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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **www.ird.govt.nz** (search keywords: public consultation).

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe at **www.ird.govt.nz/public-consultation** to receive regular email updates when we publish new draft items for comment.

Ref	Draft type	Title	Comment deadline
PUB00307	Interpretation statement and fact sheets	Goods and services tax – supplies by New Zealand hunting outfitters and taxidermists to overseas hunters	9 October 2019

IN SUMMARY

New legislation

Taxation (Research and Development Tax Credits) Act 2019 3

New tax rules have been introduced which provide a tax credit to businesses that perform research and development (R&D) in New Zealand from the 2019-2020 income year.

Binding rulings

BR Pub 19/04: Income tax – application of the employee share scheme rules to employer issued crypto-assets provided to an employee 51

This ruling follows on from *BR Pub 19/01: Income tax – salary and wages paid in crypto-assets*, *BR Pub 19/02: Income tax – bonuses paid in crypto-assets* and *BR Pub 19/03: Income tax - employer issued crypto-assets provided to an employee*. It considers whether the employee share scheme rules apply to some types of employer-issued crypto-assets provided to employees.

Questions we've been asked

QB 19/12: What is the fringe benefit tax, GST and income tax treatment of an employee contribution to a fringe benefit? 62

This Question We've Been Asked explains the fringe benefit tax, GST and income tax treatment of an employee contribution to a fringe benefit.

QB 19/13: Income tax – when does the business premises exclusion to the bright-line test apply? 68

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Operational statements

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This operational statement along with OS 19/04b replaces *OS 18/01 – Commissioner's statement on use of kilometre rate for expenditure incurred for business use of a motor vehicle.* OS 19/04a covers business deductions and OS 19/04b covers employee reimbursements.

OS 19/04b: Commissioner's statement on using a kilometre rate for employee reimbursement of a motor vehicle 85

This operational statement along with OS 19/04a replaces *OS 18/01 – Commissioner's statement on use of kilometre rate for expenditure incurred for business use of a motor vehicle.* OS 19/04a covers business deductions and OS 19/04b covers employee reimbursements.

Legislation and determinations

General Determination DEP104: Tax Depreciation Rate for lay-flat hoses 89

This determination sets a depreciation rate for lay flat hoses used for hire equipment business purposes.

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Legal decisions – case notes

Taxation Review Authority considers whether the repayment of a loan can generate an input tax deduction 90

The disputant challenged his self-assessment of GST for the two-month taxable period ending 30 September 2007. He sought to claim additional input tax deductions for taxable supplies acquired during the development of two properties. This expenditure included a payment he made to a finance company.

Court of Appeal confirms deductions for bad debts not available as operating a "Benevolence on the Conscience Loan Fund" not a money lending business 91

This was a second appeal from a decision of the Taxation Review Authority which had been upheld by the High Court on a first appeal. The Commissioner of Inland Revenue had issued assessments disallowing two deductions for bad debts in the amount of $50,000 and $122,280 respectively and imposing shortfall penalties under s 141A of the Tax Administration Act 1994 for not taking reasonable care.

Unsuccessful strike-out application to Commissioner of Inland Revenue's Property Law Act 2007 claim 93

The High Court dismissed the defendants', the late Mr Kris McPherson Robertson (Mr Wayne Andrew Wallace and Mr Clifford William Mancer acting as executors of Mr Robertson's estate), Bianca Café Limited (previously Coffee Distribution NZ Limited), and Kaffee Espresso NZ Limited (collectively "the Defendants"), application to strike out the Commissioner of Inland Revenue's ("the Commissioner") claim. Associate Judge Matthews held that the Defendants had failed to establish that the Commissioner's case was so clearly untenable that she could not succeed at trial. The defendants' application was subsequently dismissed, and the Commissioner was awarded 2B costs with a 50 per cent uplift.

Taxation Review Authority considers 'taxable activity' and entitlement to input tax deductions 95

The disputant challenged GST assessments for the periods ending 31 January 2017, 31 March 2017, 31 May 2017 and 31 July 2017, that had disallowed input tax deductions claimed by the disputant during these periods. Additionally, the Taxation Review Authority considered whether or not the disputant was engaged in a taxable activity.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Taxation (Research and Development Tax Credits) Act 2019

RESEARCH AND DEVELOPMENT TAX CREDIT

Flowchart B4, Sections EE 6, GB 56, LA 4, LA 5, LY 1 to LY 10, LZ 13, OB 4, OB 9C, Table O1, OK 2, OK 6C, Table O 17, OP 5, OP 7, OP 11C, Table O 19, YA 1, and Schedules 21 and 21B of the Income Tax Act 2007; Sections 3, 22, 33E, 36BE, 36C, 68CB, 68CC, 68CD, 68CE, 89DA, 108, 113D, 113E, 124ZH, 124ZI 138E, 141EC and Schedule 7 of the Tax Administration Act 1994

New tax rules have been introduced which provide a tax credit to businesses that perform research and development (R&D) in New Zealand from the 2019-2020 income year. The definition of R&D is in line with comparable jurisdictions and requires a person to seek to resolve scientific or technological uncertainty. The new tax credit applies not just to "white-coat" research. It also applies to the development of new or improved products or processes in a variety of industries, where that development seeks to resolve scientific or technological uncertainty. R&D expenditure that is eligible for the credit includes employee salaries, consumables, depreciation of property, and certain overheads. The credit is 15 percent of a person's eligible R&D expenditure for an income year and is claimed in the annual income tax return in conjunction with a supplementary R&D return. The credit offsets the person's tax liability. Surplus credits may be carried forward or refunded where certain conditions are met.

Passage of the Bill

The Taxation (Research and Development Tax Credits) Bill was introduced into Parliament on 25 October 2018. It received its first reading on 1 November 2018, second reading on 11 April 2019 and the third reading on 2 May 2019, followed by Royal assent on 7 May 2019.

The new Act introduces a research and development tax credit.

It amends the Income Tax Act 2007 and the Tax Administration Act 1994.

Background

The Government has set a target of raising the total amount of R&D performed in New Zealand to 2 percent 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 five 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.

Key features

Eligible person

To be eligible for the tax credit a person must:

- perform a core R&D activity in New Zealand, or have a contractor perform one on their behalf;
- carry on business through a fixed establishment in New Zealand (unless the person is a tax charity or levy body);
- own the results of their R&D activities (or the results are owned by a member of their corporate group) or have the right to use the results of the activities for no further consideration; and
- from the 2020-2021 income year, have obtained general approval of their R&D activities, or opted into the significant performer regime.

A person is not eligible if they:

- fail to file their income tax return and R&D supplementary return in time;
- receive a Callaghan Innovation Growth Grant for any part of the relevant income year (subject to a limited exception);
- are an R&D contractor for the R&D activity;
- are, or are controlled by or associated with, a Crown research institute, district health board, or tertiary education organisation; or
- if they are a non-resident member of a joint venture or partnership.

R&D activity

A core R&D activity is an activity that:

- is conducted using a systematic approach;
- has a material purpose of:
  - creating new knowledge, or new or improved processes, services, or goods; and
  - resolving scientific or technological uncertainty; and
- is performed in New Zealand;

An activity does not satisfy the uncertainty requirement if the knowledge required to resolve the uncertainty is:

- Publicly available; or
- Deducible by a competent professional in the relevant scientific or technological field.

An activity that does not satisfy the core R&D activity definition may be eligible as a supporting R&D activity provided it is inextricably linked to a core R&D activity. Certain activities are expressly excluded from being core R&D or supporting R&D activities.

Eligible expenditure

- A person needs to have approved research provider expenditure, or at least $50,000 of eligible R&D expenditure, to be eligible for the credit.
- The maximum amount a person can claim is $120 million, unless they have received approval from the Commissioner to exceed this amount.
- Most types of expenditure incurred on R&D activities are eligible, including expenditure on wages and salaries, consumables, depreciation, and the costs of creating intangible property.
- Some expenditure is expressly excluded. This includes the up-front cost of acquiring assets, amounts that go towards creating tangible depreciable assets, interest, and expenditure that relates to Government or local authority grants.
- Some expenditure is capped:
  - A $25 million cap applies to eligible internal software development expenditure.
  - No more than ten percent of a person's claim can relate to expenditure on R&D activities performed overseas.
- Where expenditure is incurred on an R&D activity performed in the course of commercial production, a person's claim is limited to the additional expenditure incurred because of that R&D activity.

ELIGIBLE PERSONS

Sections LY 3, LZ 13 of the Income Tax Act 2007

A business must meet certain criteria to claim the R&D tax credit.

Background

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.

Key features

Eligible person

To be eligible for the tax credit a person must:

- perform a core R&D activity in New Zealand, or have a contractor perform one on their behalf; and
- carry on business through a fixed establishment in New Zealand (unless the person is a tax charity or levy body); and
- own the results of their R&D activities (or the results are owned by a member of their corporate group) or have the right to use the results of the activities for no further consideration; and
- have obtained approval from the Commissioner of their R&D activities under the general approval process in section 68CB of the Tax Administration Act 1994; or
- have opted out of the general approval process and into the significant performer regime and comply with the requirements in section 68CC of the Tax Administration Act 1994 (this bullet point and the one above only apply from the 2020-21 income year – refer to the section on in-year approval for more information).

A person is not eligible if they meet one or more of the following criteria:

- Fail to file their income tax return and R&D supplementary return in time.
- Receive a Callaghan Innovation Growth Grant for any part of the relevant income year (subject to a limited exception).
- Are an R&D contractor for the R&D activity.
- Are, or are controlled by or associated with, a Crown research institute, district health board, or tertiary education organisation.
- Are a non-resident member of a joint venture or partnership.

Detailed analysis

Eligible person

Core activity performed in New Zealand

A person must perform a core research and development activity in New Zealand, or have a contractor perform the activity on their behalf.

All types of New Zealand businesses are eligible. This includes individuals, companies, partnerships, joint ventures, levy bodies, and trusts.

Carry on business through a fixed establishment in New Zealand

To be eligible, a person must carry on a business in New Zealand through a fixed establishment in New Zealand. There is no requirement that the R&D relate to the person’s business. A fixed establishment means a fixed place of business from which substantial business is carried on. This rule ensures that R&D tax credits are only provided to persons with some presence in New Zealand.

Where the person engages a contractor to perform R&D on their behalf, the contractor must carry on a business through a fixed establishment in New Zealand.

Tax charities and levy bodies are treated as carrying on business in New Zealand for the purposes of the R&D tax credit.

Ownership of the R&D results

A person must:

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

In-year approval

From the 2020-21 income year, a person must:

- obtain in-year approval of their R&D activities or criteria and methodologies; or
- opt into the significant performer regime.

See the section on in-year approval for further information.

How the eligibility requirements apply in the context of partnerships, joint ventures and look through companies

The above eligibility criteria for partnerships, joint ventures and look through companies may be satisfied at the entity level. In other words, if the partnership, joint venture or look through company as a whole would meet the criteria, then the individual members may also be treated as meeting them. Note that even if the above criteria are satisfied at the entity level, to be eligible for the credit each individual member must also be a New Zealand tax resident.

Ineligible person

Failure to file in time

In order to be eligible for the R&D tax credit, the claimant must:

- file their R&D supplementary return within 30 days of their due date for filing the income tax return under section 37 of the Tax Administration Act 1994; and
- file their income tax return containing their R&D tax credit claim no later than 1 year after their due date for the return. Note that returns that are not filed by their due dates may attract

Example 1: 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 2: 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.

The above rules are aimed at reducing the likelihood of claimants claiming R&D tax credits for R&D expenditure they identify after the end of an income year. The rationale behind these rules is that R&D tax credits 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.

In both examples above, if the income tax returns are not filed by their respective original due dates penalties or interest may apply.

Receive a Callaghan Innovation Growth Grant

A person who receives a Callaghan Innovation Growth Grant for the whole or a part of an income year is excluded from claiming the R&D tax credit for that income year. The person is also excluded from claiming the tax credit where a person controlled by or associated with them receives the Growth Grant. This is a broad exclusion and even applies to R&D expenditure for which the person hasn't received a Growth Grant.

The R&D tax credit replaces the Callaghan Innovation Growth Grant with the Growth Grant being completely phased out from 31 March 2021. This exclusion prevents a person from picking and choosing between the best aspects of each scheme.

Section LZ 13 provides an exception from this exclusion for late balance date claimants in their 2020-21 income year who may receive the Growth Grant up until 31 March 2021, and the R&D tax credit for the balance of their income year after 31 March 2021. This rule ensures that businesses with late balance dates have two years to transition from the Growth Grant to the R&D tax credit, which is consistent with the amount of time that early and standard balance date businesses receive.

R&D contractor

A person who is an R&D contractor and is paid to perform an R&D activity on behalf of another person is ineligible for R&D tax credits in relation to that activity where the principal carries on business through a fixed establishment in New Zealand. Where the principal does not carry on business in New Zealand, the contractor may claim the credit provided they satisfy the eligibility criteria outlined above.

The rationale for this is that the principal claims the credit as they make the decision to invest in the R&D. However, where the principal is based offshore and therefore cannot claim the credit, the contractor receives the credit in order to encourage R&D to be performed in New Zealand.

Whether or not a person is an R&D contractor depends on the facts surrounding the relationship with the principal. Key factors include:

- Contract for R&D or contract for outcome – if the contractor is contracted to deliver an outcome rather than to perform R&D then they are unlikely to be an R&D contractor.
- Control, ownership and financial risk – if the contractor funds the R&D, controls it (including the right to start, stop and change direction of the R&D) and owns the results of the activity, then the contractor is unlikely to be an R&D contractor and can therefore claim in their own right.

Example 3: 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 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.

Example 4: R&D contractor where 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 5: 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. Refer to the section on eligible expenditure for more information.

Crown research institutes, district health boards and tertiary education organisations

Crown research institutes (CRIs), district health boards (DHBs) and tertiary education organisations (TEOs), their associates, and entities controlled by them are not eligible for R&D tax credits. The R&D tax credit regime is designed to target private sector business R&D. The Government has more effective and appropriate ways to increase the amount of R&D that CRIs, DHBs, and TEOs undertake.

The policy to exclude CRIs, TEOs, and DHBs from the R&D tax credit regime would be ineffective if associates of these entities were not excluded.

While these entities are excluded, they are nevertheless able to perform R&D for other people as R&D contractors. It is expected that some of these excluded entities will apply to be approved research providers. See the section on *Approved research providers* for more information.

Non-resident member of a joint venture, partnership or look through company

A person who is a partner in a partnership, member of a joint venture, or an owner of a look through company, must be a tax resident for the relevant income year to claim an R&D tax credit for that year. This rule ensures that only people with sufficient presence in New Zealand receive R&D tax credits.

DEFINING R&D ACTIVITY

Sections LY 2, YA 1 and Schedule 21 of the Income Tax Act 2007.

Background

Research and development, as the term is used colloquially, does not have a precise definition. To target the tax credit, the amendments therefore introduce definitions of core research and development activity and supporting research and development activity.

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:

- creating new knowledge, or new or improved processes, services or goods; and
- 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 to 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.

The amendments define supporting research and development activities in a way that is intended to ensure a high degree of connection between core and supporting activities.

The amendments in new schedule 21 parts A and B expressly exclude certain activities from the R&D core and supporting activity definitions. Activities have been included in these schedules for a number of reasons, including:

- to clarify that the activity does not amount to R&D because the knowledge required to resolve the uncertainty the activity is seeking to resolve is publicly available or is deducible 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; and
- 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 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 is intended to reduce compliance and administrative costs.

Key features

New section LY 2 defines an R&D activity to include core activities and supporting activities.

Core activity

New section LY 2(1) defines a core activity as an activity that is:

(a) i. conducted using a systematic approach;

ii. has a material purpose of creating new knowledge, or new or improved processes, services, or goods; and

iii. has a material purpose of resolving scientific or technological uncertainty; but

(b) does not include an activity, if knowledge required to resolve the uncertainty, described in paragraph (a)(iii) is

i. publicly available:

ii. deducible by a competent professional in the relevant scientific or technological field; and

(c) does not include an activity to the extent to which it is performed outside New Zealand; and

(d) does not include an activity to the extent to which it is described in schedule 21, part A.

Supporting activity

An activity is a supporting activity (new section LY 2(3)) if it is only or mainly for the purpose of, required for, and integral to, a core activity.

Excluded activities

Activities listed in schedule 21, part A are excluded from being core activities and activities listed in schedule 21, part B are excluded from being supporting activities.

Detailed analysis

Core R&D activity

A core R&D activity is an activity that:

- is conducted using a systematic approach;
- has a material purpose of:
  - creating new knowledge, or new or improved processes, services, or goods; and
  - resolving scientific or technological uncertainty; and
- is performed in New Zealand.

An activity does not satisfy the uncertainty requirement if the knowledge required to resolve the uncertainty is:

- publicly available; or
- deducible by a competent professional in the relevant scientific or technological field.

Conducted using a systematic approach

A systematic approach is a methodical (planned and structured) approach to test possible solutions to a scientific or technological uncertainty. The solution is the idea, proposal, or hypothesis that is being investigated using the systematic approach.

Traditional scientific methods follow a systematic approach which includes hypothesis, experiment, observation and evaluation. An agile approach to R&D (such as the approach used in some software development) may also be considered a systematic approach, provided the R&D activity is planned, occurs logically, and tests whether a proposed solution (or solutions) resolves what is scientifically or technologically unknown.

Prototyping, and the type of planned and logical testing that occurs in a test kitchen or similar environment, may also be sufficiently systematic to meet the requirements for a systematic approach. The requirement for a systematic approach will, however, exclude anything discovered or produced as a result of random trial and error.

For a person's approach to be considered systematic they must keep record of the uncertainty being tested, the process followed and the outcome.

Something new or improved

To qualify as a core R&D activity, activities must have a material purpose of seeking to create new knowledge, or new or improved processes, services or goods. The test of "new" is on a worldwide basis. It is not enough that it is new to a person's business or new to New Zealand.

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.

A person may satisfy this requirement where another firm is undertaking the same R&D simultaneously but independently. It may also be satisfied where another firm has already created the new knowledge but has kept it secret, and the person is undertaking the R&D to create equivalent knowledge.

It is not a requirement that the R&D is successful and results in something new or improved. Unsuccessful R&D also increases knowledge and activities that are unsuccessful but meet the definition can qualify for the tax credit.

Resolving scientific or technological uncertainty

To qualify for the tax credit an 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 a person to undertake fundamental scientific research. It is enough to be trying to extend the practical application of scientific knowledge in a way that could not be predicted in advance.

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 possible, or does not know how achieve it. In these circumstances there is an uncertainty, or a knowledge gap, in the available scientific or technological knowledge.

If a competent professional has to use a systematic approach to discover knowledge to bridge the gap (for example through generating testable propositions which are subjected to a systematic process of testing, experimentation or prototyping), the activity involved in the systematic approach would be an activity which sought to resolve scientific or technological uncertainty.

Core R&D activity generally begins once a person has a testable idea, or proposition (hypothesis) which could resolve the scientific or technological uncertainty. A testable proposition is one that can be tested and seen to be supported (it works) or not (it doesn't).

Core R&D activity ends when a person ceases to measure and evaluate the extent to which the activities have resolved the scientific or technological uncertainty.

Competent professional with access to publicly available information

A competent professional:

- is knowledgeable about the relevant field;
- 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; and
- has access to publicly available knowledge from around the world such as the internet, relevant industry journals, and other professionals.

The test of whether the knowledge required to resolve the uncertainty is publicly available is an objective test on a worldwide basis. It is not enough that the business does not have the knowledge or that no one in New Zealand has yet done what the business is trying to do.

Publicly available means accessible where New Zealand-based professionals in that field could be expected to look; it 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.

If knowledge to resolve the uncertainty exists, but is being held as a trade secret, it is not publicly available.

Supporting R&D activity

The amendments define supporting R&D activity as an activity that is only or mainly for the purpose of, required for, and integral to, a core activity. If the "supporting" activity is not in support of a core R&D activity, it is not an eligible R&D activity for the tax credit regime. The definition is intended to create a close nexus between the core and supporting activity.

- *Mainly* requires that the major purpose of a supporting activity is to support the core R&D activity. If the supporting activity is routinely carried out for another purpose it is unlikely that its main purpose is to support the core R&D.
- *Required for* means a supporting activity must only be to the degree necessary to support the core activity.
- *Integral to* means that a supporting activity must be necessary to the core activity. That is, the core activity could not be performed or completed without the supporting activity.

An activity that is conducted overseas cannot be a core activity. An activity which would have been a core activity if performed in New Zealand may be eligible as a supporting activity if it satisfies the supporting activity definition.

Examples of supporting activities could include:

- 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/approval process; or
- disassembling testing equipment or prototypes and/or disposing of waste material.

Administrative and overhead activities, such as cleaning, or the work of the HR or finance department, are not considered supporting activities but instead maybe eligible for the tax credit as an apportioned share of overhead costs.

Excluded R&D activities

The amendments list activities in schedule 21 parts A and B which are excluded from eligibility for the tax credit. The table below identifies the excluded activities and indicates whether they are excluded as core or as both core and supporting activities.

<table>
<tr><th></th><th>Activity exclusions in Schedule 21</th><th>Core part A</th><th>Supporting part B</th></tr>
<tr><td>1.</td><td>Preproduction activities, including demonstration of commercial viability and tooling up.</td><td colspan="2">Excluded</td></tr>
<tr><td>2.</td><td>Routine de-bugging of existing computer software.</td><td colspan="2">Excluded</td></tr>
<tr><td>3.</td><td>Supporting or making minor improvements to existing computer software, using known methods.</td><td colspan="2">Excluded</td></tr>
<tr><td>4.</td><td>Routine software and computer maintenance.</td><td colspan="2">Excluded</td></tr>
<tr><td>5.</td><td>Prospecting for, exploring for, or drilling for, minerals, petroleum, natural gas, or geothermal energy.</td><td colspan="2">Excluded</td></tr>
<tr><td>6.</td><td>Market research, market testing, market development or sales promotion, including consumer surveys.</td><td colspan="2">Excluded</td></tr>
<tr><td>7.</td><td>Commercial, legal, or administrative aspects of patenting, licensing, or other similar activities.</td><td colspan="2">Excluded</td></tr>
<tr><td>8.</td><td>Activities involved in complying with statutory requirements or standards for existing processes, services, or goods.</td><td colspan="2">Excluded</td></tr>
<tr><td>8.</td><td>Activities involved in complying with statutory requirements or standards for new processes, services, or goods.</td><td>Excluded</td><td>Included</td></tr>
<tr><td>9.</td><td>Management studies.</td><td colspan="2">Excluded</td></tr>
<tr><td>10.</td><td>Activities relating to organisational design.</td><td colspan="2">Excluded</td></tr>
<tr><td>11.</td><td>Ineligible internal software development</td><td colspan="2">Excluded</td></tr>
<tr><td>12.</td><td>Research in social sciences, arts, or humanities.</td><td>Excluded</td><td>Included</td></tr>
<tr><td>13.</td><td>Quality control or routine testing of processes, services, or goods.</td><td>Excluded</td><td>Included</td></tr>
<tr><td>14.</td><td>Routine collection of information.</td><td>Excluded</td><td>Included</td></tr>
<tr><td>15.</td><td>Minor adaption of, or improvement to, existing processes, services, or goods.</td><td>Excluded</td><td>Included</td></tr>
</table>

	Activity exclusions in Schedule 21	Core part A	Supporting part B
16.	Bug testing, beta testing, system requirement testing, user acceptance testing and data integrity testing.	Excluded	Included
17	Data mapping and data migration testing.	Excluded	Included
18	Testing or comparing the efficiency of algorithms that are already known to work.	Excluded	Included
19	Testing security protocols or arrangements.	Excluded	Included
20.	Converting existing systems to, or integrating existing systems with, new software platforms.	Excluded	Included
21.	Making cosmetic or stylistic chances to processes, services or goods.	Excluded	Included
22.	Reproduction or a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications, or publicly available information.	Excluded	Included
23.	Carrying out routine operations on data, including presentation of data.	Excluded	Included
24.	An activity that hasn't been approved by the Commissioner under section 68CB of the Tax Administration Act 1994.	Excluded	

Activities excluded from being both core and supporting activities.

Preproduction activities, including demonstration of commercial viability and tooling up (parts A and B, clause 1)

Examples of preproduction activities include:

- demonstrating commercial viability;
- tooling-up for commercial production;
- planning the production process;
- developing control systems; and
- undertaking start-up procedures.

Preproduction activities occur after R&D is complete but before a product is made publicly available. They are not undertaken to resolve scientific or technological uncertainty and have been included in schedule 21 for clarity.

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 a new core R&D activity. The tests for an eligible core R&D activity must however be applied and met.

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 scientific or technological uncertainty may be eligible for the tax credit.

Routine software and computer activities: schedule 21 parts A and B clauses 2 - 4

Schedule 21 excludes:

- routine debugging of existing computer software (schedule 21 parts A and B clause 2);
- supporting or making minor improvements to existing computer software, using known methods (schedule 21 parts A and B clause 3) and;
- routine software and computer maintenance (schedule 21 parts A and B clause 4).

These activities are excluded from both the core and supporting activity definitions. Routine debugging of existing computer software and routine software and computer maintenance do not seek to resolve scientific or technological uncertainty.

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' 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.

Mining activities: schedule 21 parts A and B clause 5

Mining activities include prospecting, exploring, or drilling for:

- minerals;
- petroleum;
- natural gas; or
- geothermal energy.

Prospecting, drilling and exploring resolve uncertainty relating to geography or location rather than scientific or technological uncertainty. These activities are not activities the tax credit is intended to incentivise. Therefore, the activities are excluded from both the core and supporting activity definitions.

Examples of where there may be eligible R&D in the extractive industries are included in the guidance material that has been made available by Inland Revenue to support the R&D tax credit regime.

Market research, market testing, market development, or sales promotion including consumer surveys: schedule 21 parts A and B clause 6

These activities are excluded from the core and supporting activity definitions. These activities are undertaken to assist with commercial decision making and objectives rather than to resolve scientific or technological uncertainty.

These activities may occur within the same project as eligible R&D but the exclusion from eligibility as a supporting activity means that even where there is eligible R&D these *activities* are not eligible.

The exclusions do not exclude sensory testing when it is undertaken to resolve scientific or technological uncertainty.

Commercial legal or administrative aspects of patenting, licensing, or other similar activities: schedule 21 Parts A and B clause 7

This exclusion targets activities to protect or grant rights to intellectual property. Other similar activities include but are not limited to protections such as those conferred by plant breeders' rights or registered designs.

The exclusions clarify that commercial, legal and administrative activities related to patenting and other similar processes are not eligible as core R&D activities because they don't have a material purpose of resolving scientific or technological uncertainty. In addition, such activities are not for the only or main purpose of resolving technological or scientific uncertainty and as such cannot qualify as a support activity.

Activities involved in complying with statutory requirements or standards (for existing products): schedule 21 Parts A and B clause 8

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

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

This exclusion targets:

- routine testing and analysis of materials, products and processes to check that they comply with statutory requirements or standards; and
- 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/or support entry to a market rather than to resolve technological uncertainty.

Where there is scientific or technological uncertainty, activities involved in testing new or improved processes, services or good against the standard, this may be eligible as supporting activity.

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

Management studies and activities relating to organisational design: schedule 21 parts A and B, clauses 9 and 10

Management studies and activities related to organisational design do not qualify as R&D activities. They are not the types of activities that the R&D tax credit regime is intended to incentivise.

Even without this exclusion, many management studies and activities relating to organisational design would be excluded because their subject is the social sciences.

Ineligible internal software development schedule 21 parts A and 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, and
- 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.

This exclusion covers all forms of software development other than:

- internal software development that enhances services to customers (software used by customers to access non-software services); and
- external software development (software developed for the main purpose of sale or disposal (for example via a licence to unrelated parties).

Excluded core activities

Activities involved in complying with statutory requirements or standards: schedule 21 part A clause 8

Activities involved in testing compliance with statutory requirements or standards do not qualify as a core activity as they do not resolve scientific or technological uncertainty.

Activities to test compliance with the relevant standards for new processes, services or goods may be eligible as a support activity if compliance with the relevant standard is necessary to validate that the scientific or technological objectives of the R&D have been met.

Research in social sciences, arts or humanities: schedule 21 part A clause 12

Regardless of whether or not there is scientific of technological uncertainty, research in the social sciences, arts or humanities is not eligible as a core R&D activity. The R&D tax credit is not intended to incentivise this type of endeavour.

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 the following:

- economics
- classics
- communication studies
- education
- finance
- business studies
- geography
- languages
- literature

- music
- philosophy
- sociology
- anthropology
- psychology
- history
- religion; and
- visual and performing arts.

Research in the social sciences, arts and humanities are excluded as core R&D activities but may be eligible as a supporting activity if they meet the supporting activity tests.

Quality control or routine testing of processes services or goods: schedule 21 part A clause 13

Quality control and routine testing of processes, services or goods are excluded as core activities because the activities do not resolve scientific or technological uncertainty.

Quality control or routine testing can be eligible as supporting activities. For example, eligible supporting activity might include checking that products to be used in a trial run meet a certain level of quality before they are used in the core R&D.

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 routine testing or testing for quality control and is not caught by this exclusion.

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 exclusion of routine collection of information excludes information gathering as an R&D activity for 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.

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.

Minor adaption 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' 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 a core R&D activity, the desired change or improvement must seek to resolve scientific or technological uncertainty.

Various types of testing: schedule 21 part A clauses 16 -19

Schedule 21 part A excludes:

- bug testing, beta testing, system requirement testing, user acceptance testing, and data integrity testing (schedule 21 part A clause 16);
- data mapping and data migration testing (schedule 21 parts A clause 17);
- testing or comparing the efficiency of algorithms that are already known to work (schedule 21 part A clause 18); and
- testing security protocols or arrangements (schedule 21 part A clause 19).

Testing in itself does not satisfy the core activity definition. It does not seek to resolve scientific or technological uncertainty but identifies problems that need to be resolved. Testing is excluded by new schedule 21 for clarity.

Where there is scientific or technological uncertainty and these types of testing meet the requirements, they may qualify as a supporting activity. More information and examples are included in the guidance material published by Inland Revenue; see sector specific guidance for digital technology.

Converting existing systems to, or integrating existing systems with, new software platforms: schedule 21 part A clause 20

Converting existing systems and integrating existing systems with new platforms are considered unlikely to involve the resolution of scientific or technological uncertainty and if they do, the spill-over benefits are likely to be minimal. For these reasons these activities are excluded from being core R&D activities.

Conversion or integration activities may qualify as a supporting activity where they meet the definition.

Making cosmetic or stylistic changes to processes, services or goods: schedule 21 part A clause 21

Even if it uses a systematic approach, 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.

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

This type of reproduction is excluded because the product, system or process can be reproduced from available information without the resolution of scientific or technological uncertainty.

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, manipulated or presented. 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 (experimentation, testing or prototyping) may be eligible as a supporting R&D activity.

Activities that have not been approved

From the 2020-21 income year, the general approval and significant performer approval regimes will come into force. Under these regimes, a person's activities will not qualify as core R&D activities unless:

- the Commissioner has approved the person's core activities under the general approval process; or
- the person has opted out of the general approval process and into the significant performer process and complies with the requirements in new section 68CC of the Tax Administration Act 1994 (see the section on in-year approval for more information on the general approval and significant performer processes).

Application date(s)

From the 2019-20 income year unless otherwise stated.

ELIGIBLE EXPENDITURE

Sections LY 5 to LY 7 and Schedule 21B part A of the Income Tax Act 2007

Expenditure incurred on an R&D activity is eligible for the R&D tax credit.

Background

Expenditure is eligible to the extent it has been incurred on an R&D activity. The expenditure must be listed in schedule 21B part A (eligible expenditure), and not listed in schedule 21B part B (ineligible expenditure). Specific rules apply for R&D conducted in a commercial production environment, contracted R&D and foreign R&D.

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 companies. 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.

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; and
- limit fiscal risk.

Key features

- New section LY 5 defines eligible R&D expenditure. To be eligible, the expenditure must be listed in schedule 21B part A and incurred on an R&D activity. Expenditure that is listed in schedule 21B part B is not eligible.
- Where an R&D activity is performed in the course of commercial production, the amount that may be claimed is limited to employee expenditure on the R&D, and additional expenditure incurred because of the R&D (i.e. expenditure that would not have been incurred in absence of the R&D activity).
- New section LY 6 provides that where a principal engages a contractor to perform R&D on the principal's behalf, the principal's eligible expenditure is the amount the principal pays the contractor, minus any ineligible expenditure the contractor has incurred.
- New section LY 7 defines foreign research and development expenditure. Foreign R&D expenditure is expenditure incurred on an R&D activity conducted overseas, where that activity is integral to a core R&D activity conducted in New Zealand. It also includes expenditure for non-residents to perform R&D related services in New Zealand. The lesser of the claimant's actual expenditure incurred on the activity overseas and on non-residents performing services in New Zealand, and 10% of the claimant's total eligible expenditure, is eligible for the R&D tax credit.

Detailed analysis

Section LY 5 - Eligible research and development expenditure

In order for expenditure to be eligible it must:

- be incurred on an R&D activity
- be listed in schedule 21B part A
- not be listed in schedule 21B part B; and
- not have been incurred in the absence of the R&D, if the R&D is performed in the course of commercial production

Expenditure incurred on an R&D activity

Expenditure is eligible "to the extent" it is incurred on an eligible R&D activity. Refer to the section on defining R&D activity for information on what is an eligible R&D activity. "To the extent" allows for the expenditure to be apportioned between R&D and non-R&D activities.

There are no specific rules for how the apportionment must be applied. It is up to the taxpayer to apportion the expenditure in a way that is fair and reasonable. Apportionment could be based on:

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

There must be a sufficient relationship between the expenditure incurred and the R&D activity in order for the expenditure to be eligible. This will depend on the circumstances. Expenditure that does not have a direct connection to the R&D activity, such as expenditure which is two degrees removed, is not eligible.

Example 6: expenditure with an insufficient connection with 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.

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

Example 7: Contract for goods

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.

Expenditure listed in schedule 21B part A

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.

Example 8:

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 (i.e. R&D use as a proportion of total use 20/80 = 25%).

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
- overheads, to the extent they relate to R&D activities, and
- 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, and
- corporate services, such as human resources

Unexpired amounts

Expenditure incurred on a good that has not been used at the end of the income year (and hasn't 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.

Example 9:

A Co has incurred $150,000 on consumables to use in its R&D process. At the end of the 2019-2020 tax year, A Co has used $80,000 of those consumables in its R&D process. The $70,000 on unused consumables is not eligible expenditure for the year.

This rule ensures that only expenditure on R&D receives the credit. Whilst a good or service may have been purchased for use in R&D, it may end up being sold or used in a non-R&D process later. It would not be efficient to claw back any R&D credit received at this point, which is why an R&D tax credit is not available until the relevant good or service has been used in the R&D process.

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
- bonuses
- employee share schemes
- employee recruitment and relocation costs
- overtime
- holiday pay
- long-service pay; and
- superannuation contributions.

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.

Example 10:

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 ÷ 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 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, i.e. 23 + 1 + 2 = 26 weeks. 26 ÷ 52 = 50%.

Expenditure that is not listed in schedule 21B part B

Refer back to the section on ineligible expenditure.

Commercial production rule (section LY 5(1)(c))

Where an R&D activity is performed in the course of commercial production, the amount that can be claimed is limited to:

- expenditure in relation to an employee's contribution to the R&D; and
- additional expenditure incurred because of the R&D

This rule is intended to ensure that the extra costs associated with R&D are eligible and that costs which would have been incurred anyway as a result of commercial operations are not eligible. For example, a firm running a production line with the dual purpose of production and research would be prevented from claiming the running costs for the production line as an R&D expense, as that expenditure would have been incurred anyway.

Meaning of "in the course of commercial production"

Commercial production means producing products or services for sale.

"In the course of" refers to time and location. If a claimant performs their 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; and
- 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 in the following scenarios:

- 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.
- Goods or services produced by the activity are not widely offered for sale. For example, selling the product produced by the 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 11: 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 12: 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 "to the extent" test applies instead of the commercial production rule.

Example 13: 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 needs 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 14: 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.

Meaning of "expenditure in relation to an employee's contribution to the R&D"

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

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

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

Meaning of "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 15: 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 one 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 second 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 usual. 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).

Section LY 6 – contracted research and development expenditure

Where a principal engages a contractor to perform R&D on their behalf, the principal's eligible expenditure is calculated as follows:

Contract amount – Ineligible expenditure

The *contract amount* is the amount the principal pays the contractor to perform the R&D activities.

Ineligible expenditure is expenditure that the contractor has incurred on R&D which is not eligible – for example, because the expenditure is listed on schedule 21B part B as ineligible expenditure.

These rules ensure that claimants using a contractor to perform their R&D are treated the same as those who undertake the R&D themselves.

Section LY 7 – foreign research and development expenditure

Expenditure on an R&D activity conducted outside New Zealand is generally ineligible, apart from the 10% cap on foreign R&D provided by section LY 7.

Under this section a claimant's eligible expenditure is the lesser of:

- actual expenditure on foreign R&D; and
- 10% of total eligible expenditure.

Foreign research and development is defined as:

- 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 in New Zealand by non-residents – salary and wage payments/payments for services to non-residents for R&D activities conducted in New Zealand

Expenditure on overseas activities

The limit applies to activities performed outside New Zealand that are integral to a core R&D activity conducted in New Zealand.

Example 16: Overseas activity integral to a core R&D activity conducted in New Zealand

A Co is developing a cure for cancer in New Zealand. As part of that activity, the company needs to conduct clinical trials in Asia.

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, outlined below.

Example 17: 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 18: 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.

Expenditure for services performed by non-residents

Payments for non-residents to perform services related to R&D forms part of the 10% cap, regardless if the services are performed in New Zealand or overseas.

A non-resident is a person who is not New Zealand resident for tax purposes under New Zealand domestic law. Double tax agreements are not relevant in determining residence for R&D tax credit purposes.

Example 19: Residence

A Co is incorporated in New Zealand but has its centre of management in Australia. Under the NZ-Australia double tax agreement A Co is resident in Australia, but for R&D tax credit purposes the company is resident in New Zealand.

How foreign R&D expenditure is calculated

As mentioned above, the amount a person can claim is the lesser of the amount spent on foreign R&D and 10% of total eligible expenditure.

This 10% cap must be calculated as follows:

$$0.1 \times \text{total New Zealand R\&D expenditure} \div 0.9$$

This formula enables the capped amount of foreign R&D to be determined when the amount of New Zealand expenditure is known.

The cap is not confined to a specific project – it applies to total expenditure across all projects for the year. Therefore, for one project half of a business's expenditure could be foreign R&D expenditure, provided that the amount was no more than 10% of total eligible expenditure across all projects for the year. (Note: to be eligible, foreign R&D cannot include any core activities relating to the R&D project. Core activities can only be performed in New Zealand.)

Example 20: How foreign research and development expenditure is calculated

A 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 x 500,000 ÷ 0.9 = $55,556. This equates to 10% of their total eligible expenditure i.e. $55,556 ÷ 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).

INELIGIBLE EXPENDITURE

Income Tax Act 2007 sections LY 1(5) and LY 5(3), Schedule 21B part B

Certain kinds of expenditure are not eligible for the R&D tax credit.

Background

Certain expenditure is not eligible for the R&D tax credit, such as interest or the upfront cost of acquiring depreciable property. Expenditure is excluded for a variety of reasons, including 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; and
- limit fiscal risk.

Key features

The following types of expenditure are excluded from the R&D tax credit:

- The GST input portion of expenditure.
- Expenditure which is also eligible expenditure for someone else.
- Amounts under the $50,000 or over the $120 million thresholds:
  - This includes amounts incurred by a person and their associates on R&D to the extent the amounts exceed $120 million.
  - 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 (unless the property is only going to be used in R&D).
  - Depreciation on property, to the extent the cost of the asset is already eligible R&D expenditure.
  - Depreciation on pooled property where an item in the pool is not used solely in performing R&D; and
  - 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; and
  - 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; and
  - Expenditure to commercialise the results of an R&D activity
- Exlcusions relating to intangible property (other than software), software and ineligible technology acquired for use in R&D
  - 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 for from another country
  - Gifts; and
  - Expenditure that relates to a government or local authority grant.

Detailed analysis

GST adjustments (section LY 1(5))

GST registered persons cannot claim an R&D tax credit on the GST input portion of expenditure. The GST input amount must therefore be deducted from the expenditure in determining the amount eligible 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 21: GST input credit excluded from cost for R&D purposes

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. This means that adjustments made to GST (such as on disposal or for change of use) must be deducted from eligible expenditure for R&D purposes.

Example 22: GST adjustment deducted from eligible expenditure

James purchased $20,000 worth of oil. He intended to only use ⅔ of the oil in his R&D process and take ⅓ home for private use. In the end, James used all the oil in his R&D process.

James originally claimed GST of $1,739 (⅔ 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 (section LY 5(3))

Expenditure or loss that is eligible expenditure of someone else is not eligible for the R&D tax credit.

Example 23: Two parties seeking to claim eligible expenditure

Zeus contracts Misto to build a bridge. As part of building that bridge, Misto does some R&D. Zeus believes he is entitled to claim the R&D tax credit on the cost of the R&D, as he paid Misto to build the bridge. Misto believes he can claim the credit, as whilst he is contracted by Zeus, his R&D on the bridge is independent of the work which he was contracted to perform.

This rule is intended to ensure that two parties cannot claim an R&D tax credit for expenditure related to the same R&D activity. In the context of the example above, only one party will be able to claim a credit on the expenditure related to the R&D on the bridge. Refer to the section on eligibility for more information on who may claim the credit in this context.

Amounts under the $50,000 or over the $120 million thresholds

Expenditure or loss under $50,000 (section LY 4, schedule 21B part B clause 24)

A person must have incurred $50,000 or more on R&D in an income year to claim an R&D tax credit. For partnerships, joint ventures and look-through companies, this threshold can be satisfied by assessing the total eligible expenditure of the relevant entity.

If a person's eligible expenditure is less than $50,000 it is not eligible for the credit, unless the expenditure is for an approved research provider to perform an R&D activity on behalf of the person. In other words, claimants with less than $50,000 of eligible expenditure may only claim for the eligible portion of expenditure that was paid to an approved researcher provider to perform R&D on their behalf.

Approved research providers are research providers that have been approved by Inland Revenue. They provide R&D services under contract to other businesses. Refer to the section on becoming an approved research provider for more information.

Example 24: The minimum threshold and approved research providers

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.

Expenditure exceeding $120 million (Schedule 21B part B Clause 1, section 68 CD)

Expenditure that a claimant has incurred for an income year that exceeds $120 million or their approved research and development cap is not eligible for the R&D tax credit. The approved research and development cap is an expenditure level above $120 million that has been agreed upon by the Commissioner.

This maximum limit on expenditure includes expenditure incurred by people associated to the claimant. This means that if the combined expenditure of the claimant and an associate exceeds $120 million/the approved cap, the claimant's eligible expenditure may be reduced below $120 million/the approved cap..

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.

Depreciable property is property that costs more than $500, and that might reasonably be expected to decline in value.

Depreciation loss is the better measure of cost to a person as the property could later be sold or used for another purpose. Depreciation loss is eligible to the extent to which depreciable property is used in R&D activities.

Example 25: 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 a claimant is 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.

Expenditure incurred in the research phase of creating depreciable tangible property, which would be deductible for tax purposes, is eligible expenditure.

Example 26: 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, and
- $20,000 on labour to put the engine together.

The $2 million on research is eligible expenditure as it doesn't 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 depreciable tangible property exclusion is to prevent expenditure with a different purpose being characterised as R&D. There are also concerns about the potential fiscal cost of allowing such expenditure.

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.

A credit is not claimable for depreciation where these assets are subsequently used in R&D because the cost of the asset has already attracted the credit.

Example 27: Depreciation where the cost of the property was eligible expenditure

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.

This exclusion prevents a person from receiving R&D tax credits for depreciation loss on assets used in non-R&D activities.

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 28: No claw-back 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 five 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, an R&D tax credit is not claimable where an asset is written off or sold below its adjusted tax value.

Example 29: 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)

An R&D tax credit is not claimable for depreciation on an asset acquired from an associate, to the extent:

- the purchase price of the asset is more than the adjusted tax value in the hands of the associate; and
- the asset was used in the associate's R&D activities.

Example 30: Depreciable property acquired from an 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, a claimant cannot claim the credit for depreciation when an associate has claimed the credit in relation to the same decline in value of the property. This rule prevents associated entities from claiming R&D tax credits twice for what is essentially the same amount of depreciation loss.

Profits on R&D services and property provided by associates (Schedule 21B Part B Clause 8)

Where a claimant acquires goods or services from an associated person for use in R&D, an R&D tax credit is not claimable for any profit margin that the associate gains in supplying the goods or services.

Example 31: 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.

Amounts in excess of market value for leasing property from associates (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 32: 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 R&D is not eligible for the R&D tax credit. Instead, lease or rent payments are eligible to the extent the land has been used in R&D.

It is not appropriate to give an R&D tax credit for land purchased for use in R&D for two reasons. The first is it is difficult to apportion what cost of the land relates to R&D given the land could be used for non-R&D purposes later. The second reason is that land generally appreciates and therefore can be sold to recoup the cost.

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 ineligible for the R&D tax credit. Fees paid to a tax agent to prepare an 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.

Professional fees are excluded because they do not relate to resolving the scientific or technological uncertainty.

Expenditure to commercialise the results of an R&D activity (Schedule 21B Part B Clause 20)

Expenditure incurred to commercialise the results of an R&D activity is ineligible for the R&D tax credit.

Commercialisation of the R&D generally happens after the scientific or technological uncertainty has been resolved, so has been excluded for the avoidance of all doubt. However, if during commercialisation new scientific or technological uncertainty arises that requires resolution, a new R&D activity may arise.

Example 33: 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.

Boffita Bovine 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, but does not apply to software.

This expenditure is excluded because the R&D tax credit is not intended to fund one business paying to use intangible property created as a result of R&D performed by another business.

Costs associated with creating intangible assets from R&D activities, such as plant variety rights, may be eligible but only to the extent the creation of the intangible assets involves the resolution of scientific or technological uncertainty.

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.

Expenditure on software that is widely available, such as Microsoft Excel or project management software, may be eligible expenditure.

Bespoke software has been excluded due to fiscal risk.

Internal software development expenditure exceeding $25 million (Schedule 21B Part B Clause 16, section YA 1 definition)

Expenditure incurred on internal software development that enhances the non-digital services a business offers its customers is subject to a $25 million cap. Expenditure on this kind of software development that exceeds $25 million is therefore not eligible.

This cap groups a claimant's expenditure with that of the claimant's associates, so that the total that may claimed combined is limited to $25 million.

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.

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 exclusion includes technology that is extended, continued, developed or completed by R&D and is intended to prevent a person from obtaining an R&D tax credit for someone else's R&D

Market value related exclusions including feedstock

Above market value goods or services (Schedule 21B Part B Clause 17)

Expenditure on goods or services is ineligible to the extent it exceeds market value. The market value is the price that buyers in an arm's length transaction would be willing to pay for the good or service.

This provision is intended to apply broadly, so applies to transactions with associates and third parties. It targets arrangements where a person deliberately attempts to increase their eligible expenditure by paying above market value for a good or service.

F

eedstock rule (Schedule 21B Part B Clause 22)

For items used in, processed, or transformed as part of R&D activities, only the net expenditure is eligible. In other words, only the excess of the cost of a person's inputs over the market value of their outputs is eligible.

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: the physical good subject to or used in the process or transformation, and • 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.

Example 34: 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
Total cost of inputs	**$2,500**

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.

The feedstock rule ensures a business only gets a tax credit for the extra costs associated with their R&D.

Tax credits from another country, gifts and grants

Gifts (Schedule 21B Part B Clause 18)

A person who receives a gift and uses it in R&D is not able to claim an R&D tax credit on the value of that gift. Similarly, the person who gifted the good or service to the person is not able to claim a credit on the value of the gift.

Gifts are ineligible as only costs of doing R&D are eligible for the credit.

The cost of a gift given to a person to get them to participate in R&D, 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:

- expenditure funded by a government or local authority grant - for example if a business receives a grant and spends it on what would otherwise be eligible expenditure, that expenditure is ineligible; and
- co-funding – if a business or a third party contributes funds as a condition of obtaining a government or local authority grant, expenditure paid for by these funds is ineligible.

NEW LEGISLATION

Example 35: 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 36: 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.

Such expenditure is ineligible because the expenditure has either already been subsidised by the Government or relates to an activity that the Government has already subsidised.

Expenditure for which a person has received an R&D tax credit from another country (Schedule 21B Part B Clause 23)

Expenditure for which a person has received a tax credit in another country is not eligible to get the credit in New Zealand as it is not appropriate to give two credits for the same expenditure.

Example 37: 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. 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.

Application date

From the 2019-20 income year.

TAX CREDIT CALCULATION AND CAP

Section LY 4 of the Income Tax Act 2007, section 68CD of the Tax Administration Act 1994

Key features

Tax credit calculation

A person's R&D tax credit is calculated as follows:

$$0.15 \times \text{total eligible R \& D expenditure.}$$

Total eligible R&D expenditure is defined to mean:

- if a person's expenditure is less than $120 million, the person's actual eligible expenditure (see the section on *Eligible expenditure* for more information).
- $120 million if a person has exceeded the $120 million expenditure cap in section LY 4(3)(a) but has not received approval to exceed the cap; or
- a person's approved R&D cap, if the person has received approval from the Commissioner to exceed the expenditure cap under section 68CD.

Applying to exceed the expenditure cap

A person who expects to have more than $120 million of eligible R&D expenditure in an income year may apply to the Commissioner of Inland Revenue to exceed the expenditure cap.

Applications to exceed the cap must be made by the seventh day of the second month after the end of the relevant income year. For example, for a business whose income year ended on 31 March 2021, an application to exceed the cap would need to be filed by 7 May 2021.

The Commissioner can only approve applications to exceed the cap if satisfied that an applicant's R&D activities will give rise to a substantial net benefit for New Zealand. The Commissioner is also required to consult with the Chief Executive of the Ministry of Business, Innovation and Employment.

The cap contains the fiscal risk associated with the R&D tax credit regime. The Government believes it is important, however, for businesses to be able to apply to exceed the $120 million cap if their R&D is expected to result in a substantial net benefit for New Zealand.

The information that is likely to be required to demonstrate a substantial net benefit for New Zealand includes:

- impacts on New Zealand based economic activity;
- impacts on job opportunities and skills of New Zealanders;
- enhancements to market competition, efficiency, productivity, and service levels in New Zealand;
- wider benefits to New Zealand; and
- the durability and sustainability of the benefits to New Zealand.

Application date

From the 2019–20 income year.

RECEIVING YOUR R&D TAX CREDIT

Sections LA 4, LA 5, LY 1, LY 8, OB 4, OB 9C, OK 2, OK 6C, OP 5, OP 7, OP 11C, YA 1, Tables O1, O17 and O19.

Background

This section explains how a person can receive their tax credit and how existing tax rules, such as imputation and carry forward rules, apply when a person receives the R&D tax credit.

Key features

- R&D tax credits are offset against a taxpayer's tax liability, or refunded up to $255,000 for companies with at least 20% of their salary and wage costs related to R&D.
- R&D tax credits are applied to a person's income tax liability after imputation credits, but before refundable tax credits. The oldest R&D tax credits (i.e. from previous tax years) are used first.
- Any surplus R&D tax credits may be carried forward to a future tax year, subject to shareholder continuity requirements for companies.
- Companies and Maori authorities receive imputation and Maori authority credits equal to their R&D tax credit.

Detailed analysis

How the R&D tax credit is applied (section LA 4)

R&D tax credits are first used to satisfy a claimant's income tax liability, if any, for the income year the credit relates to. Tax credits are used in the following order:

1) Non-refundable tax credits (which are extinguished if you don't 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.

Different rules apply to the remaining R&D tax credits depending on whether they are refundable or not, as outlined in the below table:

Treatment of remaining R&D tax credits	
Non-refundable credits	**Refundable tax credits**
Any remaining non-refundable tax credits can only be offset against income tax liabilities in the current year and must then be carried forward.	Before any remaining refundable R&D tax credits can be refunded, the credits must first be applied to any other liabilities in the following order: 1. An income tax liability for the current year; 2. An income tax liability for a previous year; 3. An income tax liability for a future tax year; 4. A current provisional tax liability for a future tax year; and 5. A different tax period or type (as requested by the claimant, or as applied by Inland Revenue if the claimant has any other tax outstanding).

Example 38: How R&D tax credits are applied

Vicki is entitled to $500,000 of R&D tax credits in the 2022 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.
2. The remaining $195,000 is carried forward to the next tax year.
3. The $255,000 of refundable credits must first be applied to the $200,000 liability outstanding from the previous tax year.
4. The final result is Vicki gets $55,000 R&D tax credits refunded, $195,000 carried forward, and all outstanding tax liabilities are satisfied.

Reduction of provisional tax (Section YA 1)

R&D tax credits are subtracted from a taxpayer's residual income tax figure. A person's residual income tax is their tax to pay after all available tax credits have been subtracted.

Payment of provisional tax is generally based on the taxpayer's residual income tax for the previous year. For example, under the standard method for paying provisional tax the amount payable is 105% of the person's residual income tax for the preceding tax year. By ensuring that R&D tax credits are taken into account in calculating a person's residual income tax, taxpayers using this method will have reduced provisional tax payments in the following year.

Taxpayers who wish to benefit from R&D tax credits via reduced tax payments in the current year may use the estimation method for paying their provisional tax. Using this method will result in use-of-money interest being charged if provisional tax is underpaid (for example, if the taxpayer's R&D tax credit claim ends up being less than anticipated, or if it wasn't allowed).

Refundable R&D tax credits (Section LA 5)

Companies 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) provided the company:

- is in a tax loss position, or is in a tax paying position but has surplus R&D tax credits;
- has no outstanding tax to pay;
- satisfies the R&D tax loss cash-out corporate eligibility and wage intensity criteria in sections MX 2 and MX 3 of the Income Tax Act 2007; and
- does not derive exempt income (other than dividends under section CW 9 and CW 10 of the Income Tax Act 2007) and are not associated with anyone who derives exempt income.

These refundability criteria only apply for the first year of the R&D tax credit regime. The R&D tax incentive was developed under tight timeframes, so there was insufficient time to resolve some complex issues before legislation was drafted, such as refundability. As a result, the refundability rules in place for the first year of the regime mirror the existing tax loss cash-out rules. The Government has committed to reviewing the refundability rules, so that broader, more accessible refundability rules are available from year 2 of the incentive (the 2020-21 income year).

NEW LEGISLATION

Corporate eligibility criteria

The corporate eligibility criteria are met if a person:

- is a company (this includes companies incorporated part way through an income year);
- is tax resident in New Zealand;
- is not treated as tax resident in another jurisdiction under a double tax agreement;
- does not have fifty percent or more of its shares held by a public or local authority, a Crown Research Institute, or a State enterprise;
- is not an entity 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
- is not a listed company or otherwise listed on a recognised exchange.

Wage intensity criteria

The wage intensity criteria are set out in section MX 3. To be eligible, twenty percent or more of a firm's labour costs must be R&D related. If the company is part of a group of companies, the amount calculated for the R&D group (in the aggregate) should also be twenty percent or more, as explained TIB Vol 28 No 3 April 2016, published guidance for the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Act 2016. Wage intensity for the R&D tax credit regime is calculated in the same way as for the R&D tax loss cash-out regime.

Carry forward (Sections LY 1 and LY 8)

A business may carry forward any surplus R&D tax credits to the next tax year. For companies, the remaining tax credits are extinguished and must not be carried forward unless a group of persons has, for the continuity period:

- minimum voting interests in the company of forty nine percent or more; and
- if a market value circumstance exists for the company in the continuity period, minimum market value interests in the company of 49 percent or more.

Continuity period

The continuity period starts from the beginning of the income year in which the R&D tax credits arises and ends on the last day of the income year to which the R&D tax credit has been carried forward to.

Minimum voting interest

A minimum voting interest is the lowest voting interest that a person has in the company. A person's voting interest in a company is determined by the percentage of the total shareholder decision making rights, ascertained from shares or options over shares, the person holds for the company.

Market value circumstance

A market value circumstance exists where a person's voting interest in the company does not accurately reflect their economic interest in the company. The market value interest takes into account debentures, shares, options or other arrangements which could affect the balance of interests within the company so that a simple examination of voting power would be misleading.

Example 39: Shareholder continuity requirements are 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
		Total	**65**

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 ÷ 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 40: Shareholder continuity requirements breached

Same facts as above, 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
		Total	**45**

The minimum voting interests in Charlie Ltd over the relevant period are 45% (45 ÷ 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.

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% (65/100 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.

Part-year continuity rules (Section LY 8)

Where a taxpayer breaches the continuity rules for a full income year, a portion of the R&D tax credits that relate to the part of the year where continuity of ownership was met may be carried forward.

This can apply in the year the R&D occurs, or in the profitable year which the business is carrying the credits forward to. The business will need to keep adequate financial statements to apportion the 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 2019-2020 income year. On 26 June, the majority shareholder, James, sells his shares 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 2019**
	1 April 2019	**26 June 2019**	
James	60	0	0
Stephanie	25	25	25
Kelvin	15	15	15
Brya	0	60	0
		Total	**40**

Minimum voting interests in ABC Ltd			
Shareholders	**Shares held as at**		**Minimum voting interests as at 26 June 2019**
	26 June 2019	**31 March 2021**	
Brya	60	60	60
Stephanie	25	25	25
Kelvin	15	15	15
		Total	**100**

Continuity is breached on June 26 as minimum voting interests in the company fall below 49%. However, from 26 June 2019 to 31 March 2021 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 2019 and 31 March 2020 the firm incurred $148,000 of eligible R&D expenditure. This equates to a credit of $22,200.

1 April 2019 to 26 June 2019	26 June 2019	26 June 2019 to 31 March 2020	1 April 2020 to 31 March 2021
R&D tax credit of $9,000.	Continuity breached. Credits extinguished because no income tax to pay and eligible for refundability.	R&D tax credit of $22,200. No income tax to pay and not eligible for refund. Credits can be carried forward.	$22,200 of credits brought forward. Can be offset against ABC Ltd's income tax liability of $30,000.

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.

NEW LEGISLATION

Example: Continuity lost in profitable year

BCD Ltd performs R&D in the 2019-2020 year and receives a credit of $50,000 but is in loss so cannot use its credit. In the 2020-2021 year the firm has tax to pay of $70,000. Part way through the 2020-2021 year part of the company is sold. The shareholding is as follows:

Minimum voting interests in BCD Ltd			
Shareholders	**Shares held as at**		**Minimum voting interests as at 30 September 2020**
	1 April 2019	**30 September 2020**	
B	60	0	0
C	40	40	40
D	0	60	0
		Total	**40**

Continuity is breached on 30 September as minimum voting interests in the company fall below 49%. However, continuity was maintained between 1 April 2019 and 30 September 2020 as minimum voting interests up until this point are 100%. BCD Ltd has kept detailed financial statements and can show that from 1 April 2020 to 30 September 2020 the firm has made a profit that corresponds with a tax liability of $40,000.

1 April 2019 to 21 March 2020	1 April 2020 to 30 September 2020	30 September 2020	1 October 2020 to 31 March 2021
$50,000 R&D tax credits. Not refundable, so carried forward.	$40,000 income tax liability. Credits bought forward and $40,000 offset against tax bill.	Shareholder continuity breached. Remaining $10,000 of tax credits extinguished.	$30,000 income tax liability. No credit available to offset tax due.

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 credits is lost and cannot be used to offset the tax liability of $30,000 in the second half of the 2021-2022 tax year.

Imputation and Māori Authority Credits (Section OB 4, OB 9C, OK 2, OK 6C, OP 5, OP 7, OP 11C, and Tables O1, O17 and O19)

Companies, consolidated imputation groups and Māori authorities performing R&D receive an imputation credit or Māori authority credit respectively, equal to their R&D tax credit per sections OB 9C, OP 11C and OK 6C.

The imputation credit or Māori authority credit arises on the date the company or Māori authority files its income tax return.

Unless an imputation or Māori authority credit (as applicable) is credited equal to the R&D tax credit, the R&D tax credit will be "clawed back" when a company or Māori authority makes a distribution. This is illustrated in the below table:

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
Income tax payable			
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
Imputation credits		**Imputation credits**	
Tax paid	$13	Tax paid	$13
Imputation credits for R&D tax credit	**$0**	**Imputation credits for R&D tax credit**	**$15**
	$13		$28
Retained earnings		**Retained earnings**	
Pre-tax income	$100	Pre-tax income	$100
Tax expense	($13)	Net tax expense	($13)
	$87		$87
Dividend to shareholder*		**Dividend to shareholder***	
Cash dividend	$87	Cash dividend	$87
Imputation credits	$13	Imputation credits	$28
	$100		$115
Shareholder tax to pay		**Shareholder tax to pay**	
Tax at 28%	$28	Tax at 28%	$32
Imputation credits	($13)	Imputation credits	($28)
Shareholder tax to pay	**$15**	**Shareholder tax to pay**	**$4**

Sections OB 4, OP 7 and OK 2 ensure that companies, consolidated imputation groups and Māori authorities do not receive an imputation credit or Māori authority credit, as applicable, for tax paid by crediting an R&D tax credit. Without these amendments the company or Māori authority would receive double the amount of imputation credits than was intended – the first amount when the entity filed its income tax return, and the second amount when the entity used the R&D tax credit to satisfy a tax liability.

Application date

From the 2019–20 income year.

INTEGRITY MEASURES

Sections GB 56, LY 3(2)(a), LY 9, LY 10 of the Income Tax Act 2007, Sections 3, 33E, 68CE, 89DA, 108, 113E, 141EC, and schedule 7 clause 39.

Background

The R&D tax credit rules include various integrity measures to ensure the R&D tax credit regime is sustainable over time.

Key features

- The Commissioner may reduce a claimant's R&D tax credit claim to the amount the Commissioner considers appropriate where an arrangement exists that has the purpose or effect of defeating the intent and application of the R&D tax credit rules.
- The Governor-General may, by Order in Council, amend the lists of ineligible activities and eligible and ineligible expenditure.
- The Minister of Research, Science and Innovation must commission an objective and independent review of the R&D tax credit regime every 5 years.
- Limits are imposed on a taxpayer's ability to increase their R&D tax credit claim after it has been filed.
- The promoter penalty regime applies to people offering schemes involving R&D tax credits.
- Claimants cannot obtain a binding ruling on a question related to an R&D tax credit.
- Inland Revenue can share information with specified government agencies for the purposes of administering, evaluating, policy formation of, and statistical reporting for the R&D tax credit regime.
- The Commissioner is required to publish the name of those who have received R&D tax credits and the amount of their tax credit in dollar bands, two years after the end of the year to which the claim related.

Detailed analysis

Anti-avoidance rule (Section GB 56)

The Commissioner may reduce a person's R&D tax credit claim where an arrangement exists that has the purpose or effect of defeating the R&D tax credit rules. The person does not need to be a party to the arrangement for this reconstruction to occur.

This includes an arrangement with a purpose or effect of:

- treating ineligible expenditure as eligible expenditure;
- claiming inflated expenditure; or
- 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; and
- undertaking of real risks by the parties.

Where there are multiple purposes or effects, the purpose or effect to defeat the R&D tax credit rules must be more than merely incidental. This will depend on the facts and circumstances surrounding the arrangement.

The reconstruction provision refers to reducing the person's entitlement. This means that where there is an offending arrangement, the Commissioner may still give a credit for any legitimate expenditure that is part of the arrangement.

An anti-avoidance rule is necessary to uphold the integrity of the regime and to ensure government money is not misappropriated.

Orders in Council (Section LY 9)

The Governor-General may, by Order in Council, amend:

- the list of ineligible activities (Schedule 21 of the Income Tax Act 2007), and
- the 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.

A change made by Order in Council will apply for 4 years, from the tax year following the year in which it was made.

The flexibility offered by the ability to amend schedules 21 and 21B by Order in Council is necessary for three key reasons:

- 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.
- It enables the Government to make changes to the lists where the Government's policy intent has changed.
- 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.

Evaluation (Section LY 10)

The Minister of Research, Science and Innovation is required to conduct an independent and objective evaluation of the R&D tax credit regime every five years and report the results to Parliament. This first report is due as soon as practicable after the end of the 2023/24 tax year.

Regular evaluations are intended to contribute to the maintenance of the regime by independently identifying strengths and deficiencies in a timely manner. The Minister's report must evaluate the tax credit on:

- the delivery of the policy intent of the regime;
- the stimulation of spending on research and development activities;
- the compliance costs of the regime;
- the administration of the regime;
- the compliance with the legal requirements of the regime by taxpayers; and
- any other criteria specified by the Minister of Research, Science and Innovation.

Deadlines for filing and amending assessments (Section 33E, LY 3(2)(a), 89DA, 108, 113E)

Return due dates

The R&D supplementary return must be filed by 30 days after the due date for the income tax return.

A person will be prevented from claiming the R&D tax credit if they file their income tax return for the relevant year more than 1 year late.

Notice of proposed adjustments (NOPA) and section 113 adjustments

A person is only able to issue a NOPA or make a section 113 request to increase their R&D tax credit claim once, provided they have filed their R&D supplementary return by the due date.

The NOPA or section 113 request must be made within one year of the person's income tax return due date to which their R&D tax credit claim relates.

Time bar

The Commissioner cannot increase the amount of a person's R&D tax credit if one year has passed from the due date of the person's tax return for the relevant tax year.

Policy rationale

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 is 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.

Promoter penalties (Section 141EC)

Promoters of an arrangement involving R&D tax credits 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.

Promoter

A person is a promoter where they:

- 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; or
- provide services on a contingency fee basis in relation to R&D tax credit claims.

A person will not be considered a promoter where their 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 service is provided on a contingency fee basis where the advisor's fee is conditional on the client's R&D tax credit claim being successful.

How the promoter penalty applies

A promoter of an arrangement involving R&D tax credits may be liable for a promoter penalty where:

- the promoter offers the arrangement to 10 or more people in a tax year; and
- one or more of those people receives a shortfall penalty for an abusive tax position as a result of the arrangement.

The penalty is calculated by adding up the total tax shortfalls resulting from the arrangement.

Example 41: A promoter providing services on a contingency fee basis

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 ten 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:

- its software was offered to more than ten people; and
- 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.

The promoter penalty regime has been extended to include promoters of R&D tax credit schemes to disincentivise the promotion of such schemes.

Binding rulings (Section 3)

The definition of proscribed question in the Tax Administration Act 1994 has been amended to prevent taxpayers from obtaining binding rulings related to research and development tax credits.

Binding rulings are not available in the first year of the R&D tax credit regime as Inland Revenue will not have sufficient resources to consider them. From the 2020–21 income year, general approval and criteria and methodologies approval will be available at no cost to the taxpayer, and will offer an alternative means of obtaining certainty on key questions of eligibility (see the section on In-year approval: general approval process for more information).

Secrecy (Schedule 7, clause 39)

Inland Revenue can share information related to a person's R&D tax credit claim with specified government agencies for the purposes of:

- Policy formation - 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 the legislation allows Inland Revenue to share information with these agencies for that purpose.
- Administration - The R&D tax credit scheme will be administered jointly by Inland Revenue and Callaghan Innovation. The legislation allows employees of Callaghan Innovation to access Inland Revenue information for that purpose.
- Advice - Inland Revenue may share information with staff from MBIE and Callaghan Innovation for the purposes of those staff offering research and development advice and incentives.
- Evaluation - 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 five years. Inland Revenue will share information as is necessary for the Minister to report.
- Statistical reporting - 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 and development in New Zealand.

Publication of claimant details (section 68CE)

Amendments have been made to require Inland Revenue to publish the names of those who have received R&D tax credits and the amount of the tax credit, in appropriate dollar bands, two years after the end of the tax year to which the claim relates.

Publishing the names of R&D tax credit recipients and the bands within which their claims fall provides transparency about how the R&D tax credit regime is operating.

Application date

From the 2019–20 income year.

BECOMING AN APPROVED RESEARCH PROVIDER

Sections 124ZH and 138E of the Tax Administration Act 1994

Background

A person needs to incur at least $50,000 of eligible R&D expenditure in an income year in order to claim the R&D tax credit. Amounts under $50,000, however, may be eligible where the person uses an approved research provider to perform the R&D on their behalf.

Key features

A person is an approved research provider if they apply, the Commissioner approves their application, and they keep appropriate records.

The Commissioner may only approve a person if the person is:

- capable of performing R&D activities on behalf of other people;
- has facilities in New Zealand to perform R&D activities;
- is available to perform R&D activities on behalf of third parties; and
- performs, or will perform, R&D activities for other people for market value consideration.

If a person receives approval, the Commissioner has to notify the person and publish their name in a publication chosen by the Commissioner. The Commissioner is able to revoke approval at her discretion, although if she does revoke an approval she must provide the person with the reason for the revocation and specify the date from which the revocation takes effect. A decision made by the Commissioner under the proposed new section cannot be challenged, except through judicial review.

Application date

From the 2019–20 income year.

IN-YEAR APPROVAL

Section LY 3(1)(d) of the Income Tax Act 2007, sections 68CB, 68CC and 124ZI of the Tax Administration Act 1994

Background

Most claimants intending to apply for R&D tax credits must obtain general approval of their R&D activities before filing their income tax returns.

Significant R&D performers (businesses with eligible expenditure exceeding $2 million in the income year) can either obtain general approval or can opt into a separate process of getting their R&D expenditure certified by R&D certifier. Claimants in the significant performer regime will also have the option of applying to the Commissioner for approval of their criteria and methodologies used to determine the eligibility of their R&D activities and expenditure.

General approval is designed to do the following:

- Provide certainty – taxpayers will be able to obtain approval of their R&D activities while they are undertaking them.
- Act as an integrity measure – requiring approval closer to when an R&D 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 (compared with an assessment occurring one or two years after the R&D activity wasis 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 is intended to reduce compliance costs for businesses that conduct a significant amount of R&D and would otherwise have to describe and obtain approval for each R&D activity. The optional criteria and methodologies approval process is designed to increase certainty for significant R&D performers.

Key features

From the 2020-21 income year, most businesses will be required to get their R&D activities approved by the Commissioner before being eligible to claim the R&D tax credit. This is known as general approval and can last for up to three income years.

Businesses that have or expect to have more than $2 million of eligible R&D expenditure in an income year must do at least one of the following:

- Obtain general approval; or
- Provide Inland Revenue with an R&D expenditure estimate and an R&D certificate alongside their supplementary return. An R&D certificate is expected to include information confirming that a sample of a business's R&D expenditure has been reviewed by an R&D certifier and calculated in accordance with the R&D tax credit rules. This alternative regime is known as the significant performer regime. Businesses in this regime will also have the option of applying to the Commissioner for approval of the criteria and methodologies they use in determining the eligibility of their R&D activities and expenditure.

Inland Revenue will run a pilot of both the general approval and criteria and methodologies approval regimes in the 2019-2020 income year. Businesses who participate in the pilot may be able to obtain either general approval or criteria and methodologies approval from the 2019-2020 income year. Firms interested in participating in the pilot are encouraged to enrol for the R&D tax credit online and contact Inland Revenue to indicate their interest in the pilot. More information on the pilot selection process will be available online later this year.

Detailed analysis

Under section LY 3(1)(d), a person is required to get their R&D activities approved under section 68CB or 68CC from the 2020-2021 income year in order to be eligible for the R&D tax credit.

General approval (section 68CB)

The general approval process and deadlines

Under the general approval process, a business is required to obtain approval of both core and supporting R&D activities. The application form will require an explanation of the activities the business is seeking approval for, and the income years for which the approval will apply. Approval is free of charge and can be obtained for up to three years and no fees will be charged for the approval.

Once general approval is granted, the Commissioner must notify the person which activities are approved, the income years for which the approval applies, and any conditions of the general approval.

The Commissioner's decision to approve or reject a general approval application cannot be challenged.

Applications for approval must be made by the seventh day of the second month after the end of the relevant income year. For example, a general approval application for a taxpayer with a 31 March 2021 balance date, would be due by 7 May 2021.

Validity of approval

General approval is valid and continues to apply if:

- a person's application is accurate;
- there haven't been any material changes to the R&D activities that were approved;
- the person satisfies any conditions of the general approval that have been set by the Commissioner; and
- there is no change to subpart LY (and any associated provisions) that materially alters the basis on which the general approval was provided.

If there have been any law changes which may affect a person's approval, Inland Revenue will contact the person to discuss varying the approval.

If the Commissioner has provided general approval for more than one income year under section 68 CB(3), then the person must provide the Commissioner with confirmation that they have continued to satisfy the conditions of their general approval.

Varying an existing approval

A person can apply to vary an existing general approval if their circumstances change. An application to do this must be submitted by the seventh day of the second month after the end of the relevant income year (which is the same application deadline for new general approval applications).

Variation of approval can be used to:

- add new R&D activities; and
- amend the information already provided to obtain general approval.

Supplementary returns

R&D supplementary returns will require information the expenditure incurred on R&D allocated to each activity. Since a person will have already provided information on their R&D activities as part of the general approval process, it is expected that little additional information on R&D activities will be required as part of the supplementary return.

A person will only be able to claim for activities that have materially changed if they have applied to vary their general approval application within the required timeframe (7 May after the income year for standard balance date taxpayers).

Significant performer regime (section 68CC)

A person that has or expects to have more than $2 million of eligible R&D expenditure in an income year must either obtain general approval or be part of the significant performer regime to be eligible for the R&D tax credit.

A person must notify the Commissioner if they wish to opt out of the general approval process and into the significant performer regime by the seventh day of the second month after the end of their income year. The person must also provide the Commissioner with an expenditure estimate. For partnerships and joint ventures, the total expenditure of the partnership or joint venture may be used rather than the partner or joint venture member's individual share.

Those in the significant performer regime may still obtain general approval if they choose to (for example, to obtain certainty as to whether a particular R&D activity is eligible).

For those who choose to opt-into the significant performer regime, there is an aspect of it that is compulsory and an aspect that is optional. It is compulsory to obtain an R&D certificate and provide an expenditure estimate, but it is optional to obtain criteria and methodologies approval.

R&D certificates

Claimants who opt-into the significant performer regime are required to supply the Commissioner with an R&D certificate alongside their R&D supplementary return.

The scope of R&D certificates is still being developed, but it is expected they will confirm that:

- an R&D certifier (typically a law or accounting firm) has reviewed a sample of a person's eligible R&D expenditure;
- the expenditure sample reviewed by the R&D certifier was calculated in accordance with the R&D tax credit rules; and
- the person actually incurred, or was reasonable in estimating that they would incur, more than $2 million of eligible R&D expenditure in the relevant income year.

R&D certificates are intended to provide the Commissioner with reasonable assurance that the person has complied with the R&D tax credit rules.

R&D certifiers

Section 124ZI sets out the requirements for R&D certificates and R&D certifiers.

A person must apply to the Commissioner to be an R&D certifier. This involves providing a statutory declaration declaring that they have the appropriate accounting, legal, scientific or technical expertise to complete an R&D certificate.

A person is ineligible to apply if they have had their R&D certifier status revoked in the last two years.

Once the Commissioner approves a person's application to be an R&D certifier, the Commissioner must notify the person and publish the approval in a publication chosen by the Commissioner.

The Commissioner is able to revoke approval of an R&D certifier at her discretion. If approval is revoked, this must be published in a publication chosen by the Commissioner.

The Commissioner must revoke a person's approval as an R&D certifier if:

- the person has been liable for a promoter penalty; or
- the person has provided an R&D certificate to another person who is liable for shortfall penalties in relation to R&D tax credits.

The Commissioner will not revoke an approval where a person has wilfully misled the R&D certifier. Once approval is revoked, the R&D certifier may not be reinstated as an R&D certifier for two years.

The Commissioner's decision to approve, decline to approve, or revoke the approval of an R&D certifier cannot be challenged.

Criteria and methodologies approval

People who opt into the significant performer regime are able to apply for optional criteria and methodologies ('criteria approval') approval free of charge. This involves applying to the Commissioner for approval of the criteria and methodologies the person uses to determine eligibility of their R&D activities and expenditure.

Criteria approval is voluntary and can be granted for up to three years. Where a multi-year approval has been granted, the person still must satisfy the $2 million significant performer threshold for each year the approval applies.

The process is designed to increase certainty for significant R&D performers. It is expected that the criteria and methodologies will vary on a case by case basis.

Example 42: Criteria and methodologies approval – dedicated R&D facility

A Co is a large R&D performer with 150 different R&D projects which each involve multiple R&D activities. Most of A Co's 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 performed by A Co, and these costs could outweigh the benefit to A Co of receiving R&D tax credits for its expenditure on the R&D activities. A Co applies for criteria approval so that it can develop and have approval for a consistent, compliant approach to identifying eligible R&D activities and expenditure.

A Co meets with Inland Revenue and develops criteria and methodology that enable it to reduce its compliance costs while nevertheless satisfying the Commissioner that A Co has satisfied the requirements of the R&D tax credit rules.

A Co expects to continue doing R&D for at least the next 3 years, so it receives criteria approval for the 2020/21, 2021/22 and 2022/23 income years.

Example 43: Criteria and methodologies approval – apportionment issues

Steph's engineering business does a lot of R&D and is developing a saw that can cut through almost any material. Steph's R&D is at the stage where the saws are being evaluated alongside other heavy duty saws that the business sells.

The commercial production rule applies. Steph is trying to determine the additional cost incurred in attempting to create her "cut-anything" saw. She comes to Inland Revenue to obtain approval of the methodologies she has used to apportion the additional cost.

Application process

Applications for criteria approval must detail:

- the criteria and methodologies the person wants the Commissioner to approve;
- the income years the criteria approval will apply for; and
- any other information required by the Commissioner.

The application is due by the seventh day of the second month following the end of the income year.

Once criteria approval is granted, the Commissioner must notify the person what criteria and methodologies the Commissioner approves of, the period for which the criteria approval applies, and any conditions of the criteria approval.

Validity of approval'

Criteria approval is valid and binding on the Commissioner if:

- a person's application is accurate;
- the person satisfies any conditions of the criteria approval that have been imposed by the Commissioner;
- there is no change to the R&D tax credit rules that materially alters the basis on which the criteria approval was provided; and
- the person satisfies the other requirements of the significant performer regime (that is, the person satisfies the $2 million threshold and supplies an R&D certificate alongside their R&D supplementary return).

Varying an existing approval

Similar to general approvals, a person may vary a criteria approval if their circumstances change. A variation application must be made by the due date for the approval (seventh day of the second month after the end of the income year).

Challenging approval decisions

Decisions made by Inland Revenue regarding criteria approvals cannot be challenged. However, Inland Revenue will only decline an application after first contacting the applicant to discuss it.

Revoking criteria and methodologies approval

The Commissioner can revoke a criteria approval from the beginning of an income year to which the approval relates if she considers that a person has classified their activities or expenditure in a way that defeats the intent and purpose of the R&D tax credit regime.

Application date

From the 2020-2021 income year (although note that the pilot approval provisions apply for the 2019-2020 income year).

SOFTWARE DEVELOPMENT

Section YA 1, Schedule 21 Parts A and B clause 11, Schedule 21B part B clause 16 of the Income Tax Act 2007

Background

Software development for the purposes of internal administration is excluded from the R&D tax credit, whereas internal software development with an external focus is subject to a $25 million cap, and software developed for sale is subject to the same $120 million cap that applies to all R&D expenditure.

The rationale for excluding or limiting claims for internal software development is the limited spill-over benefits and fiscal risk associated with internal software development activities.

Limited spill-over benefits

There is likely to be limited public benefit from internal software development related to the ordinary administrative functions of a business, such as a firm upgrading its internal HR system. This kind of upgrade is specific to the firm and is unlikely to reflect the circumstances that the policy recognises. It is recognised however that there may be some spill-over benefits from internal software development for non-standard business administration. As a result, it is subject to a $25 million cap.

Fiscal risk

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 regime. This is a further reason for the outright exclusion of standard administrative functions and the $25 million cap for non-standard administrative functions.

Key features

- Internal software development for the purpose of internal administration is excluded.
- Internal software development that enhances non-digital services to customers 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 is subject to the same $120 million cap that all other R&D expenditure is subject to.

Detailed analysis

Ineligible internal software development (Schedule 21 parts A and B clause 11, section YA 1)

Software development for the purpose of the internal administration of a person or their associate's business is not eligible for the R&D tax credit.

This exclusion covers all forms of software development related to "back office" administration activities, such as:

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

Software development in the above areas may still be eligible for the tax credit if:

- the person's main purpose behind the development is to sell the software, or a right to use the software, to third parties; or
- the software is an integral part of goods that the person sells.

Internal software development subject to the $25 million cap (Schedule 21B part B, clause 16, section YA 1)

A $25 million cap applies to software developed for the purpose of enhancing non-digital services to customers.

A service is a non-digital service if the main reason why the person's customers use it is to obtain the service, not to use the software (even though that service may be enabled, supported or facilitated by the software).

Example 44: Software that enhances non-digital 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, not to use the software he has developed.

The expenditure Mohammed's business incurred to develop the software is subject to the $25 million cap.

The $25 million cap groups the person's expenditure with internal software development already claimed by the person's associates. The rationale behind applying the cap to associated persons is to prevent the cap from being circumvented by the person splitting their expenditure across associates to effectively exceed 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).

Example 45: 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 Nayana Ltd. As XW Ltd and SL Ltd are associated persons for tax purposes, their combined claim may not exceed $25 million.

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.

There are two types of external software development.

Software that is sold

If the person's main purpose behind developing the software is to dispose of it to someone not associated to them, then it is considered external software development and not subject to the $25 million cap.

This software can still be used internally without being subject to the $25 million cap, provided the main purpose behind developing the software was to sell it.

Software that is an integral part of goods that are sold

Software a person develops which forms an integral part of goods that the person sells in their business is also external software development, and not subject to the $25 million cap.

This exception is targeted at firmware – such as the software that runs inside a washing machine or TV remote.

ADMINISTRATIVE REQUIREMENTS

Sections 22, 33E, 36BE, 36C of the Tax Administration Act 1994

Background

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; and
- file an R&D supplementary return containing information on the activity performed (until general approval applies) and expenditure incurred.

Key features

Record keeping requirements

- Claimants receiving R&D tax credits must keep sufficient records to show that they are an eligible person, perform R&D activities and have incurred eligible expenditure.
- Approved research providers must keep sufficient records to show:
  - they meet the requirements to be an approved research provider; and
  - the amounts derived and incurred by them in performing R&D activities on behalf of other persons.

The records must be kept for seven years after the end of the income year to which the records relate.

R&D supplementary returns

A person claiming an R&D tax credit must file an R&D supplementary return in an electronic format prescribed by the Commissioner within 30 days of the due date of their income tax return.

The Commissioner must prescribe one or more electronic formats in which a person's R&D supplementary return must be filed. The Commissioner may also set specifications for software for use in prepopulating the R&D supplementary return.

Detailed analysis

Record keeping requirements

Section 22 of the Tax Administration Act 1994 requires persons receiving an R&D tax credit and approved research providers to keep, for seven years, sufficient records so that the Commissioner may readily ascertain:

- the amount of the person's R&D tax credit; or
- in the case of approved research providers, their compliance with the requirements to be an approved research provider, and the amounts incurred by them in performing R&D activities on behalf of others.

For Inland Revenue to calculate and approve the R&D tax credit, the claim must be based on records which are created at the time the R&D was performed, not records which are backdated or created at year end.

These record keeping requirements go beyond the general financial records that businesses must keep under section 22.

A person claiming an R&D tax credit will need to keep records for seven years to substantiate the following:

- eligibility;
- R&D activity; and
- R&D expenditure.

The type of evidence required to substantiate the above could include project documentation (such as log sheets, project plans and test results), as well as minutes of meetings, internal reports, receipts and contracts.

The onus is on the person claiming the credit to have sufficient records. This means that where the person has engaged a contractor to perform the R&D activities, the person will need to ensure that the contractor can provide them with the required evidence of the activities undertaken and the expenditure incurred.

Business eligibility

Records will need to be kept to evidence the following:

- an R&D activity is performed in New Zealand;
- the person carries on business in New Zealand; and
- that:
  - the person, or a company that is in the same group of companies as the person and is resident in New Zealand or in a country with which New Zealand has a double tax agreement, owns the results of the R&D activity; or
  - the person has the ability to use the results for no further consideration.

R&D activity

It is proposed that a person must keep records to demonstrate that the activities they undertook met the definition of R&D activity. The type of records that must be kept include records which show:

- the purpose of the R&D;
- the scientific or technological uncertainty the R&D intends to resolve;
- the state of the knowledge that existed when the R&D was undertaken;
- why that uncertainty could not be resolved by information that is publicly available or deductible by a competent professional;
- the systematic approach that was undertaken to try resolve the uncertainty; and
- the nature of any supporting activities, and evidence to show they were integral to the core R&D activity.

R&D expenditure

Records kept in relation to expenditure will need to be sufficiently detailed to show:

- the connection between the expenditure and the eligible R&D activities;
- that the expenditure is on the list of eligible expenditure, and not on the list of ineligible expenditure;
- evidence of reasonable apportionment methods where the expenditure is incurred on R&D and non-R&D activities. For example, a time recording system or weekly project report to show the extent to which staff costs relate to eligible R&D activities;
- where R&D expenditure is incurred in a commercial production environment, evidence that the expenditure is additional expenditure. That is, the expenditure would not have been incurred in the absence of the R&D activity;
- the proportion of expenditure incurred on R&D activities conducted outside New Zealand; and
- the amount of expenditure incurred on internal software development.

Record keeping requirements for approved research providers

An approved research provider will need to keep records to show that they meet the following requirements of proposed new section 124ZH(4):

- They are capable of performing R&D activities on behalf of others not associated to them and are available to do so.
- They have, in New Zealand, the necessary facilities to perform those activities.
- They perform, or will perform, those R&D activities on behalf of others for market value consideration.

In addition, an approved research provider will need to keep records of the R&D activities they perform for others and the associated expenditure, to the same detail as described above.

R&D supplementary return

Due date

Section 33E provides that the R&D supplementary return is due on or before 30 days after the due date of the person's tax return. For taxpayers who do not have assessable income, the supplementary return is due on or before 30 days after the date the person's income tax return would have been due if they had assessable income.

The tax credit will be a claimed through the person's tax return, with the supplementary return submitted as evidence of the claim.

Electronic formats

Under section 36BE, the Commissioner must prescribe one or more electronic formats in which the supplementary return must be filed. Prescribing the electronic format includes the way the information must be delivered, as well as the content.

The section also allows the Commissioner to set specifications for software for use in prepopulating R&D supplementary returns. In the future, software will be able to be used to extract relevant information and assist in completing a person's supplementary return.

Content of supplementary return

In the first year of the tax credit, taxpayers will be asked for a description of their R&D activity and expenditure incurred.

The required information will include:

Activities:

- What systematic approach was used to conduct the activity?
- What new knowledge, process, service or good did the eligible R&D aim to produce?
- What scientific or technological uncertainty did the 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?
- For supporting activities, why were they integral to the core activity?

Expenditure on:

- consumables
- depreciation
- employee remuneration
- overheads
- contractors (including expenditure paid to an approved research provider)
- R&D activities conducted outside New Zealand
- Eligible internal software development
- items used in, or subject to, a process or transformation; and
- items used in the course of commercial production.

The supplementary return will also ask additional information such as whether the claimant is a member of a joint venture and whether a person associated to the claimant is also claiming the credit.

Taxpayers who are subject to the general approval process from the second year of the R&D tax credit regime will mainly provide expenditure information with their tax return, as information on their activities will have been provided during the year. However, they will be required to provide a declaration that their activities haven't materially changed from how they were described in their general approval application, and allocate their claimed expenditure to the relevant approved activity.

Application date

From the 2019-2020 income year.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

BR Pub 19/04: Income tax – application of the employee share scheme rules to employer issued crypto-assets provided to an employee

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of ss CE 1(1)(d), CE 2 and CE 7.

The Arrangement to which this Ruling applies

The Arrangement is the provision of crypto-assets by an employer (or another company in the same group) to an employee in connection with their employment in circumstances where:

- the employer (or other group company) is issuing crypto-assets (for example, through an Initial Coin Offering or a Token Generating Event);
- the crypto-asset is a "share" as defined in s YA 1 (i.e. it provides an interest in the capital of a company);
- the employee is not required to pay market value for the crypto-assets; and
- the crypto-assets are not provided under an exempt ESS as described in s CW 26C.

The Ruling applies only to employees and does not apply to providers of goods or services or self-employed taxpayers.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The provision of the crypto-assets by the employer (or other group company) to the employees is an "employee share scheme" as defined in s CE 7.
- Section CE 2 will apply to determine the value of the taxable benefit received by the employees.
- The amount of the taxable benefit will be the employees' employment income under s CE 1(1)(d).

The period or tax year for which this Ruling applies

This Ruling will apply for a period of three years beginning on 1 December 2019.

This Ruling is signed by me on 30 August 2019.

Susan Price
Director, Public Rulings

Commentary on Public Ruling BR PUB 19/04

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 19/04 (the Ruling).

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

Summary

1. This Ruling is related to BR PUB 19/03 (Income Tax – Employer issued crypto-assets provided to an employee) and considers the income tax treatment of specific types of employer-issued crypto-assets provided to employees. This Ruling covers the situation where a crypto-asset issued by the employer is a "share" in the employer (as defined in s YA 1). The commentary briefly discusses the application of the employee share scheme rules to the Arrangement. It also briefly discusses the definition of a "share" for tax purposes, and when crypto-assets may satisfy this definition.

Background

2. The crypto-asset industry is still evolving and there is currently no standard terminology used. The Ruling uses the term "crypto-asset" to cover digital assets that use cryptography and blockchain technology to regulate their generation and verify transfers.[1] The Ruling also uses the term "equity token" to cover a specific subset of crypto-asset.
3. It is becoming more common for employees (particularly those working in crypto-asset related industries) to receive remuneration in crypto-assets. The Commissioner has been asked to provide guidance on how remuneration paid in crypto-assets is taxed.
4. This Ruling sets out the Commissioner's view on the situation where an employee receives crypto-assets issued by their employer or another company in the same group (referred to together as "the employer" for ease of reference) that is a "share". This could occur in the context of an Initial Coin Offering, a Security Token Offering, an Initial Exchange Offering, a Token Generating Event or by other means.
5. The purpose of this Ruling and commentary is to raise awareness that a crypto-asset that provides an interest in the capital of a company may be subject to the employee share scheme rules. This Ruling does not provide detailed guidance on applying the employee share scheme rules. Detailed guidance on applying the rules is provided in *Tax Information Bulletin* Vol 30 No 5 (June 2018):52.

Application of the legislation

When do the employee share scheme rules apply?

6. Section CE 1 sets out when an amount derived by a person in connection with their employment will be their income. Under s CE 1(1)(d), a benefit received by an employee under an "employee share scheme" is income derived in connection with their employment.
7. Section CE 7 provides for the meaning of an "employee share scheme" as follows:

> **CE 7 Meaning of employee share scheme**
>
> **Employee share scheme** means—
>
> (a) an arrangement with a purpose or effect of issuing or transferring shares in a company (company A) to a person—
>
> (i) who will be, is, or has been an employee of company A or of another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (ii) who will be, is, or has been a shareholder-employee in relation to company A or in relation to another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (iii) who is an associate of a person described in subparagraph (i) or (ii) (person A), if the arrangement is connected to person A's employment or service; but…
>
> (b) does not include an arrangement that—
>
> (i) is an exempt ESS:
>
> (ii) requires market value consideration to be paid by a person described in paragraph (a) for the transfer of shares in the company on the share scheme taxing date:
>
> (iii) requires a person described in paragraph (a) to put shares, acquired by them for market value consideration, at risk, if the arrangement provides no protection against a fall in the value of the shares and none of the consideration for acquiring the shares is provided to the person under an agreement that it is used for acquiring the shares.

[1] These are sometimes referred to by other terms including "cryptocurrencies" and "tokens".

8. Accordingly, an employee share scheme is an arrangement that involves the issue or transfer of shares to an employee (or a person who has been or will be an employee). The employee share scheme rules may also apply if the shares are issued to an associated person of the employee in connection with the employee's employment.

9. The employee share scheme rules do not apply to arrangements that require employees to:

 - pay market value for the shares on the "share scheme taxing date" (generally the date on which the employee holds the shares like any other shareholder); or
 - put at risk shares they acquired for market value, where the scheme provides no protection to the person against a fall in the value of the shares.

10. The employee share scheme rules also do not apply to an exempt employee share scheme (referred to in the legislation as an "exempt ESS"), which is defined in s CW 26. This is discussed further from [19].

11. Section CE 2 provides that an employee who has acquired shares under an employee share scheme receives a benefit as calculated under that section. In essence, the calculation refers to the difference between the value of the shares and what was paid for them.

12. The timing of the benefit is provided in s CE 7B, which, in brief, is the time at which the shares are held by (or for the benefit of) the employee, where there is no material risk that the ownership may change (for example, if the employee must remain employed for a certain period).

13. Where the crypto-assets are not held by (or for the benefit of) the employee, or there is a risk of a change of ownership of the crypto-assets or that the benefit may be cancelled, the share scheme taxing date will not be satisfied under s CE 7B. *TIB* Vol 30 No 5 (June 2018) contains numerous examples of how the share scheme taxing date is determined. For example, if crypto-assets are held on trust and an employee must remain in employment for 12 months before the crypto-assets are transferred to the employee, the share scheme taxing date is not satisfied until the employee becomes entitled to the crypto-assets.

14. The rules operate to tax any benefit conferred on an employee by the issuance of shares in an employee share scheme in the same way as if the employee had received an equivalent cash payment followed by an acquisition of shares.

15. Section RD 7B provides that an employer may choose whether to withhold and pay an amount of tax relating to the benefit, but it does not have to. If an employer does not choose to withhold and pay tax, the employee will be liable for tax on their employment income under s CE 1(1)(d) if they are a New Zealand resident, or a non-resident who has earned the amount here (s YD 4(4)). This is the case regardless of whether the employer is a resident or non-resident.

16. The employee share scheme rules apply only to employees and do not apply to arrangements that involve issuing shares to other providers of goods or services.

What is a "share" for tax purposes?

17. As noted above, the employee share scheme rules apply where shares are issued to employees (and the employees do not pay market value for those shares). A "share" is not specifically defined for the purposes of s CE 7. A "share" is defined broadly in s YA 1 as follows:

> **share —**
>
> (a) includes any interest in the capital of a company:
>
> (b) includes a debenture to which section FA 2 (Recharacterisation of certain debentures) applies:
>
> (bb) includes a stapled debt security to which section FA 2B(2) (Stapled debt securities) applies:
>
> (c) includes a unit in a unit trust:
>
> (d) includes an investor's interest in a group investment fund if—
>
> (i) the fund is not a designated group investment fund; and
>
> (ii) the interest does not result from an investment from a designated source; and
>
> (iii) the investor's interest does not result from an investment made in the fund on or before 22 June 1983, including an amount treated as invested at that date as pre-1983 investments under section HR 3(8) (Definitions for section HR 2: group investment funds):
>
> (e) does not include a withdrawable share in a building society, except in the definitions of investment society dividend and withdrawable share:
>
> (f) *[Repealed]*
>
> (g) is further defined in section CW 26F (Meaning of share) for the purposes of section CW 26C (Meaning of exempt ESS)

18. The Commissioner considers that the most relevant definition for the purposes of this Ruling is that contained in para (a) above. This definition includes "any interest in the capital of a company". The definition of a "share" also specifically includes many instruments that are not shares under the Companies Act 1993 (CA 1993) such as profit related debentures, stapled debt securities, units in a unit trust, and interests in a group investment fund. These are all types of instruments that exhibit general features of equity.

19. Paragraph (g) above contains a specific definition in the context of employee share schemes. Section CW 26F provides:

> **CW 26F Meaning of share**
>
> For the purposes of section CW 26C, share means, for a company whose shares are made available under an exempt ESS, a fully paid ordinary share that ranks equally with, and has the same designation as, an existing ordinary voting share in the company.

20. This definition is limited to s CW 26C, which relates to an exempt ESS. Accordingly, this specific definition of a share (being one that is a fully paid ordinary share ranking equally with existing ordinary voting shares) is relevant only for determining whether there is an exempt ESS for the specific purposes of s CW 26C. This is because an exempt ESS must be widely offered to almost all employees and provide the same rights to all employees. This narrow definition of a share for these specific purposes would relate to all types of shares (whether in the more traditional sense or any crypto-assets that satisfy the definition in s YA 1).

21. The definition of "exempt ESS" is set out in the Appendix. Whether or not there is an exempt ESS in any particular circumstances is outside the scope of this Ruling.

What does "any interest in the capital of a company" mean?

22. The phrase "any interest in the capital of a company" reflects the common law meaning of a "share" rather than the CA 1993. For income tax purposes, this definition first appeared in the definition of a "shareholder" in the Land and Income Tax Act 1916 and has remained essentially unchanged from its original enactment (at which time the Companies Act 1903 was in force), despite the companies legislation undergoing significant changes since that time.

23. The *Concise Oxford English Dictionary* (12th ed, 2011) defines an "interest" as:

> **interest** … 4 a share or involvement in an undertaking. a legal concern, title, or right in property…

24. The ordinary meaning of "any interest" is broad, and can include a share, legal concern, title, right or claim. The use of the word "any" also indicates that the term takes a broad meaning for these purposes.

25. "Capital" is also a broad term and a company's capital may generally include assets, the sum of shareholders' contributions to a company, the stock with which a company enters business and accumulated wealth.

26. In *IRC v Woolf* [1962] 1 Ch 35, the English Court of Appeal was considering whether debenture holders were "members" of a company, which was defined with reference to whether they had "an interest in the capital or profits or income" of the company. Upjohn LJ said at 46 and 47:

> The share or interest of a member in the capital of a company has no precise legal signification. In the context it may refer to the share or interest of the member in the issued share capital, or it may refer to his ultimate right to receive a dividend in liquidation after all creditors have been discharged…
>
> …
>
> … Further, the debenture-holder has no interest in the capital of the company. If "capital" refers to the share capital, that is obviously so. If it refers to the surplus in a winding-up, the debenture-holder will have been paid off before the surplus can be ascertained.

27. Upton LJ considered there needed to be a right or an expectation to share in a company's share capital or net capital (being the difference between assets and liabilities), even if that were through a liquidation of the company. A creditor does not hold an interest in the capital of a company, but rather holds an interest in its assets. These comments indicate that an "interest in capital" is a participating interest, suggesting a participation in the surplus assets on winding up of a company. A contractual debt interest is not sufficient.

28. Similarly, Donovan LJ said at 45:

> The word "capital", where it occurs as part of the definition of "member", may mean issued share capital or the net capital, being the difference between assets and liabilities, or it may mean both. …

29. Accordingly, in *Woolf*, a reference to "capital" of a company was taken to mean share capital and net capital (assets less liabilities) and included the right to receive distributions on a winding up, after all creditors have been paid.

30. Earlier case law on the meaning of a "share" (for companies law purposes) took a narrower view of capital, referring more specifically to "share capital". For instance, in *Borland's Trustee v Steel Brothers and Co Ltd* [1901] 1 Ch 279 Farwell J stated at 288:

> A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second… A share is not a sum of money settled in the way suggested, but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.

31. In *Bradbury v English Sewing Cotton Co Ltd* [1923] AC 744 (HL) Lord Wrenbury stated at 767:

> … A share is, therefore, a fractional part of the capital. It confers on the holder a certain right to a proportionate part of the assets of the corporation, whether by way of dividend or of distribution of assets in winding-up.

32. The concept of a share relating to a fractional part of capital is no longer relevant under the CA 1993, which provides that a share is personal property and provides a bundle of rights (being the rights generally set out in s 36 of the CA 1993, but which may be varied by the constitution or terms of issue of the share).

33. The decision in *Inland Revenue Commissioners v Tring* [1939] 2 All ER 105 (CA) also focused on whether a person held an interest in the capital of the company. The Court of Appeal upheld Macnaghten J's decision in the lower court (*Inland Revenue Commissioners v Tring* [1939] 1 All ER 148). Macnaghten J had stated at 152:

> I think that the words "share or interest in the capital or profits or income of a company" mean just what they say – anybody who has either a share in the capital or profits or income or has any interest in the capital or profits or income. I think the word "capital" there may cover, not only share capital, but also the pecuniary capital of a company, its capital assets.

34. Accordingly, "any interest in the capital of a company" for the purposes of the definition of a "share" in s YA 1 may refer to the person's interest in issued share capital, and a right to a share in the surplus assets on a wind up, and may include rights to other distributions. An interest in a company's capital is an interest in the performance of the company that is of an equity nature (rather than a debt or contractual right to receive payments).

35. In the GST context, the High Court in *CIR v Gulf Harbour Development Ltd* [2004] 2 NZLR 768 (HC) considered whether redeemable preference shares (RPS) were an "equity security" for GST purposes. An "equity security" is similarly defined for GST purposes as a "share in the capital of a body corporate". The RPS provided rights to membership in a club, but excluded voting rights, dividends and a share of surplus assets over and above what the members had put in. The High Court noted that the reference to a "share in the capital of a body corporate" was based on the companies legislation although (at [42] to [43]) noted that the CA 1993 had removed any reference to capital from the share definition, and instead introduced the solvency test. The court concluded:

> [47] It is undeniable that "membership shares" are "redeemable shares" within the meaning of s 68. It is also undeniable that the holder of the redeemable share contributes to "the capital of a body corporate" where, as here, the holder of the redeemable share has an entitlement in the event of liquidation within 75 years to return of the investment. That is in a very real sense "an interest in or right to a share in the capital" despite that fact that after 75 years the company may redeem the share for payment of $1 and the "share" will be a tiny fraction of the consideration originally paid.

36. The RPS holder contributed to the capital of the company where they had an entitlement in a liquidation (within 75 years) to a return of the investment. Relevantly for the present context, the decision indicates that an instrument that allows the holder to receive a return of the amounts contributed in a liquidation could satisfy the phrase "any interest in the capital of a company".

When could crypto-assets issued by an employer be a share?

37. This Ruling applies to certain types of crypto-assets (which may commonly be described as "equity" tokens) that provide ownership interests in entities. An equity token is a type of security token representing ownership or an interest in a venture. Equity tokens may provide holders with voting interests and an entitlement to a share in profits of a venture but these may not necessarily be a share unless they provide an interest in the company's capital. This distinction is important. The Ruling does not apply to all equity tokens, but only those that provide an interest in the capital of the company that issues them. In addition, the Ruling does not apply to other types of tokens (e.g. other security tokens, intrinsic tokens, asset tokens or utility tokens) unless they contain hybrid features and include interests in the capital of the company. The token issuance could occur as part of an Initial Coin Offering or Token Generating Event undertaken by the employer, or in other circumstances.

38. Crypto-assets that provide an interest in the capital of a company, such as the right to receive a share in the surplus assets on a winding up of the company and potentially other distributions from the company, will be a "share" for income tax purposes. To qualify as a share, the interests need to be by way of an equity interest in the company's performance, and

not simply a debt or other contractual right to receive payments. For completeness, the relevant interest must be in a company, so this would not include any interests in a decentralised autonomous organisation that operates over the blockchain, nor would it include a token that only provides interests in a platform.

39. Given that this will be highly fact specific and will depend on the terms of each particular crypto-asset issued, this Ruling does not rule on when a crypto-asset will be a "share". To determine whether a crypto-asset is a "share" it will be necessary to carefully consider the terms and conditions on which the crypto-asset is issued. This commentary can be used as guidance.

40. As an aside, given the broad definition of a "share" for tax purposes, there is often different categorisation of instruments for company law and regulation purposes. Crypto-assets that are a "share" for tax purposes may not necessarily be a "share" for the purposes of the CA 1993 or an "equity security" under the Financial Markets Conduct Act 2013 (FMCA 2013). For example, a profit-related debenture is a "share" for income tax purposes, a "debt security" for GST purposes, a "debt security" under the FMCA 2013, and is not a share under the CA 1993. The intention of including various equity instruments as a share for tax purposes is to generally treat instruments that have equity features as being a share if they involve distributions of company profits to the holder (and the holder has essentially borne the economic cost of the tax paid by the company).

41. Accordingly, crypto-assets issued by an employer that provide employees with certain rights such as a right to share in surplus assets on a wind up, will be a "share" under s YA 1 (even if not a "share" for the purposes of the CA 1993 or an "equity security" under the FMCA 2013). The issue of such crypto-assets to employees will be within the definition of an "employee share scheme" in s CE 7, and subject to s CE 2. If an employee receives crypto-assets from an employer under an employee share scheme and pays less than market value, the difference between the market value and any amount they paid will be employment income under s CE 1(1)(d).

42. Accordingly, the Commissioner considers that the employee share scheme rules will apply in circumstances where an employer issues crypto-assets to employees in connection with their employment, and:

- the crypto-assets provide an interest in the capital of the company;
- the employer does not require the employees to pay market value for the crypto-assets; and
- the provision of the crypto-assets is not an exempt ESS.

Examples

43. The following two examples explain the application of the law.

Example 1: Crypto-assets that provide interests in a platform

44. DigitalKeyChain Ltd, a New Zealand incorporated limited liability company, is developing a new blockchain based platform for property sales. DigitalKeyChain Ltd issues its own crypto-asset, D-KEYs, by way of an ICO.

45. DigitalKeyChain Ltd employs five full time employees. As DigitalKeyChain Ltd is unable to pay competitive rates, it proposes to provide each of the full-time employees with D-KEYs issued in the ICO to the value of NZD$5,000.

46. The D-KEY whitepaper provides that a certain number of D-KEYs are required for users to access the platform and provides holders with voting rights over the operation of the platform.

47. The D-KEYs are not "shares" as they do not provide an interest in the capital of DigitalKeyChain Ltd. Accordingly, the employee share scheme rules do not apply. However, other employment income rules are likely to apply to the benefit received by the employees (as set out in BR PUB 19/03: Income Tax – employer issued crypto-assets provided to an employee).

Example 2: Crypto-assets that provide rights on a wind-up

48. Assume that, in addition to the facts set out above, the whitepaper and relevant terms and conditions of issue provide that D-KEY holders will receive (at the discretion of the directors) a right to distributions of DigitalKeyChain Ltd's profits.

49. The whitepaper and relevant terms and conditions also provide D-KEY holders with a right to a share in surplus assets on a liquidation of DigitalKeyChain Ltd after all creditors have been paid. In these circumstances, the D-KEYs are "shares" under s YA 1.

50. The employee share scheme rules will apply to the D-KEYs issued to the five employees. The employees did not pay anything for the receipt of the D-Keys, so the full market value will be employment income.

References

Related rulings

BR PUB 19/01: Income tax – salary and wages paid in crypto-assets

BR PUB 19/02: Income tax – bonuses paid in crypto-assets

BR PUB 19/03: Income tax – employer-issued crypto-assets provided to an employee

Subject references

capital of a company
cryptocurrency
crypto-assets
employee
employee share schemes
income tax
share

Legislative references

Companies Act 1993, s 36

Financial Markets Conduct Act 2013

Income Tax Act 2007, ss CE 1(1)(d), CE 2, CE 7, CE 7B, CW 26, CW 26F, RD 7B, YA 1 (definition of "share")

Case references

Borland's Trustee v Steel Brothers and Co Ltd [1901] 1 Ch 279

Bradbury v English Sewing Cotton Co Ltd [1923] AC 744

CIR v Gulf Harbour Development Ltd [2004] 2 NZLR 768 (HC)

Inland Revenue Commissioners v Tring [1939] 2 All ER 105

IRC v Woolf [1962] 1 CH 35

Other references

Concise Oxford English Dictionary (12th ed, 2011)

"Employee share schemes", *Tax Information Bulletin* Vol 30, No 5 (June 2018): 52

Appendix – legislation

Income Tax Act 2007

Section CE 1(1) provides:

CE 1 Amounts derived in connection with employment

Income

(1) The following amounts derived by a person in connection with their employment or service are income of the person:

(a) salary or wages or an allowance, bonus, extra pay, or gratuity:

(b) expenditure on account of an employee that is expenditure on account of the person:

(bb) the value of accommodation referred to in sections CE 1B to CE 1E:

(c) [Repealed]

(d) a benefit received under an employee share scheme:

(e) directors' fees:

(f) compensation for loss of employment or service:

(g) any other benefit in money.

…

Section CE 2 provides:

CE 2 Benefits under employee share schemes

Benefit

(1) A person who is an employee share scheme beneficiary described in section CE 7(a)(i) or (ii) receives a benefit for the purposes of section CE 1(1)(d) in relation to shares or related rights under the employee share scheme equal to the positive amount calculated on the share scheme taxing date using the formula—

share value − consideration paid + consideration received − previous income.

Definition of items in formula

(2) In the formula in subsection (1),—

(a) **share value** is the market value of the shares or related rights owned by an employee share scheme beneficiary on the share scheme taxing date, if the share scheme taxing date is not triggered by a transfer or cancellation of the shares or related rights:

(b) **consideration paid** is the amount of consideration paid or payable by an employee share scheme beneficiary in relation to the transfer of the shares or related rights under the employee share scheme:

(c) **consideration received** is the amount of consideration paid or payable to an employee share scheme beneficiary in relation to a transfer or cancellation of the shares or related rights under the employee share scheme, not including relevant shares or related rights under a replacement employee share scheme:

(d) **previous income** is the total amount of income under section CE 1(1)(d) that the employee share scheme beneficiary has in relation to the shares or related rights before the date that is 6 months after the date of Royal assent for the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018.

Negative amount: deduction

(3) A negative amount calculated using the formula in subsection (1) is a deduction of the person.

Positive and negative amount: cost of revenue account property

(4) A positive or negative amount calculated using the formula in subsection (1) is added to the consideration paid by the person for acquiring the shares, for the purposes of section DB 23 (Cost of revenue account property).

Apportionment

(5) For the person's benefit under subsection (1), the portion of that benefit calculated using the formula is treated as non-residents' foreign-sourced income—

benefit before reduction × offshore period ÷ earning period.

Definition of items in formula

(6) In the formula in subsection (5),—

(a) benefit before reduction is the amount of the benefit under subsection (1):

(b) offshore period is the number of days in the item earning period on which—

(i) the person is not resident in New Zealand; and

(ii) any services the person performs for the relevant employer give rise to an amount of income that is a foreign-sourced amount:

(c) earning period is the period ending with the vesting of shares or relevant rights in the employee share scheme beneficiary and starting with the earlier of—

(i) the first date used to measure the person's right in relation to the vesting of shares or relevant rights:

(ii) the first date that the person has a right in relation to the vesting of shares or relevant rights.

When subsection (8) applies

(7) Subsection (8) applies when an employer is required to provide employment income information under sections RD 22(3) (Providing employment income information to Commissioner) and 23E to 23H of the Tax Administration Act 1994, as modified by section 23K of that Act, in relation to a benefit received under an employee share scheme.

Deferral of income recognition

(8) Despite section CE 1(1)(d), the employee share scheme beneficiary is treated as deriving employment income in relation to the benefit on the ESS deferral date.

Meaning of ESS deferral date

(9) For the purposes of this section and sections RD 6 and RD 7B (which relate to employee share schemes), the ESS deferral date is the 20th day after the share scheme taxing date for the employee share scheme beneficiary.

Section CE 7 provides:

CE 7 Meaning of employee share scheme

Employee share scheme means—

(a) an arrangement with a purpose or effect of issuing or transferring shares in a company (company A) to a person—

(i) who will be, is, or has been an employee of company A or of another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:

(ii) who will be, is, or has been a shareholder-employee in relation to company A or in relation to another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:

(iii) who is an associate of a person described in subparagraph (i) or (ii) (person A), if the arrangement is connected to person A's employment or service; but

(b) does not include an arrangement that—

(i) is an exempt ESS:

(ii) requires market value consideration to be paid by a person described in paragraph (a) for the transfer of shares in the company on the share scheme taxing date:

(iii) requires a person described in paragraph (a) to put shares, acquired by them for market value consideration, at risk, if the arrangement provides no protection against a fall in the value of the shares and none of the consideration for acquiring the shares is provided to the person under an agreement that it is used for acquiring the shares.

Section CE 7B provides:

CE 7B Meaning of share scheme taxing date

Meaning

(1) Share scheme taxing date means, in relation to shares or related rights under an employee share scheme, the earlier of the following dates:

(a) the first date when the shares are held by or for the benefit of an employee share scheme beneficiary (beneficial ownership) and after which, under the provisions of the scheme,—

(i) there is no material risk that beneficial ownership may change or that a right or requirement in relation to the transfer or cancellation of the shares may operate; and

(ii) there is no benefit accruing to the employee share scheme beneficiary in relation to a fall in value of the shares; and

(iii) there is no material risk that there will be a change in the terms of the shares affecting the value of the shares:

(b) the date when the shares or related rights of an employee share scheme beneficiary are cancelled or are transferred to a person who is not associated with a beneficiary described in section CE 7(a)(i) or (ii).

Exclusions

(2) For the purposes of applying subsection (1), the following requirements and rights are ignored:

(a) a right or requirement in relation to transfer by the employee share scheme beneficiary for market value consideration at the time of the transfer:

(b) a right or requirement that is not contemplated by the employee share scheme's provisions:

(c) a right or requirement that, at the time it came into existence, had no material risk of operating or no material commercial significance:

(d) a right or requirement in relation to the transfer of shares, if the right or requirement is 1 that also applies to shares not under the employee share scheme.

Section CW 26C provides:

CW 26C Meaning of exempt ESS

Exempt ESS

(1) **Exempt ESS** means—

(a) a scheme that had the Commissioner's approval under section DC 12 (Loans to employees under share purchase schemes) before that section's repeal by the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018:

(b) an arrangement of which the Commissioner has been notified under section 63B(1) of the Tax Administration Act 1994, if—

(i) the arrangement meets the criteria in subsections (2) to (9) of this section; and

(ii) the Commissioner has received all forms due under section 63B(2) and (3) of the Tax Administration Act 1994.

Purchase of shares

(2) The arrangement must provide that—

(a) the shares are available for no more than their market value at the date of purchase or subscription; and

(b) the market value of the shares purchased or subscribed for by an employee, or a trustee for an employee, under the arrangement is less than or equal to $5,000 in a year; and

(c) the difference between the market value of the shares purchased or subscribed for by an employee or a trustee and the amount that an employee spends on buying shares under the arrangement is less than or equal to $2,000 in a year.

Eligibility

(3) The arrangement must provide that—

(a) a full-time permanent employee to whom an offer under the arrangement is made is eligible to participate in the arrangement, on an equal basis with 90% or more of other full-time permanent employees to whom an offer under the arrangement is not subject to foreign security disclosure rules; and

(b) if it applies to part-time employees, those employees to whom an offer under the arrangement is made are eligible to participate in the arrangement, on an equal basis with 90% or more of other part-time employees to whom an offer under the arrangement is not subject to foreign security disclosure rules; and

(c) if it applies to seasonal workers, those employees to whom an offer under the arrangement is made are eligible to participate in the arrangement, on an equal basis with 90% or more of other seasonal workers to whom an offer under the arrangement is not subject to foreign security disclosure rules; and

(d) if it requires that an employee spend a minimum amount on buying shares, it requires no more than $1,000 to be spent in a year; and

(e) if it requires that an employee must have a minimum period of employment or service before the employee is eligible to participate, it requires—

(i) no more than 3 years full-time work, for full-time employees; and

(ii) no more than an accumulated period that is the equivalent of 3 years full-time work, for other employees.

Payments

(4) The arrangement must provide that—

(a) if it requires that an employee must buy the shares for more than nominal consideration,—

(i) a loan for the cost of the shares is available to the employee; or

(ii) the employee may pay for or buy the shares in regular instalments of a month or less, and any regular instalments are subject to paragraph (d)(ii); and

(b) any loan to an employee to buy shares is free of interest and other charges; and

(c) any loan or regular instalments have a maximum term of 60 months and a minimum term of 36 months; and

(d) any loan to an employee to buy shares is repayable by regular instalments of a month or less, but—

(i) the loan is repayable early in full or in part at the employee's discretion; and

(ii) in the case of an employee who is on unpaid or parental leave for more than a month, the regular instalments are suspended while on leave and the term of the loan is extended as appropriate.

Serious hardship

(5) The arrangement must provide, in the case of serious hardship that results or may result from an employee's continued participation in the exempt ESS, that, with the employee's agreement,—

(a) any regular instalments and any other terms related to payment by the employee may be varied; or

(b) the employee may withdraw from the arrangement, and any shares are bought from the employee for their market value on the day of withdrawal, subject to the repayment of any outstanding loan.

Withdrawal

(6) The arrangement must provide that the employee may withdraw from the arrangement on giving 1 month's notice to the relevant party. Any shares must be bought from the employee for the lesser of their market value on the day of withdrawal and their cost to the employee, subject to the repayment of any outstanding loan.

Period of restriction

(7) The arrangement must provide that,—

(a) if the employee has not acquired the shares for market value, there is a period of restriction during which the shares must not be disposed of and that period of restriction is the shorter of—

(i) a period of 3 years starting on the date the employee acquired the shares, or the period of repayment of a loan made to them under the scheme for this purpose, whichever is longer; and

(ii) a period starting on the date the employer acquired the shares and ending on the date the employee ends their employment with the company that employs them, or a company in the same group of companies if the employee is transferred; or

(b) if the employee has acquired the shares for market value, there is a period of restriction during which the shares must not be disposed of and that period of restriction is no longer than the shorter of—

(i) the shortest period in paragraph (a)(i) and (ii); and

(ii) any period of restriction provided by the arrangement, if that period finishes on or after the date on which the employee has no further repayment obligations for a loan made to them under the scheme.

End of period of restriction: general rule

(8) When the period of restriction provided by subsection (7) ends, the arrangement must provide that—

(a) the shares are transferred to the employee if the employee is still employed by the relevant company and they have not already been transferred; or

(b) if the employee chooses, the shares are purchased for the lesser of—

(i) the cost of the shares to the employee:

(ii) the market value of the shares on the date the period of restriction ends.

End of period of restriction: certain cases

(9) Despite subsection (8), when a period of restriction ends because the employee's employment ends through their death, accident, sickness, redundancy, or retirement at normal retiring age, the arrangement must provide that—

(a) the shares are transferred to the former employee if they have not already been transferred, or transferred to the legal representative of the employee's estate, as appropriate; or

(b) if the employee chooses, the shares are purchased for the lesser of—

(i) the cost of the shares to the employee:

(ii) the market value of the shares on the date the period of restriction ends.

Section CW 26F provides:

CW 26F Meaning of share

For the purposes of section CW 26C, share means, for a company whose shares are made available under an exempt ESS, a fully paid ordinary share that ranks equally with, and has the same designation as, an existing ordinary voting share in the company.

Section RD 7B provides:

RD 7B Treatment of employee share schemes

When this section applies

(1) This section applies for employees or a former employee in relation to benefits under an employee share scheme, if—

(a) an employer has irrevocably chosen to withhold and pay tax for a benefit for an employee under the scheme in accordance with subsection (3); or

(b) an employer chooses to withhold and pay tax for a benefit for an employee under the scheme in accordance with subsection (4).

Irrevocable obligation

(2) An employer who has made an irrevocable election described in subsections (1)(a) and (3) must comply with subsection (4)(a) to (c) for—

(a) the relevant benefit and employee under the scheme:

(b) benefits offered or provided to the employee in replacement of the relevant benefit.

Irrevocable obligation: form

(3) For the purposes of subsection (1)(a), an employer has irrevocably chosen to withhold and pay tax for a benefit for an employee, if it is a term of the offer of the benefit, or of the scheme under which the benefit is provided, that the employer must withhold and pay tax under this section.

Withholding and paying

(4) For the purposes of subsection (1)(b), an employer chooses to withhold and pay tax for some benefits for some employees by—

(a) calculating the amounts of tax that must be withheld for the relevant benefits and employees, and paying the amounts to the Commissioner as described in section RD 4(1); and

(b) including the amounts in the employer's employment income information under subpart 3C of the Tax Administration Act 1994, treating the relevant ESS deferral date as the relevant payday; and

(c) making the disclosure referred to in paragraph (b) within the time required under section RD 6(3)(a).

The definition of "share" in s YA 1 is:

share -

(a) includes any interest in the capital of a company:

(b) includes a debenture to which section FA 2 (Recharacterisation of certain debentures) applies:

(bb) includes a stapled debt security to which section FA 2B(2) (Stapled debt securities) applies:

(c) includes a unit in a unit trust:

(d) includes an investor's interest in a group investment fund if—

(i) the fund is not a designated group investment fund; and

(ii) the interest does not result from an investment from a designated source; and

(iii) the investor's interest does not result from an investment made in the fund on or before 22 June 1983, including an amount treated as invested at that date as pre-1983 investments under section HR 3(8) (Definitions for section HR 2: group investment funds):

(e) does not include a withdrawable share in a building society, except in the definitions of investment society dividend and withdrawable share:

(f) *[Repealed]*

(g) is further defined in section CW 26F (Meaning of share) for the purposes of section CW 26C (Meaning of exempt ESS)

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 19/12: What is the fringe benefit tax, GST and income tax treatment of an employee contribution to a fringe benefit?

This item will be of interest to employers who provide fringe benefits to their employees, where the employees contribute to the value of the benefit. Employees may make a full or partial contribution to the value of the fringe benefit. Employee contributions may affect the GST, fringe benefit tax (FBT) and income tax returns of employers.

Key terms

Employee contribution: an amount an employee pays for receiving a fringe benefit

Taxable value: the value of a fringe benefit for income tax and GST

Question

What is the FBT, GST and income tax treatment of an employee contribution to a fringe benefit?

Answer

The answer depends on:

- whether the employee makes a full or partial contribution to the value of the fringe benefit; and
- who the employee makes the payment to.

The consequences are summarised below:

	Partial contribution	Full contribution
Fringe benefit tax	The taxable value of the fringe benefit is reduced by the contribution. The reduced taxable value of the benefit is subject to FBT and is included in the employer's FBT return.	The taxable value of the fringe benefit is reduced to nil so there is no FBT liability.
GST on the fringe benefit	GST is imposed on the taxable value of the fringe benefit (the value of the fringe benefit less the contribution). This amount is paid in the employer's FBT return and is deemed to be FBT.	The taxable value of the fringe benefit is reduced to nil so there is no FBT liability.
GST on contributions to employers	A contribution made to the employer is consideration for a supply by the employer and must be accounted for in the employer's GST return. A contribution to a third party will not be consideration for a supply by the employer.	
Income tax	A contribution made to the employer is income of the employer and must be included in the employer's income tax return, net of GST. The employer may claim relevant deductions relating to the fringe benefit. A contribution to a third-party will not be income of the employer.	

Explanation

1. This Question We've Been Asked explains how an employer must treat an employee contribution to a fringe benefit for FBT, GST and income tax purposes.

Employee contributions

2. An employee contribution is an amount an employee, including a shareholder-employee, pays for receiving a fringe benefit. It includes any amount a person associated with that employee pays for receiving a fringe benefit. Where an employee (or associate) pays an amount for receiving a fringe benefit, the taxable value of that benefit is reduced by the amount paid up to the value of the benefit (s RD 54(1) and (2) of the Income Tax Act 2007).
3. An employee may make a partial contribution or a full contribution to the value of the fringe benefit.

4. An employee contribution may be made in different ways. For an employee, payment might involve meeting an expense that would otherwise be an expense of the business. For example, an employee with a company vehicle might sometimes pay for petrol for that vehicle. For a shareholder-employee, payment might occur by debiting the shareholder-employee's current account with the employer company.
5. An effective salary sacrifice arrangement is not treated as an employee contribution to a fringe benefit. An effective salary sacrifice arrangement is where an employee agrees to reduce their salary by an agreed amount in recognition of their employer providing them with a fringe benefit.

FBT treatment of contributions

6. The taxable value of a fringe benefit is the value of the benefit, less any employee contributions (s RD 54(1) and (2) of the Income Tax Act 2007).
7. If the employee contribution is a partial contribution, the taxable value of the fringe benefit is the value of the fringe benefit, less the amount of the contribution. The reduced taxable value of the benefit is subject to FBT and must be included in the employer's FBT return.
8. If an employee contribution is 100% of the taxable value of the fringe benefit, then the value of the fringe benefit is reduced to nil so the FBT liability is nil. However, a nil FBT return must be filed as a fringe benefit has still been provided (ss 46B(2) and 46C of the Tax Administration Act 2004).

GST treatment of contributions

9. When an employer supplies an employee with a fringe benefit, that supply is deemed to be a supply of goods and services by the employer in the course or furtherance of their taxable activity (s 21I(1) of the Goods and Services Tax Act 1985 (GST Act)). The supply will be valued under s 10(7) of the GST Act using the FBT taxable value. However, the provision of a fringe benefit will be a supply only to the extent that the employee has not paid an amount for the receipt or enjoyment of the fringe benefit (s 21I(2) of the GST Act).
10. There will also be no supply of a fringe benefit for GST purposes if the fringe benefit arises out of an exempt or zero-rated supply (s 21I(2)(b) and (c) of the GST Act and Example 2).

Partial contribution

11. If an employee makes a partial contribution to the employer for receiving the fringe benefit, the supply must be split into two supplies – a supply of a fringe benefit and a supply of the good or service the employee has paid for (a "general supply").
12. This occurs because s 21I(1) of the GST Act deems the provision of a fringe benefit to be a supply of goods and services. However, s 21I(1) does not apply to the extent that the employee pays an amount for the receipt or enjoyment of the fringe benefit (s 21I(2)). This means s 21I(1) does not apply to the general supply.

The supply of a fringe benefit

13. The value of the supply of a fringe benefit under s 21I(1) is its taxable value under the FBT rules (see s 10(7)(a) of the GST Act and s CX 20 and ss RD 54 to 57 of the Income Tax Act 2007). The GST on the taxable value of the fringe benefit is paid in the employer's FBT return and is deemed by s 23A of the GST Act to be a payment of FBT for the purposes of filing the FBT return.

The general supply

14. The employee contribution (if paid to the employer) is treated as consideration for a separate supply by the employer under the GST Act. The contribution is GST-inclusive. As a result, the employer must include any contributions received from the employee in their GST return.
15. If the employee contribution is consideration for an exempt or zero-rated supply, no GST needs to be returned on this general supply and the employer cannot claim any input tax on this supply. However, a contribution that is consideration for a zero-rated supply will still need to be included in the employer's GST return.
16. If the employee contribution is paid directly to a third-party it will not be consideration for a supply by the employer for GST purposes. Also, the employer cannot claim any input tax on this supply as there was no cost incurred by the employer.

Full contribution

17. If an employee makes a full contribution to the employer for receiving the fringe benefit there will be no deemed supply of a fringe benefit under s 21I(1) of the GST Act.

18. However, the employee contribution (if paid to the employer) is treated as consideration for a general supply by the employer under the GST Act. The contribution is GST-inclusive. As a result, the employer must include any contributions received from the employee in their GST return (see Example 5).
19. If the employee contribution is consideration for an exempt or zero-rated supply, the employer will not be able to claim any input tax on this supply as it would not have paid any GST on the supply. A contribution that is consideration for a zero-rated supply will still need to be included in the employer's GST return.
20. If the employee contribution is paid directly to a third-party it will not be a consideration for a supply by the employer for GST purposes. Also, the employer cannot claim any input tax as there was no cost incurred by the employer.

Associated supplies

21. Where an employer and an employee are associated, the supply of a fringe benefit by the employer is an "associated supply" (ss 2(1) and 2A(1) of the GST Act). It might be assumed that the associated supply is valued at open market value, rather than taxable value. This is not the case. Section 10(3)(c) of the GST Act excludes the provision of a fringe benefit from the valuation rules for associated supplies. Therefore, the value of a supply of a fringe benefit between associated parties is its taxable value (s 10(7)). The time of supply is when the fringe benefit is or is deemed to be provided (s 21I(3)).
22. Similarly, where the employer and the employee are associated, any general supply (for which an employee contribution is consideration) is valued under the general GST valuation rules (s 10(2)). It might be assumed that as the supply is an "associated supply" it should be valued under s 10(3). However, the associated supply valuation rules in s 10(3) do not apply, because the goods or services being supplied are still a fringe benefit under the Income Tax Act 2007 (even where a full contribution is made), so s 10(3)(c) is not satisfied (see "The meaning of "benefit" for FBT purposes" *Tax Information Bulletin* Vol 18, No 2 (March 2006):26).
23. The time of supply of an associated supply will be determined under either ss 9(2) or 9(3) of the GST Act, depending on whether the supply is a supply of goods or a supply of services and whether those goods or services are supplied periodically or progressively. Where goods are supplied under an agreement to hire or where services are supplied under any agreement or enactment which provides for periodic payments, the time of supply is generally when a payment becomes due or is received.

Income tax treatment of contributions

24. If an employer receives an employee contribution, the amount will be either business income of the employer (s CB 1 of the Income Tax Act 2007) or income under ordinary concepts (s CA 1(2) of the Income Tax Act 2007). The amount is consideration received by the employer for the provision of a fringe benefit to the employee. It must be included as income in the employer's income tax return, net of GST. The employer may claim relevant deductions relating to the fringe benefit. If the employer does not receive the contribution, (because it is paid directly to a third party) the amount will not be income of the employer and should not be included in the employer's income tax return (see Example 3).

Examples

Example 1 – Partial contribution towards the cost of a fringe benefit

Marjorie is the top salesperson at Bob's Discount Furniture Ltd for 2018. As part of an incentive programme, Marjorie is to be awarded a brand new 49-inch TV, valued at $2,000 (GST inclusive). However, Marjorie would like something a little larger. She has her eye on a 65-inch smart TV currently selling for $3,000 (GST inclusive). Before Bob goes to purchase the TV for Marjorie (from a third-party supplier) she asks if she can pay the difference, so she can get the TV of her dreams. Bob is happy to oblige, so Marjorie transfers $1,000 into the company account and Bob buys her the $3,000 TV.

FBT: Bob's accountant takes the total amount of Marjorie's employee contribution ($1,000, GST-inclusive) and deducts this from the value of the TV fringe benefit ($3,000, GST-inclusive). She then calculates both GST and FBT payable on the taxable value of the fringe benefit less the contribution and includes both the GST and the FBT in the FBT quarterly return. Bob's Discount Furniture files quarterly using the single rate option so the FBT payable on this fringe benefit is $985 ($2,000 × 49.25%). The GST payable is $260.87 ($2,000 × 3 ÷ 23).

GST: Marjorie's contribution is consideration for the general supply of the TV. Bob's Discount Furniture can claim GST back on the full price of the TV ($3,000). The accountant then includes the GST-inclusive amount of Marjorie's employee contribution ($1,000) as income in the company's next GST return.

Income Tax: The accountant claims a deduction for $2,608.70, being the full GST-exclusive cost of the TV and includes the GST-exclusive amount of Marjorie's contribution as income of the company for income tax purposes.

Example 2 – Partial contribution towards the cost of a zero-rated fringe benefit

Gustaf is the top salesperson at Gianni's House of Wigs for 2018. To recognise this stellar achievement, the company has decided to award him an overseas holiday. The award includes return flights for two and five nights' accommodation at a luxury resort in Fiji. The total cost of the award is $2,500. Gustaf is delighted at this recognition but would like to know if he could stay a bit longer. Gustaf asks the Managing Director if he could pay for an extra five nights' accommodation. The Managing Director agrees, and Gustaf pays Gianni's the difference which works out to be a further $1,500. There is no GST component to this contribution because the supply of accommodation takes place offshore and is therefore zero-rated.

FBT: The overseas travel is a fringe benefit. The taxable value of the fringe benefit is $2,500 (being the total cost of $4,000 less Gustaf's contribution of $1,500). This amount needs to be returned in Gianni's quarterly FBT return. No GST is paid in the FBT return because the supply is zero-rated and therefore s 21I(2)(c) of the Act applies. The provision of the overseas travel is not treated as a supply of a fringe benefit for GST purposes.

GST: For GST purposes, Gustaf's employee contribution (paid to Gianni's) is consideration for a zero-rated supply of overseas travel and accommodation. The zero-rated amount will still need to be included in Gianni's next GST return. However, Gianni's cannot claim any input tax on the cost of the holiday as it did not pay any GST on the supply.

Income Tax: The accountant claims a deduction for $4,000 being the total cost of the holiday package and includes Gustaf's contribution of $1,500 as income of the company for income tax purposes.

Example 3 – an employee pays a third-party for petrol

Supreme Carpet Ltd allows its employee Tony to take home a work van for private use in the weekend as long as he pays for his own petrol. Tony must fill up on the business account on Friday night and then fill up again using his own funds on Sunday evening. He records the value of his petrol payments in a log book.

FBT: The taxable value of the fringe benefit is the value of the benefit as determined under the motor vehicle fringe benefit rules in sch 5 of the Income Tax Act 2007. This value is an approximation of the capital and running costs of the vehicle and includes petrol. Therefore, when Tony pays for petrol (either directly to Supreme or to a third party like a petrol station), this will reduce the value of the benefit.

The Supreme accountant takes Tony's petrol payments (including GST) and deducts this from the value of the van that has been made available to him for private use over the quarter. She then calculates both FBT and GST payable on the taxable value and includes both the FBT and GST in the FBT quarterly return.

GST: Supreme providing the van to Tony is a fringe benefit and is treated as being a supply of goods and services under s 21I(1). However, it is not treated as a supply to the extent that Tony paid an amount for the receipt or enjoyment of the benefit (s 21I(2)(a)). Further, there is no supply between Supreme and Tony for which the petrol payments could be consideration for GST purposes. Supreme cannot claim any input tax on the cost of the petrol paid by Tony as that was a cost that was incurred by Tony and was not reimbursed by Supreme.

Income Tax: The payments made by Tony to the petrol station for petrol are not included in Supreme's income tax return. Supreme did not receive or otherwise earn this amount, so it is not Supreme's income.

Example 4 – an employee pays for petrol on a work petrol card and then reimburses the employer

The facts are the same as above, however instead of using his own money, Tony fills up the van with petrol using a work petrol card and then reimburses Supreme for the petrol.

FBT: The FBT outcome is the same as in example 3. The payment made by Tony to Supreme to reimburse them for the petrol used is deducted from the taxable value of the van that has been made available to Tony for private use over the quarter. The Supreme accountant then calculates both FBT and GST payable on the taxable value less the petrol reimbursement and includes both the FBT and GST in the FBT quarterly return.

GST: Supreme can claim input tax on the petrol charged to the work petrol card. However, Supreme must account for output tax on the reimbursement payment made by Tony in its next GST return. This is because the reimbursement payment is part consideration for the supply of the fringe benefit.

Income Tax: The reimbursement payment made by Tony to Supreme is income for income tax purposes and must be included in Supreme's income tax return. However, the income is effectively cancelled out, because Supreme can claim an income tax deduction for the petrol payment.

Example 5 – Shareholder-employees make a 100% contribution towards the cost of the fringe benefits and are not associated persons

Anton is one of five shareholder-employees who own Zanadoo Construction Ltd. Anton and Zanadoo are not associated persons for the purposes of s 2A(1)(b) of the GST Act. The five shareholders agree that the business will make available to each of them a ute of their own choosing. To equalise matters, they agree to each pay an annual amount equivalent to the taxable value of their vehicle to Zanadoo for FBT purposes.

The accountant advises the five shareholder-employees what the FBT taxable value is for each ute. This amount is then debited from their current accounts and credited to Zanadoo. The accountant makes the appropriate journal entries to document this transaction.

FBT: The accountant files the annual FBT return, including a nil value for the five utes.

GST: For GST purposes, the contribution paid by Anton and the other shareholder-employees is consideration for a general supply of the use of a ute. The accountant includes the total amount of the five contributions in the next GST return for Zanadoo.

Income Tax: He also includes that amount as income in the tax return, after deducting the GST returned on the contributions made.

The accountant had previously factored in an estimate of the contributions into the income budget when considering provisional tax options for the relevant tax year.

Example 6 – Shareholder-employees make a 100% contribution towards the cost of the fringe benefit and are associated persons

The facts are the same as in Example 5, however Anton is now one of three shareholder-employees who own Zanadoo Construction Ltd. Anton and the other two shareholder-employees are associated persons of Zanadoo Construction Ltd for the purposes of s 2A(1)(b) of the GST Act.

The outcome for FBT and income tax is the same as in Example 5.

For GST purposes, the contribution paid by Anton and the other shareholder-employees is consideration for a general supply of the use of a ute. The supply is also an associated supply.

The value of this supply is determined under s 10(2). The value of the supply of the use of a ute is the consideration paid by the employee (which is the taxable value for FBT purposes). The associated supply valuation rules in s 10(3) do not apply, because the supply of the use of the ute (a motor vehicle) is still a fringe benefit under the Income Tax Act 2007, so s 10(3)(c) is not satisfied. The time of supply for the supply of the use of the ute is when the payments made by Anton and the other shareholder/employees are due and received under the agreement with Zanadoo.

The accountant then includes the total amount of the three contributions in the next GST return for Zanadoo.

Example 7: An effective salary sacrifice is not an employee contribution

George is due to start work at Business Co. He has been offered a starting salary of $150,000 or $145,000 plus a car park, valued at $5,000 per annum. George needs to commute from the country so gladly takes up the offer that includes the carpark, agreeing to forgo $5,000 of his salary in exchange for the car park. The car park is in a public car park building near the offices of Business Co. It is accessed with a parking permit and there are no designated spaces for permit holders.

The agreement between George and his employer is an effective salary sacrifice arrangement. George's salary is reduced by an agreed amount in recognition of Business Co providing him with a car park. As the car park is offsite and not owned or leased by Business Co, it is a fringe benefit and is not excluded under s CX 23. However, George's salary sacrifice is not treated as an employee contribution to that fringe benefit so Business Co must return FBT on the $5,000 cost of the car park.

References

Subject references

Employee contribution
Fringe benefit
Fringe benefit tax
GST
Salary sacrifice
Shareholder-employee
Taxable value of a fringe benefit

Legislative references

Goods and Services Tax Act 1985: ss 2A, 8(1), 9(2) and (3), 10(2) and (3), 10(7), 21I, 23A

Income Tax Act 2007: ss CA 1(2), CB 1, CX 20, RD 54-57

Tax Administration Act 1994: ss 46B(2), 46C

Other references

"The meaning of "benefit" for FBT purposes" *Tax Information Bulletin* Vol 18, No 2 (March 2006):26.

QB 19/13: Income tax – when does the business premises exclusion to the bright-line test apply?

This Question We've Been Asked (QWBA) explains the business premises exclusion that applies for the purposes of the bright-line test. It will be of interest to anyone selling their business premises on what might be residential land.

Question

When does the business premises exclusion to the bright-line test apply?

Answer

Land that has been used predominantly as business premises is not subject to the bright-line test, even if the land has a dwelling on it.

"Business premises" means land, typically including a building, together with any surrounding associated land, from which a person carries on a business. In some cases, land can be business premises even if there is no building on the land.

Land will be used predominantly as business premises where:

- more than 50% of the area of the land has been used as business premises; and
- the land has been used as business premises for more than 50% of the time the seller owned it.

Key terms

Bright-line period: The bright-line period is 2 years or 5 years, depending on the rules in place when the seller acquired the land.

Bright-line test: The bright-line test applies to tax sales of residential land occurring within the bright-line period.

Business premises: means land, typically including a building, together with any surrounding associated land, occupied by a person mainly to carry on a business. However, in some cases, land without a building may also qualify as business premises.

Sale: The bright-line test applies to all types of disposals, including sales.

Explanation

The scope of this QWBA

1. This QWBA focuses on the business premises exclusion to the bright-line test. There is a separate business premises exclusion that is relevant where the sale of land is potentially taxable under other land taxing provisions in the Act (ss CB 6 to CB 11). These two business premises exclusions are briefly compared at [24]. The exclusion from ss CB 6 to CB 11 is discussed in more detail in "QB 19/14: Income tax – When does the business premises exclusion in s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?".

Bright-line test

2. The bright-line test under s CB 6A taxes the sale of residential land within the bright-line period.
3. The bright-line test applies to residential land that a person first acquired an interest in on or after 1 October 2015. The period of the bright-line test increased from 2 years to 5 years for residential land that a person first acquired an interest in, on or after 29 March 2018 (see s 6(2) of the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018). Therefore, this QWBA refers to the "bright-line period" – which will be either 2 years or 5 years, depending on when the seller first acquired an interest in the land.
4. The bright-line test under s CB 6A applies only where none of the land taxing rules in ss CB 6 to CB 12 apply (for example, s CB 6, which applies to the sale of land acquired for the purpose or with the intention of re-sale).

Definition of "residential land"

5. "Residential land" is defined in s YA 1 as meaning:
   - land with a dwelling on it;
   - land for which the owner has an arrangement to erect a dwelling; or
   - bare land that may be used for erecting a dwelling under the relevant operative district plan.
6. However, "residential land" does not include land "used predominantly as business premises".
7. In most cases, a person selling business premises will not need to rely on the business premises exclusion because usually the land will not meet the requirements to be "residential land". This is because:
   - business premises land will not usually have a dwelling on it;
   - the landowner will not usually have an arrangement to erect a dwelling on the land; and
   - business premises land will not usually be "bare land" (which would come within the definition of "residential land" if it may be used for erecting a dwelling under the relevant operative district plan).

8. Because most business premises land being sold will not meet the criteria to potentially be "residential land", the carve out for business premises will not usually need to be considered, and the land will not be subject to the bright-line test in s CB 6A.
9. The most likely situation where the business premises exclusion needs to be considered is where a person sells land that has both a dwelling and business premises on it. The presence of a dwelling means the land may fall within the definition of "residential land" and potentially be subject to the bright-line test. However, if the land is used predominantly as business premises, it will not be "residential land" as defined. Another situation where a person may need to consider the business premises exclusion is where business premises are on bare land that may be used for erecting a dwelling under the relevant operative district plan. Situations in which a person sells business premises land for which they have an arrangement to erect a dwelling are likely to be rare.

Meaning of "dwelling"

10. A "dwelling" is defined in the Act as being "any place used predominantly as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place". However, for the purposes of s CB 6A and the definition of "residential land", a "dwelling" does not include any of the following, in whole or part:
    - a hospital;
    - a hotel, motel, inn, hostel or boardinghouse;
    - a convalescent home, nursing home, or hospice;
    - a rest home or retirement village; or
    - a camping ground.

Meaning of "business premises"

11. Business premises is not defined in the Act for the purposes of the bright-line test and the definition of "residential land". "Premises" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) as:

    > A house or building, together with its land and outbuildings, occupied by a business or considered in an official context.

12. At common law, "business premises" can refer to a variety of places from which a business is carried on, whether just buildings, buildings and associated land, or bare land. (*Case Y10* (2007) 23 NZTC 13,097 (TRA); *Thames Water Ltd v Hampstead Homes Ltd* [2003] 1 WLR 198 (CA); *Gardiner v Sevenoaks Rural District Council* [1950] 2 All ER 84 (QB); *C of T v Nightcaps Coal Company (Ltd)* (1909) 29 NZLR 885 (SC)).
13. The Commissioner considers that while business premises will typically include a building, there may be instances where land without a building is business premises. For instance, a quarry may be business premises even if it does not have a building on it. It will be up to the taxpayer to show that the land is business premises.
14. As noted above, "business premises" is a place from which a business is carried on. Whether there is a "business" will be determined using the business test set out in *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). "Carrying on" a business from a location, requires some or all of the activities of the business to be conducted continuously or habitually from there. For the purposes of the s CB 6A business premises exclusion, the business premises may be those of the landowner or of a third party such as a tenant or tenants.
15. Once the land is found to have business premises on it, the s CB 6A business premises exclusion requires that the land as a whole must have been **used predominantly** as business premises. "Predominantly" in this context means more than 50%. Land will have been used predominantly as business premises where:
    - the physical area of land used as business premises is more than 50% of the total land area; and
    - that land has been used as business premises for more than 50% of the time the landowner has owned the land.
16. Where a building has multiple storeys, the floor area of each storey is included in the calculation of total land area.
17. From time to time, particularly where the split between the business premises use of the land and the land's other uses is close, the nature and the importance of the land's different uses should be considered to determine which of the uses is the predominant use. This is the approach the courts have taken to the meaning of "predominantly" (see, for example, *Paddico (267) Ltd v Kirklees Metropolitan Council* [2011] EWHC 1,606 (Ch)).
18. Because the definition of "business premises" requires the land to have been used "predominantly" as business premises, the Commissioner considers the exclusion applies on an all or nothing basis. Therefore, if the land is predominantly used as business premises, all of the land is excluded from the meaning of residential land. If the land is not used predominantly as business premises, then the exclusion does not apply, and all of the land is residential land and potentially subject to the bright-line test.

Conclusion

19. In most cases, a person selling business premises will not need to consider the business premises exclusion to the bright-line test. This is because for most business premises, it is unlikely that:
    - there will be a dwelling on the land;
    - the landowner will have an arrangement to erect a dwelling on the land; or
    - the land will be bare land (which would come within the definition of "residential land" if it may be used for erecting a dwelling under the relevant operative district plan).
20. However, even if one of the above is the case, the land will fall out of the definition of "residential land" if it is used predominantly as business premises, so the sale would not be subject to the bright-line test.
21. Using land as business premises means business activities are continuously or habitually conducted from that land. The business premises do not need to be the landowner's own business premises; they can, for example, be the business premises of a tenant or tenants.
22. Land will be used predominantly as business premises if more than 50% of the total land area is used as business premises for more than 50% of the time the landowner has owned the land.
23. The exclusion applies on an all or nothing basis. If the land is used predominantly as business premises, then all of the land is excluded from the bright-line test. If the land is not used predominantly as business premises, the exclusion will not apply to any part of the land.

Comparison of the s CB 6A and s CB 19 business premises exclusions

24. As noted at [1], the business premises exclusion to the bright-line test is not the only business premises exclusion in the land taxing rules. There is a separate business premises exclusion relevant where the sale of land is potentially taxable under other land taxing provisions in the Act (ss CB 6 to CB 11). Although these two exclusions are both described as "business premises exclusions", they are not the same. "QB 19/14: Income tax – When does the business premises exclusion under s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?" discusses the application of the s CB 19 exclusion in more detail. In short, the main differences between the business premises exclusion to the bright-line test and the s CB 19 business premises exclusion are as follows:
    - Section CB 19 relates to the land taxing provisions from ss CB 6 to CB 11. The bright-line business premises exclusion applies only to s CB 6A (the bright-line test).
    - Section CB 19 applies only to land that is the landowner's business premises (and land reserved with the premises for the use of the business). The bright-line business premises exclusion potentially applies where someone uses the land as business premises.
    - Section CB 19 specifically requires the landowner to have **acquired and occupied** or **erected and occupied** the relevant business premises **mainly** to carry on a **substantial** business. For the bright-line business premises exclusion, the premises do not have to be those of the landowner and the business does not have to be substantial.
    - Section CB 19 applies to the extent that the land is business premises (or land reserved with the premises for the use of the business), while the bright-line business premises exclusion applies to all of the land sold, or not at all.
    - Section CB 19 does not apply where the landowner has engaged in a regular pattern of buying or building business premises and selling them. The bright-line business premises exclusion does not have such an exception.

Examples

25. The following examples explain how the law applies.

Example 1: Business premises exclusion not relevant as requirements to be "residential land" not met

On 1 August 2018, Raj, a dentist, purchases a property with a villa on it. The previous owner had lived in the villa for many years. Raj fits the villa out as a dentist surgery and carries on his dentistry business from there. Three years later, Raj sells his dentistry practice and the villa and moves overseas. During the time Raj owned the villa, nobody lived in it, and Raj did not have an arrangement to erect a dwelling on the property.

Shortly after selling the villa, Raj hears about the bright-line test and asks his lawyer, Ruby, whether the sale might be subject to tax since the villa was previously a residential home.

Ruby explains that the sale of the villa is not subject to the bright-line test because the property does not meet the definition of "residential land". This is because:

- the property did not have a dwelling on it;
- Raj did not have an arrangement to erect a dwelling on the property; and
- the property was not "bare land" that may be used for erecting a dwelling under the relevant operative district plan.

Ruby explains that although the villa might look like a dwelling, it was fitted out as a dentist surgery not as a place of residence or abode. Ruby also notes there is a business premises exclusion to the definition of "residential land", but in Raj's case, this exclusion is not relevant because the property did not fall within the requirements to potentially be "residential land" in the first place.

Example 2: Land with a building that is partly business premises and partly a dwelling excluded from bright-line as predominantly business premises

Dave purchases a building in the suburbs that has a downstairs retail space and a single bedroom flat upstairs. The downstairs retail space is just over twice the size of the upstairs flat. Dave leases the retail space to Andy, who runs a florist business from it. The upstairs flat is rented to Mary under a residential tenancy.

A year later, Dave decides to move overseas and sells the building. The property meets the first requirement of the definition of "residential land" because the upstairs flat is a dwelling. However, the downstairs retail space is the business premises of the florist. Because the business premises is more than twice the size of the upstairs flat, the property is used predominantly as business premises. Accordingly, the property is not "residential land". Therefore, the sale of the property is not subject to the bright-line test.

Example 3: Land with business premises and stand-alone residence excluded from bright-line as business premises

Milk Mixer Ltd buys a large milk-processing factory. On the property is a small house where the factory's caretaker lives. Because there is a dwelling on the property (the house), the land is potentially "residential land", so potentially subject to the bright-line test. However, because the land is predominantly (more than 50%) used as Milk Mixer Ltd's business premises, all of the land is excluded from the definition of "residential land", so the bright-line test would not apply if the property were sold within the bright-line period.

Example 4: Land with business premises and stand-alone residence excluded from bright-line as predominantly business premises

Wayne buys a property that has a three-bedroom house and large stand-alone workshop on it. Wayne lives in the house with his family and operates a surfboard-building business from the workshop. Wayne's workshop and associated land make up 60% of the total land area of the property and has been his business premises since he purchased the property. Because the property has a dwelling on it (the house), the property meets the initial definition of "residential land".

Wayne sells the property within the bright-line period. Although the property meets the initial part of the definition of "residential land", it subsequently falls outside the definition because the land is predominantly used as business premises. This means the sale of the property is not caught by the bright-line test.

If the land was not predominantly used as business premises, it is still possible that the property sale would nonetheless be excluded from the bright-line test under the "main home" exclusion (s CB 16A). For details on how the "main home" exclusion in s CB 16A applies, see "QB 18/16: Income tax – bright-line test – main home exclusion – sale of subdivided section".

However, if the property was owned by Wayne's family trust, the "main home" exclusion would only be available if the principal settlor of the trust does not have a main home (e.g. if Wayne's late father settled the trust), or if the principal settlor does have a main home, then that main home is the one being sold (e.g. if Wayne settled the trust and lives in the house as a beneficiary of the trust). In this context, the principal settlor is the settlor whose settlements on the trust are the greatest or equal greatest, by market value.

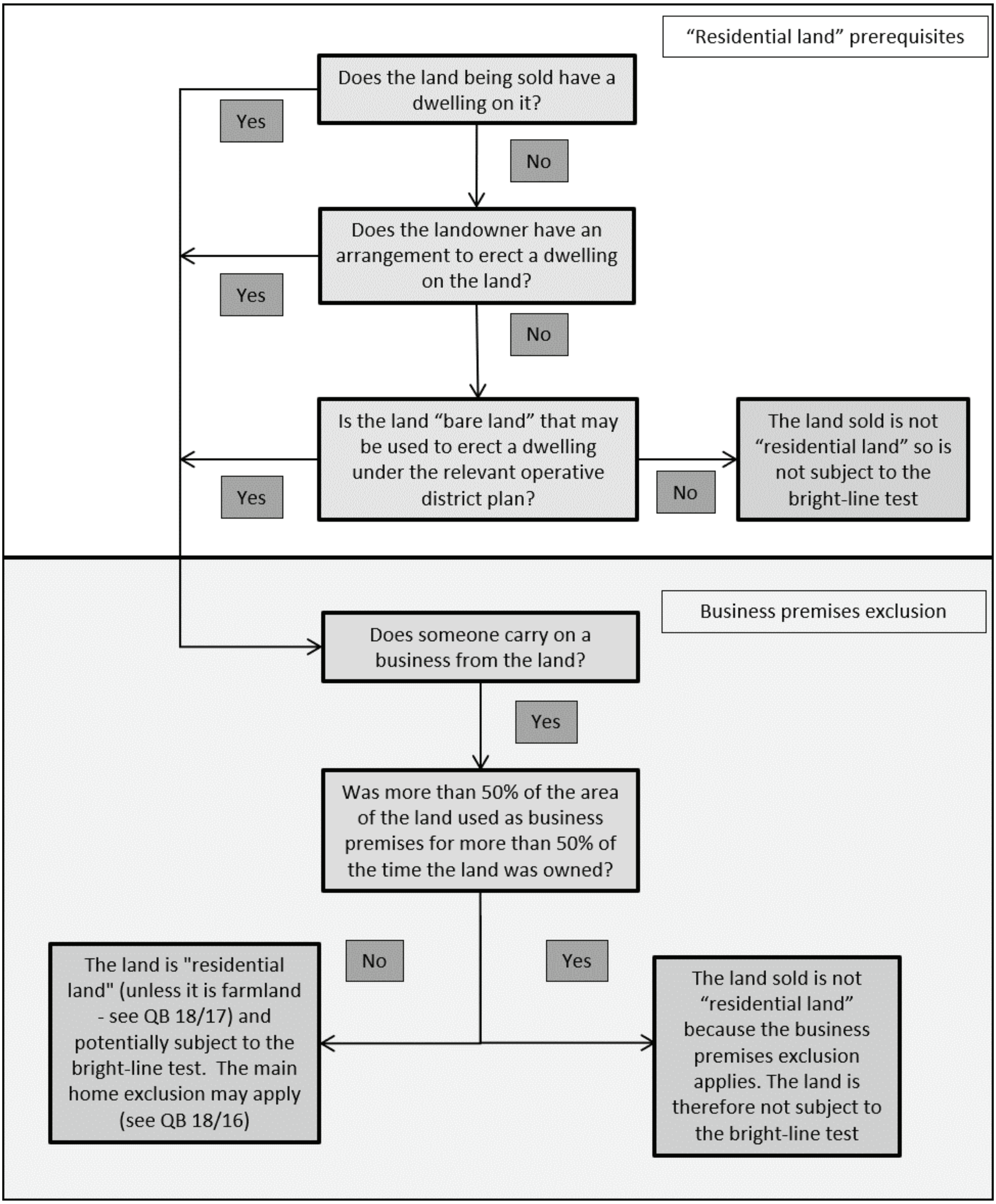
Example 5: Land with business premises and stand-alone residence not excluded from bright-line as not predominantly business premises

Jerome buys an investment property with a stand-alone studio at the front and a three-bedroom house at the rear. Jerome immediately rents the property to Denise. Denise uses the studio for her legal practice and lives in the house with her family. The studio makes up 30% of the total land area of the property and is used as Denise's business premises 100% of the time Jerome owns the property. Because the property has a dwelling on it (the house), the property meets the initial definition of "residential land".

Jerome sells the property within the bright-line period. Although the property is used as business premises, it is not used "predominantly" (more than 50%) as business premises. Therefore, the property is not excluded from the definition of "residential land", so is caught by the bright-line test. Unlike Wayne in Example 4, Jerome does not live in the house on the property. Accordingly, the "main home" exclusion (s CB 16A) is not available.

Appendix

The following flowchart sets out the steps to determine whether the bright-line test and business premises exclusion apply to a sale of land within the bright-line period:



References

Subject references

Bright-line test
Business premises exclusion

Legislative references

Income Tax Act 2007, ss CB 6A, CB 6–CB 12, CB 16A, CB 19, YA 1 ("dwelling", "residential land")

Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018, s 6(2)

Case references

C of T v Nightcaps Coal Company (Ltd) (1909) 29 NZLR 885 (SC)

Case Y10 (2007) 23 NZTC 13,097 (TRA)

Gardiner v Sevenoaks Rural District Council [1950] 2 All ER 84 (QB)

Grieve v CIR (1984) 6 NZTC 61,682 (CA)

Paddico (267) Ltd v Kirklees Metropolitan Council [2011] EWHC 1,606 (Ch)

Thames Water Ltd v Hampstead Homes Ltd [2003] 1 WLR 198 (CA)

Other references

Concise Oxford English Dictionary (12th ed, Oxford University Press, New York, 2011).

"QB 18/16: Income tax - bright-line test - main home exclusion - sale of subdivided section", *Tax Information Bulletin* Vol 31, No 1 (February 2019): 43.

"QB 18/17: Income tax - bright-line test - farmland and main home exclusions - sale of lifestyle blocks", *Tax Information Bulletin* Vol 31, No 1 (February 2019): 48.

"QB 19/14: Income tax – When does the business premises exclusion in s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?", *Tax Information Bulletin* Vol 31, No 9 (Oct 2019): 75.

QB 19/14: Income tax – when does the business premises exclusion in s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?

This Question We've Been Asked (QWBA) explains when the business premises exclusion in s CB 19 of the Income Tax Act 2007 applies to sales of land that would otherwise be subject to tax under any of the land taxing provisions in ss CB 6 to CB 11.

It will be of interest to those selling their business premises, if the sale is potentially taxable under one of those provisions. Primarily this will be taxpayers who bought the premises with the purpose or intention of resale, or taxpayers who are dealers, developers or builders, or associated with someone in one of those businesses.

Question

When does the business premises exclusion in s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?

Answer

The business premises exclusion in s CB 19 applies to premises acquired and occupied, or erected and occupied by the landowner mainly to carry on a substantial business. "Business premises" means land, typically including a building, from which a person carries on a business. Subject to certain limitations, the exclusion also applies to land reserved with the business premises for the use of the business.

The s CB 19 business premises exclusion applies only to the extent that the land sold is business premises (together with land reserved with the premises for the use of the business). However, the s CB 19 business premises exclusion is not available if the landowner has engaged in a regular pattern of buying and selling or building and selling business premises.

Explanation

The scope of this QWBA

1. This QWBA focuses on the application of the business premises exclusion in s CB 19. The s CB 19 business premises exclusion is relevant where the sale of land is potentially taxable under:
   - s CB 6 – purpose or intention of resale;
   - ss CB 7 and CB 9 – business of land dealing;
   - ss CB 7 and CB 10 – business of developing or subdividing;
   - ss CB 7 and CB 11 – business of erecting buildings; or
   - s CB 8 – land used for landfill.
2. The s CB 19 business premises exclusion is only relevant to the above land sale rules. There is a separate business premises exclusion for the purposes of the bright-line test. These two business premises exclusions are briefly compared at [30]. The business premises exclusion to the bright-line test is covered in more detail in "QB 19/13: Income tax – When does the business premises exclusion to the bright-line test apply?".

Meaning of "premises of a business"

3. Under s CB 19, the sale of land that would otherwise be taxed under ss CB 6 to CB 11 will not be taxable if:
   - the land is the "premises of a business" (referred to in this QWBA as "business premises") (s CB 19(1)(a)); and
   - the landowner acquired and occupied, or erected and occupied, the premises mainly to carry on a substantial business from them (s CB 19(1)(b)).
4. Land that is reserved with business premises for use in the business may also be covered by the s CB 19 business premises exclusion when it is sold with the business premises. This is discussed from [17] to [23].

Business premises requirements (s CB 19(1)(a))

5. "Business premises" is not defined in the Act for the purposes of s CB 19. "Premises" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) as:

   > A house or building, together with its land and outbuildings, occupied by a business or considered in an official context.
6. At common law, "business premises" can refer to a variety of places from which a business is carried on, whether just buildings, buildings and associated land, or bare land. (*Case Y10* (2007) 23 NZTC 13,097 (TRA); *Thames Water Ltd v Hampstead Homes Ltd* [2003] 1 WLR 198 (CA); *Gardiner v Sevenoaks Rural District Council* [1950] 2 All ER 84 (QB); *C of T v Nightcaps Coal Company (Ltd)* (1909) 29 NZLR 885 (SC)).

7. The Commissioner considers that while business premises will typically include a building, there may be instances where land without a building is business premises. For instance, a quarry may be business premises even if it does not have a building on it, provided that the further requirements of s CB 19 are met. It will be up to the taxpayer to show that the land is business premises.

Requirements of s CB 19(1)(b)

8. Although land may be business premises, this does not mean s CB 19 will necessarily apply. Section CB 19(1)(b) provides that the business premises must be acquired and occupied, or erected and occupied by the landowner mainly to carry on a substantial business from them.

Acquired/erected and occupied mainly to carry on a substantial business

9. The Commissioner considers that to satisfy the requirements of s CB 19(1)(b), the landowner must have first acquired or erected the premises mainly for the purpose of carrying on a substantial business from them. This is tested when the landowner acquired or erected the premises.

10. Section CB 19(1)(b) also requires the landowner to have occupied the business premises mainly to carry on a substantial business. "Occupied" in this context means the landowner (which would include their agent or employee) has a physical presence at the business premises and retains the right to exclude others from the property. A physical presence does not necessarily require a human presence at the premises. The presence of structures or equipment may be sufficient. For example, an automated self-service petrol station would satisfy the "occupation" requirement of s CB 19.

11. Where a landowner leases business premises to another taxpayer, giving them exclusive possession, the landowner does not "occupy" the business premises. Where land is owned by a trust, the trustees must have acquired/erected and occupied the premises mainly to carry on a substantial business of the trust. Occupation by a beneficiary of the trust mainly to carry on their own substantial business will not be sufficient.

12. In the context of s CB 19(1)(b), "mainly" is considered to have the same meaning as "primarily and principally", the phrase used in the earlier equivalents of s CB 19 prior to the rewrite of the Income Tax Act, which was done progressively from 1994.

13. The phrase "primarily and principally", and therefore "mainly" for s CB 19, requires that the relevant purpose (for the premises being acquired/erected) and use (the occupation of the premises) is not only the main purpose or use in the sense of outweighing all the other purposes or uses, singly or collectively, but also the primary purpose or use: *Newman Tours Ltd v CIR* (1989) 11 NZTC 6,027 (HC).

14. Situations may arise where a landowner has occupied premises to carry on a substantial business, for most, but not all of the time they owned the land. This might occur where the landowner vacated the premises prior to sale in order to give vacant possession, or where the landowner temporarily leased the premises to another taxpayer. In these situations, the s CB 19 exclusion may still apply, provided the landowner occupied the premises **mainly** to carry on a substantial business. However, it will be more difficult to argue that premises were acquired/erected and occupied **mainly** to carry on a substantial business the longer premises are:
    - occupied by a third party (and not the landowner);
    - occupied by the landowner for a non-business use; or
    - unoccupied.

15. For the s CB 19 exclusion to apply, the premises must have been acquired/erected and occupied "to carry on a … business". Whether there is a business will be determined using the business test set out in *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). Where a landowner meets the *Grieve* business test, then some or all of the activities of that business must have been "carried on" from the business premises. "Carrying on" a business from a location requires some or all of the activities of the business to be conducted continuously or habitually from there.

16. Finally, s CB 19(1)(b) requires that the landowner acquired/erected and occupied the premises mainly for carrying on a "substantial" business. Whether a business is "substantial" is a question of fact.

Requirements of s CB 19(3) – what land is included?

17. While s CB 19(1) focuses on land that is business premises, s CB 19(3) provides that non-business premises land may also be covered by the business premises exclusion where it is:
    - land reserved, with the premises, for the use of the business; but
    - limited to an area no greater than what is required for the reasonable occupation of the premises and the carrying on of the business.

"Land reserved, with the premises, for the use of the business"

18. For land to be considered "reserved, with the premises, for the use of the business" under s CB 19(3)(a), the land must:
    - be reserved for the use of the business that is carried on from the premises; and
    - have a sufficiently close physical connection to the business premises land.
19. The Commissioner considers that land reserved "with" business premises will usually be in close proximity to the business premises. Where the reserved land is not part of, or immediately adjoining the business premises land, the closer it is to the business premises, the more likely it is to be considered reserved "**with** the premises".
20. The words "for use of the business" do not require business activities to be "carried on" from the land. For example, although business activities are unlikely to be carried on from a carpark reserved for staff parking, the carpark would nonetheless be considered reserved "for the use of the business". The Commissioner considers that the words "for the use of the business", contemplate both current and future business uses. Land reserved for the future use of a business might be land not currently in use, but kept for the future expansion of the business.

An area no greater than that required for the reasonable occupation of the premises and the carrying on of the business"

21. Even if land meets the requirements of s CB 19(3)(a), s CB 19(3)(b) limits such reserved land to "an area no greater than that required for the reasonable occupation of the business premises and the carrying on of the business".
22. The amount of reserved land that is required for the reasonable occupation of particular business premises and the carrying on of the relevant business will be a question of fact. The Commissioner acknowledges that while some taxpayers might reserve additional land with their business premises for the future expansion of the business, whether all of the land reserved is "required" for the carrying on of the business will depend on the particular situation.

Must be sold with business premises

23. It is important to note that for reserved land to be covered by the business premises exclusion, it must be sold with the business premises land with which it is reserved.

Apportionment under the s CB 19 business premises exclusion

24. The s CB 19 business premises exclusion applies to the extent that the land sold meets the requirements of the provision. This means it is possible for the s CB 19 business premises exclusion to apply only to part of the land sold, leaving the other part to which the exclusion does not apply still subject to tax. Where a landowner occupies part of a building as their business premises (for example, a single storey of a multi-storey office building), then the s CB 19 business premises exclusion will apply to the proportion of the total sale price of the land that is attributable to that part of the building.
25. The residential land exclusion in s CB 16 applies in the same way. This means situations could arise where some of the land sold by a landowner is eligible for the s CB 19 business premises exclusion, with the balance of the land qualifying for the s CB 16 residential land exclusion. The result in this type of scenario would be that none of the land sold would be taxable.

Section CB 19(2) – the exclusion will not apply if there is a regular pattern

26. Although a land sale might meet the requirements of s CB 19(1) and (3), s CB 19(2) states that the exclusion will not apply if the landowner "has engaged in a regular pattern of acquiring and disposing, or erecting and disposing, of premises for businesses".
27. Whether a landowner has a regular pattern of acquiring and disposing, or erecting and disposing of business premises will be a question of fact. It will depend on the number of similar transactions and the intervals of time between them. There is no fixed rule about the number of times or how frequently you can buy and sell or build and sell business premises and still use the s CB 19 business premises exclusion. However, generally at least three prior transactions would be needed for there to be a regular pattern – see the discussion in "QB 16/07: Income tax – land sale rules – main home and residential exclusions – regular pattern of acquiring and disposing, or building and disposing", *Tax Information Bulletin* Vol 28, No 9 (October 2016): 4.
28. QB 16/07 outlines when a person has engaged in a regular pattern of acquiring and disposing, or erecting and disposing of dwellinghouses under s CB 16(3). These same principles apply to determining whether a landowner has engaged in a regular pattern of acquiring and disposing of or erecting and disposing of business premises, which would mean the s CB 19 exclusion is not available.

Business premises land sold at a loss

29. If a landowner sells land covered by the s CB 19 exclusion at a loss, the loss will be capital in nature, so will not reduce the taxpayer's net income. The sale proceeds are not income (unless a taxing provision without a business premises exclusion applies), so the cost of the land is not deductible.

Comparison between the s CB 19 and s CB 6A business premises exclusions

30. As noted at [2], s CB 19 is not the only business premises exclusion in the land taxing rules. There is a separate business premises exclusion for the purposes of the bright-line test. Although these two exclusions are both described as "business premises exclusions", they are not the same. "QB 19/13: Income tax – When does the business premises exclusion to the bright-line test apply?" discusses the application of the s CB 6A business premises exclusion in more detail. In short, the main differences between the s CB 19 business premises exclusion and the bright-line business premises exclusion are as follows:
    - Section CB 19 relates to the land taxing provisions from s CB 6 to s CB 11. The bright-line business premises exclusion applies only to s CB 6A (the bright-line test).
    - Section CB 19 applies only to land that is the landowner's business premises (and land reserved with the premises for the use of the business). The bright-line business premises exclusion potentially applies where someone else uses the land as business premises.
    - Section CB 19 requires the landowner to have **acquired and occupied** or **erected and occupied** the relevant business premises **mainly** to carry on a **substantial** business. For the bright-line business premises exclusion, the premises do not have to be those of the landowner and the business does not have to be substantial.
    - Section CB 19 applies **to the extent** that the land sold is business premises (or land reserved with the premises for the use of the business), while the bright-line business premises exclusion applies to all of the land sold, or not at all.
    - Section CB 19 does not apply where the landowner has engaged in a regular pattern of buying or building business premises and selling them. The bright-line business premises exclusion does not have such an exception.

Examples

31. The following examples explain how the law applies.

Example 1 – Business premises of a tenant not the landowner

Mungbean Holdings Ltd (MHL) is associated with Mungbean Developments Ltd (MDL), a company carrying on a business of property developments. MHL is in the business of leasing commercial office space. It owns several office buildings including one that it leases to Edamame Transport Ltd (ETL). ETL has exclusive use of the office building for its transport business.

MHL sells the office building within 10 years of purchase. The sale is taxable under s CB 10(2) because at the time MHL acquired the office building, MHL was associated with MDL, and MDL was carrying on a property development business. Although the office building was business premises, s CB 19 does not apply because MHL did not occupy the office building to carry on its own business of commercial property leasing.

MHL also owns another office building that it occupies exclusively to carry on its commercial leasing activities. If MHL were to sell that building within 10 years of acquiring it, the s CB 19 exclusion would apply, so the land sale proceeds would not be income under s CB 10(2).

Example 2 – Business premises of the landowner

Greenbean Construction Ltd (GCL) is in the business of erecting buildings. It purchases a piece of land and erects a building to use exclusively as its offices and workshop. Three years later, GCL sells the building and purchases a bigger property on the other side of town.

Absent s CB 19, GCL would be liable to pay tax on the sale of the property under s CB 11. However, because GCL erected and occupied the building to carry on a substantial business from, the s CB 19 exclusion applies, so the land sale proceeds are not income under s CB 11.

Example 3 – No building on the land

Redbean Scrapmetal Merchants Ltd (RSML) purchases a piece of bare land for the main purpose of carrying on a substantial business from it. At the time RSML acquired the land, RSML was associated with Favabean Land Dealers Ltd (FLDL), a company carrying on a business of dealing in land. RSML sets up a scrapmetal yard on the land and carries on a substantial business from there. The scrapmetal yard has no buildings on it, just an office in a converted shipping container. The business is very successful. So successful that six years later, RSML needs to move to a bigger site so it sells the land. Absent s CB 19, the sale of the land would be taxable under s CB 9(2). This is because when RSML acquired the land, RSML was associated with FLDL, and the land was sold within 10 years. However, because the requirements of the s CB 19 exclusion are met, the land sale proceeds are not income under s CB 9.

Example 4 – Land with a building that is partly business premises and partly a dwelling

Favabean Beanery Ltd (FBL) purchases a building in the suburbs. At the time FBL purchased the building, it was also associated with Favabean Land Dealers Ltd (FLDL), a company carrying on a business of dealing in land. The building comprises a downstairs retail space and a single-bedroom flat upstairs. The downstairs retail space is twice the size of the upstairs flat.

FBL purchased the property for the main purpose of carrying on its large-scale bean import business. FBL occupies the downstairs retail space and carries on its large-scale bean import business from there. The upstairs flat is rented to Mr Beane under a residential tenancy for the whole time FBL owns the property. After eight years, FBL sells the building for a profit.

Absent s CB 19, the sale of the whole property would be taxable under s CB 9. This is because when FBL acquired the building, FBL was associated with FLDL, which was carrying on a land dealing business, and the land was sold within 10 years. However, because the downstairs retail space was occupied by FBL to carry on its substantial import business, the portion of the sale price attributable to the downstairs retail space is excluded from s CB 9. The portion of the sale price attributable to the upstairs flat is income under s CB 9, because the flat was not business premises, nor reserved with the premises for the use of the business. The cost of the property should be apportioned on the same basis, with only the portion attributable to the upstairs flat being deductible under s DB 23.

Example 5 - Business premises land sold at a loss

Three Bean Salad Ltd (TBSL) purchases a small factory for $100,000 with the intention of carrying on a bean salad manufacturing business from the factory. At the time of purchase, TBSL was also associated with Favabean Land Dealers Ltd (FLDL), a company carrying on a business of dealing in land.

To TBSL's surprise, the bean salad business takes off and the company soon needs to move to bigger premises. Unfortunately, TBSL bought the factory at the peak of the property market, and when it sells, the value of the factory has dropped to $80,000. Absent s CB 19, the sale of the property would be taxable under s CB 9(2). This is because when TBSL acquired the land, TBSL was associated with FLDL, and the land was sold within 10 years. However, as TBSL occupied the premises to mainly carry on a substantial business, the s CB 19 exclusion will apply to exclude the sale of the property from being taxable under s CB 9(2). As a consequence, the $80,000 sale price will not be income to TBSL, and no deduction will be allowed for the $100,000 purchase price.

Example 6 – Business premises vacated before sale

Stringbean Prefabrication Ltd (SPL) carries on a substantial business of erecting buildings. SPL purchases bare land intending to build apartments on the land, which SPL will then on-sell. However, before building the apartments, SPL decides it needs a new workshop for prefabricating building components. The property it purchased to build the apartments on is in an ideal location for a workshop. Accordingly, instead of building the apartments on the land, SPL erects a workshop from which to carry on its business. SPL then occupies and operates its business out of the workshop.

If SPL were to sell the workshop, it would be covered by the s CB 19 exclusion. Even though SPL did not acquire the land "mainly for carrying on a substantial business", it erected business premises for this purpose. SPL then occupied the workshop mainly for carrying on a substantial business.

After three years of occupying the workshop solely to carry on its business, SPL runs into financial difficulties. SPL moves out of the workshop and tries to find a buyer for the property. The workshop is vacant for six months before SPL finally sells it.

SPL is still eligible for the s CB 19 exclusion. This is because even though SPL did not occupy the workshop for the last six months, SPL **erected and occupied** the workshop **mainly** to carry on a substantial business. SPL carried on a substantial business for three years from the premises and so **mainly** occupied them for that purpose, taking into account the whole period of ownership, including the last 6 months when the premises were vacant.

References

Subject references

Business premises exclusion

Land tax

Case references

C of T v Nightcaps Coal Company (Ltd) (1909) 29 NZLR 885 (SC)

Case G76 (1985) 7 NZTC 1,348 (TRA)

Case K21 (1988) 10 NZTC 218 (TRA)

Case M102 (1990) 12 NZTC 2,634 (TRA)

Case Y10 *(2007) 23 NZTC 13,097 (TRA)*

Gardiner v Sevenoaks Rural District Council [1950] 2 All ER 84 (QB)

Grieve v CIR (1984) 6 NZTC 61,682 (CA)

Newman Tours Ltd v CIR (1989) 11 NZTC 6,027 (HC)

Thames Water Ltd v Hampstead Homes Ltd [2003] 1 WLR 198 (CA)

Legislative references

Income Tax Act 1976, s 67(5)(a)

Income Tax Act 2004

Income Tax Act 2007, ss CB 6A, CB 6–CB 11, CB 16, CB 19, YA 1 ("residential land")

Other references

Concise Oxford English Dictionary (12th ed, Oxford University Press, New York, 2011).

QB 16/07: Income tax – land sale rules – main home and residential exclusions – regular pattern of acquiring and disposing, or building and disposing", *Tax Information Bulletin* Vol 28, No 9 (October 2016): 4.

"QB 19/13: Income tax – When does the business premises exclusion to the bright-line test apply?": 68.

OPERATIONAL STATEMENTS

Operational statements set out the Commissioner's view of the law in respect of the matter discussed. They are intended to be a preliminary view in the absence of a public binding ruling or an interpretation statement on the subject

OS 19/04a: Commissioner's statement on using a kilometre rate for business running of a motor vehicle – deductions

Introduction

Operational statements set out the Commissioner's view of the law in respect of the matter discussed and deal with practical issues arising out of the administration on the Inland Revenue Acts.

This Statement explains how the Commissioner's kilometre rates are to be applied. Future rates will be set each year as the necessary third-party data becomes available. This Statement updates and replaces Operation Statement OS 18/01 *Commissioner's statement on use of a kilometre rate for expenditure incurred for business use of a motor vehicle*, issued in July 2018.

The topic of using the Commissioner's kilometre rates is made up of two parts. Part "a" deals with deductions for the business use of a motor vehicle. Part "b" deals with the tax treatment of reimbursement payments made by an employer to an employee where the employee uses their private motor vehicle for employment purposes.

All references to "motor vehicles" and "vehicles" are referring to motor cars, vans, and tray-back vehicles such as coupe utilities. The rates do not apply to motor cycles or scooters (petrol or electric).

All legislative references are to the Income Tax Act 2007.

Deductions for business running of a motor vehicle using a kilometre rate

Where a person intends to claim an expense deduction for a motor vehicle that is used partly for business purposes and partly for non-taxable purposes, they must calculate the proportion of business use using either a logbook or actual records. Under s DE 2, a person may use one of two methods to calculate the deduction for that proportion of business use, namely:

- A cost method based on actual costs; or
- A kilometre rate method.
- Operational Practice

Summary

1. A person must determine the business use of a motor vehicle against the total kilometres travelled by that motor vehicle. A logbook (explained at [18] below), diary, calendar or other suitable method may be used for this purpose. This information will be used to calculate the income tax deduction.
2. A deduction can be made in respect of the business portion of their actual motor vehicle costs. This is known as the cost method. Alternatively, a person may use the s DE 12 kilometre rates set annually by the Commissioner for each vehicle type. This is known as the kilometre rate method.
3. A person wishing to use the kilometre rate method must make an election to use this method. That election will apply until the vehicle is disposed of.
4. The election must be made on a vehicle by vehicle basis and be made in the year the vehicle is acquired or first used for business purposes. The election to use the kilometre rate method is made by using this method in the person's return of income. If no election is made to use the kilometre rate method the person is deemed to have elected to use the cost method. In either case, the election is irrevocable.
5. The kilometre rates are set by the Commissioner by reference to industry figures that represent the average cost of operating a motor vehicle. The rates do not consider regional price variances or regional fuel taxes.
6. The various rates for selected vehicle types are made up of two tiers.
7. The Tier One rate is a combination of the vehicle's fixed and running costs. The Tier One rate applies for the business portion of the first 14,000 kilometres travelled by the motor vehicle in an income year.

8. The Tier Two rates provide only the running costs. The Tier Two rate must be used for the business portion of any travel after the vehicle has covered 14,000kms total travel in any income year.
9. The following are the rates per kilometre that apply for the 2018/2019 income year:

2018/2019 Kilometre Rates		
Vehicle Type	**Tier One Rate**	**Tier Two rate**
Petrol or Diesel	79 cents	30 cents
Petrol Hybrid		19 cents
Electric		9 cents

10. A person wishing to use the kilometre rate method will be required to keep a record of all travel undertaken by the vehicle. This requirement may be met through the use of a logbook in accordance with ss DE 6 to DE 11, or some other recording method such as a diary. Paragraphs 18 to 20 of this Statement contain more information on logbooks. Note that although not all travel (non-business as well as business travel) needs to be recorded, a person who uses the kilometre rate method will need to be able to show whether, and when, the vehicle exceeds the 14,000 annual kilometres.
11. The cost method must be used for any vehicle type not included in the above table.
12. There is no depreciation deduction or recovery of depreciation where a person has elected to use the s DE 12 kilometre rate method for a motor vehicle.
13. Close companies may use the s DE 2 cost method or kilometre rate method as an alternative to paying FBT where a motor vehicle is provided to a shareholder employee, so long as that close company's only non-cash benefit is the availability of a motor vehicle for the private use of the shareholder. The close company must make an irrevocable election to use s DE 2 to calculate the amount of their deduction.
14. The election by a close company to make deductions under s DE 2 instead of applying the FBT rules must be made within the time for filing the company's return of income in which the election is made. Elections are only available for vehicles acquired or first used for business purposes on or after 1 April 2017.
15. Where a close company elects to use subpart DE to calculate the cost of business use of a motor vehicle, any interest deductions are to be included in those calculations. This means that a close company applying subpart DE will need to ensure that any interest deduction under ss DB 7 or 8 does not relate to a motor vehicle.

Detailed Discussion

Legislation changes

16. The Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017 introduced a number of amendments that allow a person to use a simplified method of calculating deductions for motor vehicles that are used for both business and other purposes, such as for private purposes. These changes came in to effect from the 2017/2018 income year and are explained in detail in *Tax Information Bulletin* Vol 29, No 4, May 2017 at page 70. This can be viewed on Inland Revenue's website.
17. Without completely restating that explanation, the key features in respect of claiming motor vehicle expenses where a vehicle is used for both business and non-taxable purposes are as follows:
    - Instead of making a claim for the business use of a motor vehicle based on the actual costs, a taxpayer may elect to have a deduction for the business use portion based on a kilometre rate method.
    - In respect of the kilometre rate method, the Commissioner will set rates by reference to industry figures that represent the average cost of using average motor vehicles.
    - There is no longer a 5,000km limit restricting the use of these rates.
    - The rates will be divided into two Tiers –
        - The first Tier will provide for deductions based on the recovery of both the vehicle's fixed costs and the per kilometre running costs;
        - The second Tier will provide for the recovery of the vehicle's per kilometre running costs only.
    - The Tier One rate is limited to the first 14,000 kilometres (total kilometres in each income year) as the fixed costs of the vehicle ownership would be over deducted with increasing usage if a single rate were used. The Tier Two rates apply for any use above 14,000 kilometres.

- The election to use the kilometre rate method applies on a per vehicle basis and is irrevocable (s DE 2B(3) refers), so a person may not switch back and forth between methods for the same vehicle.
- The election is made by using this method in a tax return for the year in which the vehicle is acquired or first used for business purposes.
- For a vehicle held at 1 April 2017, the election must be made in the return of income for the 2017/2018 income year unless the vehicle is disposed of during that income year. Note, there are different rules that apply to close companies wishing to adopt the kilometre rates instead of paying FBT for shareholder employees. This is further explained below.
- If a person uses a vehicle for dual purposes (business and other purposes) but does not make an election to use the kilometre rate method, they are deemed to have made an irrevocable election to use the cost method (s DE 2B(3) refers).
- There is no depreciation deduction or recovery of depreciation for a motor vehicle where a person has elected to use the s DE 12 kilometre rate method for that motor vehicle because the Tier One rate includes a depreciation calculation.
- Where a close company's only non-cash benefit is the availability of a motor vehicle for the private use of a shareholder, that close company may use s DE 2 as an alternative to paying FBT provided that close company also makes an election to apply the kilometre rate method to calculate the amount of their deduction.
- The election by a close company to make deductions using s DE 2 instead of applying the FBT rules must be made within the time for filing the company's relevant return of income.
- Where a close company uses s DE 2 to calculate the cost of business use of a motor vehicle, any interest deductions are included in those calculations. This means that there is no separate interest deduction in respect of that vehicle under ss DB 7 or 8.

Use of logbooks

18. Sections DE 6 to DE 11 provide the rules for establishing the proportion of business use of a motor vehicle. Further detail can be found on the logbook page on the IR website (**www.ird.govt.nz** keywords: logbook). These rules provide that a person may keep a logbook for a test period of at least 90 consecutive days.
19. That logbook test period is used to establish the average proportion of travel by the vehicle for business purposes during the logbook term (up to three years). This proportion may be used for deductions using the cost method or where the taxpayer has elected to use the kilometre rate method.
20. In the absence of a logbook (or actual records), s DE 4(2) limits any deductions to a maximum of 25% as a proportion of business use of a motor vehicle, provided, of course, that such a percentage can be justified. For the Tier-One rate, this equates to the first 3,500 business kilometres (14,000 × 25%).

Record of total kilometres travelled each income year

21. A person who has elected to use the kilometre rate method must record their odometer reading every balance date for each vehicle covered by an election so that they can determine whether the vehicle has travelled 14,000 kilometres (business and non-business) for the year. This is because the deduction for the kilometre rate method is based on a Two-Tier approach where the Tier One rate is only available for the first 14,000 total kilometres.

Goods and Services Tax

22. The Commissioner's kilometre rates are calculated on a GST inclusive basis. However, input tax cannot be claimed on these estimated kilometre rates. GST may only be claimed on an actual basis with the appropriate tax invoices being held at the time of claiming.

The following are examples using the kilometre rate method to calculate deductions for the 2018/2019 income year:

Example one – Greater than 14,000 kms travelled – log book maintained:

The taxpayer uses their petrol car for both business and private purposes.

The previous log book test period calculates that 60% of the travel is for business purposes.

The car travelled a total of 20,000 kilometres for the 2018/2019 income year.

Deduction:

Tier One 14,000 × $0.79 × 60%	=	6,636.00
Tier Two 6,000 × $0.30 × 60%	=	1,080.00
Total deduction		$7,716.00

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Example two – Greater than 14,000 kms travelled- no log book:

The taxpayer uses their petrol car for both business and private purposes.

No log book breakdown or other record of motor vehicle use is maintained. However, it is known that the car travelled a total of 20,000 kilometres for the 2018/2019 income year and at least 25% (or 5,000km) of this travel was for business purposes.

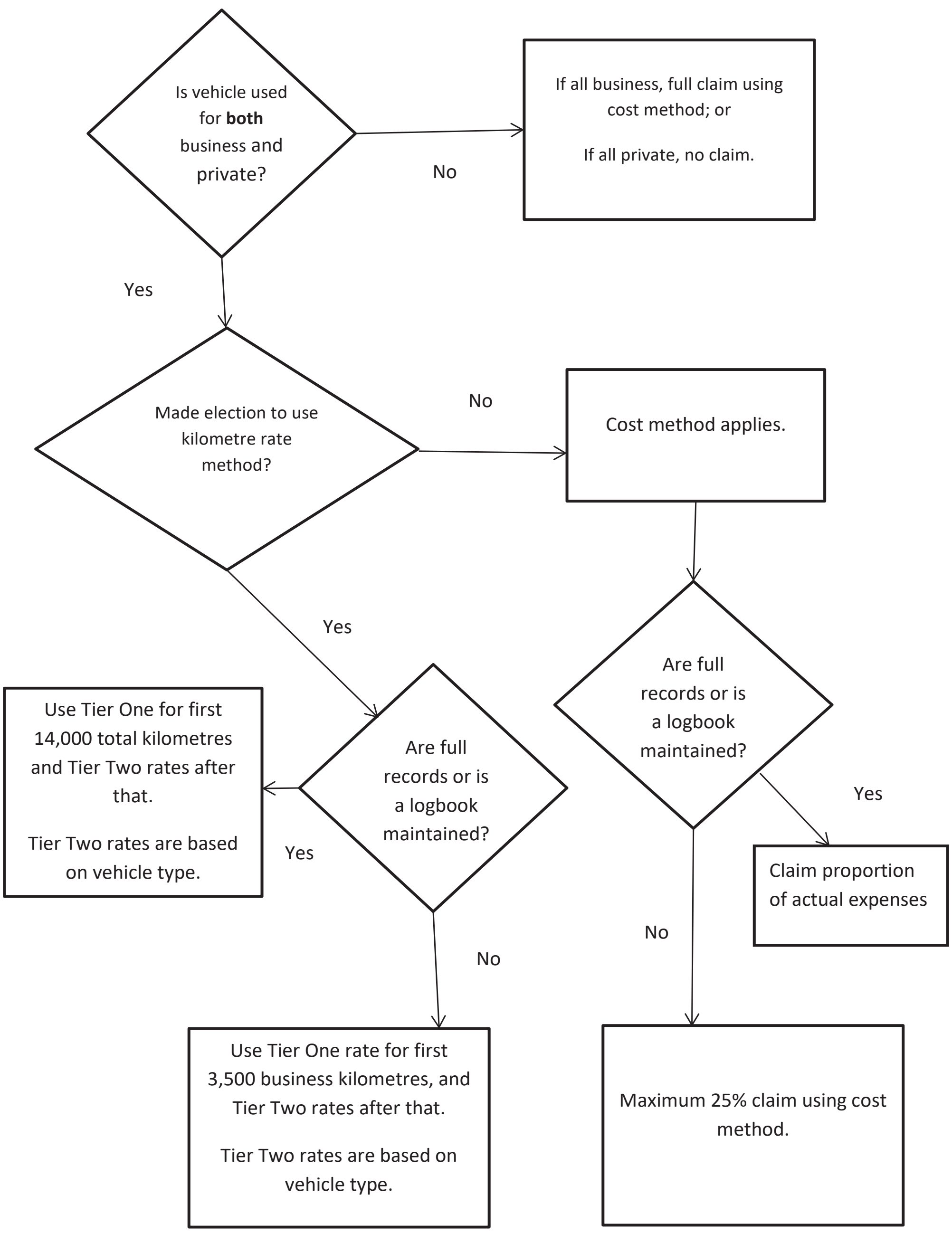
Deduction:

Tier One 3,500 × \$0.79	=	2,765.00
Tier Two 1,500 × \$0.30	=	450.00
Total deduction		\$3,215.00

This Operational Statement is signed on 16 August 2019.

Rob Wells
Manager – Technical Standards, OCTC

Subpart DE Deductions



OS 19/04b: Commissioner's statement on using a kilometre rate for employee reimbursement of a motor vehicle

Introduction

Operational statements set out the Commissioner's view of the law in respect of the matter discussed and deal with practical issues arising out of the administration on the Inland Revenue Acts.

This Statement explains the acceptable method to establish the tax-exempt portion of an amount paid to an employee as reimbursement of expenditure incurred by that employee where the employee uses their private motor vehicle in the employer's business.

Employers may reimburse their employee based on the actual expenditure incurred by that employee. Alternatively, s CW 17(3) provides that an employer may make a reasonable estimate of expenditure likely to be incurred by an employee or group of employees.

This Statement updates and replaces Operation Statement OS 18/01 *Commissioner's statement on use of a kilometre rate for expenditure incurred for business use of a motor vehicle*, issued in July 2018.

Information on the use of the Commissioner's kilometre rates is dealt with in two parts. Part "a" explains the deductions for the business use of a motor vehicle. Part "b" (this part) deals with the tax treatment of reimbursement payments made by an employer to an employee where the employee uses their private motor vehicle for employment purposes.

All references to "motor vehicles" and "vehicles" are referring to motor cars, vans, and tray-back vehicles such as coupe utilities. The rates do not apply to motorcycles or scooters (petrol or electric).

It should be emphasised that the Commissioner is not determining or suggesting what amount an employer must pay to reimburse and employee for the business use of their private vehicle. That is a matter for the employer and employee to agree upon. In this statement the Commissioner is merely confirming that the use of the s DE 12 kilometre rates is an acceptable method of calculating a tax-exempt portion of any reimbursement paid as provided under s CW 17(3).

All legislative references are to the Income Tax Act 2007.

Who does this statement apply to?

As stated above, the kilometre rate method is available to employees. "Employee" is defined in the Income Tax Act 2007 and includes a person who is entitled to receive a PAYE income payment. While such a payment includes a schedular payment, this statement only applies where the payment is made on behalf of an employer.

Who does the statement not apply to?

- A person who receives the payment in respect of their own business such as a business call out fee.
- A trustee of a trust.
- A partner of a partnership.
- Volunteers (although different rules may exempt some payments). Refer to Volunteer payments and expenses page on IR website (**www.ird.govt.nz** keywords: volunteer payments).
- Elected officials.

Application

This statement applies to employee reimbursements made from 16 August 2019.

Summary

1. This statement explains how to calculate the tax-exempt portion of any payment made by an employer to reimburse an employee when the employee uses their private motor vehicle in the employer's business by reference to the use of the Commissioner's kilometre rates.
2. The kilometre rates are set by the Commissioner by reference to industry figures that represent the average cost of operating a motor vehicle. The various rates for selected vehicle types are made up of two tiers. The rates do not consider regional fuel price variances or regional fuel taxes.

3. The Tier One rate is a combination of the vehicle's fixed and running costs. The Tier One rate applies for the employment related portion of the first 14,000 kilometres travelled by the motor vehicle in a year. Beyond that the relevant Tier Two rate, which is only the running costs, applies for the employment related portion of any travel in excess of 14,000 kilometres.
4. The following are the rates per kilometre that apply from 30 May 2019:

Kilometre Rates		
Vehicle Type	**Tier One Rate**	**Tier Two rate**
Petrol or Diesel	79 cents	30 cents
Petrol Hybrid		19 cents
Electric		9 cents

5. An employee wishing to use the kilometre rate to calculate the exempt portion of a reimbursement payment must maintain a logbook or be able to provide other evidence that establishes the employment use of the vehicle for an income year. Note that even where the employee records a logbook test period in accordance with the rules in s DE 6 to DE 11, the annual kilometres travelled must still be recorded so that it is known whether and when the 14,000km total travel for that vehicle is reached each year.
6. In the absence of records as set out in the preceding paragraph, the use of the Tier One rates will be limited to the first 3,500 business kilometres. The Tier Two rates may be used for the kilometres travelled for employment purposes above the 3,500 kilometre threshold.

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7. Where the employee maintains a logbook (explained at paragraph 11 below), or other evidence that establishes the proportion of employment use for an income year, the calculation of the exempt portion of reimbursement may be based on the kilometre rate set by Inland Revenue. The Tier One rate can be applied for the business portion of the first 14,000 kms (total) travelled by the vehicle in each income year, after which the Tier Two rates will apply. Even where the employee records a logbook test period in accordance with the rules in s DE 6 to DE 11, the annual kilometres travelled must still be monitored so that it is known whether/when the 14,000 kilometre threshold is reached each year.
8. However, where no logbook (or other record) is maintained, the use of the Tier One rate to calculate the exemption for employee reimbursement is limited to the first 3,500 kilometres travelled for employment purposes. The Tier Two rates may be used for kilometres travelled for employment purposes above the 3,500km kilometre threshold.
9. The 3,500 kilometres is based on 25% of the average annual expected (14,000) kilometres travelled for each motor vehicle. 25% is the maximum percentage allowed for business deductions where no logbook is maintained.
10. The changes to the business deductions take effect for the 2018 income year onwards and require a slightly different approach and calculation of those rates. Changes with regard to employee reimbursement will always be subject to a time lag using those figures. As such, for the 2019/2020 income year employers may reimburse employees using the new rates from the date of this Statement.

Use of logbooks

11. Sections DE 6 to DE 11 provide the rules for establishing the proportion of business use of a motor vehicle. Further detail can be found on the logbook page on the IR website (**www.ird.govt.nz** keywords: logbook). These rules provide that a person may keep a logbook for a test period of at least 90 consecutive days.
12. That logbook test period is used to establish the average proportion of travel by the vehicle for business purposes during the logbook term (up to three years).

Record of total kilometres travelled each income year

13. An employee being reimbursed using the Commissioner's kilometre rate should record their odometer reading every balance date for each vehicle covered by the reimbursement so that they can determine whether a particular vehicle has travelled 14,000 kilometres (business and non-business) for the year. This is because the reimbursement for the kilometre rate method is based on a two-tier approach where the Tier One rate is only available for the first 14,000 total kilometres. Alternatively, in the case where no log book is kept, the employer may treat any reimbursement after the first 3,500 kilometres (25%) at the tier two rate. Of course, a test period may establish a different percentage of employment related travel (refer example 3 below).

Use of third-party data

14. It is acceptable to use third party data to assist in making such an estimate although care must be taken to ensure capital/fixed costs are not over represented in the rates applied. This is likely to require some division of the rates to isolate the running costs from the fixed/capital costs, similar to the two-tier system in the Commissioner's kilometre rates.

Goods and Services Tax

15. The Commissioner's kilometre rates are calculated on a GST inclusive basis. However, input tax cannot be claimed on the estimated allowances paid to reimburse an employee. GST input tax may only be claimed on an actual basis with the appropriate tax invoice being held at the time of claiming.

The following are examples using the kilometre rate method to calculate employee reimbursement for the 2019/2020 income year:

Example One – Single Journey – No Logbook

- Employee used their private vehicle for a single 65km journey for their employment and did not maintain a logbook.
- They are entitled to treat any reimbursement as tax-free for the first 3,500 employment related kilometres at the Tier One rate.
- The employer must keep a record of how many employment related kilometres are travelled in the income year (for that vehicle) because any kilometres over 3,500 will only be tax-free calculated at the Tier Two rate.
- The calculation (assuming the 3,500 km figure was not breached) would be:

65km × 0.79 cents (the Tier One rate) = $51.35 tax free reimbursement

Example Two – Regular Journey – No Logbook

- Employee used their private vehicle, a petrol-powered motor vehicle, for a regular 65km journey for their employment and did not maintain a logbook.
- They are entitled to treat any reimbursement as tax-free for the first 3,500 employment related kilometres at the Tier One rate.
- The employer must keep a record of how many employment related kilometres are travelled in the income year (for that vehicle) because any kilometres over 3,500 will only be tax-free calculated at the Tier Two rate.
- The calculation (assuming the 3,500 km figure was breached two months earlier) would be:

65km × 0.30 cents (the Tier 2 rate) = $19.50 tax free reimbursement

Example Three – Regular Journey – Trial Logbook

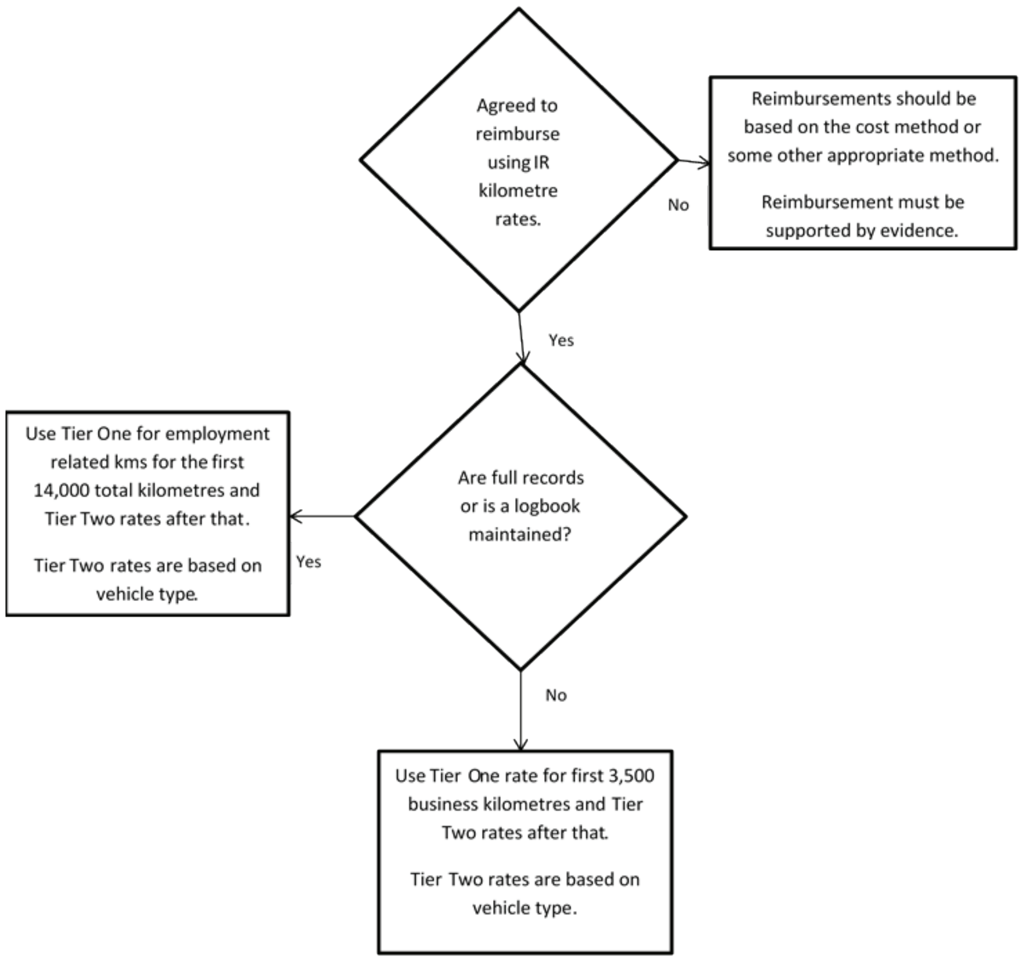
- Employee used their private vehicle, a petrol hybrid-powered motor vehicle, for a regular 65km journey for their employment and did maintain a logbook (albeit for a three-month trial period).
- Employee's logbook evidences that the vehicle is used 40% for employment related purposes and 60% for private/other use
- They are entitled to treat any reimbursement as tax-free for the first 40% of the vehicles total kilometres up to the first 14,000 at the Tier One rate.
- The employee must notify the employer when the annual kilometres reaches 14,000. This is because any kilometres from that point on will only be tax-free calculated at the Tier Two rate.
- Alternatively, the employer could keep a record of the employment kilometres and use the Tier Two calculation once the claim reached 5,600 kilometres (40% of 14,000). Using this alternative approach will mean that the employee will not need to keep any records beyond the three-month trial logbook period.
- The calculation (assuming the 5,600 km figure was breached two months earlier) would be:

65km × 0.19 cents (the Tier Two rate) = $12.35 tax free reimbursement

This Operational Statement is signed on 16 August 2019

Rob Wells
Manager, Technical Standards, OCTC

Employee Reimbursement



LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

General Determination DEP104: Tax Depreciation Rate for lay-flat hoses

Note to draft Determination:

The Commissioner has been asked to consider a depreciation rate for lay-flat hoses used for hire equipment business purposes.

Lay-flat hoses are generally viewed by the Commissioner as a component of a pump set and not a separate depreciable item. However, in the context of a hire equipment business, due to the variety of lengths that may be required, lay-flat hoses are often hired out as a piece of equipment separate to other equipment, so in these circumstances are viewed as separate depreciable property. The general determination will be available only to hire equipment businesses.

Determination DEP104: Tax Depreciation Rates General Determination Number DEP104

1. **Application**

   This determination applies to taxpayers who own items of depreciable property of the kind listed in the tables below.

   This determination applies for the 2018/19 and subsequent income years.

2. **Determination**

   Pursuant to section 91AAF of the Tax Administration Act 1994, the general determination will apply to the kind of items of depreciable property listed in the table below by:

   - Adding into the "Hire Equipment" asset categories, the new asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Lay-flat hoses	3	67	67

3. **Interpretation**

   In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed by me on the 16th day of August 2019.

Rob Wells
Manager, Technical Standards, OCTC

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

Taxation Review Authority considers whether the repayment of a loan can generate an input tax deduction

Case	*TRA 08/18* [2019] NZTRA 3
Decision date	13 June 2019
Act(s)	Goods and Services Tax Act 1985, Tax Administration Act 1994
Keywords	Input tax; invoices; GST; Goods and Services; penalties; interest.

Summary

The disputant challenged his self-assessment of GST for the two-month taxable period ending 30 September 2007 ("disputed period"). He sought to claim additional input tax deductions for taxable supplies acquired during the development of two properties ("10 and 19"). This expenditure included a payment he made to a finance company ("XYL").

The Commissioner of Inland Revenue ("the Commissioner") viewed the payment to XYL as fulfilment of the disputant's obligation under a loan agreement with XYL; the payment was not charged with GST and accordingly could not generate an input tax deduction. No tax invoices were available to support the claim.

The Tax Review Authority ("the Authority") found in favour of the Commissioner.

Impact

The judgment was an orthodox application of the law to the facts, it confirms that repayment of a loan is not consideration for a supply.

Facts

In November 2006, the disputant purchased two properties with financial assistance from XYL. A mortgage with XYL was signed and settled in December 2006 and registered over the properties in January 2007. The purchase of the properties was returned in the period the payment was made, being the period ending 31 January 2007.

On 5 June 2007, the disputant sold 19 to unrelated third parties and the sale was settled on 6 August 2007. The disputant did not file a GST return during the applicable taxable period, 30 September 2007.

On 11 March 2016, the Commissioner received a GST return for the disputed period which included the sale of the property and expenditure on supplies of $28,000.00 (being five percent of the sale price of the property). The sales returned, and expenses claimed included GST at the rate of 12.5 percent (the then applicable rate).

On 31 March 2016, based on the GST return filed, the Commissioner issued a return acknowledgement for $59,111.11 that was required to be paid, along with penalties and interest.

XYL Schedule

During the discovery proceedings, the disputant provided a schedule of expenses relating to the development of the properties. It appeared to show that the supplies were acquired by the disputant and the consideration for the supplies was financed by way of his loan with XYL.

Issues

The Judge identified three issues to be determined in the proceeding (at [3]):

1. Whether the requirement for the disputant to provide tax invoices should be waived.
2. Whether the disputant is entitled to additional input tax deductions.
3. Whether penalties and interest should be remitted in whole or in part.

Decision

On the first issue, the Authority noted that the investigator had carefully analysed the schedule of expenses disclosed during the discovery process and had told the Authority that had this information been disclosed during the dispute process, a further $63,093.24 of expenses would have been allowed. Her Honour found that in the circumstances, there were proper grounds for the Commissioner to exercise her discretion and that a waiver of the requirement for tax invoices was appropriate (at [24]).

On the second issue, the Authority found the repayment of a loan to XYL could not generate an input tax deduction (at [30]). The Authority rejected the submission that the disputant only paid for supplies on the repayment of the loan and was entitled to claim input tax deductions on that payment. Instead the Authority found that the supplies were paid for by the disputant as amounts were drawn down on the loan (as recorded in the XYL schedule) (at [28]).

The Authority did not agree that anything exceptional existed in the funding arrangement which changed the nature of the parties GST obligations (at [30]) and "importantly, repayment of a loan is not consideration for a supply and the payment made by the disputant was not subject to GST input tax" (at [30]).

On the third issue, the Authority had no jurisdiction (pursuant to ss 120I and 138L (2) of the Tax Administration Act 1994 ("the TAA")) to consider penalties and interest (at [33]). The Authority did set out the appropriate course of action for the disputant to take. (The appropriate course of action for a taxpayer who disagrees with the imposition of interest and/or penalties is to apply for remission under s 183A (Remission of Late Payment Penalty for Reasonable Cause) and/or s 183D (Remission of Late Payment Penalty and Interest under Part 7, consistent with collection of highest net revenue over time). Alternatively, a taxpayer can apply for financial relief under the hardship procedure contained in the TAA.)

The Authority increased the disputant's input tax deductions for the disputed period to $93,437.30; amended the Commissioner's assessment accordingly and otherwise dismissed the disputant's claim (at [34]).

Court of Appeal confirms deductions for bad debts not available as operating a "Benevolence on the Conscience Loan Fund" not a money lending business

Case	*Boon Gunn Hong v Commissioner of Inland Revenue* [2019] NZCA 336
Decision date	26 July 2019
Act(s)	Income Tax Act 2007 ss DA 1, DB 31(1), DB31(3), Tax Administration Act 1994 ss 15B, 138G, 141A and Insolvency Act 2006 s 304
Keywords	bad debt, deduction, reasonable care, lending business, business test, financial arrangement, shortfall penalties.

Summary

This was a second appeal from a decision of the Taxation Review Authority ("the TRA") which had been upheld by the High Court on a first appeal. The Commissioner of Inland Revenue ("the Commissioner") had issued assessments disallowing two deductions for bad debts in the amount of $50,000 and $122,280 respectively and imposing shortfall penalties under s 141A of the Tax Administration Act 1994 ("the TAA") for not taking reasonable care.

In 2005 the appellant, a barrister and solicitor in sole practice, had created a fund which he called his "Benevolence on the Conscience Loan Fund", from which he extended loans to clients facing financial difficulties. The two loans for which the appellant had claimed bad debt deductions had been advanced from this fund in 2006. The appellant wrote the debts off, claimed deductions for them in his 2011 income tax return and carried part of the losses through into the 2012 income year. He asserted that he was in the business of dealing in or holding financial arrangements and that he had physically written off the debts as bad in the 2011 income year. The Commissioner contested these assertions.

Impact

This is the first Court of Appeal authority on the application of s DB 31 of the Income Tax Act 2007 ("the ITA") (or its predecessors). It confirms the approach taken by lower courts in earlier cases, including that the *Grieve v Commissioner of Inland Revenue* [1984] 1 NZLR 101 ("*Grieve*") business test is appropriate for determining whether a taxpayer carries on a business of dealing in or holding financial arrangements and that a physical write off is required to be made in whatever books of account used by the taxpayer during the income year in which the deductions are claimed. It is also the first time the Court of Appeal considers the application of s 141A of the TAA.

The Court of Appeal also confirmed that tax litigation is a specialist area of law, meaning it is reasonable to engage out of town counsel and recover disbursements for travel and accommodation for counsel attending hearing.

Decision

The Court of Appeal found that the appellant had not shown that the loans had been written off in the books of account used by the appellant during the 2011 income year. Their Honours noted that, except for the appellant's own assertion as a witness, there was no evidence that his office administrator, Ms Chan, had entered the write-offs in the spreadsheet during the 2011 income year. The Court of Appeal upheld the lower courts' findings that the appellant had failed to discharge the onus of proof in respect of the physical write off requirement. The Court of Appeal also noted that the meta data which the Commissioner's Investigator had presented as evidence in the TRA was not excluded under s 138G of the TAA as that section only excludes new issues or propositions of law (but not evidence) from being raised unless included in the parties' Statements of Position.

The Court of Appeal further upheld the lower courts' findings that the debtors (both being natural persons) had not been released by operation of law from making all remaining payments under s DB 31(1)(a)(ii) of the ITA. This was because neither debtor had been discharged from bankruptcy at the time when the deductions were claimed.

The lower courts were found to have correctly applied the business test in Grieve and had been correct to hold that the appellant was not carrying on, even in part, a lending business for the purpose of deriving assessable income. Their Honours noted the overwhelming evidence which, viewed objectively, fell well short of establishing the appellant was engaged in the business of moneylending. Despite the appellant's repeated assertions that he subjectively intended to make a profit from his lending activities, the Court of Appeal agreed with the Commissioner's characterisation of the lending as being better described as passive investment or charitable advancement of funds. The appellant's profitmaking intention, while subjectively present, in reality amounted to little more than a "hope" that the client would eventually be able to pay interest or even a bonus to the appellant.

The Court of Appeal also agreed with the lower courts' findings that there was an insufficient connection between the appellant's legal services business and the financial arrangements for which deductions were sought. Noting the potential for a conflict of interest in advancing loans to clients and the prohibition under the Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care) Rules 2008 on engaging in conflicting business activities, their Honours' commented that the appellant could not have it both ways.

The lower courts' findings that the appellant failed to take reasonable care and was liable to pay shortfall penalties under s 141A of the TAA were also upheld. While agreeing with Jagose J's finding that it will not always be necessary to take advice from a tax adviser to take reasonable care, the Court of Appeal noted that, in the present case, the appellant had neither conducted his own research nor sought advice from a professional (because he had found it expensive).

The Court of Appeal finally confirmed that costs had been appropriately awarded to the Commissioner in the High Court. Their Honours also awarded costs for a standard appeal on band A for the Court of Appeal proceeding.

Unsuccessful strike-out application to Commissioner of Inland Revenue's Property Law Act 2007 claim

Case	*Commissioner of Inland Revenue v Wallace and Mancer (as executors of the estate of Robertson) and ors* [2019] NZHC 1820
Decision date	30 July 2019, reissued on 31 July 2019
Act(s)	r 15.1 High Court Rules 2016, ss 345 and 348 Property Law Act 2007, Part 16 Companies Act 1993.
Keywords	Strike out application, inherent jurisdiction, prejudicial dispositions, liquidation, increased costs

Summary

The High Court dismissed the defendants', the late Mr Kris McPherson Robertson ("Mr Robertson") (Mr Wayne Andrew Wallace and Mr Clifford William Mancer acting as executors of Mr Robertson's estate), Bianca Café Limited (previously Coffee Distribution NZ Limited), and Kaffee Espresso NZ Limited (collectively "the Defendants"), application to strike out the Commissioner of Inland Revenue's ("the Commissioner") claim. Associate Judge Matthews held that the Defendants had failed to establish that the Commissioner's case was so clearly untenable that she could not succeed at trial. The defendants' application was subsequently dismissed, and the Commissioner was awarded 2B costs with a 50 per cent uplift.

Impact

Unless explicitly provided for in the legislation, actions taken or omitted under the Companies Act 1993 ("the CA") will not restrict a legitimate claim brought under s 348 of the Property Law Act 2007 ("the PLA"). This decision also highlights a situation where it is appropriate for the Commissioner to claim an uplift in costs.

Facts

The Commissioner has brought an application under the PLA for compensation for dispositions of property that have prejudiced her. Coffee Suppliers Limited ("CSL") owed the Commissioner circa $300k in unpaid taxes. CSL was in receipt of a significant number of receivables from its Director, Mr Robertson. CSL and Mr Robertson restructured these receivables to go to other related entities leaving CSL without any assets. CSL was subsequently put into voluntary liquidation.

Decision

Associate Judge Matthews found that the defendants' application fell short of the well- established principles for strike out as outlined in *Attorney-General v Prince & Gardner* [1998] 1 NZLR 626 (CA) at [267]) and affirmed by the Supreme Court in *Couch v Attorney-General* [2008] NZSC 45, [2008] 2 NZLR 725 at [33] and *Carter Holt Harvey Ltd v Minister of Education* [2016] NZSC 95, [2017] 1 NZLR 78 at [10].

The Defendants contended that the Commissioner's PLA claim was an attempt to undo and/or override and/or extend the provisions of the CA and the powers of liquidators. The Court rejected this and held that the Commissioner was entitled to proceed with her PLA claim regardless of the decision of the liquidators in not taking proceedings under the CA. The Court noted that the two statutory provisions were separate and not interrelated.

It was also clear to the Court from the pleadings, that the Commissioner was not (as the Defendants argued) relying on the inherent jurisdiction of the Court to override the powers given to liquidators under the voidable transaction regime under the CA. The Commissioner's claim was squarely based on the grounds as laid out in the PLA, in which the Associate Judge had already concluded was available to the Commissioner to argue.

The Associate Judge dismissed several attempts made by the Defendants to raise substantive matters for argument by stating that those issues were to be dealt with at trial and not at strike out.

Taken together, these factors led the Court to conclude that the Defendants had not met the threshold proving the Commissioner's causes of action were "so clearly untenable that they cannot possibly succeed" or that her case was "so certainly or clearly bad" that it could not proceed.

The Court concluded that the Commissioner be awarded 2B costs plus uplift of 50 per cent and disbursements.

Taxation Review Authority considers ‘taxable activity’ and entitlement to input tax deductions

Case	*TRA 06/18* [2019] NZTRA 4
Decision date	15 August 2019
Act(s)	Goods and Services Act 1985
Keywords	Goods and Services Tax, GST, input tax, input tax deductions, taxable activity

Summary

The disputant challenged GST assessments for the periods ending 31 January 2017, 31 March 2017, 31 May 2017 and 31 July 2017 (“the disputed periods”) that had disallowed input tax deductions claimed by the disputant during these periods. Additionally, the Taxation Review Authority (“the TRA”) considered whether or not the disputant was engaged in a taxable activity.

Impact

The decision was an orthodox application of the law to the facts and may assist with future cases where a taxpayer is conducting intermittent activity that it claims constitutes a taxable activity.

Facts

The managing director (“MD”) of the disputant purchased a vehicle for $13,200 in his own name as the trustee of a foundation. Funds for the purchase of that vehicle were provided by his father. The MD proceeded to refurbish the vehicle. The purpose of this refurbishment, as told to the TRA, was to include features specific to the disputant’s business venture and also included accommodation for several people.

Following incorporation of the disputant the MD registered for GST on a payments basis. A GST return was filed by the disputant claiming an input tax deduction for the vehicle in the amount of $38,362.87. The Commissioner of Inland Revenue (“the Commissioner”) queried this claim and the return was withdrawn. The disputant then asked to be changed to an invoice basis for GST. This request was denied.

The disputant later filed a return including purchases and expenses of $50,079.38 which included an invoice of $50,000 for the sale of the vehicle to the disputant by the MD’s father. The input tax deduction that resulted from this was not paid by the Commissioner.

Decision

The TRA noted that it is a requirement of ss 20(2) and 24 of the Goods and Services Act 1985 (“the Act”), that a valid tax invoice be held before an input tax deduction can be made. Judge Sinclair found there was no evidence before her that the MD’s father had ever owned the vehicle. Therefore, there was no valid tax invoice.

Additionally, pursuant to s 20(3)(b)(i) of the Act an input tax deduction can only be made for a person on a payments basis to the extent that a payment in respect of that supply has been made during the taxable period. The invoice was never paid by the disputant.

The TRA noted that even if the MD’s father could be established to be the supplier of the vehicle and the transaction otherwise satisfied ss 3A(1), 8 and 20 of the Act the input tax deduction would be nil as the vehicle was a second-hand good and the parties to the transaction are associated parties in terms of s 2A(1)(i) of the Act. Judge Sinclair found that as the parties were associated the input tax deduction was limited under s 3(a)(3)(i) of the Act as no tax had been included in the original cost of the goods to the supplier.

Section 20(3C) only allows for an input tax deduction to the extent that the vehicle had been used for, or available for use in, making taxable supplies. Judge Sinclair held that the disputant failed to make clear what taxable supplies the vehicle had been used to make.

To claim an input tax deduction the disputant must also have been carrying on a taxable activity under s 6(1) of the Act. It is not sufficient to have an intention to carry on a taxable activity. The supply of goods must also be for consideration. The disputant failed to provide corroborative documentary evidence of supplies for the majority of invoices during the disputed periods.

The onus is on the disputant to show that the disputant was carrying on a “taxable activity” in accordance with s 6 of the Act. It is not appropriate to take an open-ended view as to when a taxable activity commenced. Accordingly, Judge Sinclair was not satisfied on the evidence that the disputant had been engaged in a taxable activity.

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The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

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