tax credits. The refundability cap does not apply to eligible expenditure on approved research providers.

#### Fact variation: mixture of ARP and non-ARP credits

Instead of contracting all of its R&D out to an ARP, Bagsy's Backpacks does some \$100,000 of its R&D in-house. The remaining \$300,000 is on eligible R&D done by an ARP. All other facts remain the same.

#### Bagsy's Backpacks: refundability calculation for the year ended 31 March 2021

Eligible R&D expenditure on ARPs	\$300,000
Multiplied by tax credit rate of	15%
<b>Total R&amp;D tax credits derived from expenditure on ARPs (fully refundable)</b>	<b>\$45,000</b>
Eligible R&D expenditure (not on ARPs)	\$100,000
Multiplied by tax credit rate of	15%
<b>Total R&amp;D tax credits (not from ARP expenditure)</b>	<b>\$15,000</b>
Refundability cap (applies to non-ARP credits) - this is the total labour-related taxes paid	\$10,000
Total non-ARP credits that can be refunded (the lesser of Bagsy's refundability cap and its total non-ARP credits)	\$10,000
Remaining credits (non-refundable in the 2020-21 income year)	\$5,000
<b>Total refundable R&amp;D tax credits (from both ARP expenditure and non-ARP expenditure)</b>	<b>\$55,000</b>
<b>Total non-refundable R&amp;D tax credits</b>	<b>\$5,000</b>

\$55,000 of Bagsy's Backpacks' R&D tax credits are refundable. The remaining \$5,000 of tax credits are non-refundable, and can be carried forward by Bagsy's Backpacks to the 2021-22 income year if it satisfies the R&D shareholder continuity requirements in section LY 8.

# Applying the old limited refundability rules (2019-20 income year only)

## Legislative reference and intent

Income Tax Act 2007 Sections CW 9, CW 10, LA 5, LA 6, MX 2, MX 3, and LZ 14

The Taxation (Research and Development Tax Credits) Act 2019 introduced limited refundability rules, which apply in the 2019-20 income year. In March 2020, the Covid-19 (Taxation and Social Assistance Urgent Measures) Act 2020 was passed. The Act replaces the (old) limited refundability rules with broader refundability rules. The broader refundability rules were originally meant to apply from the 2020-21 income year, and were initially introduced via the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Act 2020.

Bringing forward the application date of the broader refundability rules is intended to provide extra cash support to R&D performing businesses affected by the disruption caused by Covid-19. By providing additional cash support a year early, businesses will have improved cashflow now when they need it most. They will be encouraged to retain their R&D staff and (where possible) continue their R&D in the current environment. Retaining R&D capabilities and continuing to innovate will help ensure a smoother recovery once the global situation stabilises.

In the 2019-20 income year, you can choose to apply the old limited refundability rules (instead of the default broader refundability rules). The broader refundability rules will apply by default unless you opt to apply the limited refundability rules when you file your R&D claim.

More information on the filing process as it relates to refundability in the 2019-20 income year will be added to the guidance once it is available.

## Basic eligibility criteria

If you choose to apply the old limited refundability rules, you may be able to get an R&D tax credit refund of up to \$255,000 (which equals \$1.7 million of eligible R&D expenditure) if:

- you are a company
- you are in a tax loss position, or are in a tax paying position but have surplus R&D tax credits
- you have no outstanding tax to pay
- you satisfy the R&D tax loss cash-out corporate eligibility and wage intensity criteria
- you do not derive exempt income (other than the types outlined below) and are not associated with anyone who derives exempt income.

If you receive a foreign dividend or a dividend within a New Zealand wholly-owned group that are exempt income under sections CW 9 and CW 10 of the Income Tax Act 2007 respectively, you will not be ineligible for a refund of your tax credits under the old limited refundability rules.

## Corporate eligibility criteria

To satisfy the corporate eligibility criteria, you must be a company and a tax resident of New Zealand. You must not:

- be a listed company, or be otherwise listed on a recognised exchange
- be treated as a tax resident of another country under a double tax agreement
- have 50% or more of your shares held by a public or local authority, Crown Research institute, or State enterprise.

### Example: Joint venture partially owned by Crown

A tertiary education organisation and a State enterprise each have a 25% share of a joint venture company (JV Co). The other 50% of the company is owned by Bryan, a private investor.

Shares held in JV Co	
Shareholder	% of shares held
Tertiary education organisation	25
State enterprise	25
Bryan	50

JV Co cannot get a refund of its R&D tax credits under the old limited refundability rules because it is 50% owned by the Crown.

## Wage intensity criteria

To satisfy the wage intensity criteria, 20% or more of your labour costs must relate to R&D. If you are part of a group of companies, the wage intensity amount calculated for your group must be at least 0.2. Wage intensity for the R&D tax credit is calculated in the same way as for the R&D tax loss cash-out regime.

Further information on how to calculate your wage intensity is available at [ird.govt.nz/research-and-development](http://ird.govt.nz/research-and-development)

## Carrying R&D tax credits forward

### Legislative reference

Income Tax Act 2007 Sections LY 1, LY 8 and YA 1 (definitions of minimum market value interest and minimum voting interest)

You can carry forward any surplus R&D tax credits you have to a future income year, although if you're a company, you'll have to satisfy the shareholder continuity requirements. Continuity describes whether your company's shareholding has been consistent over a period of time.

The R&D tax credit shareholder continuity requirements are the same as the loss continuity requirements. To satisfy the requirements, at least 49% of voting interests (shares that carry a vote) in your company need to be held by the same group of shareholders over the continuity period, which is from the beginning of the income year your R&D tax credits arise to the end of the income year you want to carry the credits forward to.

For example, if you receive an R&D tax credit of \$100 in the 2020 income year, and you want to carry these credits forward for use in the 2021 income year, you need to maintain shareholder continuity of at least 49% for both the 2020 and 2021 income years.

You can also satisfy the shareholder continuity requirements if all the following apply:

- a market value circumstance exists for your company over the relevant time period
- at least 49% of voting interests (shares that carry a vote) in your company are held by the same group of shareholders over the relevant period
- a group of persons holds 49% or more of the minimum market value interests in your company.

A market value circumstance exists where a shareholder's voting interests in a company do not accurately reflect their economic interest in the company. It takes into account debentures, shares, options and other arrangements that could affect the balance of interests within a company.

### Example: Shareholder continuity requirements satisfied

Charlie Ltd has an R&D tax credit of \$100,000 for the year ended 31 March 2020 (the 2020 income year). Charlie Ltd wants to carry forward its R&D tax credit to the year ended 31 March 2021.

There are a total of 100 ordinary shares in Charlie Ltd. The following people have voting interests in Charlie Ltd over the relevant period.

Minimum voting interests in Charlie Ltd			
Shareholders	Shares held as at		Minimum voting interests as at 31 March 2021
	1 April 2019	31 March 2021	
Chiko	45	20	20
Sunny	30	20	20
Bailey	15	35	15
Suzy	10	25	10
<b>Total</b>			<b>65</b>

The continuity period runs from 1 April 2019 to 31 March 2021.

The minimum voting interests in Charlie Ltd over the relevant period are 65% ( $65 \div 100$  shares), which is greater than the required 49%. Charlie Ltd is able to carry its R&D tax credits forward from the 2020 income year to the 2021 income year.

### Example: Shareholder continuity requirements breached

Same facts as the previous example, except for a change in the shares held over the relevant period.

Minimum voting interests in Charlie Ltd			
Shareholders	Shares held as at		Minimum voting interests as at 31 March 2021
	1 April 2019	31 March 2021	
Chiko	45	0	0
Sunny	0	45	0
Bailey	30	20	20
Suzy	15	25	15
Clyde	10	10	10
<b>Total</b>			<b>45</b>

The minimum voting interests in Charlie Ltd over the relevant period are 45% ( $45 \div 100$  shares). Charlie Ltd is unable to satisfy the shareholder continuity threshold of 49%, so cannot carry forward its R&D tax credits to the 2021 income year.

## Part-year continuity rules

Where you breach continuity rules for a full income year, you may still be able to carry forward a portion of your R&D tax credits where continuity of ownership is met for part of the year. This can apply in the year the R&D occurs, or in the profitable year which you are carrying your credits forward to. You will need to keep adequate financial statements to apportion your income tax liability or R&D tax credit, as applicable, to the relevant part of the year where continuity was met.

### Example: Continuity lost during the year in which the R&D is performed

ABC Ltd performs R&D in the 2020-2021 income year. On the 26 June, the majority shareholder, James, sells his share in the company to Brya. The shareholding is as follows:

Minimum voting interests in ABC Ltd			
Shareholders	Shares held as at		Minimum voting interests as at 26 June 2020
	1 April 2020	26 June 2020	
James	60	0	0
Stephanie	25	25	25
Kelvin	15	15	15
Brya	0	60	0
<b>Total</b>			<b>40</b>

Minimum voting interests in ABC Ltd			
Shareholders	Shares held as at		Minimum voting interests as at 26 June 2020
	26 June 2020	31 March 2022	
Brya	60	60	60
Stephanie	25	25	25
Kelvin	15	15	15
<b>Total</b>			<b>100</b>

Continuity is breached on June 26 as minimum voting interests in the company fall below 49%. However, from 26 June 2020 to 31 March 2022 continuity has been met as minimum voting interests exceed 49%. ABC Ltd has kept detailed financial statements and is able to determine that between 26 June 2020 and 31 March 2021 the firm incurred \$148,000 of eligible R&D expenditure. This equates to a credit of \$22,200.

1/4/2020	26/6/2020	1/4/2021	31/3/2022
R&D tax credit \$9,000	R&D tax credit \$22,200	Tax liability \$30,000	
Continuity breach			

ABC Ltd may carry forward the R&D tax credit of \$22,200 for the 2020-21 tax year and offset it against the tax liability of \$30,000 in the 2021-22 tax year. The \$9,000 R&D tax credit cannot be carried forward as continuity was breached.

### Example: Continuity lost in profitable year

BCD Ltd performs R&D in the 2020-2021 year and receives a credit of \$50,000 but is in losses so cannot use its credit. In the 2021-2022 year the firm has tax to pay of \$70,000. Part way through the 2021-2022 part of the company is sold. The shareholding is as follows:

Minimum voting interests in ABC Ltd			
Shareholders	Shares held as at		Minimum voting interests as at 30 September 2021
	1 April 2020	30 September 2021	
B	60	0	0
C	40	40	40
D	0	60	0
<b>Total</b>			<b>40</b>

Continuity is breached on 30 September as minimum voting interests in the company fall below 49%. However continuity was maintained between 1 April 2020 and 30 September 2021 as minimum voting interests up until this point are 100%. BCD Ltd has kept detailed financial statements and can show that from 1/4/2021 to 30/9/2021 the firm has made a profit that corresponds with a tax liability of \$40,000.

1/4/2020	1/4/2021	30/9/2021	31/3/2022
R&D tax credit \$50,000	Tax liability \$40,000	Tax liability \$30,000	
Continuity breach			

The \$50,000 R&D tax credit may be carried forward to the 2021 year and offset against the tax liability of \$40,000. Because continuity is breached at this point, the remaining \$10,000 of R&D tax credit is lost and cannot be used to offset the tax liability of \$30,000 in the 2nd half of the 2021-2022 tax year.

## Reduction of provisional tax payments

### Legislative reference

Income Tax Act 2007 Section YA 1 (definition of residual income tax)

Your research and development (R&D) tax credits are subtracted from your residual income tax figure. You can choose to factor your anticipated R&D tax credits into your provisional tax calculations for the relevant income year.

Provisional tax payments are generally based on your residual income tax for your previous income year. For example, under the standard uplift method, your provisional tax payable for the year is generally 105% of your residual income tax for your previous income year.

If you estimate your provisional tax for the year, the reduction in your provisional tax payable will be immediate. If you use the standard uplift method for calculating provisional tax, the reduction will be delayed.

If you decide to estimate your provisional tax and take into account your anticipated R&D tax credit for the year, you will be charged use-of-money interest if you underpay your provisional tax (for example, if your R&D tax credit claim ends up being less than you anticipated, or if your claim is not allowed).

### Example: Provisional tax estimate reduced for anticipated R&D tax credits

Raspberry Ltd anticipates it will receive R&D tax credits of \$60,000 in the year ended 31 March 2020. It has provisional tax to pay of \$90,000 for that year. Raspberry Ltd decides to reduce its provisional tax payments by taking into account its expected R&D tax credits.

Raspberry Ltd - provisional tax for the year ended 31 March 2020	
Provisional tax payable (based on the standard uplift method)	\$90,000
Anticipated R&D tax credits	(\$60,000)
<b>Total</b>	<b>\$30,000</b>

Raspberry Ltd lodges a provisional tax estimate of \$30,000 and pays \$10,000 at each of its 3 instalment dates. Raspberry Ltd's R&D tax credit claim is processed, and it receives the anticipated \$60,000 of R&D tax credits. Raspberry Ltd has no UOMI to pay because it has paid the correct amount of provisional tax.

### Example: Provisional tax underpaid - R&D tax credit reduced

Same facts as above, except for the final paragraph.

Raspberry Ltd's R&D tax credit claim is reduced by \$10,000, because a review of its claim identified some ineligible expenditure.

Raspberry Ltd - provisional tax for the year ended 31 March 2020	
Provisional tax payable (based on the standard uplift method)	\$90,000
Less R&D tax credits actually received	(\$50,000)
<b>Provisional tax payable*</b>	<b>\$40,000</b>
Less provisional tax paid	(\$30,000)
<b>Underpaid tax</b>	<b>\$10,000</b>

\* based on tax payable less actual R&D tax credits received

Raspberry Ltd has paid \$30,000 of provisional tax but should have paid \$40,000 based on the actual R&D tax credits it received. It has underpaid its tax by \$10,000.

Use-of-money interest will apply to the underpaid amount of \$10,000.

## Imputation and Māori authority credits

### Legislative reference

Income Tax Act 2007 Sections OB 4, OB 9C, OK 2, OK 6C, OP 5, OP 7, OP 11C, and Tables O1, O17 and O19

If you are a company or Māori authority, you will receive imputation credits or Māori authority credits equal to your R&D tax credits. Imputation credits and Māori authority credits arise on the date you file your income tax return, regardless if you are in profit or loss. You will need to include the imputation credits you expect to receive (as a result of your R&D tax credit claim) in your imputation return.

An R&D tax credit refund or downward reassessment will lead to an imputation or Māori authority debit. The debit is equal to the amount of your refund or the amount that has been reassessed downwards. For refunds, the debit applies on the date your refund is paid.

For downward reassessments, the debit is backdated to the date you filed your income tax credit return. If you pay out a dividend between when you filed your tax return and when you were reassessed downwards, and do not have sufficient imputation credits in your imputation credit account, your imputation credit account will go into negative. This will result in penalties and interest. You should be mindful of this when you are preparing your R&D tax credit claim and when you decide your dividend policy.

### Example: Recording imputation credits for R&D purposes in your imputation credit account

In the year ended 31 March 2020, Archie Ltd has:

- assessable income of \$200,000
- allowable deductions of \$170,000
- eligible R&D expenditure of \$100,000.

Archie Ltd files its income tax and R&D supplementary returns on 31 March 2021, claiming an R&D tax credit of \$15,000 ( $0.15 \times \$100,000$ ).

Company income	\$200,000
Allowable deductions	(\$170,000)
<b>Taxable income</b>	<b>\$30,000</b>
<b>Income tax payable</b>	
Tax at 28%	\$8,400
R&D tax credit	(\$15,000)
<b>Surplus R&amp;D tax credits</b>	<b>(\$6,600)</b>

#### Archie Ltd - imputation credit account

Date	Credits	Debits	Balance
31 March 2021	\$15,000	-	\$15,000
30 April 2021		(\$6,600)	\$8,400

Archie Ltd satisfies the R&D tax credit refund requirements, so receives a refund of its surplus R&D tax credits on 30 April 2021. The company is required to record the following amounts in its imputation credit account.

**Note:** This example is simplified and is for illustrative purposes only.

### Example: Imputation debit for downwards reassessment

Rex Ltd files its 31 March 2021 income tax return on 7 July 2021 and claims an R&D tax credit of \$50,000. The company's imputation credit account is credited \$50,000 on 7 July 2021. The company pays out a dividend on 19 August 2021, using up all its imputation credits. On 18 October 2021, the Commissioner reduces the company's R&D tax credit claim by \$15,000 as some ineligible expenditure had been claimed. Rex Ltd's imputation credit account is debited \$15,000 with effect from 7 July 2021. Because a dividend was paid out in August, the firm's imputation credit account has a negative balance from 19 August, resulting in penalties and interest.

**Example: Effect of imputation credits equal to R&D tax credits received**

No imputation credits		Impact of imputation credits equal to R&D tax credit	
Company income	\$200	Company income	\$200
R&D expenditure	(\$100)	R&D expenditure	(\$100)
	\$100		\$100
<b>Income tax payable</b>		<b>Income tax payable</b>	
Tax at 28%	\$28	Tax at 28%	\$28
R&D tax credit	(\$15)	R&D tax credit	(\$15)
Tax to pay	\$13	Tax to pay	\$13
<b>Imputation credits</b>		<b>Imputation credits</b>	
Tax paid	\$13	Tax paid	\$13
<b>Imputation credits for R&amp;D tax credit</b>	<b>\$0</b>	<b>Imputation credits for R&amp;D tax credit</b>	<b>\$15</b>
Total imputation credits	\$13	Total imputation credits	\$28
<b>Retained earnings</b>		<b>Retained earnings</b>	
Pre-tax income	\$100	Pre-tax income	\$100
Tax expense	(\$13)	Net tax expense	(\$13)
	\$87		\$87
<b>Dividend to shareholder</b>		<b>Dividend to shareholder</b>	
Cash dividend	\$87	Cash dividend	\$87
Imputation credits	\$13	Imputation credits	\$28
	\$100		\$115
<b>Shareholder tax to pay</b>		<b>Shareholder tax to pay</b>	
Tax at 28%	\$28	Tax at 28%	\$32
Imputation credits	(\$13)	Imputation credits	(\$28)
<b>Shareholder tax to pay</b>	<b>\$15</b>	<b>Shareholder tax to pay</b>	<b>\$4</b>

# Managing disputes and reassessments, anti-avoidance, penalties, binding rulings and Orders in Council

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## Disputes and reassessments

### Legislative reference and intent

Tax Administration Act 1994 Sections 33E, 89DA, 108 and 113E

The rationale behind the above amendments is to limit a person's ability to retrospectively reclassify their expenditure. This includes where R&D activities or expenditure are identified after the end of an income year. If a person receives R&D tax credits for R&D they were unaware of at the time the R&D activities took place, the R&D tax credit regime has not provided any incentive to the person to undertake additional R&D.

The time limits are intended to give people enough time to prepare the required information and make any necessary adjustments to their claims, while discouraging the retrospective reclassification of expenditure.

You can only adjust your R&D tax credit claim upwards if both:

- your R&D supplementary return was filed within 30 days after the due date for filing the income tax return
- the request for the adjustment is made within the required time frames.

Filing a return which includes a claim for an R&D tax credit is making a self-assessment of the amount of the R&D tax credit. To dispute that assessment taxpayers are required to file a notice of proposed adjustment (NOPA) or a request for adjustment under section 113 of the Tax Administration Act 1994.

You are only allowed to make 1 upward change to your claim for a tax credit for any income year, regardless of whether it is a request for adjustment under section 113 or a NOPA. The change must be sought by the earlier of either:

- 4 months from the date your income tax return was filed
- 1 year after the due date to file an income tax return for that income year.

### Legislative clarification

The intent of the legislation is that if you wish to make an upward adjustment to the amount of the tax credit you have claimed by filing a NOPA or section 113 request, it must be filed by the earlier of either:

- 4 months from the date your income tax return was filed
- 1 year after the due date to file an income tax return for that income year.

If the Commissioner receives a NOPA or section 113 request, within the above time frame it is intended that the disputes process operate under the normal time constraints and can be completed. It is not intended that the disputes process must be completed within 12 months.

Amendments to clarify the legislation around the time frames for making upward adjustments and to ensure that the normal disputes process can occur when a section 113 request has been lodged are being discussed for inclusion in the next available tax Bill (likely towards the end of 2020 or sometime in 2021).

### Example: Claimant makes an adjustment within the extended time limit

For the 2019-20 income year, ACo has an extension of time to file their income tax return by 31 March 2021. ACo is in the process of internally auditing its R&D expenditure. On 15 March 2021, ACo files its income tax return and an R&D supplementary return, claiming a \$70,000 tax credit.

When ACo completes its audit, ACo discovers that it was actually entitled to a tax credit of \$80,000 and issues a NOPA relating solely to the R&D tax credit on 1 July 2021.

As the NOPA was issued within the required time frame, the disputes process will begin. Subject to the outcome of the process, ACo could receive the additional \$10,000 credit.

#### Variation of facts: claimant issues multiple NOPAs

On 1 January 2022, ACo issues another notice of proposed adjustment, revising up the credit again to \$90,000. The 2nd NOPA is ineffective because ACo has already made an upward adjustment to their R&D tax credit claim.

## More information

For more information, download our standard practice statements SPS 16/01 and SPS 16/06 from [ird.govt.nz/technical-tax/standard-practice](http://ird.govt.nz/technical-tax/standard-practice)

## Anti-avoidance rules

### Legislative reference and intent

Income Tax Act 2007 Section GB 56

The anti-avoidance rule is intended to uphold the integrity of the regime.

If you apply the R&D tax credit rules in a way that was not intended, you may be subject to the anti-avoidance rule, which allows the Commissioner to reduce your claim as appropriate.

### When the anti-avoidance rule applies

Your R&D tax claim may be reduced by the Commissioner if there was an arrangement with a purpose or effect of defeating the purpose of the R&D tax credit and its rules. This includes an arrangement with a purpose or effect of:

- treating ineligible expenditure as eligible expenditure
- claiming inflated expenditure
- representing that an ineligible person is eligible for the tax credit.

In determining whether an arrangement has any of the above purposes or effects, various factors will be considered, including the:

- manner in which the arrangement is carried out
- role of all relevant parties and their relationships
- economic and commercial effect of documents and transactions
- duration of the arrangement
- nature and extent of the financial consequences
- presence of artificiality or contrivance
- presence of inflated expenditure or reduced levels of income
- undertaking of real risks by the parties.

An arrangement is defined widely in section YA 1 of the Income Tax Act 2007 and includes formal, legal-enforceable contracts through to informal, unenforceable understandings.

Where there are multiple purposes or effects, the above purpose or effect must be more than merely incidental. This will depend on the facts and circumstances surrounding the arrangement. It does not matter whether you were a party to the arrangement.

## Important

Depending on the seriousness of the arrangement, interest and penalties may apply and civil and criminal penalties under sections 143A or 143B of the Tax Administration Act could also apply.

### More information

For more information, read our 2013 interpretation statement IS 13/01 at [ird.govt.nz/technical-tax/interpretations](http://ird.govt.nz/technical-tax/interpretations)

## Penalties and use-of-money interest

Penalties and use-of-money interest may apply to over-claimed amounts of the R&D tax credit. Find out more about penalties and interest at [ird.govt.nz/penalties](http://ird.govt.nz/penalties)

If we received your income tax return and supplementary return but have not credited the R&D tax credit by the due date of your end-of-year tax, we will pay use-of-money interest from the day after the due date for payment of the tax.

If you do not factor the tax credit into your provisional tax payments and end up overpaying provisional tax, we will pay use-of-money interest on the overpayment.

## Promoter penalties

### Legislative reference

Tax Administration Act 1994 Sections 141EB and 141EC

If you are a promoter of an arrangement involving R&D tax credits, you may be liable for a promoter penalty if the arrangement results in a shortfall penalty for an abusive tax position being imposed on a party to the arrangement.

### Who is a promoter?

You are a promoter of an arrangement where you either:

- formulate, or are significantly involved in formulating, a plan, software or programme from which an arrangement is offered
- are aware of material and relevant aspects of an arrangement and promote or sell it to 10 or more persons in a tax year
- provide services on a contingency fee basis in relation to R&D tax credit claims.

You will not be considered a promoter where your involvement with the arrangement is limited to providing legal, accounting, clerical or secretarial services to a promoter.

### Arrangement

An arrangement includes any agreement, contract or understanding, whether it is enforceable or not.

### Contingency fee

A contingency fee agreement is a payment arrangement where your fee is conditional on your client's R&D tax credit claims being successful.

Your contingency fee may be set as a fixed amount or a fixed percentage of the R&D tax credits your client receives. It is not relevant whether your client makes any payment up front or if there is any cap on your fee.

### **Example: A promoter providing services on a contingency fee agreement**

An advisor in private practice provides advice to their clients on maximising the R&D tax credit claims for a tax year. The advisor charges a contingency fee at a fixed rate of 10%.

One of their clients, Richard, makes an R&D tax credit claim of \$50,000 based on the advisor's advice. When Richard receives the \$50,000 tax credit, the advisor charges their fee of \$5,000.

For the purposes of the promoter penalty provisions, the advisor is considered to be a promoter.

### **When and how does a promoter penalty apply?**

If you are a promoter of an arrangement involving R&D tax credits you may be liable for a promoter penalty where both:

- you offer the arrangement to 10 or more people in a tax year
- 1 or more of those people receives a shortfall penalty for an abusive tax position as a result of the arrangement.

The penalty is determined by reference to the total tax shortfalls resulting from the arrangement and calculated from the maximum R&D tax credits (shortfalls) that each person in the arrangement would have obtained.

Find the general information on promoter penalties on our website.

### **Example: A provider of software from which an arrangement is offered**

RDEasy is an R&D tax advisory firm specialising in R&D tax credit eligibility assessments and claim preparation. As part of their marketing strategy, they made a free software calculator available for anyone to download and use to calculate their R&D tax credit.

The calculator was downloaded by more than 10 people including ACo and BCo.

ACo and BCo both engaged RDEasy to make an additional R&D tax credit claim of \$20,000 and \$30,000, respectively.

Both ACo and BCo have become liable to a shortfall penalty for an abusive tax position. Their claims were based on RDEasy's software calculator which incorrectly identified some ineligible expenditure as eligible expenditure.

RDEasy is liable for a promoter penalty of \$50,000 because both:

- their software was offered to more than 10 people
- both ACo and BCo are liable to a shortfall penalty for an abusive tax position as a result of its arrangement with RDEasy involving the use of the software.

## Binding rulings

### Legislative reference and intent

Tax Administration Act 1994 Section 3 (interpretation of proscribed question)

R&D questions have been excluded from the bindings ruling regime but, in recognition of the need for businesses to have confidence that the R&D activities proposed meet the legislative criteria the general approval process and criteria and methodology approval have been introduced from the 2020-21 income year.

You are not able to obtain a binding ruling on a question related to an R&D tax credit.

The provisions relating to general approval and criteria and methodologies approval offer alternative means of providing assurance on key questions of eligibility and are available at no cost to you.

## Orders in Council

### Legislative reference and intent

Income Tax Act 2007 Section LY 9

The flexibility offered by the ability to amend schedules 21 and 21B by Order in Council is necessary for 3 key reasons.

1. Given the constant and sometimes unpredictable advances of science and technology, it is impossible to fully anticipate all possible R&D activities and determine whether these activities should be incentivised by the R&D tax credit or some other support mechanism. Therefore, having the ability to amend the lists of excluded activities is necessary so that they do not remain static while science and technology continues to progress.
2. It enables the Government to make changes to the lists where the Government's policy intent has changed.
3. The Government needs to be able to add or remove activities and expenditure from the lists to close off problem areas that could impact on the fiscal sustainability of the R&D tax credit regime.

The lists of ineligible activities, and eligible and ineligible expenditure may be amended from time to time in order to make sure the legislation appropriately reflect the scientific and technological developments and is fiscally sustained.

### How Orders in Council will be made

The Governor-General may, by Order in Council, amend both the:

- list of ineligible activities (Schedule 21 of the Income Tax Act 2007)
- list of eligible and ineligible expenditure (Schedule 21B of the Income Tax Act 2007).

The changes will be made on the joint recommendation of the Minister of Revenue and the Minister of Research, Science and Innovation.

In making a joint recommendation, the Ministers must follow appropriate consultation and have regard to the following:

- maintaining the R&D activity and eligible R&D expenditure definitions in accordance with the purpose of the R&D tax credit legislation
- the effect of their recommendation on the creation of new scientific or technological knowledge
- the fiscal impact of their recommendation.

### When the changes will apply

A change made by Order in Council in a tax year (1 April to 31 March) will apply for 4 years from the start of the following tax year. Anyone with an early or late balance date must make sure they include the changes in their relevant income years.

### **Example: Claimant with an early balance date**

CoZ has an early balance date beginning 1 January.

On 31 January 2020, an Order in Council is made to add a number of expenditure to the list of ineligible expenditure. This change was made in the 2019-20 tax year so affects all customers' 2020-21 tax year and the following 3 tax years.

This means the changes will apply to CoZ for their income years from 1 January 2020 (their 2020-21 tax year) to 31 December 2023 (their 2023-24 tax year).

### **Orders in Council on our website**

Find the Orders in Council on our website at [ird.govt.nz/technical-tax/legislation](https://ird.govt.nz/technical-tax/legislation)

# Secrecy provisions

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## Legislative reference

Tax Administration Act 1994 Section 18, Schedule 7, Clause 39

Income Tax Act 2007 Section LY 10

Inland Revenue can share information related to your claim with other state sector entities for the purposes of policy formation, administration, evaluation and statistical reporting. It can also share information with Callaghan Innovation and the Ministry of Business, Innovation and Employment that is reasonably necessary for them to offer R&D advice and incentives.

Policy formation for the R&D tax credit has involved MBIE, Inland Revenue, Callaghan Innovation and the Treasury. Future policy development, including reviewing the R&D tax loss cash-out regime, will involve these agencies and will benefit from good information about the operation of the regimes.

Inland Revenue supported by Callaghan Innovation is responsible for administering the R&D tax credit and the tax loss cash-out regime. Effective administration requires that claim details are shared.

The Minister of Research, Science, and Innovation is required, by section LY 10 of the Income Tax Act to evaluate the tax credit and report to Parliament every 5 years. Inland Revenue will share information as is necessary for the Minister to report.

Inland Revenue will also share statistical information on the R&D tax credit and R&D tax loss cash-out regimes with Statistics New Zealand. Claim information will be integrated into the Longitudinal Business Database and the National Research Information System. Information held by Statistics New Zealand will be anonymised and made available to researchers with the objective of generating insights into business research in New Zealand.

# Publication of claim details

## Legislative reference and intent

Tax Administration Act 1994 Section 68CE

Publishing the names of R&D tax credit recipients and the bands within which their claims fall is intended to provide transparency about how the R&D tax credit regime is operating.

Inland Revenue will publish the name of those who have received R&D tax credits and the amount of the tax credit (in dollar bands), 2 years after the end of the tax year to which the claim related. Publication will provide transparency about how the tax credit regime is operating.

Your name and the dollar-band amount of tax credit that you received will be published. If you have claimed for multiple R&D activities the band your information is published in will reflect the total amount, not the amount for each activity or project. No detail about R&D activity will be published.

Publication will not occur until 2 years have elapsed since the end of the tax year to which your claim related. The tax year always ends on 31 March. If you have a late balance date this means that publication of your tax credit details could occur from 18 months after the end of your income year.

## Example: Claim details publication (illustrative only, actual format and dollar bands may vary)

In the 2019-20 tax year (details published after 31 March 2022):

- Kawhia Ltd receives a \$9,000 tax credit for eligible R&D expenditure
- Marsden Ltd receives a \$695,000 tax credit for eligible R&D expenditure
- Peter Smith and Karen Reid receive \$40,060 and \$74,012 respectively in tax credits for eligible expenditure on work carried out by their partnership P&R partners.

After 1 April 2022, the Commissioner publishes the following details in an online publication.

Tax year	Claimant	Expenditure band
2019-20	Kawhia Ltd	Less than \$100,000
2019-20	Marsden Ltd	\$500,000 to \$1,000,000
2019-20	Peter Smith	Less than \$100,000
2019-20	Karen Reid	Less than \$100,000

# Evaluation

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## Legislative reference and intent

Income Tax Act 2007 section LY 10

Tax Administration Act 1994 Section 18, schedule 7, clause 39

Regular evaluations are intended to contribute to the maintenance of the regime by independently identifying strengths and deficiencies in a timely manner.

The Minister of Research, Science and Innovation is required to conduct an independent and objective evaluation of the R&D tax credit regime every 5 years and report the results to Parliament.

The Minister's report must evaluate the tax credit on:

- a. the delivery of the policy intent of the regime
- b. the stimulation of spending on research and development activities
- c. the compliance costs of the regime
- d. the administration of the regime
- e. the compliance with the legal requirements of the regime by taxpayers
- f. any other criteria specified by the Minister of Research, Science and Innovation.

To help the Minister comply with the evaluation requirements, evaluation questions are included in the R&D supplementary return.

Amendments to section 18 of the Tax Administration Act 1994 enable Inland Revenue to communicate the information required for the conduct of the review to the independent reviewers.