DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 23 MAY 2014

1. The Government's 2014 Budget was announced on 15 May and included two new tax measures to support business R&D. Last week I looked at the initiative to allow R&D-intensive companies to cash-out their tax losses. This week I look at the initiatives relating to black hole R&D expenditure. The details are contained in the *Fact Sheet – Black hole R&D expenditure* ("the Fact Sheet").
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. On 7 November 2013 the Government released *Black hole R&D expenditure – A government discussion document* ("the discussion document"). According to the discussion document, the potential for there to be black hole expenditure only exists after costs have been capitalised for accounting purposes. Up to the point at which costs are capitalised under accounting rules, s. DB 34 of the *Income Tax Act 2007* allows a deduction for all expenditure that is expensed under paragraph 68(a) of NZ IAS 38 *Intangible Assets*. I reviewed the discussion document in *Weekly Comment* 15 November 2013. The measures announced in the Fact Sheet flow from the discussion document.
4. The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* ("the November 2013 Tax Bill") currently awaiting enactment also contains a number of amendments relating to black hole expenditure, and it is worth briefly re-visiting these to distinguish them from the initiatives in the Budget, which have not yet been incorporated into a Tax Bill.
5. The topics covered this week are:

   (a) Specific measures in the November 2013 Tax Bill;

   (b) R&D that results in a depreciable intangible asset;

   (c) R&D that does not result in a depreciable intangible asset;

   (d) Claw back;

   (e) Registered designs;

   (f) Copyright that has been applied industrially;

   (g) Successful software developed for own use.

Specific measures in the November 2013 Tax Bill

6. The November 2013 Tax Bill, which was reported from the Finance and Expenditure Committee on 14 April 2014, contains a number of amendments relating to black hole expenditure. These are a number of specific measures, which apply for the 2014-15 and later income years. I reviewed these measures pre the Finance and Expenditure Committee amendments in *Weekly Comment* 21 March 2013 and *Weekly Comment* 28 March 2013.

7. The deduction in s. DB 19 for expenditure relating to applying for resource consents is being extended to apply to expenditure on:

   (a) Applications that are not lodged or are withdrawn;

   (b) Applications that are refused; and

   (c) Applications that are granted, but the consent lapses or is surrendered before it is used (inserted at the Finance and Expenditure Committee review stage).

8. Resource consents granted under s. 15A or s. 15B of the *Resource Management Act 1991* have a fixed life of between 5 and 35 years and are being included in Schedule 14 as depreciable intangible assets.

9. The deduction in s. DB 37 for expenditure relating to applying for patents is being extended to apply to expenditure on:

   (a) Applications that are not lodged or are withdrawn; and

   (b) Applications that are refused.

10. A new deduction is to be provided in s. DB 40BA for expenditure relating to applications for plane variety rights where:

    (a) The applications that are not lodged or are withdrawn; and

    (b) The applications that are refused.

11. In all the above situations – i.e. applications for resource consents, patents and plant variety rights – there will be a claw back of the deduction under new s. CG 7B if:

    (a) "Application property" acquired as a result of the expenditure is later disposed of for a consideration; or

    (b) The application expenditure forms part of a later successful application, in which case, the expenditure that is clawed back will be included in the depreciable cost base of the intangible asset that is created.

12. The November 2013 Tax Bill also provides a deduction, from the 2014-15 income year, for 3 specific types of "black hole" administration costs:

    (a) Expenditure in authorising, allocating or processing the payment of a dividend or resolving disputes relating to these matters;

    (b) Stock exchange registration fees for listed companies; and

    (c) Costs incurred in holding an annual meeting of shareholders (but excluding costs relating to a special or extraordinary meeting).

Proposed new measures: R&D that results in a depreciable intangible asset

13. As foreshadowed in the discussion document, capitalised development expenditure (incurred on or after 7 November 2013) that relates to a patent, patent application or plant variety rights will be allowed to be included as part of the depreciable costs of the relevant depreciable intangible asset, for taxpayers that have carried out research and development (R&D) that has led to them acquiring one of these depreciable intangible assets. This will apply from the 2015-16 income year onwards.

14. It was noted in the discussion document that depreciable patent costs are limited to the administrative and legal fees incurred in the patent process in the Commissioner's Interpretation Statement "Income tax treatment of New Zealand patents", *Tax Information Bulletin* Vol. 18, No. 7 (August 2006).

15. In the discussion document, the Government proposed making it clear that:

    (a) The depreciable cost of a patent application and a patent expressly includes capitalised development expenditure incurred in connection with devising the invention. However, this would apply only to capitalised development expenditure incurred on or after 7 November 2013, in line with the Government's preferred policy option of targeting only new R&D expenditure from that date onwards.

    (b) Capitalised development expenditure that relates to a plant variety that is the subject of plant variety rights will be depreciable. Again, only expenditure incurred on or after 7 November 2013 onwards will qualify.

16. This policy option will require splitting expenditure capitalised on new assets into expenditure incurred before and after 7 November 2013. There will consequently be some compliance costs. Presumably, the expenditure will be depreciable over the life of the patent or plant variety right. In the discussion document the Government expressed the view is that this treatment is appropriate if the residual value of know-how at the end of the life of the patent will be nil. Whether that will be a requirement remains to be seen.

Proposed new measures: R&D that does not result in a depreciable intangible asset

17. A one-off tax deduction will be allowed for capitalised development expenditure (incurred on or after 7 November 2013) upon the intangible asset to which it relates being written off for accounting purposes, for taxpayers that have developed intangible assets that are not depreciable for tax purposes. This will apply irrespective of whether the asset was useful for a period or the R&D was unsuccessful. The deduction will be available from the 2015-16 income year onwards.

18. The Government's view expressed in the discussion document is that unsuccessful expenditure should be tax deductible if it would have led to a depreciable asset, but not otherwise. For this purpose, the Government proposed an intention test – i.e. whether the expense was intended to produce an enduring benefit as opposed to whether it actually produces an enduring benefit.

19. The rules for this deduction are yet to be stipulated. In the discussion document, the Government proposed that the following three conditions should be met:

    (a) The intangible asset to which the expenditure relates has been *derecognised* under the accounting rules (other than due to its disposal) before it is used or available for use:

(i) In deriving income; or

(ii) In carrying on a business for the purpose of deriving income.

(b) The person intended that the expenditure would lead to an item of “depreciable intangible property” (that is, an asset listed in schedule 14 of the *Income Tax Act 2007*) of the person.

(c) No deduction has been allowed for the expenditure under any other provision.

Claw back

20. The Fact Sheet includes the following “integrity measures”:

(a) 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 will 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.

(b) 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) will be clawed back as income.

Proposed new measures: registered designs

21. A registered design has a legal life of 15 years (assuming all rights of renewal are exercised). Registered designs are an item of intangible property that has a finite useful life that can be estimated with a reasonable degree of certainty on the date of its acquisition, so meet the criteria for inclusion in Schedule 14 of the *Income Tax Act 2007*. Therefore, registered designs are being made depreciable over 15 years by adding them to Schedule 14.

22. As the 15-year legal life of a registered design generally commences on the date on which the first application is made (as opposed to the date on which registration is granted), applications for the registration of a design are also being made depreciable, by adding them to Schedule 14.

23. Capitalised expenditure (incurred on or after 7 November 2013) in creating the design will be able to be included as part of the depreciable costs of a registered design (and associated application), for taxpayers that have created a design that they have applied to have registered, as well as legal and administrative fees incurred in the design registration process.

24. An immediate tax deduction will be allowed for expenditure incurred for the purpose of applying for registration of a design if registration is not obtained because the application is not lodged or is withdrawn, or because registration is refused. This parallels the tax treatment of expenditure incurred for the purpose of applying for a patent where a patent is not obtained (refer to paragraph 9 above). The deduction will be available in the income year in which the taxpayer decides not to lodge the application, withdraws the application, or is refused registration.

Proposed new measures: copyright that has been applied industrially

25. 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.

26. The measures in the Fact Sheet are as follows:

    (a) Copyright in an artistic work that has been applied industrially (as defined in section 75(4) of the *Copyright Act 1994*) will be made depreciable, by adding it to schedule 14.

    (b) Depreciation will be over:

        (i) 16 years, in the case of product designs and casting moulds; or

        (ii) 25 years, in the case of works of craftsmanship.

    (c) Capitalised expenditure (incurred on or after 7 November 2013) in creating the artistic work will comprise the depreciable costs of the copyright, for taxpayers who have created an original artistic work that they (or their licensee) have applied industrially.

Proposed new measures: successful software developed for own use

27. Tax law is being amended to clarify that capitalised expenditure incurred by a person in the successful development of software for use in their own business is depreciable.

28. It was recognised in the discussion document that the intangible asset listed in Schedule 14 as “the copyright in software” arguably has no cost when a taxpayer has self-developed software for which the copyright has arisen by operation of law, without any registration process, or fee paid. On that basis, the depreciable cost of self-developed software is arguably zero. The Government recognised that this is not in accordance with the policy intent of the Commissioner’s 1993 policy statement in the Appendix to *Tax Information Bulletin* Vol. 4, No. 10 (May 1993) and most taxpayers have been depreciating all of their capitalised self-development software costs.

29. The amendment will make the law consistent with the policy intent and Inland Revenue’s understanding of current taxpayer practice. This amendment will have retrospective effect up to the statutory time bar. Therefore, taxpayers will be able to request amendments to previous assessments where relevant.

Arun David, Director

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