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Tax policy report: **Black hole R&D expenditure – Final policy recommendations**

Date:	4 March 2014	Priority:	High
Security Level:		Report No:	T2014/361 IR2014/100

Action sought

	Action Sought	Deadline
Minister of Finance	Agree to the recommendations	10 March 2014
Minister of Science and Innovation	Agree to the recommendations	10 March 2014
Minister of Revenue	Agree to the recommendations	10 March 2014

Contact for telephone discussion (if required)

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4 March 2014

Minister of Finance
Minister of Science and Innovation
Minister of Revenue

Black hole R&D expenditure – Final policy recommendations

Executive summary

On 7 November 2013, a Government discussion document, *Black hole R&D expenditure*, was released. The discussion document outlined proposals to address black hole expenditure on R&D.

Black hole expenditure is business expenditure that is not immediately deductible for tax purposes and also does not form part of the cost of a depreciable asset for tax purposes, and therefore cannot be deducted over time as depreciation.

This report recaps the proposals outlined in the discussion document, summarises the main submissions received in response to them, and provides final policy advice.

The discussion document proposed making capitalised development expenditure part of the depreciable costs of a patent or plant variety rights. It was generally accepted that this was the appropriate way to treat this expenditure. However, a number of submitters identified other categories of expenditure that fit within this policy framework and this report recommends that depreciation be extended to them.

The discussion document proposed allowing a deduction for capitalised R&D expenditure towards an unsuccessful asset with a definable life when the asset is written off for accounting purposes. Under the initial proposals, capitalised R&D expenditure towards assets that do not have definable lives would remain non-deductible. A number of submitters were concerned that this would leave a significant category of capitalised R&D expenditure still never being deductible for tax purposes, and that this was not the appropriate treatment of expenditure on intangible assets with indefinite but finite useful lives. This report recommends that these costs also be made deductible when the asset is written off for accounting purposes.

This report recommends only allowing capitalised R&D expenditure incurred from the date of the release of the discussion document to be eligible for depreciation or deductions under the proposed changes.

As an integrity measure, the report recommends that there is a claw-back rule that applies if an intangible asset that was been written off for accounting purposes (and for which a tax deduction for capitalised R&D expenditure has been claimed) subsequently becomes useful or is sold.

The proposed changes are taxpayer-friendly and, on a prospective basis, are expected to eliminate black hole R&D expenditure. As they will reduce the cases where tax rules may be discouraging R&D investments that would be undertaken in the absence of taxation, the proposed changes are expected to increase productivity and growth.

The report also proposes that the Income Tax Act 2007 be amended to clarify that capitalised expenditure incurred by a taxpayer in the successful development of software for use in their own business is depreciable.

If the proposals are agreed to, there will be estimated fiscal costs, to be funded through the tax policy scorecard, as per the following table:

	\$m increase / (decrease)				
Vote Revenue Minister of Revenue	2013/14	2014/15	2015/16	2016/17	2017/18
Tax Revenue	-	(0.700)	(2.700)	(4.100)	(5.600)

The proposed changes would have no systems implications for Inland Revenue but may result in some additional administrative costs. These costs are expected to be insignificant and would be met within existing baselines.

Assuming that the proposed changes are agreed to, then (subject to Cabinet approval) Ministers could announce them as part of the Budget 2014 announcements. On the other hand, changes to provide relief for black hole R&D expenditure are now probably widely expected by the private sector, following the release of the Government discussion document late last year. Therefore, Ministers may prefer to restrict Budget announcements to proposals that would be seen more as “surprises” by the private sector. If this is the case, the proposed changes could be announced at a later date.

If Ministers agree with the recommended action, officials will prepare a Cabinet paper seeking approval for the proposed changes, with enabling legislation to be included in the proposed August 2014 taxation bill.

Recommended action

We recommend that you:

R&D that creates an intangible asset with a reasonably certain useful life

(a) **Agree** to make the following intangible assets depreciable (over their legal lives) by adding them to schedule 14 of the Income Tax Act 2007:

(i) Registered designs (and applications for registered designs)

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

(ii) Copyright in an artistic work that has been applied industrially

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

(b) If recommendation (a)(i) is agreed to:

Agree to allow an immediate tax deduction for expenditure incurred for the purpose of applying for the grant of registration of a design if registration is not obtained because the application is not lodged or is withdrawn, or because registration is refused.

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

(c) **Agree** to include capitalised development expenditure that relates to an asset that is listed in schedule 14 of the Income Tax Act 2007 as part of the depreciable costs of the asset, for taxpayers who have developed the asset.

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

R&D that does not create a depreciable intangible asset

(d) **Agree** to allow a one-off tax deduction for capitalised R&D expenditure upon the intangible asset to which it relates being written off for accounting purposes, for taxpayers who have developed intangible assets that are not depreciable for tax purposes.

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

Transitional approach

- (e) **Agree** to only allow capitalised expenditure incurred from the date of the release of the Government discussion document, *Black hole R&D expenditure*, (that is, 7 November 2013) to be eligible for deductibility under the changes in recommendations (a), (c) and (d).

Agreed/Not agreed *Agreed/Not agreed* *Agreed/Not agreed*
Minister of Finance Minister of Science and Innovation Minister of Revenue

Integrity measures

- (f) **Agree** that, in the event that an intangible asset that has been written off for accounting purposes becomes useful, any capitalised development expenditure previously allowed as a tax deduction be clawed back as income, with the clawed-back amount able to be depreciated over the estimated useful life of the asset if the asset is depreciable.

Agreed/Not agreed *Agreed/Not agreed* *Agreed/Not agreed*
Minister of Finance Minister of Science and Innovation Minister of Revenue

- (g) **Agree** that, in the event that an intangible asset that has been written off for accounting purposes is sold, any capitalised development expenditure previously allowed as a tax deduction (or the sale proceeds, if this amount is lower) be clawed back as income.

Agreed/Not agreed *Agreed/Not agreed* *Agreed/Not agreed*
Minister of Finance Minister of Science and Innovation Minister of Revenue

Timing

- (h) **Agree** that the changes in recommendations (a) to (g) take effect from the 2015/16 income year.

Agreed/Not agreed *Agreed/Not agreed* *Agreed/Not agreed*
Minister of Finance Minister of Science and Innovation Minister of Revenue

Financial implications

- (i) **Note** that agreeing to the above recommendations will have estimated fiscal costs, to be funded through the tax policy scorecard, as per the following table:

	\$m increase / (decrease)				
Vote Revenue Minister of Revenue	2013/14	2014/15	2015/16	2016/17	2017/18
Tax Revenue	-	(0.700)	(2.700)	(4.100)	(5.600)

Noted *Noted* *Noted*
Minister of Finance Minister of Science and Innovation Minister of Revenue

Successful software development

- (j) **Agree** to amend the Income Tax Act 2007 to clarify that capitalised expenditure incurred by a person in the successful development of software for use in their own business is depreciable, with effect from the statutory time-bar.

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

Legislative vehicle

- (k) **Note** that the legislative vehicle to give effect to the changes agreed to in the above recommendations will be the proposed August 2014 taxation bill.

<i>Noted</i>	<i>Noted</i>	<i>Noted</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

Publicity

- (l) **Agree** to announce the proposed changes agreed to in the above recommendations at Budget 2014.

<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>	<i>Agreed/Not agreed</i>
Minister of Finance	Minister of Science and Innovation	Minister of Revenue

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Background

1. On 7 November 2013, a Government discussion document, *Black hole R&D expenditure*, was released. The discussion document outlined proposals to address black hole expenditure on R&D.
2. Black hole expenditure is business expenditure that is not immediately deductible for tax purposes and also does not form part of the cost of a depreciable asset for tax purposes, and therefore cannot be deducted over time as depreciation.
3. The non-deductibility of black hole expenditures reflects the general principle that expenditures that result in an asset of enduring value should not be deducted. The classic example is land. In the area of R&D, capitalised expenditure towards assets that have definable useful lives, such as patents, should be depreciable over the life of the asset. However, an interpretation statement issued by the Commissioner of Inland Revenue takes the view that the depreciable patent costs (for a taxpayer who has lodged a patent application with a complete specification or had a patent for an invention granted) are limited to the administrative and legal fees incurred in the patent process.¹ The discussion document proposed making the capitalised development expenditure part of the depreciable patent costs. A number of submitters identified other categories of expenditure that fit within this policy framework and this report recommends that depreciation be extended to them.
4. The discussion document proposed allowing a deduction for capitalised R&D expenditure towards an unsuccessful asset with a definable life when the asset is written off for accounting purposes. Under the proposals outlined in the discussion document, capitalised R&D expenditure towards assets that do not have definable lives would remain non-deductible. A number of submitters were concerned that this would leave a significant category of capitalised R&D expenditure still never being deductible for tax purposes, and that this was not the appropriate treatment of expenditure on intangible assets with indefinite but finite useful lives. This report recommends that these costs also be made deductible when the asset is written off for accounting purposes.
5. If taxpayers are unable to claim tax deductions for legitimate business expenditure on assets that are eventually written off they would, in effect, be discouraged from making such investments. This is likely to lower productivity and growth. A reason for focusing on R&D is that this is consistent with the Government's Business Growth Agenda.
6. The aim of the tax changes is not to provide a tax-subsidy to R&D but to reduce the cases where tax rules may be actively discouraging R&D investments that would be undertaken in the absence of taxation.
7. The report rejects submissions that all black hole R&D expenditures be amortised over a fixed period, as is allowed in Australia, as this would introduce a subsidy for R&D by

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

allowing deductions that would be considerably in excess of the true economic cost of the R&D to the business.

8. This report recaps the proposals outlined in the discussion document, summarises the main submissions received in response to them, and provides final policy advice.

Proposals to address black hole R&D expenditure

9. 12 submissions were received in relation to the discussion document. A comprehensive summary of submissions is annexed to this report. The submissions were generally supportive of the proposals. However, many submitters wanted the scope of the proposals widened to provide tax deductibility for – both successful and unsuccessful – capitalised development expenditure towards intangible assets that are *not* listed in schedule 14 of the Income Tax Act 2007, which lists items of “depreciable intangible property”.

R&D that creates an intangible asset with a reasonably certain useful life

Initial proposal

10. The discussion document proposed making *successful* capitalised development expenditure that relates to:

- an invention that is the subject of a patent or a patent application; or
- a plant variety that is the subject of plant variety rights,

depreciable over the legal life of the asset to which it relates.

11. Intangible assets can only be depreciated for tax purposes if they are listed in schedule 14 of the Income Tax Act 2007. The discussion document indicated that new intangible assets can be considered for inclusion in schedule 14 on a case-by-case basis.

Submissions

12. There was general acceptance that the initial proposal in respect of successful R&D leading to a patent or plant variety rights was the appropriate way to treat this expenditure. However, there were some calls to add new intangible assets to schedule 14 and apply the same treatment to them. Several submitters called for registered designs to be added to schedule 14, with all capitalised development costs made depreciable. Additionally, the New Zealand Law Society submitted that copyright that has been applied industrially should be added to schedule 14, with all capitalised development costs made depreciable.

Officials' comment

13. To be listed in schedule 14, an asset must have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its creation or acquisition.

14. Design registration protects the external appearance of a manufactured article, especially those novel or original design features that can appeal to the eye of a customer. A registered design has a legal life of 15 years (assuming all rights of renewal are exercised). It therefore meets the criteria for inclusion in schedule 14. As the 15 year legal life generally commences on the date on which the first application is made (as opposed to the date on which registration is granted), if registered designs are added to schedule 14, applications for registered designs should also be added to schedule 14.

15. Section 75 of the Copyright Act 1994 contains a special exception from copyright protection in the case of an artistic work that has been applied industrially. The effect of this exception is that once an owner of copyright in an artistic work (or a licensee) has applied the artistic work industrially (as defined in the section), within New Zealand or overseas, their copyright protection will only last for a further 16 years (in the case of product designs and casting moulds) or 25 years (in the case of works of craftsmanship). This time limit makes the copyright in an artistic work that has been applied industrially appropriate for inclusion in schedule 14.

16. We propose making the following intangible assets depreciable (over their legal lives) by adding them to schedule 14:

- registered designs (and applications for registered designs); and
- copyright in an artistic work that has been applied industrially.

17. If registered designs are made depreciable, we propose that an immediate tax deduction be allowed for expenditure incurred for the purpose of applying for the grant of registration of a design if registration is not obtained because the application is not lodged or is withdrawn, or because registration is refused. This would parallel the treatment of unsuccessful patent applications.

18. We propose that capitalised development expenditure that relates to an asset that is listed in schedule 14 be made part of the depreciable costs of the asset, for taxpayers who have developed the asset. This will relieve black hole expenditure on successful depreciable R&D-generated assets.

R&D that does not create a depreciable intangible asset

Initial proposal

19. The discussion document proposed allowing an immediate tax deduction for capitalised R&D expenditure that results in an *unsuccessful* asset, providing certain criteria are met.

20. Under the proposals outlined in the discussion document, capitalised R&D expenditure that relates to an intangible asset with an indefinite useful life (that is, an asset that is *not* listed in schedule 14) would remain black hole expenditure.

Submissions

21. Many submitters were concerned that the initial proposals would still leave a significant category of capitalised R&D expenditure never being deductible for tax purposes. Submissions as to how capitalised R&D expenditure that creates a *successful* asset that is not listed in schedule 14 should be treated for tax purposes included:

- Accept framework set out in the discussion document; however, separate policy consideration should be given when special circumstances arise (Corporate Taxpayers Group).
- It should be regarded as creating “know-how” as a depreciable asset, with depreciation deductions being allowed on a straight-line basis over a fixed life, either prescribed in the Income Tax Act 2007 or set by determination by the Commissioner of Inland Revenue (Ernst & Young).
- A deduction should be allowed for this expenditure, either as incurred or by adding an appropriate asset class to schedule 14 (Fisher & Paykel Appliances Ltd).
- Either follow the Australian approach (make the expenditure deductible over five years), or the expenditure should be deductible over a deemed useful life (for example, 20 years), or, at a minimum, a deduction should be given at write-off for accounting purposes (KPMG).
- An asset with an indefinite life should not be depreciated. However, for an asset with a finite life that is only ascertainable at the end of its life, the most appropriate course may be to allow a deduction when the asset is written off (New Zealand Institute of Chartered Accountants).
- “Know-how” should be made depreciable over the taxpayer’s estimate of its useful life (New Zealand Law Society).
- This expenditure should be immediately deductible (New Zealand Manufacturers and Exporters Association).
- A comprehensive solution to black hole expenditure should be adopted (PricewaterhouseCoopers).

Officials’ comment

22. It would be inappropriate, from an economic perspective, to allow tax deductibility for expenditure towards creating an asset that would not have been likely to have a finite life if successful. Not allowing a deduction for losses in this situation is the counterpart of not taxing capital gains.

23. However, officials recognise that technology tends to move at a relatively fast pace and that it is likely that R&D-generated assets will have limited lives, even if those lives are not

capable of being estimated with a reasonable degree of certainty at the time of the asset's creation. Officials are therefore sympathetic towards the submitters' concern.

24. In order to respond to this concern, officials have considered alternative options that would eliminate black hole R&D expenditure on a prospective basis. Officials' view as to the best way to do this is to allow a one-off tax deduction for capitalised R&D expenditure that relates to an intangible asset that is *not* listed in schedule 14 upon the intangible asset being derecognised under the accounting rules (other than due to its disposal). This would apply irrespective of whether the asset was useful for a period or a completely unsuccessful investment.

25. While capitalised expenditure on successful R&D can lead to an asset that is worth more for a period than the amount of capitalised expenditure, so that there is a gain going untaxed, failing to allow any deduction for expenditure on an asset that can only have a finite life appears harsh. Restricting deductions to when an asset has been written off for accounting purposes restricts deductions to cases where it is clear that the expenditure is of no on-going value. It appears an improvement on the status quo.

26. This new proposal is more taxpayer-friendly than the initial proposal outlined in the discussion document. The main advantage of the new proposal is that, on a prospective basis, we expect it will eliminate black hole R&D expenditure, whereas the initial proposal would leave a significant category of capitalised R&D expenditure never being deductible for tax purposes. Another advantage of the new proposal is that, because of the wider ambit of capitalised R&D expenditure that it allows to be deducted, it provides a major simplification. This is because it removes the need to devise criteria to ensure that any deduction for unsuccessful R&D is appropriately targeted to expenditure that would have been depreciable if the R&D had been successful.

27. A risk with the new proposal is that it would place additional pressure on the definition of R&D and Inland Revenue's ability to police the line between capitalised R&D expenditure and other capitalised expenditure. Only capitalised expenditure on R&D (based on the definition of R&D in the accounting standard) would be eligible for the one-off tax deduction upon write-off. Capitalised expenditure that does not fall within this definition would not qualify for the deduction. Taxpayers would therefore have an incentive to claim that capitalised expenditure was on R&D even if it did not meet the definition of R&D. However, both the existing rules and the initial proposal require Inland Revenue to police the boundary between R&D expenditure and other expenditure, so the new proposal would only place additional pressure as opposed to creating the pressure. Officials consider that this risk is manageable.

Other options

28. Officials are not supportive of any of the other approaches suggested by submitters to relieve black hole expenditure towards *successful* assets not listed in schedule 14. Our reasons are outlined in the following paragraphs.

(i) Allow immediate deductibility

29. To allow immediate deductibility would, from an economic perspective, be an inappropriate treatment of expenditure that has an enduring benefit. Not only would it amount to a concessionary tax treatment compared to that accorded to other (non-R&D) capital expenditure, but it would see intangible assets with uncertain useful lives receive much more favourable treatment than intangible assets with reasonably certain useful lives.

(ii) Allow depreciation over a given period

30. Depreciating such expenditure over a given period of time (whether that time period is prescribed in the Income Tax Act 2007, or set by the taxpayer or by determination by the Commissioner of Inland Revenue) would be arbitrary, since the very reason this expenditure is currently non-depreciable is that the asset to which it relates has a life that cannot be estimated with a reasonable degree of certainty at the time of its creation or acquisition. It would likely create pressures for assets with longer (but certain) finite lives to be characterised as assets with finite but indefinite lives.

31. There would also be a practical issue to overcome as to when the asset's life is considered to begin. Normally depreciation is only allowed for an asset when the asset is used or available for use. At the time of asset recognition for accounting purposes, the asset might not yet be ready for use. Allowing depreciation to start immediately would also be more generous than is proposed for capitalised development expenditure that relates to an asset that is listed in schedule 14, such as a patent. The treatment proposed there is to wait until the patent application is lodged and then depreciate the capitalised costs of developing the invention (together with the legal and administrative costs of applying for the patent) over the life of the patent application/patent.

(iii) Develop a comprehensive solution to black hole expenditure

32. Officials do not support developing a comprehensive solution to black hole expenditure (that is, providing deductibility for all capital business expenditure, not just capitalised R&D expenditure), such as the Australian approach of allowing all business expenditure that would otherwise be black hole expenditure to be deducted over five years. This would be very fiscally expensive, and any time period chosen would be arbitrary. Moreover, deductions would be given for expenditure towards creating assets that would not decline in value over time if they were successful. This would artificially incentivise investment in such assets, which would be inconsistent with the goal of encouraging productivity and growth. Australia has a comprehensive capital gains tax, so providing deductibility for capital expenditure leads to fewer pressures in an Australian context, since they tax the upside.

Integrity measures

Initial proposal

33. The discussion document proposed that, if a deduction is to be provided for unsuccessful capitalised R&D expenditure, there should be the following integrity measures:

- In the event that a failed asset from an abandoned R&D project (which has had capitalised development expenditure deducted) is sold, the capitalised development expenditure previously allowed as a deduction (or the sale proceeds, if this amount is lower) should be clawed back as income.
- In the event that a failed asset from an abandoned R&D project (which has had capitalised development expenditure deducted) becomes useful, the capitalised development expenditure previously allowed as a deduction should be clawed back as income, with the clawed-back amount able to be depreciated over the estimated useful life of the asset if the asset is depreciable.

Submissions

34. Ernst & Young accepted the proposed claw-back rule in the case of sales, but expressed some concerns around the practicality of clawing back expenditure for failed assets that subsequently become useful. KPMG was of the view that the complexity of clawing back deductions for failed assets that become useful is unjustified.

Officials' comment

35. Officials consider that the proposed claw-back rule for expenditure on failed assets that subsequently become useful is an important integrity measure. If taxpayers were able to receive an immediate deduction for expenditure that has created what turns out to be a useful asset, they would receive a significant advantage. The proposed claw-back rule reduces this advantage and ensures greater economic neutrality and consistency with the treatment of expenditure that has created an asset that has always been regarded as successful. Without the claw-back rule, there would be a risk of taxpayers manipulating the system.

36. If one-off tax deductions are to be made available in the case of successful non-depreciable R&D-generated assets upon the intangible asset being written off for accounting purposes, officials consider that the proposed claw-back rules should also apply to these assets.

Transitional approach

Initial proposal

37. The discussion document outlined three options for transitioning to the new rules in the case of successful R&D that has created a depreciable asset. These were:

- *Option 1:* Only allow capitalised development expenditure incurred from the date of the release of the discussion document to be eligible for depreciation deductions.
- *Option 2:* Allow depreciation deductions for assets created (that is, recognised for tax purposes) from the date of the release of the discussion document. This option would allow all of the capitalised development expenditure relating to the asset (whenever incurred) to be eligible for depreciation deductions.
- *Option 3:* In addition to allowing all capitalised development expenditure on new assets to be depreciated, also allow pro-rated depreciation deductions for capitalised development expenditure that relates to existing assets.

38. The discussion document suggested that the option chosen should guide the transitional approach with respect to unsuccessful R&D.

Submissions

39. The majority of submitters expressed support for the proposals without specifying a preference for one of the options. It was widely accepted that the option chosen with respect to successful R&D that has created a depreciable asset should guide the transitional approach with respect to unsuccessful R&D.

40. KPMG favoured option 3, on the basis that relief should be provided if there is a genuine policy reason for doing so, and pointed out that there are boundary issues under any option. The New Zealand Manufacturers and Exporters Association also favoured option 3. The Corporate Taxpayers Group (CTG) commented that option 3 would provide a more pure tax policy outcome, but that there will be compliance costs associated with apportionment and integrity issues in relation to old documentation of costs.

41. CTG was of the view that option 2 was the more practical option and would appropriately balance concerns with the existing policy outcome and compliance costs. NZICA also favoured option 2.

Officials' comment

42. Option 3 would allow the greatest deductibility of expenditure, so it is unsurprising that some submitters favoured it. However, we consider that CTG raised some good points in relation to its higher compliance costs and integrity issues. We consider that option 3 should be discarded.

43. Option 2 would be workable in practice, and is more taxpayer-friendly than option 1, both in the sense that more expenditure would be eligible for depreciation deductions, and in that, under option 1, there could be higher compliance costs associated with going back and attributing expenditure to pre- and post- 7 November 2013 (although this was not a point raised in submissions). However, although the annual fiscal cost of options 1 and 2 would eventually converge, option 2 is estimated to be considerably more fiscally expensive over the short to medium term (with the estimated fiscal costs over the forecast period being approximately twice as high).

44. Officials continue to support option 1, which the discussion document indicated was the Government's favoured option. Option 1 targets new R&D spending only and does not give windfall gains to those who have incurred sunk costs. Therefore, the fiscal cost incurred as a result of the policy change will be more closely aligned with the Government's objective of increasing new business R&D. The other options are estimated to be considerably more fiscally expensive over the forecast period, but would provide limited additional benefit in reducing the bias that those who have incurred sunk costs have towards selling the resulting asset over continuing to hold it.

Successful software development

Initial proposal

45. The discussion document proposed that the Income Tax Act 2007 be amended to clarify that capitalised expenditure incurred by a taxpayer in the successful development of software for use in their own business is depreciable. To provide certainty for taxpayers, the discussion document proposed that this amendment be made retrospective to the statutory time-bar.

Submissions

46. The submitters that commented on this proposal were unanimous in their support for it.

Officials' comment

47. This proposed amendment would clarify the law to be in line with the policy intent and officials' understanding of current taxpayer practice. Officials consider that the proposed amendment should proceed.

Timing

48. With the exception of the proposed amendment to clarify the depreciability of software, we propose that the proposed changes take effect from the 2015/16 income year.

Financial implications

49. Preliminary fiscal cost estimates previously provided indicated that, under the preferred transitional approach, the initial proposal in relation to successful R&D would have a fiscal cost of approximately \$1 million in the first full fiscal year post-implementation, gradually rising to at least \$19 million per annum after 20 years, and that the initial proposal in relation to unsuccessful R&D would have an estimated fiscal cost of \$3 million per annum on average over the 10 years from implementation (T2013/2336, PAS2013/190 refers).

50. Given the modifications to the policy proposals and in light of additional information received from consultation, fiscal cost estimates have been refined. Under the preferred transitional approach, the proposed changes would have estimated fiscal costs, as per the following table:

	\$m increase / (decrease)				
Vote Revenue Minister of Revenue	2013/14	2014/15	2015/16	2016/17	2017/18
Tax Revenue	-	(0.700)	(2.700)	(4.100)	(5.600)

51. The fiscal costs will likely gradually increase in out-years depending on the level of R&D activity. These estimated fiscal costs are slightly lower than preliminary indications. These costs will be funded through the tax policy scorecard.

52. The above estimate of fiscal costs should be treated with some caution. Due to lack of source data and limited relevant additional information provided by submitters, significant assumptions were made in developing the estimate, for example:

- the stock of capitalised R&D expenditure;
- the percentage of capitalised R&D expenditure that will be depreciated; and
- the R&D failure rate.

53. We have carried out sensitivity analysis around some of the assumptions and the fiscal costs do not vary materially.

Administrative implications

54. The changes proposed in this report would have no systems implications for Inland Revenue but may result in some additional administrative costs, such as costs associated with

publications to communicate the changes. These costs are expected to be insignificant and would be met within existing baselines.

Compliance costs

55. The proposed changes are not expected to significantly affect compliance costs. The proposed changes are taxpayer-friendly and any minor additional compliance costs associated with them (such as in claiming a deduction for expenditure that previously would have been non-deductible) would be outweighed by the benefit to the taxpayer of the increased allowance of deductions. The most compliance cost-intensive aspect of the proposed changes is perhaps the claw-back rule for written-off assets that become useful, but officials consider that this is an important integrity measure which would not be expected to often require application.

Consultation

56. Public consultation on the Government's proposals to address black hole R&D expenditure was carried out via the release of a Government discussion document on 7 November 2013. The main issues raised in consultation have been discussed in this report, and a comprehensive summary of submissions is annexed.

Publicity

57. Assuming that the changes proposed in this report are agreed to, then (subject to Cabinet approval) Ministers, if they wish to do so, could announce them as part of the Budget 2014 announcements. On the other hand, changes to provide relief for black hole R&D expenditure are now probably widely expected by the private sector, following the release of the Government discussion document late last year. Therefore, Ministers may prefer to restrict Budget announcements to proposals that would be seen more as "surprises" by the private sector. If this is the case, the proposed changes could be announced at a later date.

Next steps

58. If Ministers agree with the recommended action, officials will prepare a paper for the Cabinet Economic Growth and Infrastructure Committee meeting on 9 April 2014, seeking approval for the proposed changes. Enabling legislation would then be included in the proposed August 2014 taxation bill.

Summary of submissions – *Black hole R&D expenditure: a government discussion document*

Submitter	Summary of submission
AJ Park	<ul style="list-style-type: none"> • Broadly supports removal of any disincentives for NZ businesses to conduct R&D. That said, suggests that now would be a good time to have a broader look at the entire tax treatment of R&D and IP. Considers that current rules are not well understood, relatively complex and do not necessarily match the actual practice of NZ businesses, particularly in the SME space. • Generally supports the proposal to make capitalised R&D spent on patents and PVRs part of the depreciable costs. • Does not know what proportion of R&D spend is typically capitalised, but understands anecdotally that more of it is deducted as an expense. • If an intangible asset is recognised at the point a patent or PVR application is first filed, then sometimes there may be a considerable R&D spend developing that asset after that point. • Agrees that at the end of a patent's legal life the value of the underlying invention will be significantly reduced. • Agrees with the proposal in relation to successful software development. • Agrees with the difficulties in allowing depreciation of know-how, however believes know-how comprises the bulk of R&D spend in NZ, so encourages looking at ways to address its tax treatment. • Recommends adding registered designs to sch 14. • Supports the proposal to allow tax deductions for capitalised development expenditure incurred on unsuccessful developments.
BusinessNZ	<ul style="list-style-type: none"> • Overall, supports recommendations in the DD. • Supports proposed changes regarding successful R&D. No strong view as to best option, but hopes the larger fiscal cost of options 2 and 3 does not mean the benefits are not considered in their entirety. • Believes addressing black hole expenditure on unsuccessful R&D is a more pressing matter. Broadly agrees with view taken by Government around associated issues and risks, but believes Government is taking appropriate steps based on the proposed criteria for qualifying for a deduction. Agrees that policy option chosen for addressing black hole expenditure on successful R&D should guide the choice of policy option for addressing unsuccessful R&D. • Believes aggregated statistics mask the true level of R&D expenditure in NZ, as businesses will often move R&D expenditure that does not qualify for deductibility into general expenditure. • Notes that main reason for businesses to undertake R&D is to grow their business and increase returns. If a project only has a marginal chance of success, it is generally better for the business and the wider economy to abandon it.

Corporate Taxpayers Group	<ul style="list-style-type: none"> • Supportive of the overall proposals in the DD. • Would support development of a comprehensive solution to black hole expenditure. • Notes that in many respects the proposals are remedial, and consideration should be given to a general simplification of the tax rules as they apply to R&D and intangible assets. • Emphasises that the main reason for businesses undertaking R&D is to grow and increase returns. A business should not be influenced by tax outcomes. • Expects that in practice taxpayers adopt varying treatment as to the expensing/capitalisation of R&D expenditure. Does not believe an assumption can be made that all taxpayers currently receive a deduction via s DB 34. • Supports proposal to allow depreciation deductions for capitalised development expenditure relating to patents/PVRs. Favours option 3 from a pure policy standpoint, but considers option 2 is the most practical. Important that “creation” of an asset is linked into the existing “available for use” concepts in s EE 6. • Supports proposed amendment relating to software development. Raises technical matter around wording of s EE 62. • In general, accepts framework set out in the DD in relation to the second scenario in chapter 3. However, considers that separate policy consideration should be given where special circumstances arise. • Suggests registered designs be added to sch 14. • Very supportive of the proposal to allow deductions for capitalised expenditure on unsuccessful R&D, but considers the proposals should be expanded to cover tangible assets and R&D acquired from a third party. Supports immediate deductibility for reasons set out in DD and reduced compliance costs. Comfortable with proposed application approach, but has a preference for option 2. • Considers that the perverse incentive that immediate deductibility would create for taxpayers not to complete marginal projects is extremely low risk. Considers that re-labelling risk is low. Expects that taxpayers would not artificially split R&D projects up.
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Ernst & Young Limited	<ul style="list-style-type: none"> • Welcomes proposals, but considers they are too limited. • Suggests a more comprehensive review of the income tax treatment of intellectual property and R&D, including consultation with businesses, with a view to: <ul style="list-style-type: none"> - Treating know-how as depreciable property. - Incorporating greater recognition of situations where the economic life of R&D-generated assets is shorter than any related legal life. • Welcomes the proposed clarification for software. • Suggests registered designs be added to sch 14, with all capitalised costs of developing them being depreciable. • Considers that future statutory amendment will be required to ensure companies which will no longer be required to prepare general purpose annual financial statements are able to deduct their R&D expenditure. • Accepts distinction between deductibility of capital costs of depreciable and non-depreciable property that is no longer used, but suggests an amendment to s EE 39 is required to ensure that the remaining undepreciated capital cost of an item of depreciable intangible property that is no longer used can be deducted. • Comments that generally it would not seem possible to meet all the proposed criteria for a deduction for unsuccessful capitalised R&D expenditure if the underlying development work were regarded as the relevant asset, but then says that such an approach would be more consistent with the proposed treatment for successful R&D. • Considers that there needs to be some clarification regarding any required linkage to intended patents or PVRs. • Considers that deductions for unsuccessful capitalised development expenditure should be immediate. • Accepts proposed claw-back rules as far as disposals are concerned, but has concerns about the practicality of clawing back expenditure for failed assets that subsequently become useful. • Suggests all capitalised development expenditure that does not result in a sch 14 asset should be regarded as creating know-how as a depreciable asset, with depreciation deductions being allowed on a straight-line basis over a fixed life (either prescribed in the ITA 2007 or set by determination by the CIR).
Fisher & Paykel Appliances Ltd	<ul style="list-style-type: none"> • Disagrees with the conclusion that is not appropriate to allow a deduction for this type of expenditure. Believes a deduction should be allowed, either as incurred or by adding an appropriate asset class to sch 14.

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KPMG	<ul style="list-style-type: none"> • Strongly supports intent of the proposals. • Believes proposals do not go far enough in that they do not cover capitalised development expenditure towards R&D assets that are not on sch 14 (e.g., know-how). • Points out a possible perverse incentive of the proposal – at the margin, it may incentivise businesses to pursue patent protection in order to secure tax deductibility, when it might not otherwise be optimal for them to do so. • Considers that any capitalised R&D expenditure should be deductible or depreciable, but acknowledges issues around determining economic lives of intangible assets. • Understands the rationale for using legal life as a proxy for a patent’s economic life for depreciation purposes, but notes that the economic life of a patent is sometimes less. • Favours option 3 of the options proposed for addressing black hole expenditure on successful R&D, noting that there will be boundary issues under any option, and considers that there is a genuine policy reason for providing relief. • Strongly supports proposal to clarify that capitalised expenditure on software development is depreciable (although considers the argument for non-deductibility to be narrow and to potentially ignore case law). • Agrees that the useful lives of intangible assets may be problematic to determine. Notes that the economic life of an intangible asset may be shorter than its legal life (if any) and suggests that the current approach of limiting sch 14 to intangible assets with fixed legal lives needs to be reviewed. • Believes that allowing depreciation deductions for know-how needs to be explored. Options suggested include the Australian approach (deductible over five years), or a deemed useful life (e.g., 20 years), or a deduction at write-off for accounting purposes. • Strongly supports proposal to allow an immediate deduction for capitalised development expenditure incurred in relation to unsuccessful R&D projects. However, considers that deductibility of capitalised development expenditure on unsuccessful projects that would not have resulted in a depreciable asset had the project been successful also needs to be addressed. • Prefers option 2 of the options proposed for addressing black hole expenditure on unsuccessful R&D. • Has serious workability concerns with the intention test. Considers that it would be difficult for a taxpayer to prove intention if project abandoned prior to start of the patenting process. Also raises the question of when the intention is to be assessed. Alternative suggestion is to allow a deduction if expenditure incurred could have resulted in depreciable property if the R&D asset had not been de-recognised under the accounting rules. Also notes that expanding deductibility beyond depreciable intangible assets would remove the need for an intention test. • Does not believe that the complexity of clawing back deductions for failed assets that become useful is justified. • Considers that concerns around residual know-how are overstated. Points out incentives for writing off marginal assets already exist in our tax system. Does not consider there is a material risk of taxpayers breaking up R&D projects, but considers that if an R&D project was broken up into multiple projects that could each potentially result in an intangible asset, then allowing a deduction for the failed projects would be the correct policy result. Does not believe there is a significant re-labelling risk. • Considers that the proposals to allow unsuccessful expenditure to be deducted would mitigate risk of Inland Revenue seeking to apply the general anti-avoidance provision to taxpayers. However, considers that it is important that the policy process clearly sets out what taxpayers are able to do to access the expanded deductions.
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New Zealand Food & Grocery Council	<ul style="list-style-type: none"> • Supports any steps to promote R&D being undertaken in NZ, including the proposals in the DD. However, believes availability of R&D tax concessions is more important in influencing decisions to invest in R&D in NZ.
New Zealand Institute of Chartered Accountants (NZICA)	<ul style="list-style-type: none"> • Welcomes the proposals and, in broad terms, supports all of the initiatives. • Favours option 2 in relation to black hole expenditure on successful R&D. However, submits that the application date should be 13 May 2013. • Supports the proposed amendment in relation to software development. • Considers that an asset with an indefinite life should not be depreciated. However, for an asset with a finite life that is only ascertainable at the end of its life, suggests that the most appropriate course may be to allow a deduction when the asset is written-off. • Supports the proposal in relation to black hole expenditure on unsuccessful R&D. However, considers that it should be sufficient if the asset is derecognised for accounting purposes, and that the requisite intention should be to create “intangible property”. • Favours option 2 in relation to black hole expenditure on unsuccessful R&D, but with an application date of 13 May 2013. • Considers that it would be very unlikely for taxpayers to derecognise a valuable intangible asset to obtain an immediate deduction. Submits that it is very unlikely that a taxpayer would decide not to complete a marginal project merely to obtain a tax deduction. Submits that re-labelling risks are low. Doubts that the risk of taxpayers breaking up R&D projects is material, but, even if it is, does not believe the outcome is necessarily incorrect. • Considers that the DD demonstrates some confusion about what is “know-how”; distinguishes it from “knowledge”.
New Zealand Law Society	<ul style="list-style-type: none"> • Registered designs and copyright which has been industrially applied should be added to sch 14 and the policy proposals also be applied to them. • Recommends that know-how be depreciable over the taxpayer’s estimate of its useful life. This would have the advantage of a consistent treatment of R&D, whatever its intended purpose. • Agrees that at a patent’s expiry, nil is a close approximation to the residual value of the underlying know-how. • Agrees with the proposed solution to the problem of black hole expenditure on successful R&D, subject to the first and second bullet points above. • Supports proposed solution with regard to unsuccessful R&D intended to generate a patent or PVR, but the same policy should apply for other unsuccessful R&D. • R&D on a successful patent should be depreciated over the maximum patent term, until the patent is abandoned or not renewed, at which point the balance of capital expenditure should be deducted. For unsuccessful R&D, deductibility should be allowed once the R&D is deemed unsuccessful. • Agrees that allowable deductions for unsuccessful capitalised development expenditure should be confined to expenditure that would have been depreciable if the R&D was successful, but only if sch 14 is extended as discussed above. • Agrees with using an intention test to determine whether expenditure would have led to an item of “depreciable intangible property” if the R&D had been successful.

New Zealand Manufacturers and Exporters Association	<ul style="list-style-type: none"> • Notes that black hole R&D expenditure is not an issue in practice for the majority of its members. • Considers that expenditure on an intangible asset with an indefinite economic life should be immediately deductible. • Pressure to start patent process ASAP, meaning that patent application can often precede the asset being recognised for accounting purposes. Even if not the case, time-period is likely small. Generally, capitalised R&D costs will be minimal. • Residual value of know-how underlying a patent is approximately nil at end of its legal life. Often patents are allowed to lapse before they expire as there is no value in cost of patent maintenance. • Prefers option 3 of the options proposed for addressing black hole expenditure on successful R&D. Suggests another option: allow taxpayers to choose between capitalising /depreciating assets or immediate deductibility, with effect from date of the DD's release. • Expenditure on an intangible asset with an indefinite useful life should be immediately deductible. • Prefers option 2 of the options proposed for addressing black hole expenditure on unsuccessful R&D. • Unsuccessful capitalised development expenditure should be immediately deductible. Agrees with an intention test. Considers that the risk of derecognising valuable assets is small. Considers that perverse incentive to not complete marginal projects would not be significant; important that unsuccessful expenditure can be immediately deducted. Considers that re-labelling risk is not significant. Considers that it would be the correct policy outcome for expenditure on failed aspects of a broader project to be immediately deductible.
PricewaterhouseCoopers	<ul style="list-style-type: none"> • Supports policy intent of the DD. • Considers that the proposals are too narrowly focussed. • Notes that taxpayers are often faced with considerable uncertainty about the deductibility of expenditure, which leads to excessive compliance costs. • Considers that a comprehensive solution to black hole expenditure should be adopted, and refers to PwC's 2008 submission in this regard.
Shepherd Hensman Ltd	<ul style="list-style-type: none"> • Proposes a specific deductibility provision for wages/salaries spent on R&D (i.e., immediate deductibility for capital R&D expenditure), to avoid the need for apportionment between deductible and capitalised wage/salary expenditure.