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Office of the Minister of Revenue

Chair
Cabinet Economic Growth and Infrastructure Committee

BLACK HOLE EXPENDITURE ITEMS

Proposal

1. This paper seeks the agreement of the Cabinet Economic Growth and Infrastructure Committee to amendments to the Income Tax Act 2007 (ITA) to allow tax deductions for certain items of "black hole" expenditure.

2. I seek agreement to include these amendments in the first available taxation bill after Budget 2013.

Executive summary

3. Some taxpayers and tax advisors, including the Corporate Taxpayers Group, 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.

4. I propose that the tax rules be amended to clarify the treatment of the following four categories of black hole expenditure:

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

5. Summarised below are the proposed changes to items of black hole expenditure discussed in this paper. These changes are consistent with the Government's tax policy framework and will reduce compliance costs for companies.

- Certain R&D expenditure that has been capitalised for accounting purposes but does not give rise to a depreciable asset for tax purposes should be made immediately tax deductible.
- Fixed-life resource consents granted under the Resource Management Act 1991 (RMA) that are not currently listed as items of depreciable intangible property should be added to Schedule 14 of the ITA, to enable the respective consent holders to depreciate these assets.
- Immediate tax deductions should be given for expenditure incurred in relation to resource consent applications that have not been lodged, rather than requiring the completion of the whole application process in order to access the deduction.

- All direct costs associated with the payment of dividends by a company to shareholders should be made tax deductible.
- Although the initial cost of listing on a stock exchange and the cost of additional share issues should not be tax deductible because of the enduring benefit they create, the annual fee to remain listed should be tax deductible as it is a regular expense of a publicly listed company.
- Annual shareholder meeting costs should be made tax deductible, but costs incurred to hold a special shareholder meeting should not.

6. The overall impact of these proposed changes should be to increase the efficiency of the tax system and provide certainty to businesses about 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.

Background

7. Some taxpayers and tax advisors, including the Corporate Taxpayers Group, have expressed concerns to Inland Revenue over the tax treatment of a number of items of "black hole" expenditure.

8. 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. The existence of black hole expenditure for tax purposes can result in economic distortions. For example, consider a risk-neutral investor who is deciding between two alternative investments offering the same expected pre-tax rate of return. If one of the investment options carries a risk of black hole expenditure occurring, it will cause the investor to prefer the other investment option.

9. This paper addresses four categories of black hole expenditure:

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

10. In considering a potential package of tax changes that could be announced in Budget 2013, I concluded that the current tax treatment of a number of these black hole expenditure items should be changed. The changes all fit well within the Government's tax policy framework, are considered to be relatively simple to make, and do not result in a significant fiscal cost. The overall impact of the changes will be to increase the efficiency of the tax system, provide more certainty, and reduce compliance costs for businesses.

Comment

Abandoned research and development

11. As part of a recent review of tax settings related to innovation, my officials identified the potential for black hole expenditure to occur where R&D expenditure is capitalised

because an intangible asset has been recognised for accounting purposes, but no depreciable asset for tax purposes is ever created. The potential for such legitimate R&D expenditure to be accorded black hole treatment results in economic distortions, including creating a disincentive to investment in R&D.

12. I therefore recommend that an immediate deduction be allowed for failed capitalised R&D expenditure which 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 ITA. Schedule 14 lists items of intangible property that are depreciable for tax purposes.

13. Providing a deduction for legitimate capital expenditure on failed projects, which is not currently deductible, will remove a disincentive to investment in R&D.

14. In the event that a failed asset from an abandoned R&D project (which has had capitalised R&D expenditure deducted) becomes useful, it is proposed that the capitalised R&D expenditure previously allowed as a deduction would be clawed back. The clawed-back amount would then be able to be depreciated over the estimated useful life of the asset.

15. In the event that a failed asset from an abandoned R&D project (which has had capitalised R&D expenditure deducted) is sold, it is proposed that the capitalised R&D expenditure previously allowed as a deduction (or the sale proceeds, if this amount is lower) would also 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, it is proposed that the entire sales proceeds would continue to be assessable income.

Fixed-life resource consents

16. A consent granted under the Resource Management Act 1991 (RMA) to do something that otherwise would contravene sections 12 to 15 of that Act (other than a consent for a reclamation) is currently listed on Schedule 14 as an item of depreciable intangible property.

17. In 1998, three sections regulating activities in the coastal marine area (sections 15A, 15B and 15C) were added to the RMA. However, Schedule 14 of the ITA was not updated to include reference to these sections. Therefore, capital expenditure incurred in obtaining consents to do something which would otherwise contravene these sections of the RMA is not currently depreciable.

18. I therefore recommend adding resource consents granted under the RMA to do something that otherwise would contravene section 15A (dumping of waste in coastal areas) or section 15B (discharging hazardous substances from ships and offshore installations) of the RMA to Schedule 14 of the ITA. These consents have a limited life of between five and thirty-five years, so should be depreciable. As the economic benefits of these assets are used up over their lifetime, allowing them to be depreciated would be consistent with existing tax depreciation frameworks.

19. Adding these resource consents 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.

20. As no person can legally obtain a resource consent to do something that would contravene section 15C (prohibitions in relation to radioactive waste or other radioactive

matter and other waste in coastal marine area) of the RMA, a reference to section 15C should not be added to Schedule 14.

21. It should be noted that certain sectors of the community may raise environmental concerns that adding resource consents granted under the RMA to do something that otherwise would contravene section 15A or section 15B of the RMA to Schedule 14 of the ITA is providing an implicit tax subsidy for polluting water. However, such concerns are likely to be primarily with allowing hazardous materials to be discharged into the coastal marine area, rather than with amending Schedule 14 itself. Allowing depreciation for fixed-life resource consents is consistent with the overall tax framework, whereas it is the specific role of the RMA to balance pollution concerns with commercial objectives.

Unsuccessful resource consents where no application is lodged

22. Under current tax rules, a deduction is allowed for expenditure incurred by a person who applies for the grant of a resource consent under the RMA and is refused the grant or withdraws the application. The current legislative wording requires that, for the expenditure to be deductible, the resource consent application process must be completed, even though it is no longer actually sought.

23. The current treatment is an anomaly resulting from the way the legislation has been drafted. I therefore recommend that this unintended policy outcome be rectified by allowing an immediate deduction for taxpayers in this situation. This corrects an unintended gap in the current legislation, and reduces an unnecessary expense for businesses in order to access the deduction for failed resource consent expenditure.

Company administration costs

24. Some uncertainty exists in the private sector about the tax deductibility of certain company administration costs, particularly costs relating to the payment of dividends, listing fees and shareholder meeting costs.

(i) Dividends

25. The current practice is that expenditure incurred on authorising dividends is deductible for tax purposes, but costs related to the allocation, payment, and disputes over the allocation of dividends are not. This has raised concerns about the compliance costs of splitting up expenses associated with the payment of dividends into deductible and non-deductible categories. In practice, taxpayers do not separately track or apportion costs to these expenditure sub-categories.

26. 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 tax deductions for costs associated with the payment of dividends. I therefore recommend that this change be made.

(ii) Listing fees

27. The current view of the law is that listing fees 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. However, making listing fees non-deductible could create an

incentive to raise debt over equity, especially as the equivalent costs of raising debt are deductible.

28. I therefore recommend allowing tax deductions to be made 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 publicly listed company, a fact in favour of making annual listing fees deductible.

29. Initial listing fees, on the other hand, 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 that these expenses should not be deductible.

(iii) Shareholder meeting costs

30. There are two generic types of shareholder meetings: annual general meetings (AGMs), which are required by law, and special shareholder meetings. There is currently some uncertainty about which shareholder meeting costs are tax deductible and which are not.

31. There is a trade-off in this situation between reducing compliance costs and accurately applying the capital-revenue test to determine deductibility. In order to provide certainty in this situation, I recommend that AGM expenses are confirmed as tax deductible, and special shareholder meeting expenses are treated as not deductible.

32. AGMs are a requirement by law and are a regular business expense, whereas special shareholder meetings are often held to consider a material change in the business, and therefore are often capital expenditure.

33. Although 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 and fail to address the underlying uncertainty.

34. Although making all special shareholder meeting costs non-deductible may appear a relatively harsh tax treatment, as some special shareholder meeting costs would potentially be deductible under the capital-revenue test, it should be noted that the proposed tax treatment of AGM costs is concessionary. An alternative option of allowing the costs associated with special shareholder meetings to be tax deductible would also reduce compliance costs, but concerns remain that this would be overly concessionary to large companies.

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

Consultation

36. As these proposals are earmarked for potential announcement as part of Budget 2013, officials have not yet consulted with taxpayers on them. However, these proposals are taxpayer friendly and have arisen in part due to correspondence received by officials from the Corporate Taxpayers Group on the subject.

37. The overall impact of the changes will be to increase the efficiency of the tax system, provide more certainty, and reduce compliance costs for businesses.

38. The Treasury has been consulted and concurs with the contents of this paper.

Financial implications

39. Agreeing to all the recommendations in this paper will have the following estimated fiscal implications:

	$m increase / (decrease)				
Vote Revenue Minister of Revenue	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**
Tax Revenue	-	(0.360)	(1.560)	(2.010)	(2.460)

40. Estimated tax revenue costs will continue to increase by $450,000 per annum to approximately $9 million per annum over time.

Administrative implications

41. The proposals have no system implications for Inland Revenue but may incur some additional administrative costs. These are expected to be insignificant and would be met within existing baselines.

Human rights

42. There are no inconsistencies with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993 arising from any of the proposals.

Legislative implications

43. The proposals will require amendments to the Income Tax Act 2007. These changes would be included in the next taxation bill after Budget 2013.

44. I recommend that the changes become effective from the 2014/15 income year. [7]

Regulatory impact analysis

45. The Regulatory Impact Analysis requirements apply to the proposals. A Regulatory Impact Statement (RIS) is attached.

46. The Work Programme Manager, Policy Advice, has reviewed the RIS prepared by Inland Revenue and considers that the RIS meets the quality assurance criteria. The reviewer notes that the proposals contained in the RIS were not consulted on. This is due to the

proposals being designated as a potential Budget 2013 item. Therefore the proposals have been treated with a commensurate level of sensitivity accorded to potential Budget items. The proposals under consideration were predominantly raised by the private sector.

Publicity

47. Following Cabinet's approval of the changes to allow tax deductions for various items of black hole expenditure, it is intended to publicly announce the changes as part of the Budget 2013 package.

Recommendations

48. It is recommended that the Committee:

1. **Agree** to allow an immediate tax deduction for failed capitalised R&D expenditure which would have been part of the cost of "depreciable intangible property" if the project had been successful.

2. **Agree** that, in the event that a failed asset becomes useful, any capitalised R&D expenditure previously allowed as a tax deduction be clawed back, with the clawed-back amount then able to be depreciated over the estimated useful life of the asset.

3. **Agree** that, in the event that a failed asset is sold, any capitalised R&D expenditure previously allowed as a tax deduction (or the sale proceeds, if this amount is lower) be clawed back (except where the sale of the failed asset would otherwise give rise to assessable income, in which case the entire sales proceeds would continue to be assessable income).

4. **Agree** to add resource consents granted under the Resource Management Act 1991 to do something that otherwise would contravene section 15A or 15B of the Resource Management Act 1991 to Schedule 14 (depreciable intangible property) of the Income Tax Act 2007. This will have the effect of making expenditure on these resource consents depreciable for tax purposes.

5. **Agree** to allow a tax deduction for expenditure on unsuccessful resource consent applications where no application has been lodged.

6. **Agree** to allow a tax deduction for expenditure incurred on paying dividends.

7. **Agree** to allow a tax deduction for the annual listing fee of a company registered on a stock exchange (while keeping initial and subsequent listing fees for new share issues non-deductible for tax purposes).

8. **Agree** to allow a tax deduction for the costs of annual shareholder meetings, while making the costs of special shareholder meetings non-deductible for tax purposes.

9. **Agree** that the changes in the above recommendations all take effect from the 2014/15 income year, with enabling legislation being included in the next available taxation bill after Budget 2013.

10. **Delegate** authority to the Minister of Revenue to make any minor or consequential amendments to the rules necessary to ensure effective implementation of the changes in recommendations 1 to 8.

11. **Note** that the estimated tax revenue costs associated with the changes in recommendations 1 to 8 are:

	$m increase / (decrease)				
Vote Revenue Minister of Revenue	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**
Tax Revenue	-	(0.360)	(1.560)	(2.010)	(2.460)

12. **Note** that the estimated tax revenue costs will continue to increase by $450,000 per annum to approximately $9 million per annum.

Hon Peter Dunne
Minister of Revenue

____ /____/____
Date