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POLICY ADVICE DIVISION

Tax policy report: Black hole expenditure items: abandoned research and development, resource consents and company administration costs

Date:	1 March 2013	**Priority:**	**High**
Security Level:		**Report No:**	T2013/419 PAD2013/026

Action sought

	Action Sought	**Deadline**
Minister of Finance (Hon Bill English)	**Note** the contents of this report **Agree** to the recommendations	6 March 2013
Associate Minister of Finance (Hon Steven Joyce)	**Note** the contents of this report **Agree** to the recommendations	6 March 2013
Minister of Revenue (Hon Peter Dunne)	**Note** the contents of this report **Agree** to the recommendations	6 March 2013

Contact for telephone discussion (if required)

Name	**Position**		**Telephone**
Matthew Gilbert (R&D black hole)	Senior Analyst, Tax Strategy, The Treasury	917 6048 (wk)	[3]
Steve Mack (other black hole items)	Principal Advisor, Tax Strategy, The Treasury	917 6096 (wk)	
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1 March 2013

Minister of Finance
Associate Minister of Finance
Minister of Revenue

Black hole expenditure items: abandoned research and development, resource consents and company administration costs

Executive summary

Some taxpayers and tax advisors, including the Corporate Taxpayers Group (CTG), have expressed concerns to Inland Revenue over the tax treatment of a number of items of "black hole" expenditure. Black hole expenditure is capital expenditure that is not immediately deductible for tax purposes and does not give rise to a depreciable asset, and therefore cannot be deducted as tax depreciation over time.

This report addresses four categories of black hole expenditure:

- abandoned development (as part of R&D);
- certain fixed-life resource consents;
- unsuccessful resource consents where no application is lodged; and
- company administration costs.

Black hole expenditure on R&D was identified as part of the recent review into tax settings relating to innovation (T2012/2282, PAD 2012/245 refers) and forms part of the wider Budget 2013 innovation package.

It is proposed that tax deductions should be allowed for most of the expenditure items discussed in this report. In the situations where deductions are proposed to be withheld, this is consistent with our policy framework and reduces compliance costs for companies.

Summarised below are the proposed changes to items of black hole expenditure discussed in this report:

- Certain research and development expenditure that has been capitalised for accounting purposes but does not give rise to a depreciable asset should be made immediately deductible.

- Fixed-life resource consents that are not listed as items of depreciable intangible property should be added to the appropriate schedule to enable the respective consent holders to depreciate these assets.
- Resource consent applications that are withdrawn should be made immediately deductible, rather than require the completion of the whole application process to access the deduction.
- All direct costs associated with the payment of dividends by a company to shareholders should be made deductible.
- The initial cost of listing on a stock exchange should not be deductible because of the enduring benefit it creates, but the annual fee to remain listed should be deductible as it is a regular expense of a publically-listed company.
- Annual shareholder meetings should be made deductible, but costs incurred to hold a special shareholder meeting should not.

The proposed policy changes should increase the efficiency of the tax system and provide certainty to businesses around the deductibility of some items of expenditure. The reduction in compliance costs will, to some extent, make doing business easier in New Zealand, especially for large and publicly-listed companies.

If all these proposals are agreed to, there is expected to be fiscal costs, as per the table below. However, there is some uncertainty over the estimated fiscal cost of some of these proposals, so estimated fiscal costs are conservative.

	Tax Revenue $m – increase (decrease)					
	2013/14	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Certain abandoned R&D expenditure	(0.25)	(1.00)	(1.00)	(1.00)	(1.00)	(1.00)
Resource consent depreciation costs	(0.11)	(0.56)	(1.01)	(1.46)	(1.91)	(2.36)
Company administration costs	Nil	Nil	Nil	Nil	Nil	Nil
Total change in revenue	(0.36)	(1.56)	(2.01)	(2.46)	(2.91)	(3.36)

The proposals relating to black hole expenditure have no system implications but may incur some additional administrative costs. These are expected to be insignificant and can be met within existing baselines.

In exploring the proposal to remove "black hole" treatment of certain expenditure on failed development (as part of R&D), officials have concluded that the impact of the proposed solution will not be as significant as first envisaged [6]

[6]

Recommended action

We recommend that you:

Research and development expenditure

(a) **Note** that since officials' previous advice on the proposal to address the issue of black hole development expenditure in failed R&D projects, by allowing a deduction for the costs that would have been depreciable if the project had been successful (T2012/3254, PAD2012/274 refers), officials now consider the benefits (and also fiscal cost) of the proposal to be more limited.

Noted
Minister of Finance

Noted
Minister of Revenue

Noted
Associate Minister of Finance

(b) **Agree** that the proposed change to allow deductions for black hole research and development expenditure, related to schedule 14, is announced at Budget 2013 as part of the wider package of black hole changes.

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

(c) **Note** that agreeing to recommendation (b) will have the following estimated fiscal costs:

	$m increase (decrease)				
	2013/14	**2014/15**	**2015/16**	**2016/17**	**2018/19 & out-years**
Tax Revenue	(0.250)	(1.000)	(1.000)	(1.000)	(1.000)

Noted
Minister of Finance

Noted
Minister of Revenue

Noted
Associate Minister of Finance

(d) [6]

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

OR

[6]

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

Fixed-life resource consents

(e) **Agree** that the proposal to add resource consents granted under sections 15A and 15B of the Resource Management Act 1991 to Schedule 14 (Depreciable intangible property) of the Income Tax Act 2007 be announced at Budget 2013. This will have the effect of making expenditure on these resource consents depreciable for tax purposes.

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

(f) **Note** that the agreeing to recommendation (e) will have the following estimated fiscal costs:

	$m – increase (decrease)					
	2013/14	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Tax Revenue	(0.11)	(0.56)	(1.01)	(1.46)	(1.91)	(2.36)

Noted
Minister of Finance

Noted
Minister of Revenue

Noted
Associate Minister of Finance

Unsuccessful resource consents where no application has been lodged

(g) **Agree** that the proposal to allow a tax deduction for expenditure on resource consents that are withdrawn without an application being lodged be announced at Budget 2013.

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

Company administration costs

(h) **Agree** to announce at Budget 2013 the following proposed change(s):

i. Allowing a tax deduction for expenditure incurred on paying dividends.

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

ii. Allowing a tax deduction for the annual listing fee of a company registered on a stock exchange (whilst keeping initial and subsequent listing fees for new share issues non-deductible for tax).

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

iii. Allowing a tax deduction for the costs of annual shareholder meetings, whilst making the costs of special shareholder meetings non-deductible for tax purposes.

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

(i) **Agree** that the changes in recommendations (b), (e), (g) and (h) all take effect from the 2014/15 income year, with enabling legislation being included in the next available tax bill after Budget 2013.

Agreed/Not agreed
Minister of Finance

Agreed/Not agreed
Minister of Revenue

Agreed/Not agreed
Associate Minister of Finance

(j) **Note** that agreeing to all the above recommendations will have the following estimated fiscal costs:

	Tax Revenue $m – increase (decrease)					
	2013/14	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19 & out-years**
Certain abandoned R&D expenditure (rec (b))	(0.25)	(1.00)	(1.00)	(1.00)	(1.00)	(1.00)
Resource consent depreciation costs (recs (e), (g))	(0.11)	(0.56)	(1.01)	(1.46)	(1.91)	(2.36)
Company administration costs (rec (h))	Nil	Nil	Nil	Nil	Nil	Nil
Total change in revenue	(0.36)	(1.56)	(2.01)	(2.46)	(2.91)	(3.36)

Noted
Minister of Finance

Noted
Minister of Revenue

Noted
Associate Minister of Finance

Steve Mack
Principal Advisor
The Treasury

Graeme Morrison
Acting Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Hon Steven Joyce
Associate Minister of Finance

Background

1. Black hole expenditure is capital expenditure that is not immediately deductible for tax purposes and also does not give rise to a depreciable asset for tax purposes, and therefore cannot be deducted as depreciation over time.

2. This report addresses four categories of black hole expenditure:

- abandoned development (as part of R&D);
- certain fixed-life resource consents;
- unsuccessful resource consents where no application is lodged; and
- company administration costs.

3. Black hole expenditure on R&D was identified as part of the recent review into tax settings relating to innovation (T2012/2282, PAD 2012/245 refers) and forms part of the wider Budget 2013 innovation package. [7]

4. Officials have concluded that the black hole expenditure items included in this project are high priority because they fit well within our tax policy framework, are considered to be relatively simple to fix, and do not result in a significant fiscal cost.

Research and development expenditure

Background

5. In December 2012, officials from the Treasury and Inland Revenue reported to Ministers on policy options to address issues identified in their review of tax settings related to innovation that may be disincentivising innovative activity, with a view to their potential inclusion in Budget 2013 (T2012/3254, PAD2012/274 refers). One of the potential policy options was the removal of the "black hole" treatment of certain expenditure on failed development (as part of R&D).

6. In exploring this issue further, officials have concluded that the impact of the proposed solution of allowing an immediate deduction for failed capitalised expenditure, which would have been part of the cost of "depreciable intangible property" if the R&D project had been successful, would not be as significant as first envisaged. This is in part because of the need to restrict the deduction to certain forms of R&D to mitigate tax avoidance risks.

[6]

Problem definition and scope

8. The potential for legitimate research and development expenditure to be accorded black hole treatment results in economic distortions. It will cause a risk-neutral investor deciding between two alternative investments offering the same expected pre-tax rate of return, but where one of the investment options carries a risk of black hole expenditure occurring, to prefer the other investment option. Furthermore, businesses may be incentivised to complete projects that (ignoring tax) have been discovered to be inefficient, simply in order to be able to avoid black hole treatment of sunk capital expenditure.

Current rules

9. Under current tax rules, a person is allowed an immediate deduction for expenditure they have incurred on research or development, where that expenditure is expensed for accounting purposes.

10. Under the relevant accounting rules, expenditure is expensed up until the asset recognition criteria are met. From the point of asset recognition, all further development expenditure is capitalised.

11. Development expenditure that has been capitalised can only be depreciated once there is "depreciable property" for tax purposes. Expenditure on intangible property may only be depreciated if the intangible property is listed on schedule 14 of the Income Tax Act 2007. For an item of property to be listed on schedule 14, it must be intangible and have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its acquisition.

12. It is important to be aware that the depreciable cost base of schedule 14 items will not necessarily equate to the total capitalised expenditure the taxpayer will have incurred from the point of asset recognition.

13. This is especially relevant to patents. According to an interpretation statement issued by the Commissioner of Inland Revenue,[1] the capital expenditure that a patent developer is currently allowed to depreciate is limited to legal and administrative fees relating to the patent application. Other capitalised expenditure relating to patented IP is not depreciable under schedule 14. Such capitalised expenditure is accorded black hole treatment whether the R&D project results in a patent or not.

[1] Interpretation statement "Income tax treatment of New Zealand patents", *Tax Information Bulletin* Vol 18, No 7 (August 2006), p 51.

14. In the event that the project does not generate a depreciable asset for tax purposes, all of the development expenditure that has been capitalised will be rendered completely non-deductible either immediately or over a period of time. This can act as a disincentive to undertake desired levels of R&D.

Proposed solution

15. A simple tax change, that could be announced at Budget 2013, would be to allow an immediate deduction for failed capitalised research and development expenditure which would have been part of the cost of "depreciable intangible property" if the project had been successful.

16. Under this proposal, in the event that the failed asset is sold, the capitalised research and development expenditure previously allowed as a deduction (or the sale proceeds, if this amount is lower) would be clawed back. The exception to this would be where the sale of the failed asset would otherwise give rise to assessable income. In such instances, we propose that the entire sales proceeds would continue to be assessable income.

17. In the event that a failed asset from an abandoned project (which has had capitalised research and development expenditure deducted) becomes useful, we would require the capitalised research and development expenditure previously allowed as a deduction to be clawed back. The clawed back amount would then be able to be amortised over the estimated useful life of the asset.

18. The deduction for failed capitalised development expenditure would be restricted to expenditure that would have been part of the cost of "depreciable intangible property" if the project had been successful. This means that the taxpayer must have incurred the expenditure in trying to create an asset that is listed on schedule 14 of the Income Tax Act 2007.

[6]

Benefits

21. An immediate deduction is already allowed for capitalised expenditure incurred in relation to a patent application that is refused or withdrawn. The proposal would extend deductibility to situations where a taxpayer that was intending to make a patent application

incurred expenditure in relation to that intended application (e.g., on patent attorney fees), but ended up not making the application for the grant of a patent.

22. The proposal would also make failed capitalised expenditure that would have been part of the cost of other items of property listed on schedule 14 immediately deductible.

23. In this way, the policy proposal would provide a deduction for legitimate capital expenditure on failed projects that is not currently deductible, thereby removing a disincentive to investment in R&D. However, the benefits of this proposal are small given some deductions for schedule 14 assets are already allowed.

Costs

Fiscal

24. This proposal has an estimated fiscal cost of $250,000 in the 2013/14 fiscal year and $1 million in each subsequent fiscal year, as per the following table:

	$m increase (decrease)				
	2013/14	**2014/15**	**2015/16**	**2016/17**	**2018/19 & out-years**
Tax Revenue	(0.250)	(1.000)	(1.000)	(1.000)	(1.000)

25. The estimated fiscal cost is lower than the original estimated $10 million per annum cost previously advised as the proposal does not include a deduction for all capitalised development costs for unsuccessful R&D [6]

Administration

26. The proposal has no system implications but may incur some additional administrative costs. These are expected to be insignificant and could be met within existing baselines.

Compliance

27. The policy proposal is not expected to result in additional compliance costs.

[6]

[6]

Officials' comment

30. Officials consider that the proposal to allow an immediate deduction for capitalised expenditure in failed R&D projects, which would have been part of the cost of "depreciable intangible property" under schedule 14 if the R&D project had been successful, could be announced at Budget 2013 as part of the wider package of black hole changes. However, as noted above, in itself, this proposal would be of limited benefit.

31. If Ministers wish to proceed with this proposal it could be included in the next available tax bill after Budget 2013 and apply from the 2014/15 income year.

[6]

Fixed-life resource consents

Background

34. The tax treatment of this item of black hole expenditure was brought to our attention through correspondence with the Corporate Taxpayers Group (CTG).

Problem definition and scope

35. In 1998, three sections regulating activities in the coastal marine area (sections 15A, 15B and 15C) were added to the Resource Management Act 1991 (RMA). However, Schedule 14 of the Act was not updated to include reference to these sections. Consideration should be given to updating Schedule 14 to account for these additional fixed-life resource consents added to the RMA.

Proposed solution

36. For intangible property (which includes resource consents) to be depreciable it must be listed in Schedule 14 of the Income Tax Act 2007 (the Act). Resource consents granted under sections 12 to 15 of the RMA are already included within Schedule 14 so are already depreciable. This is consistent with our depreciation framework; fixed-life resource consents should be depreciated as their economic benefits are used up over their lifetime in order to minimise investment distortions. Conversely, resource consents granted in perpetuity should not be depreciable as their economic benefits persist indefinitely.

37. We recommend adding resource consents granted under two of these three RMA sections to Schedule 14: section 15A (dumping of waste in coastal areas) and section 15B (discharging hazardous substances from ships and offshore installations). These resource consents for the coastal marine area have a limited life of between five and thirty-five years, so should be depreciable.

38. As no person can legally obtain a resource consent under section 15C (prohibitions in relation to radioactive waste or other radioactive matter and other waste in coastal marine area) of the RMA, it should not be added to Schedule 14.

Benefits

39. This proposal will minimise investment distortions that arise from excluding section 15A and 15B resource consents from Schedule 14, and will improve the overall consistency of the tax system.

Costs

Fiscal

40. There is considerable uncertainty around the fiscal cost of making resource consents granted under section 15A and 15B depreciable. There are few resource consents granted under these sections, with only sixteen consents of varying costs granted in 2011. Our best estimate of the fiscal cost is shown in the matrix below:

	Tax Revenue $m – increase (decrease)					
	2013/14	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Resource consent depreciation costs	(0.11)	(0.56)	(1.01)	(1.46)	(1.91)	(2.36)

41. Fiscal costs will increase by $0.45m per annum to approximately $9m per annum over time.

Administration

42. There are not expected to be any administration costs.

Timing

43. Officials recommend that the proposed changes should apply prospectively to section 15A and 15B resource consents granted in the 2014-15 and subsequent income years. Previous changes made in respect of patent applications and other resource consents are precedents for making the changes prospective. [7]

Officials' comment

Environmental concerns

44. It should be noted that this decision may raise environmental concerns from certain sectors of the community that this is an implicit tax subsidy for polluting water. However, their concerns are likely to be primarily with allowing hazardous materials to be discharged into the coastal marine area, rather than with amending Schedule 14. Allowing depreciation for fixed-life resource consents is consistent with our overall framework, and it is the role of the RMA to balance pollution concerns with commercial objectives.

Land-use consents

45. The CTG also suggested that land use consents issued under section 9 of the RMA should be added to Schedule 14. After discussions with the Ministry for the Environment we have not been able to establish that there is a policy problem in this area. Land use consents are generally granted either in perpetuity or temporarily (usually for a time period of less than one year); the former should not be depreciable while the latter should be immediately deductible. Unless we receive further information from the CTG that indicates there is a policy problem officials do not propose any further policy work in this area at this stage.

Unsuccessful resource consents where no application has been lodged

Background

46. The tax treatment of this black hole expenditure item was also brought to our attention through correspondence with the CTG.

Problem definition and scope

47. The current wording of section DB 19 of the Act seems to prevent a deduction for expenditure relating to a resource consent application that has not been lodged. The wording of section DB 19 requires that, for the expenditure to be deductible, the resource consent application process must be completed, even though it is no longer actually sought. This may result in some taxpayers incurring further expenditure to complete the application simply to obtain the tax deduction, which is clearly an inefficient outcome.

Proposed solution

48. The current treatment is an anomaly resulting from the way the legislation has been drafted. We recommend that the current unintended policy outcome be rectified by allowing an immediate deduction for taxpayers in this situation.

Benefits

49. This corrects an unintended gap in the legislation, and reduces an unnecessary expense for businesses in order to access the deduction for failed resource consent expenditure.

Costs

Fiscal

50. There will not be any fiscal cost incurred as applicants are already likely deducting this expenditure by completing the application process.

Administration

51. There are not expected to be any administration costs.

Timing

52. Officials recommend that the proposed changes should apply prospectively from the 2014-15 and subsequent income years.

Company administration costs: dividends, listing fees and shareholder meeting costs

Background

53. The 2005 and 2010 releases of the Inland Revenue exposure draft "Deductibility of company administration costs" applied the capital/revenue test and case law to assess the tax treatment of various company administration expense items. This analysis may have created some uncertainty in the private sector around the tax treatment of certain company administration costs.

54. The CTG offered two critiques of Inland Revenue's approach. One is that the level of analysis was incorrect; rather than assessing the deductibility of each item individually, they should have been viewed collectively as expenses incurred as part of carrying on a business in a company structure. The second critique claims that companies do not generally break down their company administration costs into the detail that Inland Revenue have in their analysis; if companies did so it would significantly increase their compliance costs. The sections below discuss the three high priority company administration cost categories identified by the CTG.

Problem definition and scope

Dividends

55. The exposure draft states that expenditure incurred on authorising dividends is deductible under the law, while costs related to the allocation, payment, and disputes over the allocation of dividends are not. The CTG are concerned about the compliance costs of splitting up expenses associated with the payment of dividends into deductible and non-deductible categories. In reality, taxpayers do not separately track or apportion costs to these expenditure sub-categories.

Listing fees

56. The deductibility of listing fees (initial, annual and subsequent) was also raised by the CTG. Inland Revenue's view of the current law is that these costs are non-deductible (except when raising debt securities) as they are used to raise equity capital. The difference in the current tax treatment of debt and equity capital exists because debt capital has a limited life while equity capital persists indefinitely. The CTG contends that making listing fees non-deductible will create an incentive to raise debt over equity, especially as the equivalent costs of raising debt are deductible.

Shareholder meeting costs

57. There are two generic types of shareholder meetings: annual general meetings (AGMs), which are required by law, and special shareholder meetings. The exposure draft has

generated some uncertainty over which shareholder meeting costs are tax deductible, and which are not.

Proposed solutions

Dividends

58. The payment of dividends is a regular ordinary business expense and despite some of the costs of the process being capital, it would be practical to allow deductions for the costs associated with the payment of dividends.

Listing fees

59. We propose allowing deductions for annual listing fees but not for the initial listing fee or subsequent listing fees arising from additional share issues. Annual listing fees are a regular expense associated with carrying on a business as a publically-listed company, a fact in favour of making them deductible. Initial listing fees are incurred so a company can list on a stock exchange, while subsequent listing fees help with the acquisition of further equity. Expenditure on initial and subsequent listing fees produces enduring benefits that do not decline in value over time, suggesting these expenses should not be deductible.

Shareholder meeting costs

60. There is a trade-off in this situation between reducing compliance costs and applying the capital-revenue test to determine deductibility accurately. As reducing compliance costs is a priority in this situation, we propose that AGM expenses are confirmed as deductible, while special shareholder meeting expenses are not deductible. AGMs are a requirement by law and are a regular business expense whilst special shareholder meetings are often held to consider a material change in the business, and therefore are often capital expenditure. While a more accurate alternative would be to require taxpayers to apply the capital-revenue test to the resolutions considered at the shareholder meeting, this would likely increase compliance costs while not addressing the underlying uncertainty.

61. We propose making all special shareholder meeting expenses non-deductible. While this may be a relatively harsh tax treatment, as some special meeting costs should be deductible, the treatment of AGM costs is concessionary. Alternatively, it would be possible to apply a primary purpose test to determine deductibility of special shareholder meeting costs, but this approach is not favoured because it would be a less certain test and would probably lead to the same outcome in most cases.

Benefits

62. The above proposals will reduce compliance costs and increase the certainty of the tax treatment of various company administration costs.

Costs

Fiscal

63. There will be very little fiscal cost incurred by implementing the proposed changes. Evidence suggests that most, if not all, taxpayers are already deducting these expenditure items. Clarifying their respective tax treatments may even produce a small fiscal gain as initial and subsequent listing fees and special shareholder meeting costs will be made explicitly non-deductible.

Administration

64. There are not expected to be any administration costs.

Timing

65. Officials recommend that the proposed changes should apply prospectively from the 2014-15 and subsequent income years.