

Client Newsletter

February/March 2008

Company tax rate reduction

The reduction of the company tax rate to 30% from 1 April 2008 will make a company structure more attractive than it was previously.

Despite the obvious tax advantage, there can be pitfalls as well in changing an existing business structure to a company. The obvious ones are that:

- an extra 9 or 3 cents in the dollar will need to be paid at some stage when income is streamed down to shareholders at marginal tax rates of 39% or 33% respectively
- the possible liability for Fringe Benefit Tax and depreciation recovered on assets transferred into a company from a sole trader or partnership.

It is possible, this being the election year, that there could be tax reform (cuts) announced this year. With this in mind it may be best to wait for the dust to settle later in the year before restructuring.

There are a number of transitional rules for existing companies. Some of these are listed below.

1. There is a transitional period ending on 31 March 2010 where companies can continue to pay dividends by attaching their pre-2008 tax-year imputation credits at 33%. We note that companies wishing to do this will need to keep records that clearly identify taxes paid at the 33% rate and taxes paid at the 30% rate. This is necessary for anti-avoidance rules where a company cannot pay dividends by attaching 33% imputation credits from imputation credits that arose at the 30% tax rate. A penalty tax of 10% will be payable where there are insufficient credits in the imputation credit accounts.

2. Companies will need to decide whether to declare a dividend to use their 33% imputation credits by 31 March 2010, which will mean an extra 6% tax liability for taxpayers at the 39% marginal rate or not paying a dividend which could result in a 9% tax liability at some stage in the future (assuming the top marginal tax rate remains same).
3. Dividends declared **after 1 April 2008** with only a 30% imputation credit will require a 3% Withholding Tax top-up payment. Shareholder companies receiving dividends after 1 April 2008 with 33% imputation credits will only be able to apply 30% imputation credits when they pass these dividends on to their (individual or Trust) shareholders.
4. Another change is that the payment of Qualifying Company Election Tax will now create a credit to the imputation credit account. This is significant because Qualifying Companies and Loss Attributing Qualifying Companies are required to firstly clear all imputation credits with taxable dividends before any capital dividends can be made which are tax-free.

Nevertheless, many companies with individual shareholders may consider entering the Qualifying Company regime before 31 March 2008 to allow for shareholding changes after 1 April 2008. Care is needed particularly if the Company has previously made a gain from a related party transaction.

Research and Development tax credits

What is it?

From 1 April 2008, businesses will get 15% of tax credits on Research and Development (R&D) expenditure provided they satisfy a number of criteria. Currently, businesses are able to claim valid R&D expenses but, in addition they will also be able to obtain 15 cents as tax credits for every \$1 of “eligible” R&D expenditure.

Eligibility

To be able to claim the tax credits, R&D expenditure has to be eligible. Some of the criteria to be eligible include as follows:

1. The business must be carried on in New Zealand through a fixed establishment in New Zealand.
2. The R&D activities must be related to the business, that is, the entity must control the project and own the results of the R&D activities.
3. R&D activities can be both “core” and “supporting” R&D.

Core activities are systematic, investigative and experimental activities that will result in either seeking to resolve a scientific/technological uncertainty or a new/improved product.

Supporting activities are those that are commensurate with or integral to the carrying out of core activities.

4. The R&D expenditure must be tax deductible and must be \$20,000 or more for an income year.
5. Where R&D is conducted overseas, it has to be part of a New Zealand project and the R&D costs are limited to 10% of the total project costs.
6. Example of deductible costs that may be claimed for an R&D project are:
 - R&D salaries;
 - training, recruitment, relocation, and travel;
 - consumables; and
 - depreciation on tangible property.

Expenditure that is not eligible for the tax credits are:

- interest or other financing costs;
- acquisition of core technology or intangible assets;
- development costs exceeding \$2 million for in-house software to use internally;
- cost of R&D conducted overseas (except for the 10% allocation as above);
- costs covered by Government grants; and
- professional fees incurred in determining whether the R&D expenditure is eligible.

Core R&D

The aim of the New Zealand Government is to encourage New Zealand businesses to invest in R&D, as it believes there are wider benefits in the form of spill-over improved productivity and international competitiveness. At the same time, it also has to provide protection against claiming tax credits for excessive input costs for R&D expenditure where it is marginal or to prevent businesses claiming tax credits for the same R&D twice termed “double dipping” – this is when R&D is commissioned and performed by several different parties but the benefit is received by only one party.

An example of “double dipping” can occur with the cost of purchasing core technology such as intellectual property or prototypes where they are used for further R&D activities. The party selling the core technology may have originally claimed R&D tax credits and so the cost of acquiring it is an ineligible cost.

Activities that maybe R&D but are excluded from core R&D for tax credits purposes are:

- prospecting, exploring, or drilling for resources;
- quality control or making cosmetic changes;
- commercial, legal, and administrative aspects of patenting and licensing; and
- research in social sciences, arts and humanities.

How to claim it?

The 15% tax credit can be claimed by a business in its income tax return by filing a supporting statement (detailing the R&D projects) with the tax return by the normal filing date.

The tax liability of the business will be reduced by the R&D tax credits and if the R&D credit is in excess, then the surplus will be refunded by the Inland Revenue Department (IRD).

It is therefore important that businesses wanting to claim R&D tax credits establish a proper process where the R&D project is planned, systematic, and logical with a relevant documentary trail to support the statement filed with the IRD.

Note that the foregoing is not in force yet and the IRD has indicated that it will undertake further work to check eligibility of some expenditure once the regime is in operation. The above is only information that is open to interpretation and we strongly advise you to contact your tax advisor for details.

Important: This is not advice. Clients should not act solely on the basis of the material contained in the *Client Newsletter*. Items herein are general comments only and do not constitute or convey advice per se. Changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. The *Client Newsletter* is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and should not be made available to any person without our prior approval. 170/08.