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## WEEKLY COMMENT: FRIDAY 10 JULY 2020

1. The *COVID-19 Response (Taxation and Social Assistance Urgent Measures) Act 2020* (the “first COVID-19 Tax Amending Act”) received the Royal assent on 25 March 2020. The Act contains a number of tax changes. Last week I looked at the depreciation amendments and use-of-money interest remission.
2. This week I look at the increased access to research and development tax credit (“R&D tax credit”) refunds.

### **Refunds arising from R&D tax credits**

3. The R&D tax credit regime enacted on 7 May 2019 provided for an R&D tax credit equal to 15% of eligible expenditure, subject to the minimum eligible expenditure threshold of \$50,000. The details of the R&D tax credit regime will be discussed in future issues of Weekly Comment. The discussion this week is focused on the new refundability amendments enacted in March 2020.
4. R&D tax credits in excess of those required to settle a business’s income tax liability for the year, including the refundability of excess R&D tax credits, are dealt with in s. LA 5.
5. The rules on the refundability of excess R&D tax credits have been amended twice in 2020 after they were initially enacted in 2019:
  - (a) The initial rules on refunding of tax credits were set out in s. LA 5(4B) inserted by s. 9(1) of the *Taxation (Research and Development Tax Credits) Act 2019* enacted on 7 May 2019 and in force from 1 April 2019;
  - (b) New rules were set out in a revised s. LA 5(4B) and newly inserted sections LA 5(5B) and LA 5(5C) contained in s. 155 of the *Taxation (KiwiSaver, Student Loans, and Remedial Matters) Act 2020* enacted on 23 March 2020, applying to the 2020-21 and later income years;
  - (c) The application of the new rules in the revised s. LA 5(4B) and sections LA 5(5B) and LA 5(5C) was brought forward to the 2019-20 and later income years by s. 15 of the first COVID-19 Tax Amending Act; and
  - (d) The optional application of the initial rules enacted on 7 May 2019 for the 2019-20 income year is allowed under s. LA 5(5D) and s. LZ 14 inserted by sections 15 and 16 of the first COVID-19 Tax Amending Act.

### Optional application of the initial refundability rules for the 2019-20 income year

6. Sections LA 5(5D) and LZ 14(1), which apply for the 2019-20 and later income years, provide that the initial rules on refundability of tax credits, as enacted on 7 May 2019, can apply if a person chooses to apply the initial rules in their return of income for the 2019-20 income year.
7. Inland Revenue has stated, in *Tax Information Bulletin* Vol. 32, No. 5, June 2020 (“the June 2020 TIB”) on page 6, that when filing an R&D supplementary return for the 2019-20 income year, a business will be asked to confirm whether it intends to apply the initial refundability rules enacted on 7 May 2019 or the revised refundability rules enacted on 23 and 25 March 2020. Inland Revenue has noted on page 7 that a business may choose to use either the initial refundability rules or the revised refundability rules in the 2019-20 income year, but it cannot use both. From the 2020-21 income year only the revised refundability rules can be used.
8. The initial rules, now set out in s. LZ 14(2) and available by choice for the 2019-20 income year, state that a person’s research and development tax credit is used by:
  - (a) First, the Commissioner refunding the tax credit up to a maximum of \$255,000, by treating it as a refundable tax credit and applying s. LA 6(2) if the person:
    - (i) Meets the corporate eligibility criteria in s. MX 2 (the corporate eligibility criteria for the R&D tax loss cash-out regime); and
    - (ii) Meets the wage intensity criteria in s. MX 3 (the wage intensity criteria for the R&D tax loss cash-out regime); and
    - (iii) Does not derive exempt income, ignoring income from dividends that is exempt income under sections CW 9 and CW 10; and
    - (iv) Is not associated with a person that derives exempt income, ignoring exempt income under sections CW 9 and CW 10;
  - (b) Secondly, by applying s. LY 8 to carry forward the remaining research and development tax credit to the extent to which paragraph (a) does not apply to the tax credit.
9. A refund of \$255,000 equates to a tax credit of 15% on eligible expenditure of \$1,700,000.
10. The corporate eligibility criteria in s. MX 2 (which applies to the earlier **tax loss cash out scheme**), are that:
  - (a) The person must be a company that is tax resident in NZ; and
  - (b) The company must not be treated as tax resident in another country under a double tax agreement; and
  - (c) The company cannot be established by, or subject to, the *Education Act 1989*, the *New Zealand Public Health and Disability Act 2000*, or the *Crown Entities Act 2004*; and
  - (d) The company cannot have 50% or more of its shares held by a public or local authority, a Crown Research Institute, or a State Enterprise; and

- (e) The company must not be a listed company or otherwise listed on a recognised exchange.
11. The wage intensity criteria in s. MX 3 (which also applies to the earlier **tax loss cash out scheme**), are that:
- (a) The company's R&D labour expenditure (i.e. salary and wages to employees and shareholder-employees for providing R&D material plus 66% of amounts, excluding GST, paid to contractors for providing R&D material) must be at least 20% of its total labour expenditure (i.e. total salary and wages to employees and shareholder-employees plus 66% of GST-exclusive payments to contractors for providing R&D material); and
- (b) If the company is a member of a group of companies, the R&D labour expenditure for the group of companies must be at least 20% of the group's total labour expenditure.
12. A company that meets the corporate eligibility criteria and the wage intensity criteria may choose to have R&D tax credits in the 2019-20 income year refunded under s. LZ 14 providing that neither the company itself, nor an associated person, derives any exempt income.

#### **The new rules on refundability of R&D tax credits**

13. The new rules on refundability of R&D tax credits are set out in sections LA 5(4B), LA 5(5B) and LA 5(5C), and apply for the 2019-20 and later income years.
14. New s. LA 5(4B) states that a person's research and development tax credit is used by:
- (a) First, the Commissioner refunding the tax credit up to the maximum limit of the person's refundability cap, by treating it as a refundable tax credit and applying s. LA 6(2). There is no maximum limit for refunding the tax credit, if and to the extent to which:
- (i) The person is a levy body researcher;
- (ii) The tax credit is for eligible research and development expenditure on approved research providers;
- (b) Secondly, applying s. LY 8 to carry forward the remaining research and development tax credit, to the extent to which paragraph (a) does not apply to the tax credit.
15. The meaning of "refundability cap" is set out in sections LA 5(5B) and LA 5(5C). The cap is the sum of:
- (a) The total amount of PAYE, ESCT and FBT (i.e. the total amount of taxes paid on behalf of, or in relation to, employees) that the person pays for the tax year, and that has not been allocated to another person's refundability cap calculation;
- (b) If the person is a company, the sum of the following amounts, excluding amounts allocated to another person's refundability cap calculation:
- (i) The PAYE, ESCT and FBT paid by other companies in the same wholly-owned group that is allocated to the person's refundability cap calculation; and

- (ii) The PAYE, ESCT and FBT that companies that directly or indirectly control the person allocate to the person's refundability cap calculation.

### **Eligibility under the new rules**

16. A person will be eligible to obtain a tax refund under the new rules if the person meets the general eligibility rules in s. LY 3 for the R&D tax credit rules to apply. Section LY 3(1) states that the R&D tax credit rules will apply for a person, for an income year, if:
  - (a) The person (or a joint venture the person is in) performs a core R&D activity in New Zealand, or an R&D contractor that carries on business through a fixed establishment in NZ performs the core R&D development activity on behalf of the person; and
  - (b) The person (or a joint venture the person is in) carries on business through a fixed establishment in NZ; and
  - (c) The results of the core R&D activity and any related supporting R&D activity:
    - (i) May be used by the person (or a joint venture the person is in) for no consideration; or
    - (ii) Are owned by the person or a joint venture the person is in, or if the person is a company, are owned by a group company resident in NZ or a country with which NZ has a double tax agreement; and
  - (d) For the 2020-21 and later income years, the R&D activity and the person, as applicable are approved by the Commissioner under sections 68CB and 68CC of the *Tax Administration Act 1994*.
17. If a business is eligible for R&D tax credits, it will be eligible for refundability of R&D tax credits if it is in a tax loss position or has insufficient income to use all its available R&D tax credits. This means that the person will not need to meet the corporate eligibility requirements or the wage intensity criteria under the new rules. In particular, it means that entities other than companies will be eligible for refunds of R&D tax credits and that it will not be necessary for R&D labour expenditure to be at least 20% of total labour expenditure.
18. Companies that derive exempt income or whose associated persons derive exempt income will be eligible to obtain tax refunds of R&D tax credits in the 2019-20 income year under the new rules. However, from 2020-21 onwards, a new s. LY 3(2)(f) makes tax exempt entities generally ineligible for R&D tax credits (see paragraph 26 onwards below).

### **The new refundability cap**

19. R&D tax credits are refundable up to the amount of total labour-related taxes paid by the person (PAYE, ESCT and FBT), including labour-related taxes paid and allocated to the person by companies in the same wholly-owned group or companies that directly or indirectly control the person (excluding any amounts allocated to other persons for the purposes of their refundability caps).
20. Note that if a company's refundability cap is lower than \$255,000, a company could opt to apply the old rules in the 2019-20 income year if it meets the requirements (see **paragraph 6 onwards** above).

21. The refundability cap will not apply (i.e. R&D tax credits will be refundable in full) if:

- (a) The person is a levy body researcher (defined in s. YA 1 as an industry organisation to which a levy is payable under an Act – Inland Revenue has provided the example of an industry organisation to which levies are payable under the *Commodity Levies Act 1990* on page 20 of *Tax Information Bulletin* Vol. 32, no. 4, May 2020 (“the May 2020 TIB”)); or
- (b) The tax credit is for eligible research and development expenditure on approved research providers (who are defined in s. YA 1 as persons approved by the Commissioner under s. 124ZH of the *Tax Administration Act 1994* as approved research providers).

### **Ordering rules for using R&D tax credits**

22. Section LA 5(4B)(a) states that R&D tax credits up to the limit of the refundability cap may be treated as refundable tax credits by the Commissioner applying s. LA 6(2).

23. Section LA 6(2) sets out the order in which refundable tax credits are to be applied against existing tax liabilities before any remaining credits can be refunded, as follows:

- (a) First, the tax credits must be used to settle any income tax outstanding for earlier income years;
- (b) Second, the tax credits must be used to settle any income tax outstanding for later income years, beginning from the immediately succeeding year;
- (c) Third, the tax credits must be used to pay provisional tax for later income years, beginning from the immediately succeeding year;
- (d) Fourth, the tax credits must be applied against tax payable of a different tax type as requested or as determined by the Commissioner; and
- (e) Fifth, the remaining tax credits can be refunded.

24. Non-refundable R&D tax credits are used first. In the May 2020 TIB Inland Revenue has provided the example on page 22 of a business that had paid no labour-related taxes and had incurred \$50,000 of eligible R&D expenditure of which \$30,000 had been paid for eligible R&D activities performed by an approved research provider.

25. In this example:

- (a) The refundability cap will not apply to the \$30,000 paid to the approved research provider;
- (b) Therefore, refundable credits amount to \$4,500 (15% of \$30,000) and non-refundable credits amount to \$3,000; and
- (c) The non-refundable R&D tax credits of \$3,000 will be applied first against any outstanding tax liabilities.

## **Tax exempt entities**

26. Under the initial refundability rules which apply by choice for the 2019-20 income year, companies that derive exempt income or that are associated with persons that derive exempt income cannot have refunds arising out of R&D tax credits.
27. Also under the initial rules applying from the 2019-20 income year onwards, a Crown Research Institute, District Health Board, Tertiary Organisation, Foreign Tertiary Organisation and Callaghan Innovation and persons associated with these entities are not eligible for R&D tax credits. Inland Revenue has stated that the R&D tax credit regime is designed to target private sector business R&D and the exclusion of these entities is consistent with that policy.
28. Under the new rules, other specified tax exempt entities are also not eligible for R&D tax credits. However, this new exclusion of specified additional tax exempt entities only applies from the 2020-21 income year.
29. Therefore, for the 2019-20 income year, these additional specified tax exempt entities may qualify for R&D tax refunds under the new rules, which apply by default.
30. Effective from the 2020-21 income year, a new s. LY 3(2)(f) excludes the R&D tax credit rules from applying to a person who derives exempt income under any of sections CW 38 (public authorities), CW 39 (local authorities), CW 40 (local and regional promotional bodies), CW 41 and CW 42 (charities) and CW 55BA (tertiary education institutes and their subsidiaries), if the person is not a levy body researcher (i.e. an industry organisation to which a levy is payable under an Act).
31. These exclusions do not apply in the 2019-20 income year. The option to apply the new refundability rule in s. LA 5(4B) is available in 2019-20, meaning that these excluded persons who derive exempt income will qualify for refundability of R&D tax credits to the extent of their refundability cap in 2019-20.
32. Any R&D tax credits not refunded in 2019-20 cannot be carried forward because the R&D tax credit regime ceases to apply to these entities from the 2020-21 income year onwards. New s. LY 8(2B), which applies from the 2019-20 income year onwards, states that if a person is not a levy body researcher, and the person derives exempt income for the tax year under section CW 38, CW 39, CW 40, CW 41, CW 42, or CW 55BA, the remaining tax credit is extinguished and must not be carried forward and credited.
33. A relevant aspect of the exclusion in s. LY 3(2)(f) is that it will not apply to persons associated with the excluded tax exempt entities.
34. These exclusions do not include broader association rules in relation to the excluded entities. A subsidiary taxpaying business is not ineligible for the credit merely because it is owned by an excluded entity which tax-exempt income. This means that an excluded entity which undertakes eligible R&D may set up a non-tax-exempt subsidiary to claim the credit.
35. Inland Revenue has noted in the May 2020 TIB on page 24 that:
  - This exclusion of entities which derive tax exempt income does not include broader association rules, so that entities associated with tax-exempt entities affected by this exclusion may still claim the credit, if they otherwise satisfy the credit's eligibility criteria;

- A subsidiary taxpaying business is not ineligible for the credit merely because it is owned by an entity which derives excluded tax-exempt income, which means that an excluded entity which undertakes eligible R&D may set up a non-tax-exempt subsidiary to undertake the R&D and claim the credit;
- For example, a charity may establish a subsidiary to conduct its R&D and claim the credit on the basis that the subsidiary itself derives no exempt income, even though it is owned by the charity;
- Levy body researchers are not affected by this exclusion, so may be eligible even if they receive exempt income under any of the above sections, as R&D performed by levy bodies is typically funded by businesses in the relevant industry for these businesses' benefit, so levy body R&D is fundamentally business R&D.

### **Inland Revenue processing of Research and Development Tax Incentive (RDTI) credit refunds**

36. Inland Revenue has reminded taxpayers in *Business Tax Update* Issue No. 111, July 2020 that the R&D supplementary return must be filed to claim the RDTI credit. The supplementary return must be filed within 30 days of the due date for the income tax return.

37. Where the RDTI credit is refundable, Inland Revenue states that:

“This process will take up to 8 weeks assuming the required information is presented up front and in the right format. Assessment of claims is complex and is managed across Inland Revenue and Callaghan Innovation.”



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