

Budget 2007 Business Tax Reform Package Backgrounders and FAQs

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Business Tax Reform – R&D fact sheet

15 per cent tax credit to promote investment in R&D

New Zealand businesses conducting research and development – R&D – will be eligible for a tax credit of 15 per cent of allowable expenditure.

To qualify, R&D activities must be systematic, investigative and experimental. They must either seek to resolve scientific or technological uncertainty or involve an appreciable element of novelty and be directed at acquiring new knowledge or creating new or improved products or processes. Certain activities are excluded, as they are in other jurisdictions, generally to delineate more clearly the boundary between innovative and routine activity. Activities that support core R&D activities can be eligible.

Encouraging businesses to invest more in R&D will have wider benefits to New Zealand. The tax credit is designed to help improve productivity and international competitiveness, especially with Australia.

How will it work?

- ✓ New Zealand businesses conducting R&D in New Zealand will be eligible for a credit of 15 per cent of allowable expenditure.
- ✓ To qualify for the credit, a business must control the R&D project, bear the financial and technical risk of it and own the project results.
- ✓ The R&D must be carried out predominantly in New Zealand.
- ✓ Eligible expenditure includes the cost of employee remuneration, depreciation of tangible assets used primarily in conducting R&D, overhead costs, consumables and payments to entities conducting R&D on behalf of the business.
- ✓ Ineligible expenditure includes interest, loss on sale or write-off of depreciable property, the cost of acquiring core technology (technology used as a basis for further R&D), expenditure funded from a government grant or the required co-funding, expenditure on intangible assets and professional fees in determining eligibility.
- ✓ R&D credits will reduce tax payments, and imputation credits will arise for the amount of the reduction. R&D credits will be paid out in cash to loss making businesses such as start-ups. The person to whom it is outsourced will not get the credit.
- ✓ Businesses will be able to claim the tax credit as part of their normal tax return process.
- ✓ Businesses that commission R&D from Crown Research Institutes, tertiary institutions and District Health Boards may be eligible for the credit, but those institutions will not receive a credit for R&D undertaken on their own account.
- ✓ The credit will be available for software R&D but software developed for in-house use will normally be subject to a \$2 million cap.

Example of how the tax credit will work

COM Ltd is a New Zealand business that manufactures shirts. In 2010 it has a gross income of \$1 million. It spends \$200,000 of eligible expenditure on an R&D activity to improve its stain- proof fabric. The expenditure includes salaries paid to R&D staff, chemicals used on test fabrics, payments to a third party to test the fabrics and overheads.

COM Ltd files its tax return as follows:

Gross income	\$1,000,000
Less	
Eligible expenditure	\$200,000
Net income	\$800,000
Tax liability	\$240,000
Less	
R&D tax credit	\$30,000 (credit to imputation credit account)
Tax still to pay	\$210,000

If COM Ltd had a tax loss for the 2010 year and has no outstanding tax liabilities, it will receive the **\$30,000** in cash.

Where to from here?

The changes are part of the taxation bill to be introduced following the Budget. Once enacted, the credit will be available from the 2008/09 income year.

R&D tax credit: questions and answers

Why is the R&D tax credit being introduced?

The credit is intended to encourage New Zealand businesses to invest more in R&D, to innovate and develop improved products and processes. This is expected to have wider benefits for the New Zealand economy and boost productivity and international competitiveness.

The credit is one of the business tax reforms that are a substantial and important part of the government's Economic Transformation agenda. The aim is to have a sustainable economy built on innovation and quality, producing the kinds of products for which other countries will pay a premium. The business tax reforms are intended to help foster an environment that enables New Zealand businesses to grow and compete in a global economy.

The Business Tax Review is a key feature in the government's Confidence and Supply Agreements with United Future and with New Zealand First.

Who will get the credit?

New Zealand businesses undertaking R&D on their own account or outsourcing it will be eligible. They will have to incur at least \$20,000 of eligible expenditure in the year a claim is made unless the R&D is outsourced to a listed research provider. Businesses will be eligible, regardless of their legal structure, if the R&D is carried out predominantly in New Zealand. It is expected that up to 2,500 businesses could start claiming the credit.

How much is the credit?

The credit will be 15 per cent of the claimant's total eligible expenditure for the year. Income tax deductions for the expenditure will not be reduced by the amount of the claim received in relation to the expenditure.

What is R&D?

For the purposes of the tax credit, R&D is activity that is systematic, investigative and experimental which seeks to resolve scientific or technological uncertainty or that involves an appreciable element of novelty and that is carried on for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes or services. This activity is referred to as "core" R&D.

Support activities can also be eligible if those activities are commensurate with, required for, and integral to the carrying on of the activity described above.

What activities are not eligible as R&D activities?

Activities that are ineligible as a core activity include:

- research in social sciences, arts or humanities;
- making stylistic or cosmetic changes; and
- market research.

These activities are not eligible as core R&D because the credit is intended to incentivise scientific and technological advancement. They may be eligible as a supporting R&D activity.

Why restrict the credit to businesses in New Zealand?

Increased investment in R&D by New Zealand businesses has wider benefits for the New Zealand economy.

Extending the R&D tax credit to cases where R&D is carried out by a party who is not in business in New Zealand may have some benefits to the New Zealand economy, but would enable the wider benefits associated with firms developing and marketing new products and processes to be captured overseas rather than in New Zealand.

Extending the R&D tax credit to cases where R&D is performed as a service for an offshore commissioner would increase the fiscal cost of the R&D incentive, potentially unsustainably, as New Zealand accounts for a small share of global R&D. This extension is also likely to crowd out investment in R&D by New Zealand businesses as, at the margin, the capacity and capability to perform R&D are relatively scarce.

Why must the R&D be carried out predominantly in New Zealand?

Many of the wider benefits from doing the R&D are likely largely to arise in the location in which the R&D is carried out. The requirement is intended to ensure that New Zealand can capture those benefits. However, the credit will apply to R&D carried out overseas as part of a project based in New Zealand, for up to 10 per cent of the eligible expenditure incurred in New Zealand.

Why is there a minimum threshold of \$20,000 of eligible expenditure?

The threshold exists to minimise compliance and administrative costs associated with the reclassification of small amounts of expenditure as R&D. However, there will be an exception to the threshold if the R&D is carried out by a listed research provider. The exception is designed to allow small businesses to access the credit at a low compliance cost.

Why are there requirements that the claimant must control the R&D, bear the technical and financial risk, and own the results of the R&D?

When R&D is subcontracted out, the incentive will go to the party commissioning the R&D, instead of the party carrying it out. These requirements are designed to prevent multiple claims for the same expenditure. Also, the requirements are intended to ensure that the incentive goes to the party making the R&D investment – which will be the party taking the risks, deciding how much R&D will be undertaken, and benefiting from the results.

Who is ineligible and why?

Crown Research Institutes, tertiary institutions and District Health Boards, their associates and entities controlled by them will be ineligible for the credit. However, if a New Zealand business commissions R&D from these institutions, the business may be eligible for the credit.

These entities are excluded because the credits are intended to encourage private sector investment in R&D, and there are more effective mechanisms for increasing the amount of R&D carried out by these institutions.

Why is the credit based on volume of R&D, rather than incremental R&D?

The credit is based on the volume of R&D done (that is, the total amount of R&D) rather than R&D done above a base-year level (an incremental system). The volume method is simpler to understand and apply. It will also give firms more certainty about the benefit of the R&D credit when planning their R&D investment over the longer term. International experience suggests that this certainty is important.

In addition, as the amount of R&D carried out grows over time, a fixed-base incremental credit will increasingly have the same effect as a volume credit.

What expenditure is eligible?

Eligible expenditure includes employee salaries and training, depreciation of tangible assets used primarily in conducting R&D, overhead costs, consumables, and payments to entities conducting R&D on behalf of the claimant.

What expenditure is not eligible?

Ineligible expenditure includes interest, the loss on sale or write-off of depreciable property, the cost of acquiring core technology (technology used as a basis for further R&D), expenditure funded from a government grant or the required co-funding, expenditure on intangible assets and professional fees in determining eligibility.

When does the credit come into effect?

The credit will apply from the 2008/09 income year.

How do claimants get the credit?

The credit will be claimed as part of the annual income tax return process. A supporting statement will also need to be filed. Businesses with only exempt income will need to file an income tax return to access the credit.

How will businesses without a tax liability get the credit?

The R&D credit will reduce tax payments, but if there is no tax to pay the credits will be paid out in cash. Therefore loss-making businesses, such as start-ups, or businesses, which only have exempt income will receive their credit in cash.

Won't the credit be clawed back when profits are paid to shareholders?

The credit has been designed to minimise claw-back. Imputation credits will arise for a tax liability satisfied by the R&D credit. Those imputation credits will therefore be available to be attached to dividends as though the tax was actually paid.

Why is there a \$2 million cap on software developed for internal use?

Overseas experience highlights a risk that routine in-house software development may be reclassified as R&D expenditure. Expenditure on in-house software development as core R&D is therefore eligible only up to \$2 million a year.

However, the cap does not apply to software development that supports core R&D. Australia does not allow software developed solely for in-house use to qualify as core R&D.

The Minister of Finance may increase the eligible amount for internal software development if the Minister is satisfied that the R&D activity is in the national interest – that is, it will be exploited mainly for the benefit of New Zealand, New Zealand will receive a substantial net benefit from the activities, and the claimant is committed to keep the value of their business in New Zealand.

What about co-operatives that do R&D?

There are special provisions for industry research co-operatives, which are sector-based groups that undertake or commission R&D mainly on behalf of New Zealand businesses. If contributions or levies received by a co-operative from those businesses are applied to R&D that relates to the businesses, the co-operative may be eligible for the credit. The co-operative does not need to meet the requirement to be in business in New Zealand.

Company tax rate change: questions and answers

1 Why is the company tax rate being reduced from 33 per cent to 30 per cent?

Business tax reforms are a substantial and important part of the government's economic transformation agenda. Our aim is to have a sustainable economy built on innovation and quality, producing the kinds of products for which other countries will pay a premium. The business tax reforms are intended to help foster an environment that enables New Zealand businesses to grow and compete in a global economy.

The Business Tax Review was a key feature in the government's Confidence and Supply Agreements with United Future and with New Zealand First.

Reducing the company tax rate will allow successful businesses to keep a greater share of their profits. This is expected to increase investment in New Zealand which in turn will boost productivity. It is also expected to increase profits recognised in New Zealand which in turn will lift our international competitiveness, especially with Australia.

2 Who will get the company tax rate reduction?

The tax rate reduction applies to New Zealand companies, including unit trusts.

3 Why is the rate reduction restricted to companies?

The Business Tax Review discussion document, released in July last year, consulted on the possibility of a company tax rate reduction. The Review noted that most business activity in New Zealand is undertaken by companies and acknowledged that a company rate reduction would not benefit unincorporated businesses. Submissions on the Review strongly supported a company tax rate reduction, though some also supported reducing personal tax rates at the same time.

A company tax rate reduction increases incentives to invest and improve productivity for New Zealand companies. It also improves the attractiveness of New Zealand as a location for companies, especially in relation to Australia. Therefore a reduction in the company tax rate directly addresses the two main objectives of the Business Tax Review.

Personal tax reductions are a less direct way of reducing taxes on businesses (and addressing these objectives) as business income is a relatively small share of total personal income.

4 When does the tax rate reduction come into effect?

Most of the amendments apply from the beginning of taxpayers' 2008/09 income years. The exceptions are:

- the amendments that relate to Qualifying Company Election Tax, which will apply from 17 May 2007; and
- the amendments that relate to benchmark dividends, which will apply from 1 October 2007.

5 How do companies take advantage of the tax rate reduction?

Companies calculating their tax liability should use the reduced rate from the start of their 2008/09 income year. There will be special rules for provisional taxpayers who use the uplift method to allow for the tax rate reduction.

6 Won't the tax rate reduction be clawed back when profits are paid to shareholders?

The imputation system allows credits for tax paid at the company level to be passed through to shareholders, offsetting their tax liability on dividends received. Following the company tax cut, to the extent that profits are distributed to New Zealand taxpaying shareholders, less tax will have been paid at the company level, requiring additional tax to be paid at the shareholder level. However, companies will benefit from the lower rate so long as profits are retained and reinvested in the company.

7 What associated changes are being made as part of the company tax rate reduction?

Reducing the company tax rate will require a number of associated changes. These include amendments to the imputation rules, altering the tax credit ratios for shareholders, amending the foreign investment tax credit and available subscribed capital formulas, changes to the qualifying company rules and adjusting the Branch Equivalent Tax and Conduit Relief Accounts.

8 Why are there transitional imputation rules?

The maximum imputation credit ratio is set equal to the company tax rate. Allowing the imputation ratio to change at the same date as the company tax rate is simple but would adversely affect many shareholders since dividends are usually paid out in arrears. Profits taxed in the company's hands at 33 per cent would be imputed only to 30 per cent, leading to an additional top-up tax being paid by shareholders.

The transitional period therefore allows for profits that have been taxed at 33 per cent to be passed through to shareholders with credit for this higher rate of tax.

The transitional period will run from the beginning of the 2008–09 income year to the end of the 2009/10 imputation year (being 31 March 2010). At the end of this period, companies will be able to distribute any 33 per cent tax credits at the new imputation ratio of 30/70.

9 Why do shareholders who are companies or widely held savings vehicles not fully benefit from the transitional imputation provisions?

That is to prevent those shareholders with a 30 per cent tax rate from being able to use the additional 3 per cent credit to shelter other income from taxation.

10 How do companies take advantage of the transitional imputation period?

Companies will need to calculate the level of their 33 per cent tax credits. To the extent that they have a balance of these credits during the transitional period they will be able to allocate them at a maximum tax credit ratio of 33/67.

11 Why is no associated change being made to the resident withholding tax (RWT) rate?

No change is currently proposed in relation to the rates of RWT on interest and dividends, as 33 per cent is a final tax for a number of shareholders, including a number of individuals who do not have to file tax returns because their income is presently fully taxed. In addition, Inland Revenue is considering carrying out an operational review of RWT.

Business Tax Reform – international tax fact sheet

Less tax for New Zealand companies operating overseas

The introduction of a tax exemption for the active income of New Zealand businesses operating overseas will bring New Zealand into line with international norms. The exemption is designed to encourage businesses with international operations to remain in New Zealand and enable New Zealand businesses to be able to compete more effectively in foreign markets. Compliance costs will also be substantially reduced for many businesses.

At present, New Zealand taxes its residents on their worldwide income. That includes income earned by a foreign company that is controlled by New Zealand residents – referred to as a “controlled foreign company” – regardless of how it is earned. In contrast, many other countries distinguish between the active and passive income of controlled foreign companies – for example, distinguishing between income from manufacturing and income from investment such as interest, dividends and royalties. Those countries either delay taxing offshore active income until dividends are paid or exempt it altogether.

How will it work?

- ✓ Active income, such as income from manufacturing, earned by New Zealand-resident companies through their controlled foreign companies will be exempt from domestic tax. Only their passive income will be taxed.
- ✓ Dividends from controlled foreign companies to the New Zealand parent will be exempt from domestic tax.
- ✓ The government plans to develop a simple “active business” test that exempts all controlled foreign companies with less than 5 per cent passive income, no matter where they do business. The test will be designed to replace the current eight-country “grey list” exemption.
- ✓ Even if a controlled foreign company does not meet the active business test, only its passive income will be taxed back in New Zealand.
- ✓ Once the exemption is in place, interest allocation rules will limit the extent to which New Zealand businesses can deduct interest costs relating to offshore investments that are outside the New Zealand tax base.
- ✓ The rules on conduit taxation, which deal with the New Zealand tax liability on foreign income of the non-resident owners of New Zealand-resident companies, will be repealed.

Example of the benefits to a New Zealand company operating overseas

NZ Co, a New Zealand-resident company, has a manufacturing subsidiary in China, China Co, which earns profits of \$100,000. If, for example, China Co qualifies for a special 10 per cent tax rate in China, it will pay \$10,000 tax in China.

NZ Co will be taxed in New Zealand on China Co's profits of \$100,000, with tax credits provided for the tax paid by China Co in China. Under the new 30 per cent company tax rate, NZ Co will pay \$30,000 in tax: \$20,000 paid to New Zealand, with credit for the \$10,000 paid to China.

If the active income of its subsidiary is exempted from New Zealand tax, NZ Co can benefit from any low tax rate that China offers. The income of China Co will no longer be taxable to NZ Co. In other words, the only tax paid is the \$10,000 to China.

The benefit to China Co from the low tax rate in China will be greater because dividends from controlled foreign companies will be exempt from New Zealand tax. If not, NZ Co would be required to pay \$20,000 of New Zealand tax on China Co's profits when the profits are distributed.

Where to from here?

As part of the continuing review of New Zealand's international tax law, a second round of consultations will be undertaken to work through the detailed design and implementation of the active income exemption.

The goal is for legislation to be introduced early in 2008, with application beginning from the 2009/10 tax year.

International tax review: questions and answers

What are the major features of the international tax reform package?

The central feature of the reform is the introduction of a tax exemption for active income (such as manufacturing) of a controlled foreign company (CFC). This constitutes a major policy change, and means that the offshore active income of New Zealand business will no longer be taxed as it is earned, but will instead be exempt from New Zealand tax.

As part of a package of proposals for the implementation of an active income exemption, the following additional in-principle policy decisions have been made:

- Ordinary dividends from CFCs to the New Zealand parent will be exempt from domestic tax.

- A simple “active business” test will be developed to exempt all CFCs with less than five percent passive income, no matter where they do business. The test will be designed to replace the current eight-country “grey list” exemption.
- Even if a CFC does not meet the active business test, only its passive income will be taxed back in New Zealand.
- A relatively limited definition of passive income, that would include dividends, interest, royalties and certain rents, will be developed.
- A limited set of “base company” rules for services will be adopted.
- Once the exemption is in place, interest allocation rules will limit the extent to which New Zealand businesses can deduct interest costs relating to offshore investments that are outside the New Zealand tax base.
- The conduit rules will be repealed.

What are these changes intended to achieve?

The international tax reform package is aimed at improving New Zealand’s international competitiveness through promoting an environment for globally connected firms to locate in and expand from a New Zealand base. The reform fits within the government’s Economic Transformation agenda, recognising that tax is one of a number of factors that influence firms’ location decisions. With an increasingly borderless global economy, New Zealand must be able to attract and retain capital and our businesses must be able to compete effectively in foreign markets.

New Zealand’s current CFC rules tax offshore income more comprehensively than other countries, which generally exempt active income earned offshore or defer tax until that income is returned in the form of dividends. Australia, in particular, has an extensive active income exemption in its CFC rules.

An exemption of offshore active income will bring New Zealand into line with international norms. This will put New Zealand companies on a more equal footing internationally by removing an additional tax cost not faced by firms based in comparable jurisdictions, enabling them to expand into new markets from a New Zealand base.

Who will benefit from the active income exemption?

New Zealand businesses will not have to pay New Zealand tax on the active income earned by their CFCs. Firms with active CFCs in non-grey list countries will be relieved of both tax and compliance burdens. As a result, New Zealand firms will be better able to expand their business overseas and compete more effectively in foreign markets.

How do these changes compare with the Australian system?

New Zealand has had the opportunity to learn from the Australian system in developing our rules. Australia uses a comparable framework for its taxation of

CFCs, although some key features differ. For example, Australia has retained a “listed country” exemption. On the other hand, we propose a narrower definition of passive income, to minimise compliance costs and avoid getting in the way of the legitimate business arrangements of New Zealand firms operating offshore.

Why replace the grey list?

The new system needs to be looked at as a whole. The proposed rules exempt dividends from CFCs and allow considerable margin in the application of the interest allocation rules. In that context, taxation of passive income, no matter where it occurs, forms a cornerstone in protecting the domestic tax base from tax-eroding strategies.

The grey list exemption is based on the assumption that eight listed countries have tax systems that are comparable to New Zealand. In reality, however, there can be no guarantee that passive income will be comparably taxed in those countries. Non-taxation of passive income may occur from the architecture of the other country’s tax system, or as a result of tax arbitrage, exploiting technical differences between tax systems.

What are the implications for firms’ compliance costs?

Compliance costs will be minimised through the adoption of a simple “active business” test, which will exempt all CFCs with less than five percent passive income, no matter where they do business. Combined with a narrow definition of passive income, and narrow base company rules, it is anticipated that most substantially active CFCs will not need to attribute any income at all.

Other aspects of the system will also help to minimise compliance costs by comparison with other countries’ regimes. For example, New Zealand will have no base company rules for goods and will exempt dividends from CFCs.

Why repeal conduit relief?

Conduit tax relief is currently available for the CFCs to the extent that the parent company is owned by non-residents.

Conduit relief will become redundant for active income once the proposed reforms are in place. The case for continuing to provide conduit relief for passive income is weak and would involve on-going risk to the tax base. In particular, it can encourage non-residents to re-characterise New Zealand source income as foreign income.

Why extend our interest allocation rules to New Zealand firms with CFCs?

The introduction of an active income exemption will create an incentive for New Zealand companies with outbound investment to over-allocate their global interest costs against their New Zealand income. As such, there is a strong case in principle for extending our existing interest allocation rules on inbound investment to New Zealand firms with CFCs with the introduction of an exemption for active income earned by CFCs.

To ensure that the rules do not unduly affect most New Zealand business, the government proposes to maintain the current thresholds, including a 75 per cent safe harbour. This will result in New Zealand having rules which are similar to Australia's.

What about Non-Resident Withholding Tax?

The Budget announcement focuses on the design of an active income exemption. Changes to NRWT will be taken forward through bilateral treaty negotiation. Associated changes to the Foreign Investor Tax Credit and the Approved Issuer Levy are also best considered as part of that process.

What are the next steps?

An update on the international tax review has been released with Budget materials. It provides a stock-take of the package of proposals discussed here and sets out the areas of which further detailed consultation, analysis and decisions are still required.

Over the next few months, officials will release a series of technical papers covering in greater depth the topics requiring further consultation and analysis. Officials will then consult on the topics covered in the papers, and written submissions will be invited.

Following this second round of consultation, the government expects to consider the detailed proposals and finalise the reform package later this year, with a view to introducing legislation in early 2008 (for application beginning the 2009/10 tax year).

In order to develop a workable and robust reform package, it is critical that supporting and consequential details are carefully considered. For this reason, the determination of a finalised policy package is conditional on the outcomes of a secondary round of detailed work and consultations.

Business Tax Reform – savers fact sheet

Savers also benefit from new company tax rate

People who save through managed funds such as unit trusts and most superannuation and group investment funds will also benefit from the new 30 per cent company tax rate.

As a complementary measure, the top tax rate on investment income earned on behalf of individuals who invest in managed funds that choose to use the new portfolio investment entity tax rules will also reduce from 33 per cent to 30 per cent.

Less tax paid on income from these savings vehicles will mean faster accumulation of savings by individuals.

How will it work?

- ✓ The tax rate for unit trusts and group investment funds taxed as companies will change to the new, lower company tax rate of 30 per cent.
- ✓ People who invest in life insurance savings products will have tax paid on their behalf by life insurers at the rate of 30 per cent.
- ✓ Widely held superannuation funds and widely held group investment funds that are taxed as trusts will be taxed at 30 per cent.
- ✓ The top tax rate on income earned by portfolio investment entities for individual savers will be 30 per cent, down from 33 per cent.

Example

Sara, whose top personal tax rate is 33 per cent, regularly invests in a widely held superannuation fund (which is one that generally has more than 20 investors). Under current law, her share of the fund's income is \$1000, on which the fund pays \$330 tax. Her share of after-tax income is \$670.

Under the new 30 per cent tax rate, the tax on her investment income of \$1000 will be \$300. Her share of the after-tax income will be \$700, which means additional savings of \$30 a year.

If she invests in a managed fund that chooses to use the new portfolio investment entity tax rules, the fund will pay tax on the investment at a top rate of 30 per cent. The \$1000 income it earns for her, less \$300 tax, will also give her a \$700 after-tax return.

Where to from here?

The changes are part of the taxation bill to be introduced following the Budget. Once enacted, the 30 per cent tax rate will apply from the 2008/09 income year.