NEW ZEALAND
LAW SOCIETY
NZLS EST 1869

Law Society Building, 26 Waring Taylor Street, Wellington,
DX SP20202, Wellington or PO Box 5041, Lambton Quay,
Wellington 6145, New Zealand

TEL +64 4 472 7837 • FAX +64 4 473 7909
E inquiries@lawsociety.org.nz
www.lawsociety.org.nz • my.lawsociety.org.nz

29 August 2013

R&D Tax Losses Proposal
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

By email: policy.webmaster@ird.govt.nz

R&D Tax Losses

1. The Law Society appreciates the opportunity to comment on the Officials' Issues Paper, *R&D tax losses, July 2013* (Issues Paper).

General comments

Complexity

2. The proposed rules for cashing out losses on R&D expenditure are relatively complex when the nature of targeted taxpayers is considered. The rules are by design intended to apply to start up entities, with limited resources and potentially constrained in their ability to access expertise on detailed tax matters such as the measures proposed. It may be an expensive exercise to compile the documentation needed to support a claim to cash out losses. Given that the cash received is, in effect, a contingent loan (and limited to $140,000 initially), there may be a reluctance to incur this expenditure. To deal with this, any documentation requirements need to be as simple as possible to comply with.

3. The experience with the R&D tax credit regime was that in many cases, the IRD followed up with detailed questions before a claim could be substantiated. Given the revenue risks inherent with such a regime, this is unsurprising, but does throw some doubt on the value and potential pick up of the regime given the relatively modest claims available.

True nature of barrier for R&D funding

4. The true nature of the issue here is an inability to access timely funding for R&D rather than the tax system itself. Creating a new business through R&D innovation is, by its nature, higher risk than many other new business activities, which limits the investment pool available. However, there are many other businesses that face similar issues. It is difficult to see that the tax system is the best way to address this problem, in this one particular situation.

Grant funding

5. A clear preference for grant funding will remain given that there is generally no obligation to repay grants.

Qualifying expenditure

Exclusion for Software, Clinical Trials

6. The exclusion of certain types of expenditure, particularly software coding, from the qualifying R&D definition reduces the potential scope of claimants substantially. Yet there are many innovative software companies needing funding, and even those companies creating tangible products may often incur significant software expenditure. It is difficult to see why this expenditure should be excluded from the definition, when companies will face the same funding constraints for this expenditure as with other R&D expenditure.

Reliance on the accounting definition, and penalties

7. The definition of R&D for accounting purposes is one that is open to interpretation, therefore there may be cases of taxpayers unwittingly treating expenditure as R&D for accounting purposes, and obtaining a cash out of the tax loss, in situations where ultimately the IRD disagrees with the interpretation taken. Given that R&D is expensed under differential reporting, there may typically be less accounting scrutiny of this expenditure for the smaller companies that this measure targets. These companies may need to incur greater expenditure in determining eligible expenditure, and/or having their auditors or advisors assess this.

8. In light of the fact that the payment here is essentially a loan, the penalties provisions need to be relaxed somewhat. Otherwise, the taxpayer is assuming a potentially significant penalty risk on a loan, which appears out of step with the benefit, and may be discouraged from applying as a result.

20% intensity threshold

9. The threshold of a 20% intensity for R&D sets a very high bar. Setting the threshold so high runs the risk that there is very little uptake, and presumably this measure is being proposed in order to achieve a genuine difference in outcomes for New Zealand innovation. The issues paper does not outline any analysis behind the use of 20% specifically. The Law Society believes this threshold should be set at a lower level, with a view to increasing uptake. It can be reviewed and raised, perhaps at the same time as the maximum amount of $500,000 is increased, if experience suggests it is not achieving the intended outcomes at that lower level.

Inclusion of contracted R&D in the calculation

10. The proposals suggest that contracted R&D could also be included in the salary and wage calculation. While this is desirable in theory, as it should help achieve the 20% threshold, in practice this would require the R&D provider to supply a level of information that is beyond what is presently required. Contract R&D providers may consider providing details of their salary costs to be commercially sensitive information. Given that R&D providers may operate across a number of different clients, the exercise of allocating salary costs to a specific provider may be subjective, and expensive to compile. If the information provided was incorrect, it would be inappropriate for the taxpayer to be liable for this error. Equally, given that the R&D provider gets minimal benefit from providing this information, it seems draconian that any significant liability should fall on them in the event that the information is incorrect.

Making the claim

Time lag before cash available

11. There will invariably be a significant time lag between when tax losses are incurred, to when tax returns are filed, to when claims are processed and the funding is received. This difficulty arises from using the tax system as opposed to a grant system. Coupled with the uncertainty over whether a company's

claim will be approved, and when this might occur, there are significant difficulties for a start-up company in being able to plan its R&D activities when these are dependent on funding. It would be highly desirable for clear time frames to be established for IRD so that taxpayers can plan their activities with a greater degree of certainty about any funding.

Clawback of the cash out

Accounting for the repayment liability

12. The issues paper does not address how the cash out of the losses may be treated from an accounting perspective. If this will result in a liability needing to be reported in the accounts, this may impact on companies in a number of ways, such as balance sheet value, solvency test considerations, thin capitalisation rules, and debt covenants. On the other hand, the Law Society acknowledges that at present the tax losses are probably not being recognized as a deferred tax asset.

Sale of shares triggering clawback of cash out payment

13. The concept of requiring a shareholder to repay the cash up losses out of proceeds of sale is very difficult to apply in practice. This would require any incoming shareholders to be aware of the potential liability that they might have on a future sale, to repay the losses. This could lead to double taxation, whether for resident shareholders owning shares on revenue account, or for overseas shareholders, who might not get a tax credit in this situation.

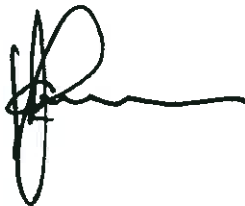
14. It also requires potentially quite small shareholders to have a detailed knowledge of the tax profile of the company, to be able to know whether they are potentially liable on a sale and if so, how much they are liable for. They would be relying on the company for accurate information on this.

15. Therefore the Law Society suggests that only majority shareholders should be liable, and then only if they are holding those shares on capital account. Some certainty would be needed in respect of foreign tax credits for overseas shareholders also, if the regime does apply to non-residents, otherwise foreign investment may be discouraged.

Conclusion

16. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please do not hesitate to contact the committee convenor Casey Plunket, through the committee secretary Rhyn Visser (04 463 2962, rhyn.visser@lawsociety.org.nz).

Yours sincerely



Chris Moore
President