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# Research & Development Tax Incentive (RDTI)

## Guidance for contracting out R&D activity

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# Guidance for contracting out R&D activity

**This guide is to help businesses intending to claim the R&D Tax Incentive (RDTI) while using contractors to conduct some or all of their R&D activities.**

You should determine if the work your contractor (including an approved research provider) is doing is eligible for the RDTI as early as possible in the process to help ensure you meet the following responsibilities as an RDTI claimant:

- you are eligible to claim the RDTI,
- all activities included in your claim are eligible 'R&D activities',
- any expenditure incurred by the contractor, and included in your claim as expenditure on a contractor or an approved research provider, meets the definition of eligible expenditure,
- you have the information you need to file your R&D supplementary return and records to substantiate your claim if required. Note that from the 2020/2021 income year, you will also use the information to apply for general approval or recognition as a significant performer.

Contractors performing R&D for someone else are referred to in the legislation as 'R&D contractors'.

## Approved research providers

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**Approved research providers are a special kind of R&D contractor provided for in the RDTI legislation. R&D expenditure of less than \$50k in one year is ineligible for the RDTI, unless it is performed by an approved research provider.**

To help make the RDTI accessible to businesses of all sizes, eligible R&D expenditure with approved research providers is not subject to the \$50k minimum expenditure threshold. If your eligible R&D expenditure is above \$50k, you can, but do not need to, use an approved research provider.

The word 'approved' in the term approved research provider is not an endorsement of the quality of their services, it simply indicates that they provide research services to other people.

A list of approved research providers is maintained on Inland Revenue's [website here](#).

Status as an approved research provider is not limited to the particular fields that the provider has included in their listing. You are accountable for ensuring that your contractor has the required capability.

# Am I eligible to claim the RDTI?

To qualify for the RDTI, you must:

- 1. be an eligible entity,**
- 2. undertake core R&D activities in New Zealand,**
- 3. own the results of the R&D or be able to use them for no further cost,**
- 4. have eligible expenditure or depreciation loss relating to R&D activities of at least \$50k in the year, unless the eligible expenditure is with an approved research provider.**

The following section introduces the RDTI eligibility requirements and links to more comprehensive information. More detail about the issues that can arise in the context of the RDTI when using a contractor for your R&D appears in the 'Using Contractors and claiming the RDTI' section.

## ELIGIBLE ENTITY

**Private sector businesses located in New Zealand and doing their R&D in New Zealand are generally eligible for the RDTI, which is available to sole traders, partnerships and joint ventures. Industry levy bodies are also eligible.**

You are not eligible to claim the RDTI if you are in one of the following situations:

- 1. You are not eligible to claim if you are, or are owned by, controlled by or associated with a Crown Research Institute, district health board or tertiary education organisation.**

The associated persons rules in the Income Tax Act 2007 are designed to ensure that taxpayers can't use people or entities they are connected with to derive a tax benefit. The rules define when 'persons' are associated and include the following.

- Two companies are associated if there are a group of persons whose total voting interests in each company are 50% or more,
- a company and an entity other than a company are associated if the entity has a voting interest in the company of 25% or more.

The association rules can also apply if effective control is exercised by means other than voting. Inland Revenue has developed a guide to the associated persons rules IR620 which is available [here](#) or from the website.

- 2. You are not eligible if you are acting as an 'R&D contractor'. More detail is provided in the 'Using contractors and claiming the RDTI' section.**
- 3. You are not eligible if you are receiving a Callaghan Growth Grant in the same income year. There is a limited exception for businesses with late balance dates in the 2020/2021 income year. (NOTE: The Growth Grant has been retired in the 2020/21 income year)**
- 4. If you are a charity, the RDTI is not refundable in the 2019/2020 income year. Note the Government is proposing a change to the legislation that would make charities ineligible from the 2020/2021 income year.**

We recommend that you read [the full eligible entity requirements](#) to understand your situation. Note that to be eligible, you must also meet the filing requirements.

## ELIGIBLE R&D ACTIVITY

**Not everything that a business calls 'R&D' will qualify for the RDTI, whereas some activities that you deem 'problem solving' may be eligible. To be eligible, your activities must meet the legislative definitions. These are the key requirements;**

Firstly, you must have a 'core R&D activity.' If you have core R&D activities, there may also be related 'supporting R&D activities' that are eligible for the RDTI.

A core activity must:

- take place in New Zealand,
- seek to resolve scientific or technological uncertainty,
- follow a systematic approach,
- seek to create new knowledge or new or improved processes, services or goods.

New guidance has been released on [Inland Revenue's website](#) (March 2021) to help you understand each of these requirements. Here is an overview of the key definitions:

### Scientific or technological uncertainty

Scientific or technological uncertainty exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, **is not publicly available or deducible by a competent professional working in the field.**

Scientific or technological uncertainty includes the following:

- A problem of a scientific or technological nature, whether an objective is scientifically or technologically possible or how it can be achieved.
- An uncertainty of a scientific or technological nature using the adaptation of knowledge or capability:
  - within the same field of science or technology; or
  - from another field of science or technology.
- Where limitations in the current state of technology hinder the development of a new or improved capability.
- A technological constraint that needs to be overcome, uncertainty arising in relation to:
  - Whether the output will meet desired specifications such as response time, reliability or cost; or
  - How the desired specifications can be achieved amongst possible alternative methodologies or solutions.
- The use of known processes, technologies and methodologies where the result or outcome is unknown.
- System uncertainty, wherein the components of a system and their interactions are known, but the outcome/result of the system cannot be deduced from the outset.
- Technological uncertainty may also arise where something has already been shown to be possible but needs further work to make the technology more cost-effective, reliable or reproducible.

### A systematic approach

To be eligible for the RDTI a core R&D activity must also follow a systematic approach. A systematic approach involves a planned, logical investigation to solve the problem (for example through testing, experimentation or prototyping). A systematic approach can be flexible and adaptive, changing in response to results, but the approach remains logical and focused on solving the problem.

Random or unplanned trial and error is not a systematic approach, regardless of whether this produced something useful.

An accidental discovery is not disqualified from meeting this test provided it was produced while undertaking a systematic approach.

### **Purpose of creating something new or improved**

To be eligible for the RDTI your business needs to identify 'why' you are undertaking your R&D activities.

Your core R&D activity(s) must have a material (important or significant) purpose of seeking to create new knowledge, or to create new or improved processes, services or goods.

New or improved processes, services or goods are created when something is changed or adapted to the point where it is 'better' than the original.

### **Supporting R&D activities**

If you have core R&D activity, there may be related activities that, although they do not meet the definition of a core R&D activity, are directly related to it and required to conduct the core activity. These activities may qualify as supporting R&D activities.

To qualify for the RDTI, a supporting activity must:

- support the core activity as its only or main purpose,
- be required for and integral to the core R&D activity.

[Read more about supporting R&D activities.](#)

## **EXCLUDED R&D ACTIVITIES**

A number of activities are excluded as core R&D, but may be eligible as supporting activities:

- research in social science, arts, or humanities,
- quality control, routine testing, routine collection of information and routine operations on data,
- reverse engineering a commercial product or process from an existing product or system or from plans, blueprints, detailed specifications, or publicly available information,
- data mapping and data migration testing,
- bug testing, beta testing, system requirement testing, user acceptance testing, and data integrity testing,
- minor adaptations, cosmetic or stylistic changes or improvements, including to software,
- testing or comparing the efficiency of algorithms already known to work,
- testing security protocols or arrangements,
- converting existing systems to, or integrating existing systems with, new software platforms.

The following are excluded as both core and supporting activities:

- pre-production activities, including demonstration of commercial viability and tooling up,
- routine de-bugging of existing computer software,
- supporting or making minor improvements to existing computer software, using known methods,
- routine software and computer maintenance,
- prospecting for, exploring for, or drilling for minerals, petroleum, natural gas, or geothermal energy,

- market research, market testing, market development, or sales promotion, including consumer surveys,
- commercial, legal, or administrative aspects of patenting, licensing, or similar activities,
- activities involved in complying with statutory requirements or standards for pre-existing processes, services, or goods,
- management studies,
- activities relating to organisational design,
- ineligible internal software development.

[Read our detailed guidance on excluded activities.](#)

## ELIGIBLE EXPENDITURE

To claim the RDTI, you must be able to identify your eligible expenditure, which has a direct connection with eligible R&D activities.

[Read our detailed guidance on eligible expenditure.](#)

To claim the RDTI, your eligible expenditure must be more than \$50k in your tax year, unless it is for a contract with an approved research provider. The maximum eligible expenditure in any year is \$120m, unless you receive approval for a higher limit.

If resources are used on both eligible R&D and ineligible activity, you will need to apportion the relevant expenditure on a reasonable basis, supported with documentation.

## TYPES OF ELIGIBLE EXPENDITURE

The following types of expenditure are eligible for the RDTI:

- Depreciation loss for items used in performing eligible R&D activities.
- Expenditure or loss on acquiring goods and services used in performing R&D activities. This category includes contracts for R&D services.
- Amount for employees performing R&D activities.

Special rules apply in a number of circumstances—some of these are briefly detailed below.

[Read more in our detailed guidance on eligible expenditure.](#)

### **Production expenditure**

If you perform your R&D in the course of your commercial production, you can only claim the employee costs related to, and additional costs incurred as a result of the R&D. In these circumstances, costs like rent, rates, insurance and maintenance won't qualify for the RDTI.

### **Foreign expenditure**

If you carry out R&D activities outside New Zealand which are not integral to a core R&D activity conducted in New Zealand, the expenditure on those activities is not eligible for the RDTI.

Expenditure on supporting R&D activities carried on outside New Zealand might be eligible, but the foreign expenditure can't exceed 10% of your total eligible expenditure.

If you contract out some or all of your R&D to another person, your eligible expenditure must reflect the rules outlined above and be reduced by any ineligible expenditure incurred by the contractor.

## INELIGIBLE EXPENDITURE

The following types of expenditure are ineligible for the RDTI:

- GST input portion.
- Someone else's eligible expenditure.
- Amounts in excess of \$120m unless you have approval for a higher amount.
- Expenditure incurred in acquiring depreciable property.
- Expenditure that contributes to the cost of depreciable tangible property.
- Depreciation on property to the extent the cost of the property is eligible expenditure.
- Depreciation on pooled property where an item in the pool is not used solely in performing R&D.
- Depreciation when an asset is written off or sold below its adjusted tax value.
- Certain amounts of depreciation when property is acquired from an associated person.
- Profits on R&D services provided by associates.
- Amounts in excess of market value for leasing assets from an associate(s).
- Expenditure to purchase land.
- Interest and other financing costs.
- Professional fees for determining your entitlement to the RDTI.
- Expenditure on acquiring an interest in intangible property other than software.
- Expenditure on bespoke software.
- Internal software development expenditure in excess of \$25m.
- Expenditure on goods or services in excess of market value.
- Gifts.
- The cost of acquiring technology that is used as a basis for further R&D activities.
- Expenditure to commercialise the results of R&D activity.
- Expenditure that relates to a government or local authority grant.
- Expenditure for which you have received an R&D tax credit from another country.
- Expenditure on inputs used in, or subject to transformation, to the extent the expenditure does not exceed the value of the output from that expenditure (the feedstock rule).
- If your eligible expenditure is less than \$50k, expenditure or loss that is not for an approved research provider.

The above expenditure types are ineligible if you incur them directly or if they are included in a contractor's invoice. For example, if your payment to a contractor includes an amount so the contractor could purchase specialised equipment (depreciable property for the contractor) your expenditure for the cost of that specialised equipment is not eligible. More information appears in the 'Using contractors and claiming the RDTI' section.

[Read our detailed guidance on ineligible expenditure.](#)



## Using Contractors and claiming the RDTI

### Who is entitled to claim the RDTI in a contract situation?

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**The aim of the RDTI is to increase the amount of R&D undertaken in New Zealand, and is designed to reward the entity making the decisions about investing in R&D.**

A person doing R&D on contract for someone else is not making the investment decision—as such they are defined in the RDTI legislation as an ‘R&D contractor’ and are not eligible to claim. **This is true even if the entity letting the contract is an ineligible entity such as a CRI or university.**

If you contract another entity to perform R&D activity on your behalf as an ‘R&D contractor’, you can claim the RDTI for that activity.

However, situations may arise where it is unclear who has the right to claim—is the contractor acting as an agent for you, or are they doing the R&D on their own account? In these situations, you will need to determine who has the right to claim.

In determining your right to claim, you need to consider the facts surrounding your relationship with your contractor, including the contract itself. Key factors to consider are listed below. You don’t necessarily have to tick all three boxes, the decision can be made on balance, but you should be aware that there is an outright exclusion on claiming R&D expenditure which is eligible expenditure for someone else.



## CONTRACT FOR R&D OR CONTRACT FOR OUTCOME

If you have engaged the contractor to perform R&D you are likely to have ultimate control and ownership of the R&D and to be bearing the financial risk so you will have the right to claim.

However, if you have engaged the contractor to deliver an outcome, for example a product or process, and they perform R&D as part of delivering that outcome, they may have the right to claim if they meet control, ownership, and financial risk requirements for that R&D.

### Control over the R&D activity

Having control means you can make decisions to start or stop the R&D activity or change its direction. This test is not about the day-to-day management of the R&D.

### Ownership or right to use

Do you own, or have the right to use for no further cost, the results arising from the R&D activity? The ownership requirements are not satisfied if you own or have a right to use the physical output of the R&D, but not the intellectual property.

Ownership or the right to use may be shared with others but if there is an obligation to pay a royalty, licence payment or similar, you may not be able to establish that you have the right to use the R&D for no further cost.

[Read our detailed guidance on ownership of R&D results.](#)

### Financial risk

Do you bear the financial risk of the R&D activity? If you have to pay for the activity regardless of the result, you are taking the financial risk. If your agreement with your contractor stipulates that their fee is only payable provided the outcome is successful or acceptable to you, then the contractor is likely to be bearing the financial risk of the R&D activity.

Two parties cannot claim the RDTI for the same expenditure. If there is doubt, you and your contractor should make sure you agree on who has the right to claim for any eligible R&D expenditure before you submit a claim.

## Identifying and documenting eligible R&D activity

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The situations in which you use contractors may vary from:

- 1. Straightforward cases where you are confident you are eligible to claim, you have an eligible R&D activity, and the contract is for a subset of that activity. In this case, the issues that may arise are most likely to be around excluding any ineligible expenditure and ensuring that you can access records to substantiate what the contractor did for you.**
- 2. Situations where you are unsure if your work would meet the definition of eligible R&D activity. See the *Competent professional test* set out below.**
- 3. Situations where you know that your contract includes a combination of eligible and ineligible R&D activities. In these cases, the issues will include being able to separate out the costs associated with eligible and ineligible activities.**

## THE COMPETENT PROFESSIONAL TEST

**The test for a core R&D activity uses the concept of a competent professional in the relevant field of science or technology. You may be a competent professional or have one on staff. If not, while you are not required to engage a competent professional or tell us who you have used, this is the standard we apply if we review your claim.**

A competent professional is a person who:

- is knowledgeable about and experienced in the relevant field of science or technology,
- possesses the relevant qualifications and/or experience to participate in the field with a reasonable level of skill,
- is aware of the current state of knowledge in the field,
- has access to knowledge from around the world, including access to publicly and generally available resources, for example the internet, relevant industry journals and other professionals.

If you are unsure if your project includes eligible R&D activities and are contracting with someone, you should consider whether they meet the definition of a competent professional set out above.

Regardless of whether your contractor is a competent professional or you are relying on other sources, you should ensure that you can access the information required to complete and substantiate a claim you make for the RDTI:

- Is the knowledge needed to complete your project already publicly available? The test for the availability of knowledge is international, but it is applied by asking where New Zealand-based professionals would be expected to look for the information.
- If the knowledge is not available, what are the scientific and technological uncertainties (the questions that existing knowledge cannot answer) involved in your project?
- Is there any work in the contract which is neither a core R&D activity nor a supporting R&D activity? For example, the contracted work might include activities that are ineligible or are not for R&D as defined above. If so, the information you get from the contractor must enable you to exclude these activities and the related expenditure from your RDTI claim.

The answers to the above questions may be (implicit) in your project documentation or may represent an addition to the proposed schedule of work. You should consider what (if anything) you should include in your contract to ensure you can access the information you need.

If we review your claim we will not follow up directly with your R&D contractor without your knowledge but if you cannot source or arrange for us to access the required information we may not be able to progress your claim.

The legislation imposes an obligation on approved research providers to maintain records that show the amounts they derive and incur when performing R&D activities on behalf of others claiming the RDTI. To benefit from this provision, you must inform the approved research provider that you intend to use them in this capacity.

## Excluding ineligible expenditure

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The first requirement is that any expenditure claimed must be incurred on eligible R&D activity. If your contract includes both eligible R&D and ineligible activities, the contractor will need to put a process or system in place to enable you to identify the expenditure on eligible R&D.

You will also need to ensure:

- that none of the expenditure you include in your claim for payments to contractors is an ineligible expenditure type,
- that any expenditure by the contractor that is subject to a cap is identified,
- that any expenditure subject to rules relating to feedstock or R&D in the course of commercial production is correctly calculated.

### INELIGIBLE EXPENDITURE TYPES

The 'Ineligible expenditure' section sets out a number of expenditure types that are excluded from eligibility for the RDTI, regardless of whether you incur them directly or they are incurred by a contractor and included in your payments.

If you are in any doubt, you should review the list with your contractor and agree how they will break down their charges so that you can exclude ineligible expenditure from your claim. This might be achieved by:

- your contractor identifying expenditure types in sufficient detail to allow you to exclude the ineligible,
- agreeing that your contractor will separate their expenditure into subtotals reflecting what is ineligible and eligible,
- your contractor confirming in writing that none of their expenditure is ineligible.

### CAPPED EXPENDITURE

Foreign R&D expenditure is limited to 10% of your total claim, and expenditure on internal software development is limited to \$25 million in the year.

If your contractor incurs expenditure on foreign R&D or internal software development, you will need to know the amounts so that they can be reported in your R&D return and included in the calculation of your caps.

### EXPENDITURE SUBJECT TO RULES RELATING TO FEEDSTOCK OR IN THE COURSE OF COMMERCIAL PRODUCTION

If your contractor is conducting your R&D in a context where the rules relating to commercial production and feedstock apply, you will need to be able to calculate the eligible amount for the RDTI and be able to access the relevant records to substantiate your claim if needed.

[Read our detailed guidance on eligible expenditure.](#)