



WEEKLY COMMENT: FRIDAY 30 AUGUST 2013

1. Last week I started to have a look at *R&D tax losses – An officials’ issues paper* (the “R&D IP”). I looked at the current rules on R&D expenditure and the types of expenditure that would be excluded from applying as R&D expenditure for the purposes of the new proposal to allow some companies to cash out their tax losses.
2. This week I look at the new proposals in detail:
 - (a) The eligibility criteria to be able to cash out a tax loss;
 - (b) The amount of tax loss that can be cashed out;
 - (c) Loss recovery income following a cash out; and
 - (d) Administration aspects.

The eligibility criteria to be able to cash out a tax loss

3. In order to be able to cash out a tax loss, applicants will need to meet the following criteria:
 - (a) R&D expenditure on wages and salaries that can be monitored by Inland Revenue must be at least 20% of total expenditure on wages and salaries for the company, or the group of companies, as relevant:
 - (i) Wages and salaries expenditure on excluded activities (discussed last week) will not be eligible to be part of the 20% calculation; and
 - (ii) Inland Revenue must be able to monitor and verify the wages and salaries expenditure;
 - (b) The applicant company, or group of companies, as relevant, must be in a tax loss position for the income year;
 - (c) The applicant must be a company resident in New Zealand and cannot be a listed company, a qualifying company, a look-through company, or a special corporate entity.
4. Expenditure on wages and salaries is to be used as the yardstick for measuring the intensity of R&D activity. Officials are of the view that setting a wage intensity threshold of at least 20% will help to ensure the policy is targeted towards assisting R&D-intensive start-up companies.
5. As discussed last week, certain activities that generally take place later in the R&D process are excluded from being ‘qualifying R&D’ for the purposes of the loss cash out rules. Wages and salaries on such activities are excluded from being part of the 20% calculation.

6. The above rules can apply to outsourced R&D expenditure: the criteria will apply to the provider of the R&D to see whether the purchaser of the R&D is able to cash out its tax losses. The R&D supplier will have to provide the purchaser with details of the R&D wage and salary costs subject to PAYE, and the cost of any other qualifying R&D.
7. Officials prefer to exclude shareholder salaries unless they are subject to PAYE tax deductions, because Inland Revenue cannot monitor total expenditure on salaries and wages other than through the PAYE system.
8. Eligibility for the cashed-out tax loss will be restricted to losses incurred in the current income year. There will be no ability to cash out tax losses from previous income years.
9. Only certain NZ resident companies will be able to access the cashed-out loss. Certain types of companies will be excluded: listed companies, qualifying companies, look-through companies and special corporate entities. No other business structures such as partnerships or trusts will be eligible for a cashed-out loss.
10. However, a company that is a partner in a partnership may be eligible based on its share of the partnership income and expenses. Officials believe that restricting cash-outs to companies will simplify matters, because tax losses can only be cashed out at a single rate: the company tax rate, which is currently 28%.
11. The eligibility criteria will apply to groups of companies on a group basis. Officials are concerned that the criteria could otherwise be circumvented by company groups:
 - (a) An ineligible entity could incorporate a subsidiary that might be eligible: for example, a large company with a low R&D intensity could incorporate a special purpose subsidiary to undertake the R&D activity; or
 - (b) A group of shareholders of an ineligible company could incorporate a sister company that might be eligible: for example, a group of shareholders of a company that has finished some R&D and is starting to promote a product for sale could incorporate a separate company to undertake the promotional activities, retaining a high eligible R&D intensity in the initial company.

The amount of tax loss that can be cashed out

12. The proposal is to use a multiplier of 1.5 to eligible R&D salary and wage expenditure so as to effectively allow for other (non-salary and wage) R&D expenditure. In other words, eligible companies will be able to cash out tax losses up to the amount of 1.5 times their salary and wages expenses on R&D.
13. However, the total tax losses available to be cashed out cannot exceed the company's tax loss for the year or its qualifying R&D expenditure.
14. Furthermore, the maximum tax loss that can be initially cashed out will be capped at \$500,000 (which equates to a cashed-out amount of \$140,000 at 28%). Officials have suggested an incremental increase in the amount of losses to be cashed out, so that the initial cap of \$500,000 rises over time to \$2 million (equivalent to a cashed out tax loss of \$560,000).
15. Companies would be eligible to carry forward any losses in excess of the amount cashed out to future years.

16. In summary, companies that qualify for the proposal will be able to cash out the least of:

- (a) 1.5 times their eligible salary and wage expenditure in the relevant year;
- (b) Their total tax loss in the relevant year;
- (c) Their total qualifying R&D expenditure in the relevant year; and
- (d) The tax loss cap that applies for that year.

17. For example, if a company's R&D wage expenditure is \$100, its qualifying R&D expenditure is \$180, its tax loss for the year is \$200, and the cap for the year is \$500, its tax loss available to be cashed out will be limited to \$150 – which is 1.5 times its R&D wage bill of \$100 and the least of the alternatives listed above.

Loss recovery income following a cash-out

18. In the R&D IP, a cashed-out tax loss is likened to an interest-free loan, which becomes a grant if the R&D expenditure never results in a viable product.

19. The premise is that an R&D company will have funds available to pay back the value of the cashed-out loss if:

- (a) It is able to sell its intellectual property;
- (b) The whole R&D company is itself sold; or
- (c) Shareholders are able to sell some of their shares in the company.

20. It is proposed that upon a sale of intellectual property to a third party, loss recovery income will arise up to the balance of any remaining cashed-out losses. The tax losses that were used to obtain the cash-out are then reinstated, regardless of whether there has been a breach in shareholder continuity. This proposal is expected to work similarly to the tax depreciation rules:

- (a) If sufficient taxable income has already been derived to repay the cashed-out tax loss, there would be no further recovery (unless the sale of the IP is taxable under some other provision – such as the sale of patents and the supply of know how);
- (b) Where sales of intellectual property are made intra-group:
 - (i) A deemed sale at market value rule may be required to ensure that loss recovery income is not understated; or
 - (ii) The potential liability to loss recovery income could be moved to the purchaser company (this rule could also apply to amalgamations, where the liability is moved to the amalgamated company).

21. If all of the shares in the R&D company are sold, taxable income will arise to the shareholder(s) who are NZ residents (due to collection difficulties and double-tax agreement implications with foreign shareholders) in proportion to their shareholding, who will be held jointly and severally liable for the tax on the income, to the extent that:

- (a) A profit is made on the sale of the shares; and
- (b) The company has remaining cashed-out losses that have not yet been repaid.

22. There is also a suggestion to extend the loss recovery income rule to the sale of part of the shares in the R&D company when the proportion of shares sold exceeds 5%. The loss

recovery income would be in proportion to the shares sold, and the value of the remaining cashed-out losses in the company would be correspondingly reduced. An alternative suggestion is to keep the cashed-out loss within the company, with recovery income only being triggered by subsequent profits, or the sale of intellectual property or a majority stake in the company itself, due to the following recognised difficulties:

- (a) An anti-avoidance rule would be required to ensure that multiple shareholders are not able to individually sell less than 5%, but collectively sell more than 5%;
- (b) Claiming loss recovery income from overseas shareholders could pose collection challenges; and
- (c) Correctly assessing loss recovery income from the resale of shares that have previously been sold and have previously had some cashed-out losses recovered will be highly complex.

23. It is not proposed that a new issue of shares would have any loss recovery income implications. However, officials have expressed a concern to ensure that such an exemption could not be used to get around loss recovery income arising upon a sale of shares, for example in an initial public offering.

Administration aspects

24. It is recognised that the new proposals would necessitate:

- (a) Changes to the IR 4 company tax return: some additional “boxes” will need to be added to the IR 4 company tax return so as to facilitate the claim for tax losses to be refunded;
- (b) The requirement for a new Statement of R&D Activity and Expenditure to be filed within 30 days of the income tax return being filed: Inland Revenue will need to know the nature of the R&D activity and the amount of expenditure; and
- (c) Changes to the imputation rules and the IR 4J imputation return: a tax refund arising from a cashed-out tax loss would give rise to an imputation debit; under the current rules an ongoing debit balance would result in penalties, and rules will have to be introduced to provide relief from such penalties.

25. Officials have stated that a high level of scrutiny will be required to discourage fraudulent claims. Experience with the now repealed R&D tax credit apparently proved that reclaiming money from incorrect claims was very difficult. Officials have suggested that processing claims will involve an initial screening based on the Statement of R&D, followed by further investigation where that appears warranted.

26. The purpose of the Statement of R&D is to establish eligibility by detailing the nature of the R&D activity and the amount of qualifying expenditure. The information required would include:

- (a) Details of the R&D activity that show it meets the accounting definition of R&D;
- (b) Evidence that the R&D is being undertaken in New Zealand;
- (c) Salary and wage expenditure that relates to R&D activity; and
- (d) Details of the company grouping, ownership and shareholding.

27. Officials are of the view that in most instances it will be possible to make a payment based on the information provided in the Statement of R&D, along with other information already held by Inland Revenue (such as PAYE schedules).
28. Officials have also noted that while the proposals could impose an additional compliance burden, the policy proposal is advantageous for taxpayers.



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