Inland Revenue
Te Tari Taake

12 May 2022

Dear

Thank you for your request made under the Official Information Act 1982 (OIA), received on 21 March 2022. You requested *copies of all documents and information in relation to the current status of policy development concerning the income tax treatment of computer software developed for sale or licence*.

On 31 March 2022, we partially transferred your request to the Minister of Revenue as he holds information within scope of your request.

On 14 April 2022, the time limit for deciding on your request was extended to 12 May 2022, due to the large quantity of information involved and consultation with other departments was required.

I have interpreted your request to be in relation to the beginning of Policy and Regulatory Stewardship's work on the income tax treatment of software development expenditure, following the publication of *Issues Paper No.10 Income tax treatment of software development expenditure*.

The attached table includes my decisions on the documents within scope of my interpretation of your request. Some information or documents have been withheld in full under the following sections of the OIA:

- 9(2)(a) – to protect the privacy of natural persons
- 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information or who is the subject of the information
- 9(2)(ba)(i) – to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied
- 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the advice tendered by minister and officials
- 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions by or between or to Ministers of the Crown or members of an organisation or officers and employees of any public service agency or organisation in the course of their duty
- 18(c)(i) – making the requested information available would be contrary to the provisions of a specified enactment, namely Inland Revenue's confidentiality obligation in section 18 of the Tax Administration Act 1994 (TAA). Disclosure of this information does not fall within any of the exceptions to the confidentiality obligation listed in sections 18D to 18J of the TAA.

The enclosed documents contain information that is outside the scope of your request. This information has not been considered for release and has been withheld and marked as "Not in scope".

No public interest in releasing the withheld information has been identified that would be sufficient to outweigh the reasons for withholding.

The NZ Tech Alliance Survey mentioned in the correspondence is withheld in full under section 18(d) of the OIA as the summary of the survey is publicly available. You can find the summary here: https://nztech.org.nz/wp-content/uploads/sites/8/2021/03/NZTech-Alliance-Software-Tax-Survey-March-2021-Final-Results-002.pdf.

Right of review

If you disagree with my decisions on your OIA request, you can ask an Inland Revenue review officer to review my decisions. To ask for an internal review, please email the Commissioner of Inland Revenue at: CommissionersCorrespondence@ird.govt.nz.

Alternatively, under section 28(3) of the OIA, you have the right to ask the Ombudsman to investigate and review my decision. You can contact the office of the Ombudsman by email at: info@ombudsman.parliament.nz.

Publishing of OIA response

Please note that Inland Revenue regularly publishes, on its website, responses to requests that may be of interest to the wider public. Your personal details or any information that would identify you will be removed prior to it being published.

Thank you again for your request. I trust that the information provided is of assistance to you.

Yours sincerely

Thomas Allen
Policy Lead

Date	Document description	Decision
31/01/2020	Research notes on the reporting treatment (commercial and tax) of software development expenditure	Released in full
02/03/2020	Deductibility of software expenditure	Released in full
06/03/2020	Stakeholder Engagement Plan – Timing of deductions of software expenditure	Withheld in full under section 9(2)(g)(i)
13/03/2020	Policy Commissioning Paper – Timing of deductions of software expenditure (for software developed for sale or licence)	Released with redactions under section 9(2)(ba)(i)
26/06/2020 and 16/07/2020	Items from Inland Revenue's weekly Status Report to the Minister of Revenue	Released in full
09/09/2020	1993 Policy Statement - Income Tax Treatment of Computer Software	Released with redactions under section 9(2)(a)
16/10/2020	Consultation letter to MBIE: Software Development Expenses and MBIE policies for innovation	Released in full
06/11/2020	Software development expenditure: Notes from pre-consultation call with MBIE	Released with redactions under section 9(2)(g)(i)
24/11/2020	Consultation letter: Software development expenses and MBIE policies for innovation	Released in full
03/12/2020	Software development expenditure: Notes from pre-consultation call with NZTE	Released with redactions under sections 9(2)(a) and 9(2)(ba)(i)
27/01/2021	Software Development consultation _Business stakeholders_2021-01-25_V3.docx	Released with redactions under section 9(2)(a)
28/01/2021	Consultation letter to stakeholder: Software development expenses – review tax policy settings	Released with redactions under sections 9(2)(a) and 9(2)(ba)(i)
03/02/2021	Software Developers - Tax policy review of income tax settings for software development expenditure	Released with redactions under section 9(2)(a)
04/02/2021	Software expenditure consultation - Callaghan	Release with redactions under section 9(2)(a)
16/02/2021	IRRUIP 10 Income tax treatment of software development expenditure	Released with redactions under section 9(2)(a)
18/02/2021	Discussion notes ahead of Software developers consultation meeting 10am	Released with redactions under sections 9(2)(a) and 9(2)(ba)(i)

Date	Document description	Decision
18/02/2021 and 19/02/2021	Notes from Consultation – [9(2)(ba)(i)] and NZ Tech	Released with redactions under sections 9(2)(a), 9(2)(b)(ii) and 9(2)(ba)(i)
19/02/2021	Policy work on software development?	Released with redactions under section 9(2)(a)
24/02/2021	Consultation notes - deductions for software expenses	Withheld in full under sections 9(2)(a), 9(2)(b)(ii) and 9(2)(ba)(i)
03/03/2021	Review of tax treatment of software development expenditure	Released with redactions under section 9(2)(a)
03/03/2021	Software Development Expenses	Withheld in full under section 9(2)(a)
12/03/2021	Consultation letter: Software development expenses – reviewing tax policy settings	Released with redactions under section 9(2)(a)
15/03/2021	Memo to Emma Grigg, Policy Director	Released with redactions under section 9(2)(a)
15/03/2021	Tax treatment of the software sector	Released with redactions under section 9(2)(a)
16/03/2021	Software development expenditure with [9(2)(ba)(i)]	Withheld in full under sections 9(2)(a), 9(2)(b)(ii) and 9(2)(ba)(i)
16/03/2021	Software development expenditure with CA ANZ – Technical Advisory Group	Released with redactions under section 9(2)(a)
18/03/2021	Results from NZ Tech Alliance Survey – Tax Accounting Treatment for Software Development – March 2021	Released in full
23/03/2021	Software development expenditure with [9(2)(ba)(i)]	Withheld in full under sections 9(2)(a), 9(2)(b)(ii) and 9(2)(ba)(i)
26/03/2021	Accounting Treatment of Software Development under GAAP	Released in full
30/03/2021	Software development expenditure	Released with redactions under section 9(2)(a)
08/04/2021	Purchase price allocation - software-related material	Released with redactions under section 9(2)(a)
15/04/2021	TGC Action points	Released with redactions under section 9(2)(a)
19/04/2021	Software expensing – consultation: [9(2)(ba)(i)]	Withheld in full under sections 9(2)(a), 9(2)(b)(ii) and 9(2)(ba)(i)
22/04/2021	Software meetings + potential bill timeline	Released with redactions under section 9(2)(a)

Date	Document description	Decision
22/04/2021	Software development sector	Released with redactions under section 9(2)(a) Attachment partially released, some information withheld under section 18(c)(i)
13/05/2021	Projects for consultation	Released with redactions under sections 9(2)(a) and 9(2)(ba)(i)
31/05/2021	Software Sector consultation	Released with redactions under section 9(2)(a)
10/06/2021	Memo to Emma Grigg, Policy Director	Withheld in full under section 9(2)(f)(iv)
02/07/2021	RE Re: Upcoming consultation	Released with redactions under section 9(2)(a)
02/07/2021	Re: Upcoming consultation	Released with redactions under section 9(2)(a) Attachment released in full
07/07/2021	Software project policy memo	Withheld in full under section 9(2)(f)(iv)
09/08/2021, 13/08/2021, 26/08/2021	Draft policy reports	Withheld in full under section 9(2)(g)(i)
07/09/2021	Draft policy report: Taxation of software development expenditure	Withheld in full under section 9(2)(g)(i)
21/09/2021	FW IR2021/346 Signed	Withheld in full under section 9(2)(g)(i)
21/09/2021	IR2021/346 Signed	Withheld in full under section 9(2)(f)(iv)
24/11/2021	Software developers	Withheld in full under section 9(2)(f)(iv)
Undated	Memo: Software Development Expenses	Released in full

File note

Date: 31 January 2020

Author: Craig Phillips

Subject: Research notes on the reporting treatment (commercial and tax) of software development expenditure

Background
This research arises from a review of IR practice as set out in TIB 4 May 1993, in appendix B of software developed for sale or licence. However, there are also spill-over relationships for software developed for in-house use and commissioned software which are related to the potential for distortion of classifications to obtain the most favourable timing treatment for expenses. ensure that the

The core principles applied are:

Software developed for in-house use:
- pre-development expenses deducted as incurred
- Development expenses capitalised until project completed (WIP)
- Depreciation 40% DV 30% SL
- Unsuccessful development deducted when unsuccessful decision made
- Ongoing maintenance deducted as incurred
- Upgrades capitalised (same as for original development)

Commissioned software
As for software developed for in-house use except there would be no pre-development costs

Software developed for Sale or license
- Development costs deductible in year incurred
- Value of unbilled work in progress and unsold completed software must be taken into account as trading stock. The value of trading stock at balance date must be included as income in your return. (effectively defers deduction until year of sale or licence)

The project focus is the tax treatment of expenditures on software developed for sale or licence.
The review document is IRRUIP -10

Overview of review document
This file note documents key points from a number of sources to build up information about the various approaches to tax treatment of software development costs around the world.

The core issues:

Deductibility of software development costs
Absorption costing & software development costs
An appropriate timing of deductions for software development costs
An appropriate treatment for disposals of developed software.

Not in scope

Accounting & software development NZIAS 18

The trend in the accounting field is to capitalize software development costs.54 According to a recent survey, twenty percent, if not more, of computer industry firms capitalize some of their software expenditures.

The capitalisation of software increases earnings per share because amortisation is less than immediate deduction.

Planning & design phase

Post planning and designe phase based on feasibility being established.

Feasibility assurance is typically the point at which capitalisation of software costs begins

Accounting approach is seeking consistency – and tax could follow principles underpinning. Need to consider changes in practices that might not yet be reflected in required IFRS standards.

Not in scope

Tax base

Principles of

fairness,(horizontal & vertical equity)

administrative feasibility cost of administering & implementing must be as low as possible

and economic rationality – what are the effects of tax/deductions/amortisation?

Haig-Simons

Income = ∑ market value of rights exercised in consumption of property rights and change in value of store of property rights

Consumption tax.

Spark business Works November 26 2018

Important to financial health and operation of any company that is building or buying software to understand the principles of expensing and capitalising that expenditure in the financial reports of the software developer..

GAAP is promoted as the basis to determine what to expense and what to capitalise. However the purpose of GAAP is to enable investors and creditors to compare contrast extract and analyse financial information of an organisation.

GAAP guidelines are rooted in the concept of whether the software development will result in an enduring economic benefit – software development costs can be classified as either:

- Costs that produce value at a later date; and
- Costs that do not produce value at a later date.

In essence, this is the underlying question for tax policy, and the core issues for costs that produce value at a later date, are:

The timing of deductibility of those costs; and

The recovery (including timing of recovery) of costs on disposal of an asset or on recovery of sunk expenses.

Types of software development processes under GAAP

Waterfall approach

Software development follows sequential steps.

Expense/ capitalisation depends on the which step the costs are categorised as.

The steps themselves differ depending on whether the development is for internal use or external use (e.g. sale or licence or commissioned work)

Software for internal use:

Examples, CRM tools; Accounting systems; Project Management Tools, Internal Data tools

Project Stage	Typical costs	Expense/Capitalise
Planning	Creating requirements, developing a project plan	Expensed
Development/Coding	Testing, third-party developers, software purchase costs, encoding	Capitalise
Implementation	User training, data usage analysis	Expense

Software for external use (sale, licence/lease)

Project Stage	Typical costs	Expense/Capitalise
Feasibility & Planning	Creating requirements, developing a project plan, creating requirements, developing a project plan	Expensed
Software established as feasible	Testing, third-party developers, software purchase costs, encoding	Capitalise
Software available for use	User training, customer service, other post-launch costs.	Expense

- Capitalisation is thought to better represent the long term value software brings to the organisation
- Expensing for tax reduces tax expense, and improves cash flow for yearly operations.
- Expensing for financial reporting can lead to higher operations efficiency ratios (longer term)

Not in scope

Revenue Canada: R&D projects containing software development

https://www.canada.ca/en/revenue-agency/services/scientific-research-experimental-development-tax-incentive-program/information-seminars-webinars/eligibility-work-projects-containing-software-development-transcript.html

Eligibility policy for the credit/benefit : expressed in legislation by definition
Technology definition – similar to NZ definition in DB 34 **and now also in R&D tax credit (2019 rules) ???? [Check new R&D tax credit rules]**

The analysis in the webinar is concerned with determining the eligibility for a R&D tax credit of work containing software development

5 questions (all must be yes to qualify):
- o Is there a scientific or technological uncertainty?
- o Is the development specifically aimed at reducing or eliminating that uncertainty?
- o Is the development approach consistent with the scientific method?
- o Is the overall development for the purpose of making scientific or technological advancement
- o Is there a record of the progress of the process of applying the scientific method.

Examples of new or improved product, process or device:
Codec software
Web information system & document management on the web
Protein structure prediction software

A new or improved product process or device can be from a combination of hardware and software. (slide 8)

Software development may be necessary but the developed software is not part of the product process or device (slide 9)

Technology is the practical application of scientific knowledge and principles. The development of cloud technology has allowed a platform for modern big data applications.

Slide 15: Understanding the capability and limitations of systems to develop an information system is about a product and is not related to the concept of technology or advancement of technology or scientific uncertainty. The question is whether the current state of technology is insufficient to resolve a problem. If a system has technological deficiencies that prevent the desired outcome -that can be development but if the new system merely replicates what is kept manually it is no more than an information database that is developed.

IAS 38

- Para 4: When the software is not an integral part of the related hardware, the computer software is treated as an intangible asset.
- Para 5 – IFRS 38 applies to expenditure on advertising training, start-up research and development activities. R & D activities are directed to the development of knowledge
- Para 8:Definitions
    - An *intangible asset* is an identifiable non-monetary asset without physical substance.
    - *Development* is the application of research findings to other knowledge to a plan or design or other knowledge to a plan or design of the production of new or substantially improved … systems or services before the start of … commercial production or use.
    - *Research* is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge or understanding.

Para 9

Software is included in the list of common examples where a firm will expend resource for developing maintaining or enhancing

Para 10

Definition of intangible asset requires:

- Identifiability, control over a resource and existence of future economic benefit.

Para 11-12 Identifiability

Requires either being able to be separated and sold, licensed, rented or exchanged OR

Arises from contractual or other legal rights (regardless whether or not those rights are severable or tradable.

Paras 13 to 16 Control

Obtain future economic benefits and restrict access of others to those benefits. Legal rights to enforce demonstrate control but are not a pre-condition for control

Paras 18 to 24 – recognition

Based on probability of flow of future economic benefit to the firm AND reliable measurement

Measurement at cost initially

Pars 51 to673 – Internally generated Intangible assets

Main issues related to identification of an asset that gives future economic benefits and reliability of cost measurement

Research costs – all expensed

Note only development costs are capitalised – note also that probable economic benefits are determined using the principles in IAS 36

 Para 61 62 is relevant also to considerations of tax policy

Cost –

Para 65 6o 67 – cost of internally generated intangible asset is ∑expenditure incurred from date the asset meets first the recognition criteria in paras 21, 22 and 57

Not in scope

Inland Revenue
Te Tari Taake

File note

Date: 2 March 2020

Author: Benjamin Hammond

Subject: Deductibility of software expenditure

The software sector

-   The software sector can be divided into three general business models:
    1. The business of designing and selling software for a business (DataCom)
    2. The business of designing and licensing software to multiple businesses (Xero)
    3. The business of designing and using software internally (Banking, agritech, Fintech).

-   Designing software, although the details and focus can vary between business model, is relatively simple. The key building blocks are:
    1. Coding and engineering.
    2. Minimum viable product.
    3. Customer acquisition.
    4. Feedback.
    5. Improvement.
    6. Scalability.

-   The development of software has changed rapidly over time, shifting from a traditional "waterfall" model to an agile "incremental" model. Submitters agreed that the incremental development business model is now commonplace in the industry. The incremental model has no clear beginning, middle and end. Agile methodologies may result in the developed software never being a "finished" product as improvements are constantly being made based on customer feedback.

-   The incremental development models go hand-in-hand with the recent boom in "subscription business models". Where consumers receive products or services on a recurring basis often for an annual fee (McKinsey report).

-   Cash for software businesses.

-   Exernalities

-   Other initiatives : R&D.

-   Options

    1. Deduction of the expenses in full as they are incurred
    2. Deduction of the expense in full when the developed software is first able to be commercially exploited.
    3. Capitalised as a business asset, and the cost amortised over the economic life of the developed software (this is the general tax policy framework applying to assets that are used within a business setting).

Technology Investment Network (TIN)

-   Succeed because they have global ambition – providing inspiration and example for others to follow. 'HealthTec'.

HEALTHTECH IS THE LARGEST SECONDARY SECTOR IN THE TIN REPORT, GENERATING $1.9B IN REVENUE AND BOASTING A FIVE YEAR CAGR OF 9.1%.

Of the 200 companies in the 2019 TIN Report, 22 (or 11%) are HealthTech firms, yet they generate 15.4% of the TIN200 revenue, which clearly shows the size and significance of the HealthTech sector in New Zealand.

Number of TIN200 HealthTech Companies

22

11.0% of TIN200 Companies

Total HealthTech Revenue

$1.9B

15.4% of TIN200 Revenue

HealthTech Revenue Growth

$92m

8.2% of TIN200 Growth

HealthTech 5-Year CAGR

9.1%

8.9% TIN200 5-Year CAGR

% of TIN200 Revenue

$12.1B

- Other 34.5%
- HealthTech 15.4%
- IT Services & Support 14.8%
- Appliances 14.6%
- Agritech 11.3%
- Fintech 9.4%
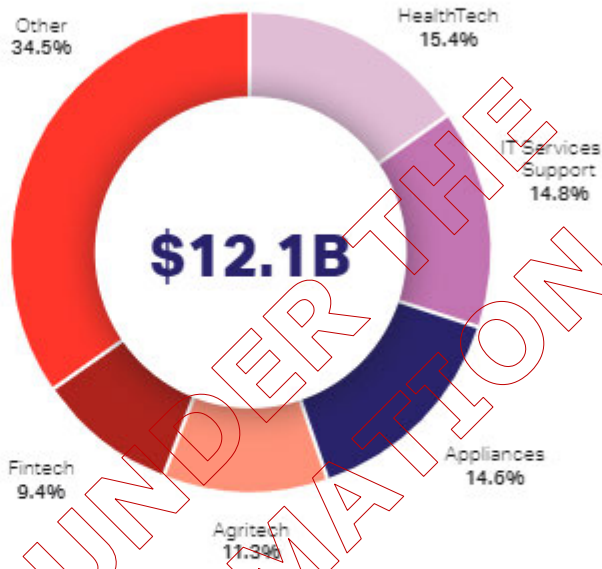
TIN200 Revenue and Growth by Secondary Sector

	REVENUE ($000)	GROWTH ($000)	% SHARE OF TIN200 REVENUE	% SHARE OF TIN200 GROWTH
HealthTech	$1,871,668	$92,255	15.4%	8.2%
IT Services and Support	$1,792,596	$190,998	14.8%	17.1%
Appliances	$1,772,069	$90,563	14.6%	8.1%
Agritech	$1,374,092	$30,925	11.3%	2.8%
Fintech	$1,134,441	$240,668	9.4%	21.5%
Operational Support	$850,717	$119,622	7.0%	10.7%
Electronics	$742,360	$43,667	6.1%	3.9%
Digital Media	$727,891	$93,468	6.0%	8.3%
Software Solutions	$640,857	$110,298	5.3%	9.8%

3

New Zealand:
Open for Business

A WELL ESTABLISHED ECO-SYSTEM SUPPORTS NEW ZEALAND'S TECHNOLOGY INDUSTRY GROWTH.

Regional Development Agencies
17 regional Economic Development Agencies provide local support to technology companies.

Mature & Emerging Financial Markets
- A long-established stock market, the NZX.
- The NXT public market for small and emerging businesses allows raising of capital with lower compliance costs.
- Five active equity crowdfunding platforms to fund early stage companies.

Simple, Predictable and Fair Tax Environment
- No general capital gains tax.
- Establishment in 2019 of the R&D tax incentive programme, providing a tax credit at a rate of 15% of eligible R&D spend up to $120 million.
- US-based Tax Foundation (2019) ranks New Zealand's overall tax system as second in the developed world for its competitiveness.

Strong Angel Investor Network
- A well-developed network exists of early-stage investment vehicles for seed capital.

Collaborative Working Spaces
- A growing number of collaborative workspaces and innovation hubs in all regions (BizDojo, Generator, GridAKL, StartUp Dunedin, and more.)

World-leading Tertiary Institutions
- New Zealand universities are ranked in the world's top 50 in 22 subjects and top 100 across 39 subjects.*
- Numerous entrepreneurial development programmes support student ventures.

Government Policy
Initiatives within the Government's Digital Economy Programme include:
- Establishment of ICT graduate schools.
- Funding to increase the number of engineering graduates.
- A Global Impact Visa system encouraging entrepreneurs and investors to create and support innovation-based ventures from New Zealand.
- Supporting the establishment of the annual Techweek NZ event, featuring over 500 tech events across the country.

World-leading Internet Speeds
- Government has committed to spend over $2B to provide Ultra-Fast Broadband to 80% of New Zealanders by 2022.
- Five existing international fibre cables plus two additional cables due to go live shortly.

Government Support Agencies
- Callaghan Innovation provides companies with R&D support in the form of grants and expert and technical advice.
- 280 New Zealand Trade & Enterprise (NZTE) overseas advisors help New Zealand companies expand their offshore operations.
- NZ Venture Investment Fund (NZVIF) supports the early stage investment market with $245m in funds under management.
- $330m Elevate NZ Venture Fund launched in March 2020 to make it easier for high-potential technology companies to raise money.

*Source: Universities New Zealand, Nov 2018.

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Possible consultation parties:
- ANGEL, Angel HQ, MIG Angels, Flying Kiwi Angels, Canterbury Angels, Launch Taranaki.

4. Software and other intangibles

(i) Software and other intangible asset balances Software development expenditure is capitalised only where costs are directly attributable, and once the product or process is

commercially feasible, the benefits are probable, and the Group intends to sell or use the completed software.

Software assets are amortised over their useful lives of up to seven years on a straight line basis, and reviewed annually for indicators of impairment.

Intellectual property (IP) assets are amortised over their estimated useful lives, being up to 13 years.

The genetic data in the LIC database increases in value with each successive generation. Both goodwill and the LIC database have indefinite useful lives. They are recognised at cost and are not amortised, are allocated to a cash generating unit ("CGU") and tested for impairment annually.

At reporting date, software includes $20.565 million (2019: $17.290 million) of work in progress, which is not being amortised until it is ready for use.

Capitalised Software Development Costs including impairment

Why significant

Intangible assets make up 79% of the Group's non-current assets. The most significant of these intangible assets is capitalised software development costs.

The Group capitalises costs incurred in the development of its software. These costs are then amortised over the estimated useful life of the software.

The Group's process for calculating the value of internally developed software involves judgment as it includes estimating time which staff spend developing software and determining the value attributable to that time.

NZ IAS 36: Impairment of Assets requires that finite life intangible assets be tested for impairment whenever there is an indication that the intangible assets may be impaired. This assessment requires judgment including consideration of both internal and external sources of information.

Disclosures relating to Intangible Assets, including key assumptions, are included in Note 10 to the consolidated financial statements.

How our audit addressed the key audit matter

Our work on capitalised development costs focused on the Group's process for estimating the time spent by staff on software development that can be capitalised under NZ IAS 38: Intangible Assets.

Our audit procedures included the following:

- Assessing the nature of a sample of projects against the requirements of NZ IAS 38 to determine if they were capital in nature;

- Assessing the procedures applied by the Group to review the rates applied to capitalise payroll costs;

- Assessing the effectiveness of controls over the processing of payroll costs;

- Assessing capitalised costs with reference to actual payroll information for a sample of employees;

We assessed the factors that the Group considered regarding impairment of capitalised development costs and whether any indicators of impairment existed. This included having regard to:

- Significant changes in the extent or manner in which the associated software is used;

- Potential or actual redundancy or disposal of developed software;

- Amortisation periods applied by the Group to developed software relative to its experience of software lifecycle;

- Significant changes in the market in which the assets are used; and

We assessed the adequacy of the disclosures related to capitalised development costs and related impairment considerations in the consolidated financial statements.

IFRS NZ IAS 38

Intangible assets 9 Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and

publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. 10 Not all the items described in paragraph 9 meet the definition of an intangible asset, ie identifiability, control over a resource and existence of future economic benefits. If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see paragraph 68).

Development phase

57   An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

    (a)   the technical feasibility of completing the intangible asset so that it will be available for use or sale.

    (b)   its intention to complete the intangible asset and use or sell it.

    (c)   its ability to use or sell the intangible asset.

    (d)   how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

    (e)   the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

    (f)   its ability to measure reliably the expenditure attributable to the intangible asset during its development.

58   In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.

59   Examples of development activities are:

    (a)   the design, construction and testing of pre-production or pre-use prototypes and models;

    (b)   the design of tools, jigs, moulds and dies involving new technology;

    (c)   the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

    (d)   the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

60   To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in NZ IAS 36 *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in NZ IAS 36.

61   Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

62   An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

63   Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.
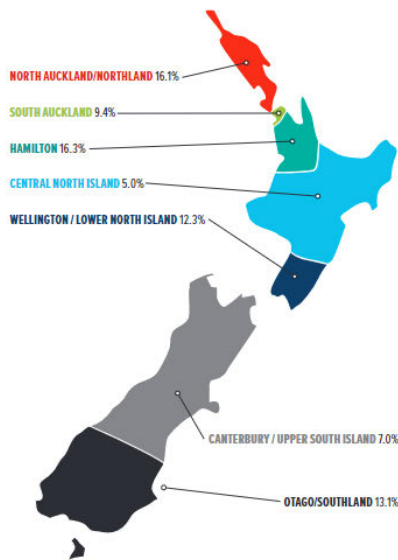
Proposal

Replacing the current rule of treating software development expenditure as being the cost of producing trading stock to being treated as the cost of producing a depreciable asset.

SURGING LEVELS OF INVESTMENT IN NEW ZEALAND TECH COMPANIES

THE NEW ZEALAND TECHNOLOGY EXPORT SECTOR GREW BY MORE THAN ONE BILLION DOLLARS LAST YEAR, AND IS NEW ZEALAND'S THIRD LARGEST EXPORT SECTOR.

% REVENUE GROWTH (2018)

NORTH AUCKLAND/NORTHLAND 16.1%

SOUTH AUCKLAND 9.4%

HAMILTON 16.3%

CENTRAL NORTH ISLAND 5.0%

WELLINGTON / LOWER NORTH ISLAND 12.3%

CANTERBURY / UPPER SOUTH ISLAND 7.0%

OTAGO/SOUTHLAND 13.1%

POPULATION: 4.9 million

SURGING INVESTMENT IN NEW ZEALAND COMPANIES

RECORD ANGEL INVESTMENT
$99.1M in angel investment in early stage NZ tech companies[1]

SIGNIFICANT CAPITAL INVESTMENT
$1.1B in private equity and venture capital funds invested in NZ companies in 2018[2]

GROWTH IN ANGEL INVESTMENT
31.1% increase in past 12 months

GROWTH IN CAPITAL INVESTMENT
24.8% increase in past 12 months

SECOND YEAR OF BILLION DOLLAR GROWTH FOR THE TOP 200 TECH EXPORTING COMPANIES (2018)

RATE OF GROWTH
11.0%

SIZE OF SECTOR
$11.1B revenue generated in the past year

SCALE OF GROWTH
$1.1B record level of growth

TECHNOLOGY IS NEW ZEALAND'S
3rd largest export sector

SPREAD OF GROWTH
Growth is evident across every New Zealand region, with North Auckland/Northland and Hamilton regions growing by over 16%. The highest growth sectors were:
Fintech 33.2%   Software Solutions 20.3%

HIGH EXPORT REVENUES
$7.9B in offshore revenue

IN TOTAL, THE NEW ZEALAND TECHNOLOGY SECTOR

CONSISTS OF:
21,411 companies[3]

EMPLOYING:
120,350 workers[3]

[1] PWC/Angel Association NZ (2019). [2] NZ Private Equity and VC Monitor NZVCA/EY (May 2019). [3] TechNZ 2017 Update (NZ Technology Industry Association, 2017).

OVERVIEW 01

✓ **Stable, business-friendly government** with a low-compliance tax system and government funding to assist research and development, training, and international growth

The New Zealand government has committed to raising New Zealand's research and development (R&D) expenditure to 2% of GDP over 10 years. This year NZ companies, and in particular tech companies, will be able to access a 15% tax credit of up to $18m per year. The government is committed to fostering a New Zealand-based R&D ecosystem with a strong focus on technology.

5 YEAR 2018 REVENUE CAGR FOR NEW ZEALAND'S HIGHEST GROWTH TECHNOLOGY SECTORS (TOP 200 NZ TECH EXPORT COMPANIES)
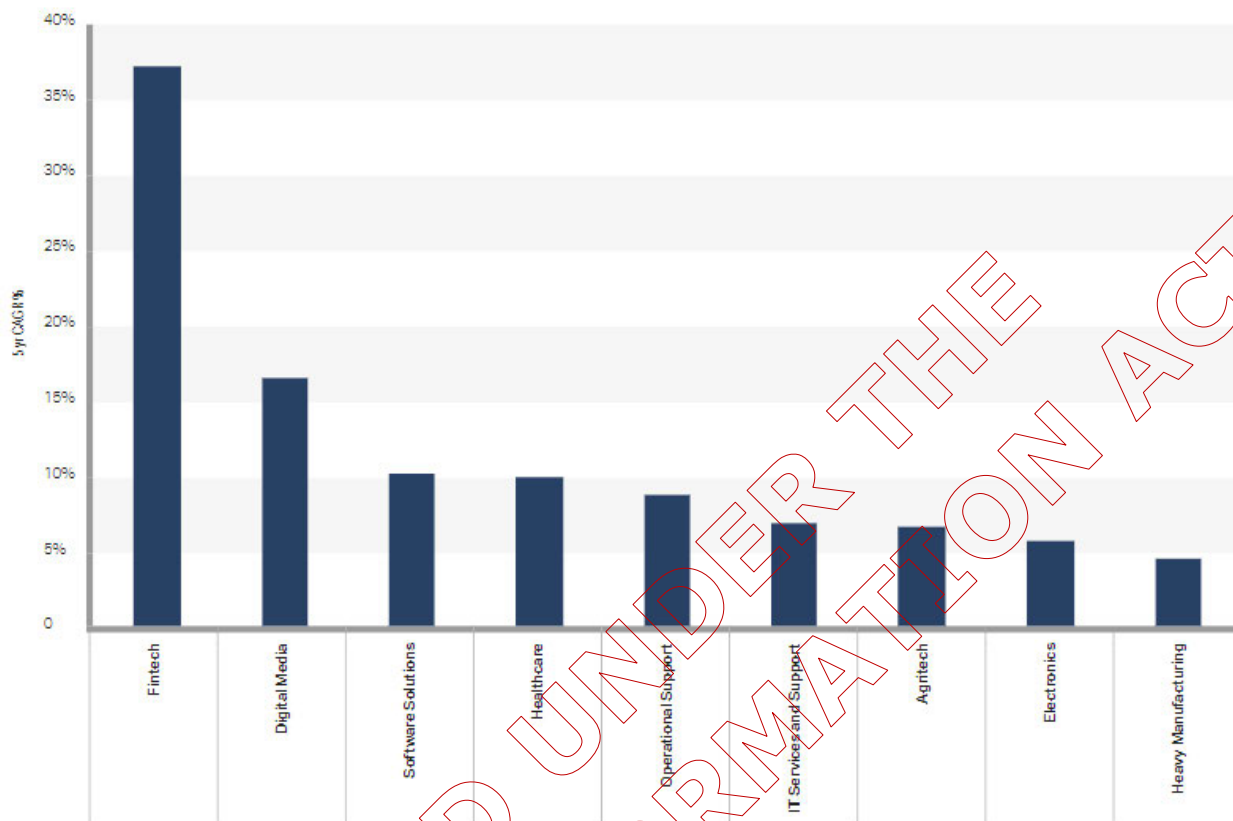
Potential – industry organisations/networks
-   TIN, NZTech, IITP, NZGDA, FinTechNZ, NZ Rise, TiDA, The MacDiarmid Institute.

Research and Development Tax Credit

-   The Government has set a target of raising the total amount of R&D performed in New Zealand to 2 percent of gross domestic product (GDP) by 2028. To meet this goal, there needs to be a significant increase in the amount of business R&D performed in New Zealand.

-   The rationale for providing R&D tax credits to businesses is that there is under-investment by businesses in R&D because the investing firm does not capture all the benefits of the investment. Some of the benefit is captured by other businesses or consumers, rather than by the investing firm. The tax credit is intended to provide an offset for the likely spill-over benefits to other firms and individuals in New Zealand. This is expected to help transform the New Zealand economy into a high-skill, knowledge-based, and productive economy.

-   Most types of expenditure incurred on R&D activities are eligible, including the costs of creating intangible property.

-   A $25 million cap applies to eligible internal software development expenditure.

-   A person who receives a Callaghan Innovation Growth Grant for the whole or a part of an income year is excluded from claiming the R&D tax credit for that income year.

-   Excluded R&D activities:

    1. Routine de-bugging of existing computer software.

2. Supporting or making minor improvement to existing computer software, using known methods.
3. Routine software and computer maintenance.
4. Ineligible internal software development.
5. Converting existing systems to, or Integrating existing systems with, new software platforms.

Ineligible internal software development schedule 21 parts A and B, clause 11 This exclusion covers software development undertaken for the only or main purpose of the internal administration of your business. or the business of your associate(s). The purposes of internal administration include but are not limited to:

• payroll systems
• accounting systems
• executive or management information systems
• human resources systems
• enterprise resource planning systems
• purchasing
• invoicing systems, and
• inventory systems.

This exclusion covers both core and supporting activities and applies because the spill over benefits of the excluded activities are considered to be insufficient to warrant the provision of a government subsidy. This exclusion covers all forms of software development other than:

• internal software development that enhances services to customers (software used by customers to access non-software services); and
• external software development (software developed for the main purpose of sale or disposal (for example via a licence to unrelated parties).

Exclusions relating to intangible property (other than software), software and ineligible technology acquired for use in R&D
– Expenditure on acquiring an interest in intangible property other than software
– Expenditure on bespoke software
– Internal software development expenditure incurred by a person and their associates, to the extent it exceeds $25 million
– The cost of acquiring technology that is used as a basis for further R&D activities

Example 44: Software that enhances non-digital services to customers

Mohammed runs a courier business and develops software that enables his customers to pinpoint the exact location and condition of their packages.

This satisfies the definition of internal software development expenditure, because Mohammed's customers are using his services to receive the goods he delivers, not to use the software he has developed.

The expenditure Mohammed's business incurred to develop the software is subject to the $25 million cap.

> **Example 45: Associated persons with internal software development expenditure**
>
> SL Ltd incurs $20 million of internal software development expenditure and XW Ltd incurs $11.5 million. SL Ltd and XW Ltd are wholly owned by Nayana Ltd. As XW Ltd and SL Ltd are associated persons for tax purposes, their combined claim may not exceed $25 million.

External software development

External software development is not subject to the $25 million cap. Instead, it is subject to the same cap as all other eligible R&D expenditure, which is $120 million.

There are two types of external software development.

Software that is sold

If the person's main purpose behind developing the software is to dispose of it to someone not associated to them, then it is considered external software development and not subject to the $25 million cap.

This software can still be used internally without being subject to the $25 million cap, provided the main purpose behind developing the software was to sell it.

Software that is an integral part of goods that are sold

Software a person develops which forms an integral part of goods that the person sells in their business is also external software development, and not subject to the $25 million cap.

This exception is targeted at firmware – such as the software that runs inside a washing machine or TV remote.

Project no. PUB00240/c

Instead of being the cost of producing trading stock, the issues paper suggested software development expenditure should be treated as the cost of producing a depreciable asset.

Starting point: described within TIB V 4, No 10 (May 1993). The TIB items says software development expenditure is the cost of producing trading stock. This means it is deductible when incurred but may be added back as income as the value of any trading stock on hand at balance date. However, the TIB item also treats the software as sold outright when it is first licensed. This means all software development expenditure is deducted in the income year the software is first licensed.

First, there was agreement with the issues paper's analysis that the:

- trading stock approach is inappropriate (and was always so);
- the depreciable asset approach is correct; and
- the R&D provisions can apply.

1. The depreciable asset approach would adversely affect cash-flows.
2. Its practical application would raise complex and compliance-heavy issues. This is especially so considering the practice of incremental development.
3. It would possibly lead to tension with Callaghan Innovation grant requirements which cannot be met once an asset is recognised.

Generally, there was a preference was for the R&D provisions to apply, with the choice of applying the depreciable asset approach.

Incremental development business model is now commonplace in the industry and that this model blurs the lines between the traditional phases of developing software.

There was also concern that, if finalised, the issues paper's proposals would have the result of one arm of government counteracting the efforts of others to promote the industry.

The relationship between the R&D provisions and the depreciable asset approach.

Whether software can also be depreciated as a Fixed Life Intangible Asset.

Iran, Singapore, Estonia?

Better aligning Tax and IFRS

Amending s DB 40B (unsuccessful software development).

Reviewing or amending the depreciation rate for software – presumably to increase the available deductions – The current estimated useful life of software is four years.

International

- Tech hubs (Shanghai, Beijing, Silicon Valley, Toronto, New Delhi, Sao Paulo, Sydney, Sotckholm and Amsterdam. Cape Town?
- $5.3b spent by the Iranian government on technology infrastructure since 2013.
- Dublin and Austin.
- Sydney – tax breaks
- Ireland – Corporate tax rates have been one of the principal elements of the favourable enterprise environment in Ireland since the 1950s. The irish tax regime is open and transparent and complies with the OECD guidelines and EU competition law. Ireland offers a transparent corporation tax regime, with the lowest rate in Western Europe of 12.5%, accompanied by a growing network of international tax treaties. The country also has an OECD-compliant knowledge development box, an attractive 25 percent R&D tax credit, relief for expenditure on IP, and an attractive holding company regime.
- Israel provides tax relief.
- Singapore low taxes and tax incentives.
- Stockholm (up and coming), Bangalore (growth).
- Tel Aviv.

UK – Scotland, Manchester and London. Mainly focused on R&D tax credits. Blockchain and Data AI video games both eligible for the R&D tax credit. Immigration policy.

Beijing and Shanghai.

Exit strategy – without big exits, the ecosystem is like a roach model, money can come in, but it doesn't get out. And that's not a good thing for anyone.

Deductibility of computer software expenditure

- The deductibility of computer software expenditure depends upon the nature of the expenditure incurred. For example:
    1. expenditure on developing computer software that creates an asset to be used in the taxpayer's business can be expected to be of capital nature that may be allowed as deduction by way of a depreciation loss.
    2. The same outcome applies for expenditure incurred in creating a website.
    3. Expenditure on purchasing computer software with a cost of $500 or less can be claimed as an immediate deduction.
    4. Expenditure on computer software may be eligible for the deduction allowed fo research and development
    5. S DB 40B allows taxpayers an immediate deduction for the costs associated with unsuccessful software development where the taxpayer incurs expenditure on the development of software for use in the taxpayer's business, the development is abandoned before the copyright in the software is depreciable property and, if the development had been completed, the copyright in the software would have been depreciable property. The deduction is available to the extent to which no other deduction has been allowed for the expenditure, and it is allocated to the income year in which the development is abandoned. The section overrides the capital limitation, but the general permission must still be satisfied.

6. Software developers
    - Development costs may be expensed, the trading stock treatment of value as income at the end of the income year applies to unbilled WIP and unsold but completed software, and maintenance costs may be expensed with upgrading costs to be capitilsed.
7. IS 17/04 (taxpayers who purchase, lease, license, develop, or commission software for use in a business.
    - Software purchased will generally be a capital asset that must be depreciated at 50% diminishing value or 40% straight-line.
    - An immediate write-off for software costing less than $500 will be allowed where the conditions in s EE 38 are satisfied.
    - Maintenance costs may be deducted when incurred.
    - Upgrade costs must be capitalised and depreciated.
8. Periodic payments for the right to use or access software (often online software) are generally deductible when incurred.
9.

Background

The Commissioner's current tax treatment is that software development is the cost of producing trading stock. This means expenditure is deductible when incurred but added back as income as the value of any asset on hand at balance date.

The Commissioner also treats software when it is first licensed as sold outright. This means all software development expenditure is deducted in the income year the software is first licensed.

Research and Development (R&D) provisions, specially DB 34 allow for immediate deductibility for expenditure they incur on research and development which can apply to some types of software development.

Issues paper, IRRUIP 10, suggested the current treatment may not be correct in most cases. Suggesting the expenditure should be treated as the cost of producing a depreciable asset, not trading stock.

Issues

The depreciable asset approach would adversely affect cash-flow. Cash-flows are essential for funding growth and the continuing R&D expenditure needed to maintain competitiveness.

Issues incremental development

Positive externality

Policy Commissioning Paper

Policy Commissioning Paper – Timing of deductions of software expenditure (for software developed for sale or licence)

Prepared by: Ben Hammond and Craig Phillips

Date: 13 March 2020

Description of policy issue – what is the problem?

- Inland Revenue's current administrative approach for the income tax treatment of development on software for sale or licence is based on a statement published in 1993 (TIB Vol 4 No 10). This administrative approach adopted the trading stock framework for deduction of costs.

- Under this framework, it was intended that the deduction for software development expenses developed for sale, lease or licence would be allocated (timed) to the year in which the software was first able to be exploited by the developer. However, in practice, the sector is treating software development expenditure as deductible when incurred under the mechanics of the trading stock rules (i.e. the value of work-in-progress is treated, for income tax purposes, as nil).

- In 2016 OCTC released an issues paper for external consultation titled IRRUIP 10: *Income tax treatment of software development expenditure (IRRUIP 10*). This issues paper suggested Inland Revenue's 1993 approach may not be correct and software development expenditure should, in most cases, be capitalised and depreciated.

- External submissions to IRRUIP 10 raised widespread concern at the practical difficulties and adverse commercial effects of implementing a capitalise and depreciation approach for software development expenditure. Submitters were also concerned that the depreciation model proposed was based on an outdated process for software development.

- The problem is that if we do nothing, we are left with either the trading stock approach, or the depreciation model proposed in IRRUIP 10. Neither of these two options may be consistent with policy frameworks or appropriate for current business practices and the Government's 2019 economic plan

Policy context and purpose

- External submissions to IRRUIP 10 raised widespread concern at the practical difficulties and adverse commercial effects of implementing the capitalisation approach and it's inconsistency with current software development life cycle processes (often termed an agile methodology) and the use and exploitation of open-source software.

- OCTC subsequently referred the income tax treatment of expenses incurred for developing software for commercial exploitation to Policy in December 2016 (IR PUB00240/c refers).

- Policy tensions already exist between:

   o the research and development incentive rules (the R&D rules) which give immediate deductibility;

   o the timing of software development expenses under the trading stock approach which is intended to defer the deduction of software development expenses until the time the software could be exploited; and

1

- o the suggestion in IRRUIP 10 that software development expenditure should be capitalised and depreciated over the useful life of the software.

- The issues raised in IRRUIP 10 requiring policy consideration are as follows:

  - o uncertainty about what costs should be included in the tax cost base of the asset due to the changing nature of development processes in the software sector;

  - o uncertainty about when the software asset should be recognised;

  - o tension between the depreciation rules and deductibility for certain research and development expenses;

  - o IRRUIP 10 precedes and so does not address the relationship between subsequently enacted tax credit rules (R&D tax credits and R&D tax losses) and the depreciation rules;

  - o IRRUIP 10 notes that the question of feasibility expenditure also needs to be addressed;

  - o depreciation rates for software in New Zealand are more favourable than many overseas jurisdictions; and

  - o without further legislative amendment the depreciable asset approach may have a negative impact on the software development industry in New Zealand.

- If we continue to delay work on the policy issues, there are two possible scenarios that will occur i.e.:

  - o current trading stock treatment remains - OCTC continues to wait for Policy to complete its review of the tax treatment of software developed for sale, lease, or licence; or

  - o the Capitalisation approach is adopted – OCTC confirms their public item that expenses incurred to develop software for commercial exploitation should be either capitalised and depreciated unless the expenses are subject to the R&D deduction rules.

- An interpretation that negatively impacts the software market in New Zealand would be inconsistent with Government priorities, as recognised within their 2019 Economic Plan to build a productive, sustainable, and inclusive economy.

- The risks of doing nothing are as follows:

  - o if the current treatment remains, then software development costs will continue to be deductible in the year the costs were reported. This, as mentioned is inconsistent with policy intent and generally accepted policy frameworks for the timing of deductions relating to expenditure giving rise to revenue account property or an asset able to be exploited commercially other than by sale or assignment; and

  - o if the capitalisation approach is adopted in line with IRRUIP 10, Policy would be concerned that without critical analysis of the capitalisation approach there may be severe negative consequences and political backlash from New Zealand's growing software development industry.

- Further concerns identified are as follows:

  - o uncertainty and timeliness for the private sector: The private sector expects timely and certain responses to policy issues raised that have a potential material impact on commercial activity; and

o uncertainty for OCTC, which referred the issues for policy consideration in December 2016. The uncertainty is whether a policy project is to be commenced or whether they should proceed with implementing the capitalisation and depreciation approach set out in IRRUIP 10.

Policy impact and quality

- The project will consider the most appropriate treatment of software development costs for software intended for sale or licence or assignment, and for the treatment of consideration derived from disposing or assigning (not licencing) of a software asset.

- Submissions from members of the industry referred to the effects as "severe", "very damaging", "massive" and "disastrous". In their view it would "undermine the growing [software] industry" or be "stifling to innovation efforts". One submitter (s 9(2)(ba)(i)) suggested "the result would be software development companies increasingly looking offshore to establish innovation and development centres"(we note that some trading partners in the ASEAN region incentivise the establishment of innovation and development centres). Common reasons raised for these views were:

  o it would adversely affect cash-flows needed to fund on-going R&D expenditure essential to maintaining business competitiveness and further growth;

  o its practical application would raise complex and compliance costs - tracking time and costs;

  o it would possibly lead to tension with the Callaghan Innovations grants and the R&D provisions; and

  o since 1993, the sale, leasing or licencing of software has evolved to include new ways of delivering software, for example, software as a service (e.g. online accounting software). Any new rules would need to take account of these innovations to ensure that as much as possible the effects of tax are neutral on investment decisions.

- The project will consider the most appropriate treatment of software development costs for software intended for sale, lease, licence or assignment, and for the treatment of consideration derived from disposing or assigning (not licencing) of a software asset.

- Ideally, we would want to update the tax treatment of software development costs to be consistent with relevant current policy settings, including recovery income on disposal of an asset.

- Note that there is likely to be some pressure to extend the scope of the review to include issues identified by the private sector with the current R&D rules. These are outside the scope of the project and would be referred to the R&D team, if appropriate. Nevertheless, this makes scope creep a risk.

Policy Approach and collaboration

- Factors that contribute to making this project a priority are:

  o The importance placed by Government on innovation in its 2019 Economic Plan.

  o The uncertainty about the income tax treatment of software development expenditure developed for sale, licence or lease since consultation was completed on IRRUIP 10.

- The following policy approach will be undertaken, if the project is accepted:

- Inclusion of the policy project on the internal work programme:

3

- o consult with the software development sector to clearly define the policy problems that need to be resolved;

- o identify and critically analyse a possible range of high-level policy options (including the status quo) for consultation with stakeholders, using the generally accepted evaluation criteria:

  - Equity (horizontal and vertical).

  - Efficiency.

  - Fiscal impacts.

  - Compliance costs.

  - Administrative costs.

  - Trade-offs.

- o As part of this option analysis, engage with SD&I (Government Solutions) and consider the following at a high level:

  - What is the likely volume of taxpayers affected?

  - Is it likely to change how taxpayers interact with Inland Revenue? Or is this something new?

  - When does it take effect? Might the change be retrospective?

  - Do these taxpayers use external software developers and/or open-source software? This affects the lead-in time required to implement.

- The project's scope is limited to the income tax treatment of expenses incurred to develop software for commercial exploitation. The project will also include consideration of practical concerns with the treatment and overlap with the R&D provisions. The R&D provisions will be taken at face value and any specific concerns relating to the R&D provisions generally are out of scope and will be referred to the R&D policy team, where appropriate.

- Given consultation was already undertaken as part of IRRUIP 10, targeted engagement with those submitters would be sufficient (see consultation plan for further details).

- The broad timeframes are to complete consultation and consideration of submissions in 2020 with a view to developing legislation for a bill in 2021.

- A data set has been developed (by the Forecasting unit) that identifies the volume and incidence of tax across the sector based on current administrative practices.

RASCI Analysis - Timing of deductions of software expenditure

Function/Roles	David Carrigan/ relevant director	Craig Phillips *Principal Advisor*	Ben Hammond *Policy Advisor*	Chris Gillion *Policy Lead*	Phil Whittington *Policy Lead*	TCO (TBC)	SD&I (TBC)
Develop initial position	I	R A	R	C	C	C	C
Internal consultation	I	R A	R	C	I	C	C
External consultation	I	R A	S	C	I	C	I
Reporting	I	R A	S	C	–	C	I
Implementing Policy Change	–	C	I	C	–	C	A

Key

R: Responsible (the person who does the work)
A: Accountable (the decision maker)
S: Support (helps the responsible person responsible to do the work)
C: Consult (must provide input to aid decision making)
I: Inform (needs to be aware of the work, either updates or implementation)

Items from the Status reports

Date issued 26 June 2020 for week commencing 29 June 2020

Tax deduction treatment of software development	The software development sector has submitted for more clarity on the tax deduction treatment for software development expenses incurred to create software for sale, licence, or assignment. There are significant differences between the legislation and the current commercial practices for deducting expenses that relate to the development of software. We intend to consult with the software development sector and MBIE (as this has some relationship to their work on the recovery phase from COVID-19) in the near future. The purpose of this consultation is to determine whether a policy response is required. We will provide your office with a briefing note on this issue on 6 July.

Date issued 16 July 2020 for week commencing 20 July 2020

Income tax treatment of software development expenses	The software development sector has sought more clarity on the tax deduction treatment for software development expenses incurred to create software for sale, licence, or assignment. At present, they consider there are significant structural differences between the income tax treatment of these expenses and the commercial practices followed in developing such software. After the General Election, officials intend to consult with stakeholders in this sector (including MBIE) to address the concerns raised, with a view to reporting on outcomes of consultation.

From:	Craig Phillips
To:	Yvonne Coghlan
Cc:	Chris Gillion; David Cuellar
Subject:	RE: 1993 Policy Statement - Income Tax Treatment of Computer Software
Date:	Wednesday, 9 September 2020 1:52:39 PM
Attachments:	image001.png

HiI Yvonne

I am not sure what you mean by PAS work on the policy (operational) statement in the TIB from 1993. So I will set out what we are currently working on as this may be of help to you.

The policy work we are undertaking is a review of the tax policy settings for software development expenditure incurred in the process of developing software for commercial exploitation in conjunction with MBIE's innovation work stream. This work is derived from IRRUIP-13 released by TCO (which reviewed the operational policy set out in the 1993 TIB) and for which some considerable number of submissions were received. I understand TCO has released a practice memo that undertakes to continue the practices set out in the 1993 operational statement until such time as we have concluded our policy review.

This policy work will carry on through to 2021 and we are consult with the Sector as well as across the various processes in IR before making any recommendations to MoR and cabinet. Should we make recommendations for legislative change on this to Cabinet we would plan any necessary amendments be included in an available omnibus tax bill in the latter part of 2021. However, if we do not recommend legislative change, we will advise TCO at the time we make this decision.

Cheers

Kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*

Policy & Strategy | *Kaupapa Here me te Rautaki*

Inland Revenue | *Te Tari Taake*

DDI s 9(2)(a)

Email @ird.govt.nz

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From: Yvonne Coghlan <s 9(2)(a) @ird.govt.nz>

Sent: Wednesday, 9 September 2020 9:54 AM

To: Craig Phillips <s 9(2)(a) @ird.govt.nz>

Subject: 1993 Policy Statement - Income Tax Treatment of Computer Software

Good morning Craig,

Please see the email string below relating to the PAS review of the 1993 Policy Statement on the Income Tax Treatment of Computer Software. Susan has advised that you are the PAS person to ask about this.

Can you please advise the present status of the PAS work on the policy statement. Thanks.
Yvonne

Yvonne Coghlan | Tax Counsel
Tax Counsel Office | Inland Revenue
T. s 9(2)(a)
E. @ird.govt.nz
Hours of Work: Tuesday to Friday

From: Susan Price <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 4 September 2020 5:32 PM
To: Lynn Smiley <s 9(2)(a) @ird.govt.nz>; Yvonne Coghlan <s 9(2)(a) @ird.govt.nz>
Subject: RE: A question from the past...

Not in scope

Sorry a bit late to this – yes PAS are working on this – Craig Phillips is on point in Graeme Morrison's domain...not sure how advanced nor whether it is visible on the PAS work programme

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From: Lynn Smiley <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 4 September 2020 5:04 pm
To: Yvonne Coghlan <s 9(2)(a) @ird.govt.nz>
Cc: Susan Price <s 9(2)(a) @ird.govt.nz>
Subject: RE: A question from the past...

Not in scope

Yvonne,

Not in scope

As I understand it from Susan in July this year there was an agreement for it to go on PAS's work programme – it may not be showing up yet. Susan may know more.

Lynn Smiley | Tax Specialist, Tax Counsel Office | Inland Revenue
e: s 9(2)(a) @ird.govt.nz
DDI: s 9(2)(a)

From: Yvonne Coghlan <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 4 September 2020 4:26 PM
To: Lynn Smiley <s 9(2)(a) @ird.govt.nz>
Subject: A question from the past...

Not in scope

Hi Lynn,

Not in scope

My question relates to what happened after PUB00240 was closed and the issues referred to PAS. Do you know if anything came of the referral? I can't find anything on the PAS work programme. Do you have any suggestions about who I could contact in PAS about this?

Thanks (and have a great weekend)

Yvonne

Yvonne Coghlan | Tax Counsel
Tax Counsel Office | Inland Revenue
T. s 9(2)(a)
E. @ird.govt.nz
Hours of Work: Tuesday to Friday

Inland Revenue
Te Tari Taake

Policy and Strategy
Te Wāhanga o te Rautaki me te Kaupapa
55 Featherston Street

PO Box 2198
Wellington 6140
New Zealand

T. 04-890 1500
F. 04-903 2413

Consultation letter

16 October 2020

To: Robyn Henderson, Policy Director EDT, MBIE
CC: Katie Sadetskaya, Senior Policy Advisor, Innovation Policy, MBIE

From: Craig Phillips

Software Development Expenses and MBIE policies for innovation

Background

The tax system is based on a broad-base low-rate approach to taxing profits of businesses on an annual basis. Profits for each year are determined as the difference between income and expenses that relate to each year. The annual determination of taxable profit requires consideration of general accounting principles and specific tax rules that both interact to determine:

- when income is derived or a business expense (which includes the cost of business assets) is incurred; and
- whether that income or expense relates to that year or other years (for example, the cost of a business asset is usually amortised over the economic life of the asset – this is known as tax depreciation).

We are presently reviewing the policy settings and practices relating to the taxation of software development in order to determine an appropriate tax accounting treatment for income and expenses within the software development sector.

This review has identified a variety of practices that are either being applied or are proposed for the deductibility of development expenses, including:
- deduction of the expenses in full as they incurred;
- deduction of the expenses in full when the developed software is first able to be commercially exploited; and
- capitalised as a business asset, and the cost amortised over the economic life of the developed software (this is the general tax policy framework applying to assets that are used within a business setting).

Our policy review arises from Inland Revenue publishing an exposure draft of a proposed change in Inland Revenue's view on the tax treatment of software development expenses (*IRRUIP10 – Income tax treatment of software development expenditure*[1]).   A number of submissions were received on the views expressed in that document:
- Many submitters opposed any change to existing tax accounting practices in the software development sector.
- Existing provisions in the Income Tax Act 2007 gave inconsistent outcomes for the treatment of software development expenses. This inconsistency between provisions has been creating confusion within the software development sector.

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[1] https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/consultations/issues-papers/irruip10.pdf?la=en&hash=85038059438AB31059D4273F86406A27

Implications of problem

Submissions to IRRUIP10 were consistent in noting that if the tax policy problem is not solved, then the software development sector would likely be adversely impacted because of:

- the tax effects on operational cashflows within the sector; and
- an increase in demand for capital due to the need to fund higher cash flows.

Consultation with MBIE

This letter is written as part of our review, and we have identified some issues for which we seek your feedback from the perspective of your policy objectives for the innovation sector.

In particular, we are wanting to determine an appropriate framework for the taxation of the software development sector's business income and expenses. This requires analysis of:

- the size of the software development industry in terms of participants, contribution to the economy, and profitability;
- characteristics of business processes used in developing software;
- characteristics of funding and funding limitations within the software development sector;
- characteristics of an expected life cycle of software developed for commercial exploitation;
- Government policies administered by other Government agencies relating to the software development sector; and
- Government policies in other jurisdictions for their innovation sectors.

Wide Government policy on supporting innovation (and in particular the development of software) will be relevant when considering the analysis of the appropriate tax treatment of development costs for software. To this end, we are interested in any insight you can provide for the following questions:"

1. Are you able to either provide data on the size of the software development sector (number of participants, contribution to the economy, profitability), or point us to where this data could be obtained?
2. Are you able to differentiate between software developers that mainly produce software for their internal use (e.g. banks have developed software internally to comply with anti-money laundering legislation), and other developers?
3. What MBIE policies relate to the innovation sector and are any of these objectives linked to any particular characteristics of their business processes and if so, how?
4. What MBIE policies relate to capital funding for the innovation sector? For example, are there any particular special funding schemes (e.g. the R&D Loan Scheme developed in response to COVID-19) and what is the policy purpose of any such funding scheme?
5. Are there any MBIE policies for the innovation sector that are related to the life cycle of software development, and if so what is their objective?
6. Are there any other Government agencies that you are aware of that implement Government policies relating to the innovation sector (we are aware of Callaghan Innovation), and if so, who are they and what is their focus?
7. Are you able to provide us with an analysis of Government policies relating to the innovation sectors in overseas jurisdictions that you have analysed in the development of innovation sector policies for New Zealand?

Next steps

We are wanting to meet with you later in October or early November to receive your feedback on our questions and to identify any other sources that you may be aware of relating to data for this sector. We will be in touch to arrange a time to meet, either digitally or in person.

After receiving your feedback, we will be consulting with stakeholders in the software development sector on issues raised in this letter plus some tax technical matters. We are planning to undertake this consultation post-general election We also plan to engage you in this process if you think that is desirable.

We are planning to complete our review by mid–2021, with a view to making any necessary recommendations to Government after that time.

Software development expenditure
Notes from pre-consultation call with MBIE

Attendees

IR:	MBIE (on Teams):
Chris Gillion	Robyn Henderson
Craig Phillips	Mary Mulholland
David Cuellar	Katie Sadetskaya

Notes

MBIE is engaged with Keith and Graham on software development issues to do with the Research and Development Tax Incentive (RDTI).

Preamble from David, Craig, Chris, on the scope of the project:
- Background and objectives.
- Current expectations versus what is happening in practice (businesses claiming deductions as they go, trading stock models).
- Potential for treatment of some software as a capital asset.

Questions (numbered in consultation letter):

Q1

MBIE will send us some data. MBIE has their Digital Technology Transformation Plan and are getting updated data. Also have an IT sector report (seen by IR already). Another report (behind paywall) that MBIE will send to us.

Software development sector is important with regard to growth potential. MBIE is going to interview some of the most successful companies to understand their success and how it can be replicated.

Q2

Key difference between types of software developers will be skills and employers, e.g. software developers employed by banks for internal use. Want to get a handle on the number of entities of each type.

Commercially exploitable software is developed over a longer period of time, whereas internal software is developed on shorter timeframes. Will ask tech sector to clarify.

Agri-tech sector is growing and experiencing a lot of activity. IR interested in the differences between general innovation and what is required for agri-tech. MBIE says there are difficulties in defining the agri-tech sector. Software development is not their main activity; they are more concerned with investment in AI and machine learning to produce different outputs. More into robotics.

Q3

Innovation policies are sector-agnostic.

RDTI is their flagship one but the software sector is having a lot of challenges with it. CI helps MBIE with investing in innovative businesses. Note project grants have a significant proportion of digital and software recipients.

The overarching goal is to increase business investment in R&D. May start to see more initiatives targeted at encouraging businesses to collaborate more as well.

Craig asks about the R&D Loan Scheme's contribution to the innovation space and talking to CI. MBIE has initial figures from CI but notes that the impact is difficult to measure; can send over their statistics regardless.

CI has digital sector specialists. MBIE's role more to do with Government objectives and policies, whereas CI focuses on implementation and operationalisation (they are much closer to individual companies than MBIE so have good sector intelligence). MBIE has a focus on the start-up sector and trying to improve the evidence base of that sector. Have just procured a company to build a database.

MBIE has a focus on innovative activity across the economy. Role for these businesses to play in selling services to other sectors in New Zealand and helping to improve national productivity.

Q4

Emphasis on sector-agnostic initiatives.

Elevate NZ Venture Fund – a fund to create more funds in New Zealand to invest in more companies.

Aspire NZ Seed Fund – addresses the capital needs of start-ups, a large proportion being digital/software sector companies and assists at an early stage in fundraising (seed stage, up to $2 million). Type of venture capital.

(More info on these funds in a proactively released Cabinet paper titled "Update on the Venture Capital Fund's Progress and the Wider Capital Markets.)

Tech incubators fall into this category but are more targeted at tech science, but work with digital/software firms as well. They are more to do with IP, used to be more focused on software but moving toward science. MBIE has just signed a new tech incubators contract.

Project grants – software companies would make use of these. Grants are part of CI, and MBIE funds them (similar to tech incubators program).

Q5

Policy settings target different business growth stages rather than different stages of the software development life cycle. Aspire NZ Seed Fund targeted at building capability rather than proof of concept.

CI has Regional Business Partner programme, co-funded by NZTE and they provide a lot of support for companies at early stages.

On the RDTI, the software sector has not benefitted much. There is a broad spectrum of innovation - the RDTI is targeted at the R&D end but eligibility requires expenditure on activities that resolve scientific or technological uncertainty. Software companies do that up front and then spend a lot of the time/effort/money later on in development, whereas previously they were qualifying for CI Growth Grants that captured a broader range of their activities.

Funding to commercialise ideas that come out of universities. Centre for Digital Excellence in Otago targeted at the early ideas stage, students based in Dunedin can get funding for ideas related to software development.

Q6

NZTE has digital marketing campaign and has a fund regarding digital enablement for exporting firms. Like CI, they do not take a sector-specific approach; NZTE works with high-export growth potential companies regardless of what sector they are in. Tech sector lead at NZTE is worth talking to, and they are working closely within the Industry Transformation Plan.

Q7

s 9(2)(g)(i)

Craig notes we are interested in trading partners' tax frameworks and impacts on cross-border economy. MBIE suggests that how other countries treat depreciation is important.

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Consultation letter

24 November 2020

To: Hayley Horan, Mark Debenham, NZTE; Bruce Jarvis, Callaghan Innovation
CC: Robyn Henderson, Policy Director EDT, MBIE Katie Sadetskaya, Senior Policy Advisor, Innovation Policy, MBIE

From: Craig Phillips

Software development expenses and MBIE policies for innovation

Background

We are presently reviewing the policy settings and practices relating to the taxation of software development in order to determine an appropriate tax accounting treatment for income and expenses within the software development sector. This review is a "*first principles*" review of general income tax principles as they relate to the software development sector. This review does not include within its scope any aspect of the research and development tax incentive or any other incentives promoting innovation in the sector.

The tax system is based on a broad-base low-rate approach to taxing profits of businesses on an annual basis. On a first-principles basis, profits for each year are determined as the difference between income and expenses that relate to each year. The annual determination of taxable profit requires consideration of general accounting principles and specific tax rules that both interact to determine:

- when income is derived or a business expense (which includes the cost of business assets) is incurred; and
- whether that income or expense relates to that year or other years (for example, the cost of a business asset is usually amortised over the economic life of the asset – this is known as tax depreciation).

This review has identified a variety of practices that are either being applied or are proposed for the deductibility of development expenses, including:

- deduction of the expenses in full as they incurred;
- deduction of the expenses in full when the developed software is first able to be commercially exploited; and
- capitalised as a business asset, and the cost amortised over the economic life of the developed software (this is the general tax policy framework applying to assets that are used within a business setting).

Our policy review arises from Inland Revenue publishing an exposure draft of a proposed change in Inland Revenue's view on the tax treatment of software development expenses (*IRRUIP10 – Income tax treatment of software development expenditure[1]*). A number of submissions were received on the views expressed in that document:

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[1] https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/consultations/issues-papers/irruip10.pdf?la=en&hash=85038059438AB31059D4273F86406A27

- Many submitters opposed any change to existing tax accounting practices in the software development sector.
- Existing provisions in the Income Tax Act 2007 gave inconsistent outcomes for the treatment of software development expenses. This inconsistency between provisions has been creating confusion within the software development sector.

Implications of problem

Submissions to IRRUIP10 were consistent in noting that if the tax policy problem is not solved, then the software development sector would likely be adversely impacted because of:
- the tax effects on operational cashflows within the sector; and
- an increase in demand for capital due to the need to fund higher cash flows.

Consultation with other Government agencies

This letter is written as part of our review, and we have identified some issues for which we seek your feedback from the perspective of your policy objectives for the innovation sector.

In particular, we are wanting to determine an appropriate framework for the taxation of the software development sector's business income and expenses. This requires analysis of:
- the size of the software development industry in terms of participants, contribution to the economy, and profitability;
- characteristics of business processes used in developing software;
- characteristics of funding and funding limitations within the software development sector;
- characteristics of an expected life cycle of software developed for commercial exploitation;
- Government policies in other jurisdictions for their innovation sectors.

Wider Government policy on supporting innovation (and in particular the development of software) will be relevant when considering the analysis of the appropriate tax treatment of development costs for software. To this end, we are interested in any insight you can provide for the following questions:
1. Are you able to either provide data on the size of the software development sector (number of participants, contribution to the economy, profitability), or point us to where this data could be obtained?
2. What policies of your agency relate to the innovation sector and are any of these objectives linked to any particular characteristics of their business processes and if so, how?
3. What policies of your agency relate to capital funding for the innovation sector? For example, are there any particular special funding schemes (e.g. the R&D Loan Scheme developed in response to COVID-19) and what is the policy purpose of any such funding scheme?
4. What policies of your agency relate to the life cycle of software development, and if so, what is their objective?
5. Are you able to provide us with an analysis of Government policies relating to the innovation sectors in overseas jurisdictions that you have analysed in the development of innovation sector policies for New Zealand?

Next steps

We are wanting to meet with you either late November or early December to receive your feedback on our questions. We will be in touch to arrange a time to meet, either digitally or in person.

After receiving and analysing your feedback, we will be consulting with stakeholders in the software development sector on issues raised in this letter plus some tax technical matters. We are planning to undertake this consultation post-general election. We also plan to engage you in this process if you think that is desirable.

We are planning to complete our review by mid–2021, with a view to making any necessary recommendations to Government after that time.

Software development expenditure
Notes from pre-consultation call with NZTE

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Attendees

IR: NZTE (on Teams):
Craig Phillips   Mark Debenham
David Cuellar

___

Notes

Craig

David

General

NZTE comes at this issue from an NZTE perspective and the associated challenges and frictions.

Regarding the RDTI, NZTE observed businesses trying to get access to R&D credits but they either did not know whether they were eligible for the credits or what they needed to do to access the credits. NZTE were offering workshops to assist but it became an expensive exercise to go through the process of accessing the credits.

s 9(2)(a)   – Deloitte – sits on the R&D Tax Credit advisory (committee?)

Questions (numbered in consultation letter):

Q1

NZTE says five years ago, tech companies in a broad sense may have been one or two in ten new companies that go through NZTE. Nowadays that is approximately about five out of ten. NZTE has a dedicated tech team, which is the biggest team they have. Growth has been tenfold.

NZTE has to talk to firms in sectors including manufacturing, food and beverage, and widget sellers to get them through the door to NZTE. Conversely, tech companies are much more likely to proactively approach NZTE, so it does not have to make as much of an advertising effort to tech companies.

1,500 companies at NZTE are managed (in portfolios of ~15 with a lot more focus) and 4,000 are unmanaged (which get help by reaching out to NZTE).

TIN100 and TIN200 reports have a lot of commentary of numbers and the size of the industry.

Note that a lot of "tech companies" do not develop and/or sell software but perceive themselves to be tech companies, especially in the manufacturing space.

Q2

NZTE are enablers and connectors, but not innovators or drivers of policy. Role of NZTE is to support, push, drive, build awareness of sector so as to position New Zealand in the world market in accordance with its competitive advantages. Hayley Horan sits on Government Tech Action Group for NZTech, but NZTE does not generally set policy or drive the industry.

NZTE has access to a lot of industry around the tech sector and aligns to some areas more than others, such as the FinTech sector. Next major sector was the AgTech sector; a lot of movement around boosting AgTech. Note Digital Technologies Industry Transformation Plan that is being developed as a partnership between MBIE and NZTech.

New Zealand is not behind gaming technology but perhaps should be getting into it. Also, not behind the payments sector as an area of tech. For example, s 9(2)(ba)(i)

Ultimately, bigger businesses are able to help themselves before NZTE can get to them. At the same time, NZTE markets itself more toward smaller businesses. There are misconceptions about NZTE being able to help pre-revenue firms – they can do but it is not their focus/speciality. Callaghan Innovation helps with that first gear and NZTE helps in second gear.

Q3

NZTE administers growth funds. A lot of due diligence undertaken, requires a lot of information about plans and people involved. Amounts are matched dollar for dollar up to $600,000.

Market validation fund is for the first stage where a business is still trying to validate whether a certain international market is the right one to enter into. Has a cap of $100,000 contribution from NZTE i.e., for a $200,000 project. Prior to COVID-19, this would involve sending people into markets, attending conferences, going to trade shows, etc. Given restrictions imposed by COVID-19, much more of this activity involves paying people already in the market to undertake those activities. Essentially a feasibility analysis.

Full international growth fund is for helping to execute in the market, accelerate growth, double-down on expansion. Has a cap of $500,000 in a two-year period (down from three) and a business can apply again after that period, though the application has to be

for expenditure beyond business-as-usual – must be associated with new projects/processes/products.

Additional funding was provided by the Government in June, doubling the total bucket from $30 million to $60 million. NZTE not expecting to spend the whole amount. NZTE does not fund any roles to do with software or product development – all about delivery and moving the dial with products being sold in market. Funding software developers would be seen as funding business-as-usual.

Q4

Not entirely applicable to NZTE.

Companies grow and get acquired or list/undertaken an IPO. NZTE will still work with them insofar as R&D/innovation is still undertaken in New Zealand and/or New Zealanders are being employed.

In one sense, New Zealand companies getting bought out is a sign of success, but it also represents lost IP. May be nice for New Zealand funds to be buying that IP. Otherwise New Zealand profits then become foreign profits.

Q5

NZTE compares itself to close equivalents in other jurisdictions with respect to size and location. Countries doubling down on the tech sectors and provide a lot of promotion/support include:

- Australia
  - Rules around closer economic ties have been restricted during COVID-19.
- Ireland
- United Kingdom
- Singapore (Economic Development Board)
- Ukraine, Hungary, other Eastern-Europe countries
- South Korea
  - Big tech sector

New Zealand does not have the same scale – big difference in how careful New Zealand is in disbursing funding compared to the leniency observed in other countries.

Not in scope

I'm ok either way on establishing a meeting –happy to follow your thoughts.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*
s 9(2)(a)
Email   @ird.govt.nz

From: David Cuellar <s 9(2)(a)   @ird.govt.nz>
Sent: Tuesday, 26 January 2021 6:20 pm
To: Craig Phillips <s 9(2)(a)   @ird.govt.nz>; Chris Gillion <s 9(2)(a)   @ird.govt.nz>
Subject: RE: Software Development consultation _Business stakeholders_2021-01-25_V3.docx

Not in scope

Thanks Craig, looks good. My only question is do we need to wait for a response before we propose to set up a meeting? We could make it clear if we're expecting acknowledgment before we reach out for consultation or if we will just send a follow-up request for a meeting regardless.

I've drawn up a timetable as follows if we are trying to make introduction of the 2021 Bill:

Software development timetable (tentative)

Deadline (2021)	Completed milestone	Comment
19 February	Conclude first round of consultation	Understanding business processes in the software development sector
5 March	Develop proposed rules and write next consultation document/letter	Assuming targeted consultation and that we will not go to Cabinet with an issues paper
2 April	Conclude second round of consultation	Seeking feedback on the proposed rules and making adjustments
8 April	**Budget moratorium begins**	**Unlikely that we will be able to report during the moratorium as Ministers will not want to send a Cabinet paper for consultation**
20 May	**Budget Day TBC**	**Moratorium ends**
21 May	Report to Ministers with attached Cabinet paper	
3 June	Lodgement for DEV	Unlikely to get the paper lodged by this date if reporting after the moratorium, meaning we would miss introduction of the Bill
9 June	DEV approval	
14 June	Cabinet approval	

I think the key things to bear in mind are:

- I can't see a path to having policy approval before the Budget moratorium, which means we need to seek approval after the moratorium.
- It is unlikely that we will be able to send a Cabinet paper to Ministers for their review/sign-off before 20 May. It sounds like Ministers will not be comfortable consulting on what might be a net-positive proposal during the moratorium.
- Given that we will likely need to report after the moratorium, we would only have about two weeks between reporting to Ministers and lodging the Cabinet paper,

which is possible but significantly pushing timeframes. We would need to test this with Thomas Allen/Paul Young/Paul Fulton.

- If we can't report and have the Cabinet paper lodged within approximately two weeks after the moratorium, then we won't make Bill introduction.
- There are likely to be a number of other projects facing the same constraints as us, which will make it more difficult to expedite this project from Ministers' offices' perspectives.

If we can't make Bill introduction, then our options are:

- Include software development changes in a SOP at the select committee stage.
- Include software development changes in a SOP at the COWH stage.
- Delay software development changes until the next bill.

Interested in thoughts from both of you. There a number of different permutations so you may have alternative views on timelines.

Cheers,

David

-----Original Message-----
From: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Sent: Tuesday, 26 January 2021 3:50 PM
To: Chris Gillion <s 9(2)(a) @ird.govt.nz>; David Cuellar <s 9(2)(a) @ird.govt.nz>
Subject: Software Development consultation _Business stakeholders_2021-01-25_V3.docx

Not in scope

Updated as discussed for your comments.
https://aus01.safelinks.protection.outlook.com/ap/w-59584e83/?
url=https%3A%2F%2Firnz.sharepoint.com%2Fsites%2FCraigscrossdomainwork%2FSha
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Consultation letter

28 January 2021

To: s 9(2)(a), s 9(2)(ba)(i)   , NZ Technology
Industry Association, s 9(2)(ba)(i)   (by email)
CC: Robyn Henderson, Policy Director EDT; Mark Debenham, NZTE; Callaghan Innovation

From: David Cuellar and Craig Phillips

Software development expenses – reviewing tax policy settings

Background

1. We are presently reviewing the policy settings and practices relating to the taxation of software development in order to determine an appropriate tax accounting treatment for income and expenses within the software development sector.

2. Our policy review arises from Inland Revenue publishing an exposure draft of a proposed change in Inland Revenue's view on the tax treatment of software development expenses (*IRRUIP10 – Income tax treatment of software development expenditure[1]*).

3. Several submissions were received on the views expressed in that document:

    *   Many submitters opposed change to existing tax accounting practices in the software development sector.
    *   Existing provisions in the Income Tax Act 2007 have inconsistent outcomes for the treatment of software development expenses. This inconsistency between provisions is creating confusion within the software development sector.

4. Submissions on IRRUIP10 were consistent in noting that if the tax policy problem is not solved, then the software development sector would likely be adversely impacted because of:

    *   tax impacts on operational cashflows within the sector; and
    *   an increase in demand for capital due to the need to fund higher cash flows.

Purpose of this review

5. The objective of the review is to identify appropriate tax policy settings that are consistent with:

    *   optimal economic efficiency for the sector;
    *   the nature of business practices in the sector; and
    *   the broad-base low-rate tax framework underpinning the tax system in New Zealand.

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[1] https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/consultations/issues-papers/irruip10.pdf?la=en&hash=85038059438AB31059D4273F86406A27

www.ird.govt.nz

6. Given these objectives and the background, this is a "*first-principles*" review of general income tax principles as they relate to the software development sector. This review does not include within its scope any aspect of the research and development tax incentive or any other incentives promoting innovation in the sector.

Economic efficiency, taxation, and the broad-base low-rate system

7. Economic efficiency is important, as it relates to policies that seek to minimise the effects of deadweight costs arising from the taxation system. Efficiency considerations require an understanding of both the framework of the New Zealand tax system and the way in which business sectors carry on their business.

8. The tax system is based on a broad-base low-rate approach to taxing profits of businesses on an annual basis. This framework supports business activity by ensuring that:

   - business activities having similar capital and operational characteristics are treated on a similar basis (horizontal equity); and
   - tax settings do not give rise to distortions for investment decisions.

9. A first-principles review is based on the following elements of the income tax system:

   - The annual profits of a business are taxable. In the income tax system, these annual profits are known as taxable income.
   - Taxable income for a year is the difference between total assessable income and deductible expenses relating to that year.
   - The calculation of taxable income considers applies accounting principles and specific tax rules for recognising the existence and timing of both assessable income and deductible expenses.

Current practices

10. To date, this review has identified a variety of tax accounting practices for the deductibility of software development expenses, including:

   - deduction of these expenses in full as they incurred;
   - deduction of these expenses in full when the developed software is first able to be commercially exploited; and
   - capitalisation of these expenses until the developed software is recognised as an asset, with the capitalised expenses are amortised (as a deductible expense) over the economic life of the related developed software.

Consultation

11. This letter is written as part of our review of the tax policy settings for software development expenses. IRRUIP10 proposes to apply a capitalisation model to recognise software assets based on a business process that is similar to that applied to traditional manufacturing activities.

12. We acknowledge that the software development sector and the technology sector generally is an important part of the Government's economic policy. Up until now, we have been consulting with other government agencies to better understand the economic and incentive policies for your sector that are promoted and managed by other agencies.

13. Other government agencies have indicated that operational processes in your sector have characteristics and methodologies that differ from a traditional manufacturing business. This observation is consistent with several submissions from your sector on the proposals in IRRUIP10. Consequently, the purpose of this letter is to assist us in understanding operational processes within your sector before consulting on any changes in the tax policy frameworks for software development expenditure.

14. Issues for which we seek your feedback are:

- the size of the software development sector in terms of participants, contribution to the economy, types of organisations (e.g. agritech) and profitability;
- characteristics of business processes used in developing software;
- characteristics of funding and funding limitations within the software development sector;
- characteristics of an expected life cycle of software developed for commercial exploitation;
- Government policies in other jurisdictions for their innovation sectors.

15. To this end, we are interested in any insights or information you have on:

- Typical business and life-cycle processes adopted across all aspects of the software sector in New Zealand.
- Why Government policies for the innovation sector are or should be linked to any specific characteristics and life cycle of the sector's business processes and, if so, how?
- Any specific characteristics of capital funding and funding risks that exist for the innovation sector that differ from general capital funding principles.
- The processes of developing and using open source software to create software that can be commercially exploited.
- Any other matter relating to your sector that you consider provides any insights on structural or operational differences to traditional manufacturing activities.

Next steps

16. We are wanting to meet with you in February of 2021 to receive your feedback on our questions. We will be in touch shortly to arrange a time to meet, either digitally or in person. We would also appreciate an indication from you of any other key stakeholders in this sector for the next consultation step (see below).

17. After receiving and analysing your feedback, we intend to consult further with stakeholders on whether the general tax policy frameworks discussed above would be appropriate going forwards or whether some alternative approach should be considered that appropriately reflects the sectors businsess practices.

18. We are planning to complete our review of tax policy settings for the treatment of software development expenses as soon as possible following that second round. We would make any necessary recommendations to Government after that time to clarify the tax policy settings for software development expenses.

19. If you have any questions, please contact us. Our contact details are as follows:

David Cuellar | Policy Advisor | *Kaitohutohu Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

DDI s 9(2)(a)

Email:
s 9(2)(a) @ird.govt.nz

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

DDI s 9(2)(a)

Email:
s 9(2)(a) @ird.govt.nz

Meeting Subject: Software Developers - Tax policy review of income tax settings for software development expenditure

Meeting Date: 3/02/2021 4:00 pm
Location: WGN 8.4.60 Levy
Link to Outlook Item: *click here*
Invitation Message
Participants
    Craig Phillips (Meeting Organizer)
    Chris Gillion (Accepted in Outlook)
    David Cuellar (Accepted in Outlook)
    Benjamin Hammond
    s 9(2)(a)   @callaghaninnovation.govt.nz (Accepted in Outlook)
    s 9(2)(a)   @callaghaninnovation.govt.nz (Accepted in Outlook)

Notes

(IR) - Introductions

Data or comment on the size of the software development sector?
- CH - Nothing further to elaborate from what has previously been provided.

Agency's policy, and link with business processes
- CH - Overall, Callaghan's objective is to increase the spend on R&D in New Zealand as a percent of GDP.

- CH - You have to remember that the 'software market' encapsulates a number of different subparts:
    - Building and selling software products e.g. Datacom
    - SAAS models - in-house building for exploitation e.g. Xero
    - Internal design and use of software e.g. Banking software

- CH - IRD's tax incentive is not about the internal design and use but about developing products to be sold overseas to contribute to NZ's GDP, and leading to higher paying jobs for New Zealanders.

- IR - As you know, internal software use (e.g. banking) would increase output of the user and therefore contribute to GDP, so I am assuming we see further increases in GDP from external exploitation of software - some type of spill-over benefits?

- CH - Yes, spill-over benefits are globally recognised within the software industry. As an example, the number of accounting firms that popped up after Xero, or the Navman software which created opportunities for marine audio. We don't see these types of clear benefits from internally exploited software.

- NZTE are focused primarily on increasing exports and that link to maximising GDP, while we at Callaghan are more focused on medium sized businesses. Software is everywhere, there is a large amount of product services - largely website designs. We general think the software is a vertical industry, where software is the product being developed and sold, but a lot of software is horizontal, as different industries try to integrate software into their businesses (agri-tech, fintech etc.), software is not often their main business.

- Software in fintech is actually a growing industry In NZ, the FMA allow businesses to push the boundaries more, and aren't sand-boxed like they are in Australia.

Policies of your agency that relate to capital funding for the innovation sector

- CH - The main one is the R&D tax incentives. However, we also still have project grants but these are much smaller. Generally, we see companies with good prospects have no issue getting funding via Blackrock, simplicity etc. etc. There is a large amount of capital waiting for a home, and a lot of the venture capital funds will say they have money but there aren't enough opportunities. It should be said that some companies will tell you that they are struggling to find capital but in general we do not think it is an issue.

- CH - Venture capitalists are attracted to companies that already have traction, that have demonstrated product market fit (the product meets a customer's desires, solves a problem in the market). If the company is struggling with product market fit it is unlikely they will have access to capital.

- CH - traction is usually measured by demonstrating that product market fit through growing customer acquisitions and usage.

- CH - The venture capital space, is a bit of a chicken and egg exercise, businesses generally want funding to grow and scale production to acquire customer acquisitions and usage. While venture capitalist generally don't provide funding until the business demonstrates that, by that time the businesses may not need funding.

- CH - NZ tec (s 9(2)(a)) might also be able to help you guys.

Life-stages
- CH - There is no clear end product (and in some cases there will never be a final product). For most SAAS products they will have a minimum viable product that they will test in the market, and then they'll see if the product is being used, what customers want from it, how it can be improved. Xero is again a great example of this they started off as bookkeeping software, then moved to a full suite accounting software, now they've added tax capabilities.

- CH - Once product market fit and MVP is achieved. The next big step for any SAAS provider is scalability, sales have to be ready to scale - can you create an engine that creates a cycle.

- CH - The life stages are 'linear' but they can overlap significantly, there is no clear start and finish to each stage. Once sales take-off, you need to keep improving your product, its kind of like 'building a plane while it flies'.

- CH - The largest expense, or the point with the most cost pressures is the coding and engineering of the software. This is the point businesses are most susceptible to falling over. Engineers are often in short supply and cost a lot. Generally, businesses prefer NZ based engineers and prefer for them not to work remotely, but often when they grow their engineering base they will look overseas (Brazilian example). Once the business is in the scalability stage - family and friends will often retract their money, and the venture capitalists will come in (if needed). The business during this stage is generally more robust (i.e. they have a product market fit and have acquired some customers).

- CH - in terms of internally used software, much of the development can be outsourced, e.g. banking software.

When is an asset formed and valued?
- CH – As mention, an asset is never finished. But the company will be able to identify that their idea is exploitable quite early. If the business has good accounting processes then in theory they could value the business. The method of valuing the asset may be another story, but when I was developing software we simply used a contributions of cost method. Other valuation methods could be based on sales, compound growth rates, discounted cash flow methods etc.

What do you see internationally?
- CH - Callaghan is a little unique when you look overseas, most countries don't generally have a comparable. And sometimes we see NZ firms being overly reliant on Callaghan.

- CH - As mentioned that ability of fintech's to think outside the sandbox (unlike in Aus) is important.

- CH - Every country is always trying to tinker to maximise R&D. Estonia is a unique example. They have a growing digital market, and a big part of that growth is their innovative procurement process, where many of the big tech contracts go to local firms, which then helps them to grow. Singapore is another example with a booming tech industry, as part of this they try to match up complementary tech firms to help them both grow. They also have a National Digital Identity (NDI) project - a centralised identification system.

Closing remarks.
End.

From:	David Cuellar
To:	Benjamin Hammond; Craig Phillips
Cc:	Chris Gillion
Subject:	RE: Software expenditure consultation - Callaghan
Date:	Thursday, 4 February 2021 5:28:00 PM

Thanks very much Ben, this is great.

I thought it was interesting that they perceived the software development process, including bringing product/service to market and scalability, to be linear. They did note the overlap between stages, but I had thought from prior reading there might be a few more feedback loops.

I think the distinction between software as a product and software as a service will be one of the harder things to grapple with as we think about what the most appropriate tax treatment for certain expenditures within the sector is. I expect there will be big grey areas in cases where it's not clear whether some software is a product or service.

Cheers,

David

From: Benjamin Hammond <s 9(2)(a) @ird.govt.nz>

Sent: Thursday, 4 February 2021 2:03 PM

To: Craig Phillips <s 9(2)(a) @ird.govt.nz>; David Cuellar <s 9(2)(a) @ird.govt.nz>

Cc: Chris Gillion <s 9(2)(a) @ird.govt.nz>

Subject: Software expenditure consultation - Callaghan

Hey team,

My notes from yesterday's discussion with Callaghan are here. Please make changes and inclusions as you see fit.

Great job facilitating the discussion David, even with the internet issues.

My four crude takeaways from the discussion were:

1. The software development process although never-ending could be considered linear, in the sense there are a few steps that need to be completed (at least partially) for the company to progress: Minimum viable product (MVP), Product market fit and scalability. 'Build the plane as it flies.'

2. Currently, acquiring capital is not an issue for companies with good ideas and traction (However, to get to this point you still need family and friends $).

3. Companies with good accounting processes (unsure what % this is) should be able to "value" their software asset. The method of valuation does vary: Book value, Sales multiples and growth rates, Discounted cash flow.

4. We need to be clear what software expenditure we are focused on and the different treatments. Internal use, SAAS or building and designing software.

Am keen to hear others key takeaways.

Regards,

Ben

From:	Diane Fairbrother
To:	Craig Phillips; Sara Bathgate
Cc:	Chris Gillion; David Cuellar; Benjamin Hammond
Subject:	RE: IRRUIP 10 INCOME TAX TREATMENT OF SOFTWARE DEVELOPMENT EXPENDITURE
Date:	Tuesday, 16 February 2021 6:53:09 AM

Not in scope

Thanks Craig,
I appreciate your time.

Not in scope

I found this paper and IS 17/04 INCOME TAX – COMPUTER SOFTWARE ACQUIRED FOR USE IN A TAXPAYER'S helpful – also, the ACTONZ cases.
Thanks for the insight.

Regards

Diane

Diane Fairbrother | Technical Specialist, Legal Services | Inland Revenue

T. s 9(2)(a) @ird.govt.nz

Not in scope

From: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Sent: Monday, 15 February 2021 3:50 PM
To: Sara Bathgate <s 9(2)(a) @ird.govt.nz>; Diane Fairbrother <s 9(2)(a) @ird.govt.nz>
Cc: Chris Gillion <s 9(2)(a) @ird.govt.nz>; David Cuellar <s 9(2)(a) @ird.govt.nz>; Benjamin Hammond <s 9(2)(a) @ird.govt.nz>
Subject: RE: IRRUIP 10 INCOME TAX TREATMENT OF SOFTWARE DEVELOPMENT EXPENDITURE

Not in scope

Hi Diane,

We are currently in the process of consulting with the sector for the purpose of a first-principles review of the BBLR tax settings as they apply for the software development sector. We are working towards putting up a cabinet paper for potential policy changes (one policy issue which we intend to progress is the tax treatment of sales of the code /IP in software – at present this is a sale of a capital asset and we don't think that is consistent with the treatment of having allowed deductions in the past under the trading stock approach or under s 40B or s DB 34 or even the proposed feasibility rules. It is a very wide review.

If you wish to be included in our CCS & TCO consultation (coming up), please let us know.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*
DDI s 9(2)(a)
Email @ird.govt.nz

From: Sara Bathgate <s 9(2)(a) @ird.govt.nz>
Sent: Monday, 15 February 2021 3:20 pm
To: Diane Fairbrother <s 9(2)(a) @ird.govt.nz>
Cc: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: IRRUIP 10 INCOME TAX TREATMENT OF SOFTWARE DEVELOPMENT EXPENDITURE

Not in scope

Hi Diane
No further work has been undertaken on this by the Tax Counsel Office. It's now been referred

to PAS.

Craig, are you able to help Diane?

Cheers,

Sara

From: Diane Fairbrother <s 9(2)(a)@ird.govt.nz>

Sent: Monday, 15 February 2021 12:07 pm

To: Public Consultation <PublicConsultation@ird.govt.nz>

Subject: IRRUIP 10 INCOME TAX TREATMENT OF SOFTWARE DEVELOPMENT EXPENDITURE

Not in scope

Hi,

Would you please tell me what's become of the issues in this consultation paper of 2016?

Regards

Diane

Diane Fairbrother | Technical Specialist, Legal Services | Inland Revenue

T. s 9(2)(a)   @ird.govt.nz

Not in scope

Kia ora koutou, discussion notes below per previous email. Talk to you all soon. s 9(2)(a)

A perennial problem for software companies is the treatment of software development costs in terms of whether to capitalise those costs or not. The underlying difference from any other type of investment really comes from software being infinitely copyable(i.e. There can be near zero marginal cost for reuse).

Consider the following development activities and what we might consider reasonable in terms of whether that investment could be capitalised from the perspective of a tax office combined with the effect on the business.

Situation	Capitalisation Approaches	Effect on business if changed
A company develops a piece of software for a client for an agreed price	Tax on profit derived by the business, may be capitalised by the client	Unlikely to affect developers
A company develops a piece of software for a client but keeps a copy of the developed IP on the hope of finding an opportunity to reapply the same solution in the future	Tax on profit from sale. Some argument may now exist for capitalising a portion of the build	Similar to other businesses. Tax disincentive to keep IP if required to capitalise, which will lower long-term productivity of the sector
A company develops a new piece of software which they resell to multiple clients	Some business capitalise, while others treat as the cost of servicing the contracts with each client	Tax burden lies heaviest on companies that are trading profitably as they are taxed on both the sales and the growth of the internal asset. Less effect on funded startups as they rarely aim to turn a profit in early years.
A company develops a piece of software intending to find buyers but only achieves low sales	Indistinguishable from previous case so both options plausible	Being forced to capitalise would significantly affect profitability threshold required for a product to "bootstrap" as the minimum amount of revenue before the business realised a profit after tax would increase markedly.

A company develops or purchases a tool for internal use	Some combination of opex and capex with amortization over the life of tool's use	Comparable to non-software purchases
A company develops a piece of software which it publishes as open source	In practice never capitalised but would need a special carve out if guidance from government enforced stronger capitalization rules.	Major reduction in contributions to the commons if businesses are forced to capitalise. Potential increase in contributions if given a carve-out by itself.

These scenarios illustrate a few key problems with the idea of capitalising software development with broad strokes:

- Software's ease of duplication leads to inflated balance sheets if all software is capitalised by everyone using

- Some businesses, especially those trying to build products off the back of profits, would be heavily affected by enforced capitalisation as they would show both sales and the cost of those sales as income.

- While some of these situations(such as the growing software startup with many clients leveraging off a platform) appear to make sense for capitalisation it is hard to know ahead of time that a business will be in that situation - i.e. the business that kept a copy of a solution may suddenly find their solution in demand but they might never have bothered keeping that copy if it had a negative tax effect in the short term.

While some of these problems could be solved with policy if the government still wished to enforce stronger capitalisation there is a significant problem of vagueness around the asset value of software - most software business valuations are done entirely on the basis of revenue multiples rather than asset analysis.

Given the direct impact of lowering lowing term productivity outcomes for New Zealand, being complex to enforce, and likely generating limited we would recommend against the broad capitalisation of software development costs.

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_____

s 9(2)(a), s 9(2)(ba)(i)

s 9(2)(a), s 9(2)(ba)(i)

Inland Revenue
Te Tari Taake

Notes from Consultation – s 9(2)(ba)(i) and NZ Tech

Date: 18 and 19 February 2021

Subject: Deductibility of software expenses

18 February 2021 – s 9(2)(ba)(i)

Attendees:
s 9(2)(a), s 9(2)(ba)(i) , David Cuellar, Craig Phillips, Ben Hammond (Inland Revenue).

Background:
s 9(2)(ba)(i)

Setting the scene -
Our previous submission on this topic and past discussions with IRD were about added flexibility in the area of deducting software expenses. We agree that the 1993 TIB needs updating, even at the time it was released it was arguably out of date. This is because for most software products there is no clear final product. However, any changes should consider the potentially massive adverse impacts on business cash flows. Questioned the purpose of re-visiting the issue, since its been 5 years from when the issues paper was released, wondered if it was due to overall tax revenue concerns following COVID.

The sector –
Treatment of software expenses is different across the sector. Many businesses focus on EBITDA figures, even if this is likely to show the business is more profitable than it really is. If they go down that route, they would prefer immediate expensing. This is likely to be common for businesses in the product improvement model.

It is very hard to describe the whole sector, there are some businesses with software legacy systems, which pay a monthly service type fee, others may give the product out for free (an open source model) where they look to receive revenue through support services and maintenance fees – i.e. they try to gain traction first. Other businesses build bespoke products or develop plug-ins on the big global platform – Microsoft/google etc.

The life-cycle of software has changed significantly and is varied across the sector, you can get the legacy systems that were created in the 1980s that can still be used today, others like in the game development can be released and be switched off in a matter of days or weeks, there can be a huge range. The sector calls this "bit rot" where the decay of computer software can be exponential and start depreciating immediately.

Software development is similar to creative work like writing. Books can be written hundreds of years ago and can still be relevant, others might write articles or books about the book, on the other hand certain news articles are obsolete the day after they are released.

It is not worth developing software if the business is not going to constantly improve the product or provide support for customers.

Other Government interactions and policies –

Callaghan are largely focused on the early-stage and start-up businesses. The Callaghan grants were very good, we used to receive them for 5-6 years (might have misheard that). The R&D expensing and the tax credit seem good but we cannot qualify for that, there is a good guidance document out on it though, so that's been helpful. It would be good to see what projects are approved so we know if we could be approved. Especially to see how many Agri-tech or Health-Tech are actually receiving and what for.

Issues facing the sector -

Cashflow is the key driver. Cash to pay salary and wages and other expenses. Simplicity is also important, but less so. Most businesses employee an external accountant, but try to limit the amount that the accountant has to do though to keep costs down.

Getting bank finance at an early stage is often quite hard, businesses are less likely to want to capitalise the expenses because it is difficult to lend against an intangible asset like IP (also mentioned Banks look at key person risk, i.e. 1 big customer). However, if you can show a bank you have good cash flow (immediate expensing helps with this) it can help show serviceability.

On the other side of financing is venture capital. But there is a reason these are often referred to as vultures, it is a ruthless business. It is more at the start-up stage. VC is changing in NZ there is more of it available, but it is still incredibly expensive, far more than debt financing which is a very cheap form of finance.

In terms of aligning accounting standards, we really don't think that's a big deal at all (had not even heard of IFRIS, and knew very little about GAAP). Potentially that's once your business gets larger, but believed that only 0.5% of business would be impacted. s 9(2)(a) did mention that some of the businesses they manage were starting to think about what they had to report, but mentioned it was more for publicly listed companies (mentioned s 9(2)(ba)(i)).

Open source and other models –

Open source is a different model it is underpinned by copyright (back to that analogue of creative works). A permissible license is used, where other business are free to use the software. They provided some examples of a library system (Colab?) and a car manufacturer (Catapult?). s 9(2)(b)(ii)

A good example of an open source business is RedHat, which were recently acquired by IBM.
The sector often refers to the benefits of open source software as "buy a brick and you get a house". The software is not really licensed, no-one owns it.

Software development is risky- there is no certainty as to whether anyone will buy the product. It may take some time to receive sales, and often each customer can make up 5-15% of revenue. Might only be selling to a few customers.

Cash flow is king in all models, we think many businesses may not have survived during the early years if they could not deduct all expenses. That 2nd year when prov tax kicks in can be very tight, salaries for software development can be very high (hinting at both the cash flow and the amount of tax paid on wages).

The level of reinvestment required and can be very high, we are often competing with MNEs who at times have a vast amount of cash due to other ventures or wealthy owners, we often need as much support as we can get.

19 February 2021 – NZTech

Attendees:
s 9(2)(a)   (NZTech), Chris Gillion, David Cuellar, Craig Phillips, Ben Hammond
(Inland Revenue)

Background:
NZTech are a not for profit NGO whose purpose is to connect, promote and advance tech ecosystems and to help the economy grow to create a prosperous digital nation. The organise the NZ Tech week and Tech story with MBIE. The entire ecosystem can be quite confusing.

The questionnaire to our members is now live on how the treat software expenses, we email this out to all our members, and hundreds of small, medium and large software businesses read each email.

Capitalisation vs expensing:
Without seeing the results, I would guess that 70% of companies would expense, many being early stage concerned about cash flow, and 30% would capitalise.

The sector is very diverse for example game developers will often be working on a game for 12-18months for release, once they release it, it is available for use – an asset has been formed. They will still have to continuously be trying to improve, create new characters or expand the map etc. It is akin to a movie that gets better the longer you watch it. Rocketwerkz are a good example of this, I can pass on any contact details and be the link between you and the actual businesses. On the other hand SAAS companies may never actually have an asset per se, they might always be improving it and seeking customer feedback the likes of Pushpay or Xero who are constantly improving.

Concerns of members:
Obviously cash is always a concern but businesses are currently struggling with the border closures, like many firms they are struggling to employee those with the skills that they need. Probably 80% of software developers are immigrants. Many businesses are now employing remotely from other countries, which comes with it challenges but it is a work around for now. NZ does not get the same benefits from that type of employment. Another issue is the Māori and Pasifika communities and how we are still not capturing all the benefit that can come from these communities, we are also seeing the use of algorithms which import values from big tech companies like Google, which can be issue.

Recent research
Treasury a few years ago commissioned NZIER to report on the business models of 20 SAAS companies and where correlations were. I remember one was that they all used AWS, which could be a future issue.

Cost pressures
Software companies face massive costs, due to very high wages and salaries - some of the highest in New Zealand. These are paid every month so if you have a down month in terms of revenue then this can be tough.

From:	Chris Gillion
To:	Craig Phillips; David Cuellar; Benjamin Hammond
Cc:	Paul Fulton
Subject:	RE: Policy work on software development?
Date:	Friday, 19 February 2021 12:24:09 PM
Attachments:	image001.jpg

[UNCLASSIFIED]

Hi everyone

I think we should engage tax agents as soon as possible. We can explain to them that we have been doing some talking to other govt depts and some businesses to get an idea of how the industry works but now we are going to consult more directly on the tax issues. I would simply give s 9(2)(a) from PWC a call to explain. I will put it on the agenda for the next CTG meeting, for example, and Stewart can do the same for CA ANZ just to raise awareness and we can start talking to tax agents.

Hope that helps.

Chris

Chris Gillion| Policy Lead | Kaihautū Kaupapa Here

Policy & Strategy | Kaupapa Here me te Rautaki

Inland Revenue | Te Tari Taake

s 9(2)(a)

E. s 9(2)(a) @ird.govt.nz

From: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 19 February 2021 11:36 AM
To: David Cuellar <s 9(2)(a) @ird.govt.nz>; Benjamin Hammond
<s 9(2)(a) @ird.govt.nz>; Chris Gillion <s 9(2)(a) @ird.govt.nz>
Subject: FW: Policy work on software development?

[UNCLASSIFIED]

Can we have a chat this afternoon to agree on a response to PWC? The tax advisors would have been the last group on the consultation train in my line of thinking but it's ok from my perspective to engage sooner – but it will be important that we don't duplicate effort and waste time – I'm keen to chat about our response – I have some thoughts but maybe it will be best to bounce the issue off each other asap.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*
s 9(2)(a)
Email @ird.govt.nz

From: Craig Phillips
Sent: Friday, 19 February 2021 11:31 am
To: Stewart Donaldson <s 9(2)(a) @ird.govt.nz>
Subject: RE: Policy work on software development?

[UNCLASSIFIED]

Yes we will respond

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*
s 9(2)(a)
Email @ird.govt.nz

From: Stewart Donaldson <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 19 February 2021 10:24 am

To: Craig Phillips <s 9(2)(a) @ird.govt.nz>; Chris Gillion <s 9(2)(a) @ird.govt.nz>; David Cuellar <s 9(2)(a) @ird.govt.nz>

Subject: FW: Policy work on software development?

[UNCLASSIFIED]

Hi guys

After the CA ANZ / NZLS meeting today, s 9(2)(a) from PWC sent me the below query about software development expenditure.

I see from the PAS work programme register that this topic sits with you.

Am I able to leave it to you to send an appropriate response to s 9(2)(a) **?**

Thanks

Stewart

From: s 9(2)(a) @pwc.com>
Sent: Friday, 19 February 2021 9:55 AM
To: Stewart Donaldson <s 9(2)(a) @ird.govt.nz>
Subject: Policy work on software development?

Hi Stewart

A question for you (which I didn't want to take up everyone's time asking on the call just now) - the NZ Technology Industry Association has sent out the message below to its members. This isn't something that appears on the current work programme, and it is the first I and others at PwC have heard of this.

Are you able to give me any further information on this review or who to contact within IR? We have a large number of clients in the tech industry space that this is relevant to, so would be very keen to get involved in or provide feedback in relation to any project happening in IR on this.

Thank you!

s 9(2)(a)

NZTech Submission Survey – Tax Accounting Treatment for Software Development

Dear X

The IRD are presently reviewing the policy settings and practices relating to the taxation of software development in order to determine an appropriate tax accounting treatment for income and expenses within the software development sector.

If this will impact your business we would like your feedback.

Please complete this very short (10 questions, 2 minutes) survey.

Complete Survey

The information will be used to help inform the discussion within IRD and between IRD and the software sector as they aim to improve the tax treatment of software development. The results will be used to produce

industry facts to support the development of a tax policy that benefits the majority of software companies.

Thank you for your time.

From:	Craig Phillips
To:	Benjamin Hammond
Cc:	David Cuellar
Subject:	RE: Consultation notes - deductions for software expenses
Date:	Wednesday, 24 February 2021 5:00:51 PM
Attachments:	image001.png

Not in scope

Thanks Ben, I have gathered quite a bit of info from conferences and maybe next week I can run through what is in our teams folder so we have better awareness of what we have already gathered as a resource.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*
s 9(2)(a)
Email   @ird.govt.nz

From: Benjamin Hammond <s 9(2)(a)   @ird.govt.nz>
Sent: Wednesday, 24 February 2021 4:59 pm
To: David Cuellar <s 9(2)(a)   @ird.govt.nz>; Craig Phillips <s 9(2)(a)   @ird.govt.nz>
Subject: RE: Consultation notes - deductions for software expenses

Not in scope

FYI I think this is the report s 9(2)(a) was referring to:
https://nzier.org.nz/static/media/filer_public/4c/61/4c61994e-a66a-463b-b486-d00ee5dd0da9/new_zealand_services_firms_approach.pdf
I have a saved it under the 'Research' folder in Teams.

From: David Cuellar <s 9(2)(a)   @ird.govt.nz>
Sent: Wednesday, 24 February 2021 4:46 pm
To: Craig Phillips <s 9(2)(a)   @ird.govt.nz>; Benjamin Hammond
<s 9(2)(a)   @ird.govt.nz>
Cc: Chris Gillion <s 9(2)(a)   @ird.govt.nz>
Subject: RE: Consultation notes - deductions for software expenses

Not in scope

Thanks Ben, these notes are great.
I think the conversation on bit rot was interesting, and we'll be pushed on whether the economic life of software for tax purposes reconciles with how fast software deteriorates/becomes obsolete in reality.
Cheers,
David

From: Craig Phillips <s 9(2)(a)   @ird.govt.nz>
Sent: Wednesday, 24 February 2021 4:34 PM
To: Benjamin Hammond <s 9(2)(a)   @ird.govt.nz>; David Cuellar
<s 9(2)(a)   @ird.govt.nz>
Cc: Chris Gillion <s 9(2)(a)   @ird.govt.nz>
Subject: RE: Consultation notes - deductions for software expenses

Not in scope

Thanks Ben, I'll read through later on today.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*
s 9(2)(a)
Email   @ird.govt.nz

From: Benjamin Hammond <s 9(2)(a) @ird.govt.nz>
Sent: Wednesday, 24 February 2021 4:33 pm
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>; David Cuellar <s 9(2)(a) @ird.govt.nz>
Cc: Chris Gillion <s 9(2)(a) @ird.govt.nz>
Subject: Consultation notes - deductions for software expenses

Not in scope

Hey team

As promised here are my notes from the consultation meetings with s 9(2)(ba)(i) and NZTech. Happy for you to make changes where there are gaps or where I may have misunderstood something – as mentioned this morning, I think given the current plan for targeted consultation having meeting notes that are well documented (and accurate) is important.

To continue on with my 3(ish) takeaways from each consultation, many of these we discussed after the meeting:

s 9(2)(b)(ii), s 9(2)(ba)(i)

NZ Tech:

s 9(2)(b)(ii)

Happy to chat

Ben

Benjamin Hammond (he/him) | *Policy Advisor* | Kaitohutohu Kaupapa Here
Policy & Strategy | Kaupapa Here me te Rautaki | Kaitiakitanga
s 9(2)(a)
E. s 9(2)(a) @ird.govt.nz | W. taxpolicy.ird.govt.nz

Craig Phillips

[IN CONFIDENCE RELEASE EXTERNAL]

Hi s 9(2)(a) ,

Quick introduction as I haven't been in touch before. I work in Policy and Regulatory Stewardship at Inland Revenue – Steph has passed on your details.

I am emailing to let you know about a review that officials are undertaking on the taxation of software development. Craig, Ben, Chris, and I make up the team working on this. The project is a first-principles review on the tax treatment of software development expenditure. This review is motivated by uncertainty within the sector and inconsistency as to how different firms involved in developing software account for their expenses. For example, some businesses may take tax deductions as software development expenses are incurred while others may use a capitalisation and depreciation model. I have attached an issues paper from 2016 (available on the Inland Revenue tax technical website) that serves as background.

We do not yet have any options or recommendations to disclose. At this stage, we are just giving an early heads-up to interested parties about our review and are seeking views on business models within the software development sector. This review is not confidential, and we expect that some NZLS members may have interested clients. Our current aim is to finalise any legislative amendments in time for introduction of the next tax bill (currently expected to be in August). We expect to be going back and forth on consultation with interested parties for the next three months. Toward the end of March/beginning of April, we will be seeking to send out a consultation letter that outlines the taxation options under consideration, at which point we will invite feedback more specifically on those options.

Unless you see a reason to the contrary, we would like to undertake consultation with members of the NZLS Tax Law Committee if they are interested, rather than seeking the formal views of the NZLS.

This is the first time that we are emailing you with respect to this review. We have a couple of questions at this stage:

1. Will members of the NZLS Tax Law Committee be interested in engaging on this project and, if so, how would they like to engage?
2. Will members be interested in engaging with us to inform our understanding of the software sector, or only on proposed amendments once we have firmed our understanding of the sector?

As we have not been in touch before, please let me know if there is anything else that you wish to bring to our attention at this stage, whether to do with this project or more generally.

Kind regards,
David Cuellar

1

From:	Craig Phillips
To:	s 9(2)(a) @charteredaccountantsanz.com)
Cc:	David Cuellar; Benjamin Hammond; Chris Gillion
Subject:	Software Development Expenses
Date:	Wednesday, 3 March 2021 11:08:59 AM

Hi s 9(2)(a)

First thanks for your feedback. We envisage a two-step consultation process, the first being to tap into the Advisory Group's skill set so that we are able to develop a better understanding (from an accountant's perspective) of the various business processes within the sector, the relative importance of clear and settled tax settings for the sector, the nature of software assets and obsolescence (We are also canvassing the sector to develop an understanding about their business processes, the different types of software development, the risks and impact of risks on their capital needs and business processes, all with a view to establishing how the tax system could address those concerns.

The second stage we envisage will be about developing and consulting on any policy proposals for addressing key concerns raised in the first stage. We envisage that any proposals would likely be included in an omnibus tax bill that could be introduced in the third or fourth of this year. This would mean both stages of consultation would occur over the next three or so months.

We would like to engage with you and those in the advisory group that have a particular interest in this sector via a digital meeting platform within the next two weeks. We envisage a time commitment for the first stage of approximately one hour. We are happy to accommodate your time frames to maximise the participation by those in the advisory group that have a particular interest in this sector as well as your tax team more generally.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā
Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
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Consultation letter

March 2021

From: David Cuellar and Craig Phillips

Software development expenses – reviewing tax policy settings

Background

1. We are presently reviewing the policy settings and practices relating to the taxation of software development in order to determine an appropriate tax treatment for income and expenses within the software development sector.

2. Our policy review arises from Inland Revenue publishing an issues paper on the tax treatment of software development expenses (*IRRUIP10 – Income tax treatment of software development expenditure[1]*). This issues paper asked whether the current tax treatment of software development expenditure is outdated and inappropriate.

3. Submissions we received on that document included:

    *   Many submitters agreeeing that the current treatment is outdated but opposed change to existing tax practices in the software development sector.
    *   Many submitters raising concerns that existing tax rules create inconsistent outcomes for the treatment of software development expenses. This inconsistency between rules is creating confusion within the software development sector.

4. Submissions noted that if the tax policy problem is not solved, then the software development sector would likely be adversely impacted because of:

    *   tax impacts on operational cashflows within the sector; and
    *   an increase in demand for capital due to the need to fund higher cash flows.

Purpose of this review

5. The objective of the review is to identify appropriate tax policy settings that are consistent with:

    *   optimal economic efficiency for the sector;
    *   the nature of business practices in the sector; and
    *   the broad-base low-rate tax framework underpinning the tax system in New Zealand.

6. Given these objectives and the background, this is a "*first-principles*" review of general income tax principles as they relate to the software development sector. This review does not include within its scope any aspect of the research and development tax incentive or any other incentives promoting innovation in the sector.

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[1] https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/consultations/issues-papers/irruip10.pdf?la=en&hash=85038059438AB31059D4273F86406A27

Consultation

7. This letter is written as part of our review of the tax policy settings for software development expenses. IRRUIP10 proposes to apply a capitalisation model to recognise software assets based on a business process that is similar to that applied to traditional manufacturing activities.

8. We acknowledge that the software development sector and the technology sector generally is an important part of the Government's economic policy. Up until now, we have been consulting with other government agencies to better understand the economic and incentive policies for your sector that are promoted and managed by other agencies.

9. Other government agencies have indicated that operational processes in your sector have characteristics and methodologies that differ from a traditional manufacturing business. This observation is consistent with several submissions from your sector on the proposals in IRRUIP10. Consequently, the purpose of this letter is to assist us in understanding operational processes within your sector before consulting on any changes in the tax policy frameworks for software development expenditure.

10. Issues for which we seek your feedback are:

   - characteristics of business processes used in developing software;
   - characteristics of funding and funding limitations within the software development sector;
   - characteristics of an expected life cycle of software developed for commercial exploitation;
   - Government policies in other jurisdictions for their innovation sectors.

11. To this end, we are interested in any insights or information you have on:

   - The life-cycle processes of developing, selling and improving a product.
   - How and when is a product ready for exploitation or sale?
   - Does the decision on whether to the sell the product or license the rights to the product change the life-cycle or exploitation process?
   - Any specific characteristics of capital funding and funding risks that exist for the innovation sector that differ from general capital funding principles.
   - The processes of developing and using open-source software to create software that can be commercially exploited.
   - Any other matter relating to your sector that you consider provides any insights on structural or operational differences to traditional manufacturing activities.

Next steps

12. After discussing and consulting with software businesses in an attempt to understand the processes within the software sector, we intend to consult further with stakeholders on how general tax policy frameworks would apply to the software sector and whether that application is appropriate.

13. We are planning to complete our review of tax policy settings for the treatment of software development expenses as soon as possible following that second round. We would make any necessary recommendations to Government after that time to clarify the tax policy settings for software development expenses.

14. If you have any questions, please contact us. Our contact details are as follows:

David Cuellar | Policy Advisor | *Kaitohutohu Here*
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Memorandum

15 March 2021

To: Emma Grigg

From: Craig Phillips
        Benjamin Hammond
        David Cuellar

CC: Kerryn McIntosh-Watt
        Chris Gillion

Tax treatment of the software development sector (2020-005-P)

The purpose of this memo is to respond to your request for a note on a survey being run by NZTech. We understand that this survey was raised in a conversation with TGC. This memo provides relevant context and further details about the survey.

Background

OCTC (now TCO) released an issues paper, **IRRUIP10**, in 2016 that proposed a capitalisation and depreciation treatment for software development expenditure. This conflicts with the trading stock treatment endorsed in a 1993 TIB item. As a result, there is uncertainty and inconsistency with regard to how software development expenditure should be treated for tax purposes.

The project

A policy project commenced on the software development sector, in part because of inconsistent tax treatment within the software sector and in part because of strong opposition by the software sector to TCO's proposed change to the treatment of expenditure.

The first stage of this project, the "discovery" stage, is to seek to understand the business processes and risks within the software sector. This knowledge will support the second stage of the project, the "options analysis" stage, which is to identify the preferred tax treatment of software expenditure.

Project update

Since November 2020, we have been consulting with Government agencies, tax practitioners and software businesses to understand the nature of the sector (the "discovery" phase). Once we conclude these initial discussions with the sector, we will consider appropriate tax settings for the sector and engage in consultation targeted at determining what those settings should be.

The survey

As part of our consultation to date, we have engaged with NZTech's s 9(2)(a) .
NZTech is an industry body within the software sector with more than 1000 members.

NZTech designed and launched a survey titled "**Tax Accounting Treatment for Software Development**".[1] The survey is an NZTech initiative and was published on NZTech's website on 18 February 2021. The purpose of this survey is to gather feedback from members of NZTech on practices and attitudes of businesses involved in software development. The survey is NZTech's initiative and was not requested by PaRS. We were informed of it before it was launched. The questions asked in the survey are contained in **Appendix 1**.

The survey's landing page notes that "the results will be used to produce industry facts to support the development of a tax policy that benefits the majority of software companies". This is contrary to the language we have been using in our consultation to date, which has not been about benefitting the software sector. We have been consistent in saying that we are beginning the project from a stance of tax neutrality and we have no pre-conceived ideas about what changes we may recommend to the tax treatment of the sector. One of the project's core objectives is to provide more certainty for the sector.

Attached to this memo in **Appendix 2** are preliminary insights from the survey as of 19 February 2021. NZTech has noted that the full results will be sent through soon. The survey is now closed.

If you have any further questions, please get in touch with any of us.

Craig Phillips
Principal Policy Advisor

Benjamin Hammond
Policy Advisor

David Cuellar
Policy Advisor

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[1] The survey landing page can be found here.

Appendix 1: NZTech Submission Survey – Tax Accounting Treatment for Software Development

Screening question: Do you develop software for use in a business?
a. Yes
b. No

If = yes: continue
If = no: This survey is only for companies that develop software for use in a business. Thank you for taking the time to consider this survey, please keep an eye out for other NZTech survey's in the future.

1. Do income tax implications for developing software for use in a business pose a significant issue for your business?
a. Yes
b. No

2. What accounting treatment is predominantly used when developing software for use in a business?
a. Expensing
b. Capitalisation
c. Comments (comment box)

3. Are existing rules on the accounting treatment of developing software for use in a business adequate or inadequate and why?
a. Adequate
b. Inadequate
c. Comments (comment box)

4. In your experience, are there other countries that have a superior accounting treatment of developing software for use in a business than New Zealand?
a. Yes
b. No
c. Unsure
d. Comments (comment box)

5. How is the development of software for use in a business primarily funded?
a. From revenue
b. From business units
c. From equity
d. Comments (comment box)

6. What best describes your development software for use in a business?
a. Standalone
b. Software as a service
c. Cloud-based
d. Applications
e. Other (comment box)

7. Which percentage represents the contribution to business revenue of developing software for use in a business?
a. 1-10%
b. 11-20%
c. 21-30%
d. 31-40%
e. 41-50%
f. 51-60%
g. 61-70%
h. 71-80%

i.   81-90%
j.   91-100%

8. How many staff and/or contractors today, are engaged developing software for use in a business (full-time equivalent basis)?
a.   1-9
b.   10-19
c.   20-29
d.   30-49
e.   50-99
f.   100+

9. What has been average expenditure developing software for use in a business over the past three financial years (or most recent financial year if less than three)
a. $100,000-$500,000
b. $501,000-$1,000,000
c. $1,000,000-$2,500,000
d. $2,500,001-$5,000,000
e. $5,000,000+

10. What would improve the taxation treatment of developing software for use in a business?
a.   Comment box

Appendix 2: Initial insights from early NZTech survey results (verbatim comments of
s 9(2)(a) **NZTech)**

- 78% think there are issues with tax treatment of software development
- 70% expense and 30% capitalise, but in the comments about 10 said they use a mix, so we have added that as a new option.
- Pretty much no one thinks any other country is doing this better. Most are unsure.
- 64% fund software development from revenue, 29% from equity and 7% from other business units.
- 46% are developing SAAS solutions, 29% custom applications, 18% cloud solutions, 7% standalone software.
- The revenues from the software development as a proportion of all revenues is spread, but it was 100% for 30% of respondents.
- Most respondents have less than 20 software developers, but 3 had over 100.
- Most were spending up to $500K on development, with 5 spending over $5m a year.

Full results still to come.

From:	David Cuellar
To:	Thomas Allen
Cc:	Craig Phillips; Benjamin Hammond; Chris Gillion
Subject:	Tax treatment of the software sector
Date:	Monday, 15 March 2021 11:53:00 AM
Attachments:	image003.png

Hi Thomas,

This is a quick email to let you know about a piece of work that we are in the early stages of in relation to software development. It is a review of the treatment of income and expenditure within the software sector that was approved by PPAC in June 2020. The industry is complex, and regulators (including for the tax system) often struggle to keep up with how the software sector develops. Our project will consider what are the appropriate tax settings for the sector. Some of the issues we are looking at include different variations of commercial exploitation (assignment of rights, licencing, leasing, etc.), major subsectors (AgriTech, HealthTech, game development, etc.), and what are repairs and maintenance versus capital improvements of software. We are particularly interested in understanding the reasons (if there are any) for why the software industry is different from other industries in a way that would justify having industry-specific tax rules.

We are emailing because we anticipate there is a chance you or the Minister may hear about our review from interested stakeholders, but we are not planning to report to the Minister on it for a while since we are still in the early stages of the project. Currently, we are talking to stakeholders within the industry to understand business models within the sector; NZTech has launched a survey to get some data that they have offered to share with us. Our next stage of consultation will then move onto developing options for any potential changes and testing those with the sector and tax practitioners.

Let us know if you have any questions or require more details.

Cheers,
David

David Cuellar | *Policy Advisor* | Kaitohutohu Kaupapa
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![Inland Revenue Te Tari Taake logo]

Consultation – Software development

Date: 16 March 2021

Subject: Software development expenditure with CA ANZ – Technical Advisory Group

Attendees: s 9(2)(a)

(CA ANZ - TAG), Craig Phillips, David Cuellar, Ben Hammond, Sam Rowe (Inland Revenue).

Consultation letter provided prior to the meeting:
Software Development consultation_Business Stakeholders

1. ***Introduction and project background – Craig***
2. ***Open question – Craig***

3. ***Consistency with accounting***

- R&D expenditure. The continuation of the deduction rules in DB 33-40B work well.
- It generally follows accounting principles, see IAS 38 Intangible Assets.
- The difference between sale and license should be contemplated within the rules.
    o The rules currently appear to favour the seller not the retainer.
- In 2016, a business I was advising was making changes on the fly and we found it difficult to know what to do.
- The Depreciation rate seems appropriate from what I know of it.

4. ***Is Software different?***

- When developing when does the business start expensing vs capitalising.
- It is simply a capital vs expenditure question, and although difficult is not exclusive to software.
    o When is an asset generated?
    o There are different phases of software development.
    o We don't want a situation where everything just defaults to capitalisation.
    o Its similar to the retirement home business you need to make judgement calls, on what planning and construction costs are expensed vs capitalised.
- There is a slight difference between when software is created than other assets.
    o This is because there is a practical overlay, around the question of when is the software 'available for use'.
- There could be an argument that the sector should be treated different. You build the asset and have to continuously add to and develop and maintain it.
- Capitalisation is probably the correct outcome.
- Members disagreed about whether software was inherently different or similar to businesses that develop tangible assets.
- A commercial building example was used.
    o Maintenance of a building could be ripping out tilling or walls, those things are now gone. With software maintenance is different.
- Some agreement that at the early stage there might be more of a case to depreciate until the asset is available for use but this is difficult to apply.

5. *Abandoning/blackhole*

- There is always concerns here.
- If you have partial completed the software for commercial exploitation, then you use EE50.
- It is always fact specific.
- DB40B means that abandoned items should be covered.

6. *Sales of outright code*

- Is not the norm
- If this happens the purchaser will just purchase the whole company and not specific assets.
- This is not their usual business. From experience, one business I advised did sell and treated the software like it was trading stock, and therefore would be on revenue account.
- Other members of the group confirmed it is quite rare.

File note

Date: 18 March 2021

Subject: Results from NZ Tech Alliance Survey – Tax Accounting Treatment for Software Development – March 2021

Background

1. NZTech is assisting the Inland Revenue consultation phase by undertaking a survey across a broad range of member organisations that engage in software development. The survey, ran in March 2021, had 60 responses. The sample size can only be treated as indicative and not statistically significant.

2. The survey was to support understanding of the different software development business models and the resulting different approaches to tax.

Results and key takeaways

Demographics – responders were primarily small-medium enterprises in the business of software development (mainly in the SAAS subsector), who used revenue to fund software development.

1. The majority (71%) of respondents could be regarded as small software development businesses with less than 20 staff engaged in developing software on a daily basis. However, 15% of more respondents have more than 50 staff developing software on daily basis. About half of respondents develop SAAS products.

2. 59% of respondents reported that the majority (>60%) of there revenue was sourced from developing software. The majority (72%) reported average annual expenditure of less than $2.5 million.

3. The majority (65%) of respondents' fund development of software through revenue, with about a quarter (28%) funding expenses through equity.

Accounting rules - Responders primarily expensed software for accounting purposes but felt the rules were inadequate.

4. Nearly two-thirds (62%) of respondents are expensing software development for accounting purposes. Common responses to the accounting treatment question, included:
   a. Depended upon the nature of the project.
   b. Software development costs are expensed due to uncertainty of the outcome.
   c. We expense to align with R&D cash out, RDTI and Callaghan reporting.
   d. We capitalised in the past and now have that asset on our balance sheet and it doesn't feel correct.

5. The majority of respondents (68%) found the existing accounting rules for developing software as inadequate. Common answers to why, included:
   a. Current rules are heavily focused on the traditional fixed asset-reach or service-based technology businesses, but poorly address agile process or current trends.

b. Software by its very nature is a continuously evolving product. Hence it is hard to define completion of a product.
c. The don't cover the wide range of software activities taking place in NZ. It seems to me the IRD doesn't understand the sector and what is involved in software.
d. Typical approach with US companies is to capitalise, and so the fact we expense everything always raises questions with potential investors or acquirers.

Tax rules – Responders signalled that tax poses a significant issue for the business and thought better access to tax credits would help improve the tax treatment of software.

1. *The majority of respondents (75%) confirmed that income tax implications posed a significant issue for their business.*

2. Respondents though the following could help improve the taxation treatment of developing software for use in a business:

   a. Improved ability to classify software development as R&D for RDTI.
   b. All expenditure able to be deductible immediately.
   c. Reduce blackhole expenditure risk.
   d. Clear understanding of the rules and how we can leverage incentives to grow this sector.
   e. Existing rules are fit for purpose. Alignment of tax and accounting is critical.
   f. The switch from Growth Grant to RDTI does not work for loss making software businesses. We rely on the cashflow to help co-fund R&D.

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File note

Date: 26 March 2021

Author: Craig Phillips

Subject: Accounting Treatment of Software Development under GAAP

Purpose of this note

This note provides background from accountancy practices that could be helpful for resolving the policy issue in the software development project around the lack of statutory of clarity on how to account for development costs for tax purposes. The note is divided into 4 parts:

- PART 1: Why the timing of cost recognition is important for the sector.
- PART 2: An outline of the financial accounting reporting framework mandated by the External Reporting Board (this has the status of secondary legislation) [NZ Conceptual Framework].
- PART 3: An outline of the financial statement requirements [NZ IAS 1]. This part of the note also outlines:
  - core terms (and their meanings) used in accounting standards; and
  - tax minimum reporting requirements.
- An overview of the elements of XRB standards that could be relevant to our policy analysis:
  - NZ IAS 38 Intangible Assets
  - IFRS 15 Revenue from contracts
  - IFRS 16 Leases

Recent law changes in the ARFER bill (feasibility, IFRS 16, purchase price allocation) may have relevance to our policy analysis, but this note does not include a discussion on those items.

For completeness, I attach an appendix comparing the application of NZ IAS to software costs incurred for developing intangible property to the outcomes set out in IS 17/04 and IRRUIP 10

Part 1: Recognising Costs for Accounting Purposes: Research Stage & Development Stage

Why does recognition of costs matter to investors?

Submissions to IRUIPP-13 identified that both high-tech start-ups and new projects generally devote a significant amount of their time and money into software development.

The accounting and tax treatment of these costs likely have a huge impact on both the current and future financial performance of the entity. There are a few things that need to be understood prior to diving into how the accounting rules for NZ IAS 38 might be thought of as a conceptual resource for tax policy frameworks.

Part 2: NZ's Financial Reporting framework

Various enactments prescribe specific types of preparers of general-purpose financial reports (GBFR) (e.g. Financial Reporting Act, Charities Act, Incorporated Societies Act. These preparers may be required to comply with reporting standards set by the External Reporting Board (XRB).

The XRB standards are developed using the principles set out in the NZ Conceptual Framework (issued by the XRB, 2018) and modified from time to time.

NZ Conceptual Framework

The NZ Conceptual Framework (NZCF) sets out the objectives of GPFR and some definitions that are important to understand each of the standards.

The main objective for GPFR is about providing financial information (about the reporting entity) that is useful for investors (existing and potential), lenders and other creditor in making decisions relating to providing resources to the entity.

IR as a creditor does not seem to fall within this concept. This is clearly set out in para 1.10 of NZCF where regulators stated as not being a primary user of GPFR. However, as tax is a major cost to the company, it is recognised with its own reporting standard.

At para 1.12 the framework identifies that GPFR provides information about the reporting entity's economic resources and claims against the entity, the effects of transactions and other events that change economic resources and claims, based on the accrual accounting concept. As such the nature of GPFR may have relevance to our BBLR tax base, as our tax system seeks to tax the economic outcomes of transactions subject to considerations related to the government objectives as to appropriate timing of income and expenditure.

Tax outcomes may differ from accounting constructs as to timing, in particular the treatment as expenditures as a capital or a period cost and also generally does not take account of economic impacts not having a transaction effect (exceptions exist, including impairment of trading stock and impairment & revaluation of lease asset values – recent IFRS 16 provisions).

Qualitative characteristics of transactional effects for GPFR – likely also relevant for tax policy settings

- Relevance e.g. nature (research or development), nexus for deductions
- Materiality e.g. relevant in IS 12/01 R&M statement
- Faithful representation: complete, neutral and error free but does not mean error free e.g. the different scales of offence in the penalties' regime is largely based on this principle
- Comparability e.g.(year-by-year trends), verifiability e.g. record storage rules, IR audit, timeliness (e.g. annual return of income enables forecasting of revenue information), and understandability (e.g. foreign exchange conversion rules, language requirements) are also central factors to the concept of integrity of the tax system.

GPFR identifies and values: assets, liabilities, equity, income and expenses and also provides non-financial information on assets labilities don't meet recognition criteria (e.g. future events having potential effect on current value of net assets e.g. effects of pandemic on a health insurer).

Key definitions of GPFR elements

Asset: a present economic resource controlled by the entity because of past events. An economic resource is a right that has the potential to produce economic benefits.

This principle is probably relevant to BBLR tax settings in determining when an asset is created (see paras 4.3 to 4.25 of the NZ Accounting Framework)

Liability: a present obligation to transfer an economic resource because of a past event.

(e.g. a right to receive contractual cash flows or produces cash flows related to a resource implies an asset exists for the entity.

This principle is relevant to BBLR as it has a high relevance to determine timing of deductions – i.e. when an expenditure is incurred (whether capital or revenue)

Executory contracts combined right and obligations to transfer economic resources A contract, or a portion of a contract, that is equally unperformed—neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent..

Contractual rights - Need also to consider the impact of FA leasing rules and IFRS 16 for leased software.

Income : an increase in assets or decrease in liability that results in an increase in equity (other than equity transactions)

Expense: a decrease in assets or decrease in liability that results in an increase in equity (other than equity transactions)

Potential to produce economic benefit: Does not require certainty, or likelihood – however the right (to own/control the resource) must already exist (e.g. trademark, ownership) i.e. until the right exists, there is no potential to produce economic benefit. [1]

A potential to produce economic benefits arises from:
- Receipt of contractual cash flows
- Exchange of economic resources on favourable terms
- Receipt of cash or other resources by disposing of the resource
- Extinguishing liabilities by transferring the resource (e.g. distributing the asset to settle a liability); or
- Receiving cash outflows or avoiding cash outflows by using the resource to either:
  - produce goods or services (e.g. cloud services); or
  - enhance the value of another resource (e.g. using data to produce reports); or
  - leasing (licensing?) the resource to another party.

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[1] – this might be a cornerstone of any legislative change around capitalising software – it doesn't answer the question of what the tax value of that right should be – I will go to NZ IAS 38 to explore this question.

Part 3: XRB A1 – Application of the Accounting Standards Framework

Entities having public accountability (defined in XRB A1: Application of the Accounting Standards Framework) must comply with generally accepted accounting practice (GAAP). In this context public accountability arises because the entity either has:

- debt or equity instruments traded in a public market; or
- holds assets in a fiduciary capacity (e.g. banks, credit unions, insurance companies, securities brokers etc)
- Smaller reporting entities are subject reduced disclosure requirements for compliance cost reasons. These RDRs are identified in the relevant NZ IAS standard.

- However, most small, and medium sized for-profit entities do not have public accountability and, consequentially, have no obligation to prepare financial statements that comply with GAAP. Companies not required to comply with GAAP are required under the TAA to file annual financial statements that meet statutory minimum financial reporting requirements (ss. 21B and 21C, and related regulations)[2].

Public benefit entities and not-for profit entities having intangible assets may be required to prepare financial statements under the public entity standards which do not require full compliance with GAAP (e.g. NZ Automobile Association). However, entities may optionally elect financial reports in accordance with GAAP.

For-profit entities are required to comply with NZ IAS as follows:

- **Tier 1 entity**: has public accountability (e.g. listed on NZX) or is a large for-profit public sector entity with total expenses > $30million.
- **Tier 2 entity** has no public accountability and is not a large for-profit public sector entity with total expenses ≤$30million **and elects** to be in Tier 2.

Public benefit entities (for not-for-profit & public sector) are required to comply with the Public benefit entity standards as follow

- **Tier 1 entity** has public accountability or is a large PBE with total expenses greater than $30million.

- **Tier 2 entity**, has no public accountability, is not large, has total expenses less than $30million but greater than $2million, and that **elects** to be in Tier 2 follows the PBE Standards Reduced Disclosure Regime.

- **Tier 3 entity** has no public accountability and has total expenses less than $2million that **elects** to be in Tier 3, follows the PBE Simple Format Reporting Standard.

- **Tier 4 entity** has no public accountability and is allowed by law to use cash accounting, and elects to be in Tier 4.

Accounting requirements under NZ IAS 1

Tier 1 (compulsory) and Tier 2 (by election) for-profits must comply a range of accounting standards, as to the types of financial statements e.g. they must produce a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity and a statement of cash flows: NZ IAS, NZ IAS 2, NZ IAS 7, NZ IAS 8, NZ IAS 27.

There are many standards that apply to specific elements of a balance sheet or income statement. Some are likely to have relevance to policy analysis within the software project as they provide an understanding how accountants think about the economics involved.

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[2] Tax Administration (Financial Statements) Order 2014, and also for trusts under section 59 of the TAA and the Tax Administration (Financial Statements—Foreign Trusts) Order 2017, and new trust reporting requirements for trusts (sections 59BA and 59AB of TAA).

Standards that apply to **Intangible assets and associated revenue flows** –are NZ IAS 38 (intangible assets), NZ IFRS 15 (revenue from contracts), NZ IFRS 16 (leases – lessor and lessee)

Statutory accounting requirements (tax laws)

Note there are minimum financial statement requirements for a company (also applies to look through companies) in the TAA under subpart 3AC – ss 21B, 21C, and the

Small companies (including incorporated societies & small look-through companies) are exempt from the minimum financial statement requirements (income < =< 30,000 and not in tax loss and not part of a group of companies. However, if another enactment prescribes minimum requirements then the other act must be complied with e.g. Charities Act requirements, large company Part 11 of Companies Act.

Minimum statutory accounting requirements (Tax laws)
- Balance sheet (A – L = OE) and P&L.
- Must use double-entry & accrual accounting and comply with certain valuation rules. Reconciliation of accounting income to taxable income, fixed asset schedule (tax values), and certain associated persons transactions.

Part 4: Standards relevant to software development costs

NZ IAS 38: Intangible assets

This part of the note provides an overview of NZ IAS 38 and comments how it could be used a resource in considering appropriate policy settings for the software development sector. as to how it could relate to our software project.

Objective of NZ IAS 38: prescribe when to recognise and how to measure the value of intangible assets not otherwise dealt with specifically in another standard (e.g. NZ IAS 32, intangibles held for sale in ordinary course of business (inventory).

IAS 38 doesn't apply to: Software that is integral to the operation of hardware – that is part of the hardware, e.g. the operating system of a laptop is part of the laptop asset.

Software development costs for internally created software

Under NZ IAS 38, the accounting treatment of software costs for internally created intangible asset is the same whether the software asset is created to be used by the entity or created for commercial exploitation.[3] The only issue is whether the recognition criteria can be satisfied (future economic benefits[4] from an existing right and reliability of cost measurement satisfied).

Under NZ IAS 138 – Intangible Assets, software costs are either[5]:
* Capitalised to an asset, with the asset value being based on the costs[6] ; or
* Expensed in the year in which they are incurred (research costs).

The accounting treatment of software costs depend on whether to whether they are either:
* costs of research
* costs of development; or development costs; or
* occur within either a research phase or a development phase; and

NB if the research phase cannot be distinguished from the development phase, the expenditure is treated as research expenditure (para 53).

Definitions and some more detailed comment

Definition of intangible asset: an identifiable non-monetary asset without physical substance (see earlier for definition of "asset").

Recognition of a "thing" as an intangible asset is the same as for assets generally under GAAP. There are 3 **requirements** (typically, these are the same things that are considered when an asset is recognised for taxation purposes):
* identifiability and
* control over a resource; and
* the existence of future economic benefits i.e. the economic benefits must exist and be able to be accessed (assuming the software is not acquired in a takeover/merger).

Identifiability requires:
* the ability to either dispose of or exchange the software in any manner (sale/assignment/other disposal); or
* contractual or legal rights relating to the software (e.g. acquired/ licensed)

Control requires:
* The "owner" to have the power to obtain the future economic benefits;
* Generally, requires existence of enforceable legal rights (e.g. copyright, trademarks) , but may have this control through other means.

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[3] This raises the issue as to whether IS 17/04 and our work should be aligned – this has an impact for TOC
[4] Future economic benefits can be either receiving cash outflows or avoiding cash outflows by using the resource to either:
    o   produce goods or services (e.g. cloud services); or
    o   enhance the value of another resource (e.g. using data to produce reports to meet regulatory oversight requirements); or
    o   lease (license?) the resource to another party.
[5] Paragraphs 52 to 67
[6] This treatment depends on identifying the existence of a present right to future economic benefit to the entity and their reliable measure

Future economic benefits include:
- revenue from the sale of products or services,
- cost savings, or
- other benefits resulting from the use of the asset by the entity (e.g. software that reduces production costs).

Key requirements for recognition of an intangible asset – [7]
- probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

An intangible asset is normally **measured** using historic cost principles.[8] Historic cost is the basis of for measuring an expense or a revenue in the tax system.

Accounting treatments differ for an intangible asset: [9]''

The Standard sets out recognition and measurement criteria for the software development expenses as they relate to a stated "characteristic" of how the asset has become "owned":
- acquired (unique items)
- acquired in a business combination
- acquired by way of a government grant
- exchanges of intangible assets
- internally generated intangible assets (same treatment applies whether used internally or commercially exploited)[10].

For each of the above "classes", recognition of an asset on a balance sheet can only occur if the recognition requirements are satisfied.

Whatever outcomes we arrive at for policy settings, we need to analyse what effects recent law changes will have:

- Check if to be subject to the recently enacted purchase price allocation rules in GC 20 and GC 21.
- Check if feasibility rules could apply or should apply or should be excluded – note especially DB 67(1) and any potential interface.
- Check effect of IFRS 16 rules for leases (recognition of asset & sale of)

Brief overview of the different "classes/characteristics" of how an asset has become owned

Separate acquisition

Usual basis is price paid and other attributable costs that relate to the acquisition. Para 27 sets out attributable costs to include, and para 28 sets out examples of directly attributable costs, and paras 29 & 30 list examples of costs not included in the carrying cost. Para 32 addresses contemplates deferred payment contracts where the cost and the inherent interest component are treated separately.

Acquired in a business combination

Fair value, if separable from aggregate assets. Fair value must be supported by evidence.

Subsequent expenditure following acquisition

Apply approach in paras 54 to 62 for both research and development expenditure, i.e.

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[7] Paras 21 – 23 of NZ IAS 38 : probability of expected future economic benefits based on reasonable and supportable assumptions that represent management's best estimate sof the set of economic conditions that will exist over the useful life of the asset. Judgement is used to determine the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence. (relevant to how most assets are recognised for tax).

[8] What is included in the historic cost of an asset is set out in paras 25 to 53, recognition of an expense of an intangible item is set out from paragraph 68. The type of costs included in the cost of an intangible asset is set out in paragraphs 54 to 67

[9] Paras 25 ff

[10] This has relevance to our work as it relates to the discrepancies between IS 17/04 and IRRUIP-10

- Research costs expensed
- Development costs expensed if do not meet recognition criteria
- Development cost capitalised if meet recognition criteria

Acquired by way of a government grant (e.g. Maori settlements)

NZ IAS 20 may apply – fair value plus costs of preparing for use e.g. software included in [11]

Exchanges of intangible assets

Fair value of exchanged assets, subject to no commercial substance exception and subject to reliable measurement criterion

Internally generated intangible assets

- Is there an identifiable asset?
- Reliably measure the cost[12] - as per paras 52 to 67 of NZ IAS 38[13]
- Cost classification required – Research/Development with only development costs capitalised

Definitions

Research: Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Research phase[14]: the period in which an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits.

Examples of research activities –
- obtaining new knowledge.
- feasibility analysis.
- search for alternatives for materials devices, products, processes, systems, or services.
- formulation of design, evaluation, and final section of possible alternatives

Development: Development is the application of research findings or other knowledge to a plan or design to produce new or substantially improved materials, devices, products, processes, systems, or services before the start of commercial production or use.

Development Phase:

The period in which the entity can demonstrate it meets **all** the stated requirements in para 57. Examples of development activities are given in para 59

If the stated requirements are not met, satisfied, the software cost is expensed

Costs of an internally generated intangible asset are set out in the standard [15]
Nb para 71 prevents reinstatement of costs previously expensed.
If an entity can't distinguish whether a cost is in the research phase or in the development phase, the costs is expensed.

Note that interest costs may be capitalised – NZ IAS 23 applies
See example 65 in NZ IAS 38.

Recognition of expense requirements

Expenditure is expensed as incurred unless:

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[11] Nb -government grants in ITA are netted off against cost of asset so only additional costs should be recognised for tax to be consistent
[12] Constant issue is distinguishing cost of running day to day operations vs cost of the internally generated asset – we will need to draw a boundary here if we adopt a capitalisation route
[13] Note the exclusions in para 67 and the example
[14] Paras 54 to 56
[15] Paras 65 to 67

- It is part of the cost of an intangible asset that meets the recognition criteria; or
- The expenditure relates to an item acquired in a business combination and can't be recognised – intangible goodwill on consolidation.

Expenditure in intangible to provide future economic benefits but no intangible asset exists - expensed

Appendix 1: Comparison of IS 17/04 (in house use) & IRRUIP-10(commercial exploitation) to NZ IAS 18 [16]

Issue	IS 17/04 Software developed internally for use in own business		
Asset recognition	Remains a matter of judgment as to when intangible property can be use and available for use – see example 5 Valuation includes direct and some indirect costs not allowed as below. Also includes installation costs and integration costs	Created for sale or exchange – treated as inventory If not created for sale or exchange but need to consider when the software is available to provide Cloud or SaaS services. – requires a decision point. Valuation includes direct and some indirect costs not allowed as below. Also includes installation costs and integration costs. Specifically refers to coding and testing costs	Recognition criteria must be met
Early stage feasibility	Deduction as incurred per IS 17/01 (a limited set) but this is likely to be modified given enactment of DB 66 & DB 67	Same as IS 17/04. Pre-decision as to development expenditure	Research expenditure expensed
Research expenses	para 20-21 DB 34 – recognised for FR purposes or an immaterial expense– deduction as incurred	As for IS 17/04, but note paras 74 & 75	Research expenditure expensed
Development expenses	Para 22 DB 34, EJ 23 deduction as incurred or electively deferred	As for IS 17/04, but note paras 74 & 75	Development expenses expensed if not related to an existing intangible asset.
Post-development maintenance	Maintenance expense deduction as incurred	As for IS 17/04	Generally same as tax
Post-development upgrade	Upgrade capitalised and depreciated	As for IS 17/04	Generally same as tax
Other post-development costs	Usually deduction as incurred	As for IS 17/04	Generally same as tax
Depreciation	All costs not deductible under feasibility rule depreciated Depreciation rate determined Depreciation when available for uses Must be listed on schedule 14 – i.e. copyright in software, right to use software, not excluded under EE 7	As for IS 17/04	Amortisation over useful life unless no useful life can be identified. Indefinite useful life – no amortisation.

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[16] Nb feasibility rules in ARFER Act not intended to apply to software development expenses ss DB 66(1B) & DB 671B ITA 07 if an intangible asset already exists – but are intended to apply to an intangible asset within an acquired company that is abandoned so that the abandonment rules don't apply? Wait for TIB /special report

Issue	IS 17/04 Software developed internally for use in own business		
Depreciation recovery income/depreciation loss on disposal	Does not apply if "same kind" intangible property replaces Outright sale (no copy retained) depreciation recovery/loss rules apply Not usable, no longer used – write off TBV (subject to exceptions listed in para 41	As for IS 17/04	Gain/loss on sale calculated – sale proceeds less carrying costs and costs of sale.
Unsuccessful software development	Accumulated costs deduction on abandonment. Suggest costs from prior years have been carried as WIP	As for IS 17/04	
Sale of a copy of developed software Original asset retained	Sale proceeds assessable Original asset retained continues to be depreciated	Sale proceeds assessable May include assignment	
Commissioned software	Same as all the above		
Finance lease	Para 44 – relevant if developer leases the software they have developed for internal use. Deemed sale and loan with interest component. Depreciation applies Lease end – retained by lessee [lessee has rollover but may be subject to tax on subsequent disposal] Lease end – returned to lessor and FA 10 apply	As for IS 17/04	IFRS 16 applies
Operating lease	Becomes a finance lease – adjustments required	As for IS 17/04	IFRS 16 applies
IFRS 16	Check new rules	Check new rules	

From:	Joshua Fowler
To:	David Cuellar; Paul Fulton
Cc:	Craig Phillips; Benjamin Hammond
Subject:	RE: Software development expenditure
Date:	Tuesday, 30 March 2021 3:51:09 PM
Attachments:	image001.png

Not in scope

Thanks David – I've removed this policy project from the s/s (or rather, noted it as "removed")

Joshua Fowler | *Policy Advisor* | Kaitohutohu Kaupapa

Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture

DDI. s 9(2)(a)

E. s 9(2)(a) @ird.govt.nz

From: David Cuellar <s 9(2)(a) @ird.govt.nz>
Sent: Tuesday, 30 March 2021 11:50 am
To: Paul Fulton <s 9(2)(a) @ird.govt.nz>; Joshua Fowler <s 9(2)(a) @ird.govt.nz>
Cc: Craig Phillips <s 9(2)(a) @ird.govt.nz>; Benjamin Hammond
<s 9(2)(a) @ird.govt.nz>
Subject: Software development expenditure

Not in scope

Hi Paul and Josh,
I'm briefly emailing to let you know that we are no longer seeking to include any amendments relating to the software development project in the 2021 omnibus bill. Let me know if you have any questions.
Cheers,
David

From:	Craig Phillips
To:	David Cuellar; Benjamin Hammond; Sam Rowe
Subject:	RE: Purchase price allocation - software-related material
Date:	Thursday, 8 April 2021 4:48:00 PM
Attachments:	image001.png

[UNCLASSIFIED]

Thanks for this.

Kind regards, have a nice day | Nga mihi, kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Aporei*
Policy and Regulatory Stewardship | *Kaupapa me te Tiaki i ngā Ture*
Inland Revenue | *Te Tari Taake*

s 9(2)(a)
Email ███████ @ird.govt.nz

From: David Cuellar <s 9(2)(a) @ird.govt.nz>
Sent: Thursday, 8 April 2021 2:38 pm
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>; Benjamin Hammond
<s 9(2)(a) @ird.govt.nz>; Sam Rowe <s 9(2)(a) @ird.govt.nz>
Subject: FW: Purchase price allocation - software-related material

[UNCLASSIFIED]

Hi all,

FYI - Thomas has helpfully extracted the software areas traversed during the legislating of the PPA rules.

Cheers,
David

From: Thomas Minot <s 9(2)(a) @ird.govt.nz>
Sent: Tuesday, 6 April 2021 5:37 PM
To: David Cuellar <s 9(2)(a) @ird.govt.nz>
Subject: Purchase price allocation - software-related material

[UNCLASSIFIED]

Hey Dave,

A while ago you asked me if I could dig up any purchase price allocation material related to software. Below are some nuggets.

From officials' issues paper

2.14   The possibility of depreciable property having a value greater than cost has increased considerably since fixed life intangible property and software became depreciable. Such   property is often self-created, which tends to produce a very low cost-base due to a failure to accurately capitalise expenditure. However, it can have a

very high value. The asymmetry between the vendor's treatment (on capital account, to the extent it exceeds cost) and the purchaser's (depreciable, sometimes over a relatively short period) means that the parties may have a common interest in overstating the amount allocated to such property.

Excerpts from submissions on issues paper

Deloitte

'Concerning software, Officials should focus on reviewing and reforming the tax treatment of software more generally instead of correcting capital / revenue issues by legislating on PPA.'

'As with other integrity issues we believe that specific concerns with mixed supplies involving commercial property, software and fixed life intangible property ("FLIP") can be resolved without affecting all mixed supplies.'

'We consider that the issues paper presents a 'sledgehammer' reaction to specific concerns about the asymmetric tax treatment of transactions involving commercial property and, potentially, FLIP (most notably software).'

'Noting previous discussions we have had with Inland Revenue Officials concerning the tax treatment of software, we consider that outside of commercial property, the core problem is the tax code's archaic capital / revenue treatment of software. Instead of changing the PPA rules as they relate to software, we submit that Officials should focus on reviewing and reforming the tax treatment of software more generally. This will resolve the underlying issues that give rise to the 'common interest' issue described at [2.14].'

'Software is highlighted as an area of potential concern, due to taxpayers failing to adequately capitalise software expenditure. This is a capital / revenue issue which is quite separate to the issue of purchase price allocations. The tax treatment of software is a broader matter which should have a tax policy review applied to it (including provisions overriding the capital limitation) if Officials consider the current policy framework is incorrect.'

Corporate Taxpayers Group

'The issues paper raises a base maintenance concern about software at paragraph 2.14.

The Group acknowledges that there is a concern in some parts of the Inland Revenue about software and the Group is aware of protracted disputes being undertaken in this space with a number of taxpayers. However, the Group does not consider that it is appropriate to pursue a law change for all business sales as a consequence of a few disputes focused around software.

In particular, a change to law around purchase price allocations would not address the perceived concern that there is "a failure to accurately capitalise [software] expenditure". Whether or not expenditure should be capitalised relies on a number of factors, including the application of the general permission, the capital limitation and specific provisions overriding the capital limitation.

A business who is undertaking software development may expense a wide range of costs associated with the creation of software, and this may be permitted under financial reporting standards, in particular NZ IAS 38 (Intangible Assets). NZ IAS 38 specifies when amounts related to intangible assets should be expensed as research or development. In particular paragraph 57 of NZ IAS 38 specifies:

An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.
b) its intention to complete the intangible asset and use or sell it.
c) its ability to use or sell the intangible asset.
d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Paragraph 65 of NZ IAS 38 also specifies:

The cost of an internally generated intangible asset for the purpose of paragraph 24 is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in paragraphs 21, 22 and 57. Paragraph 71 prohibits reinstatement of expenditure previously recognised as an expense.

Section DB 34 overrides the capital limitation and specifically allows a deduction for expenditure on research or development which has been expensed in accordance with NZ IAS 38.

The Group submits that if legislative reform is to be made which applies to software that Inland Revenue first needs to undertake a full analysis of what the tax policy framework is intended to be for intangible assets, as the Income Tax Act 2007 (and its predecessors) clearly contemplate the ability to claim immediate deductions for certain software expenditure despite the capital limitation. This project should not be used as a back door way to introduce a partial capital gains tax on software assets.

If, after the policy review, it is felt that there is evidence of a "failure to adequately capitalise [software] expenditure" then Inland Revenue should look at providing guidance in the form of an interpretation statement (or similar) in relation to software expenditure as well as appropriate enforcement action to ensure that there is compliance. We see little merit in advancing law if the real issue is compliance, simply because those who do not comply with the current law are equally as likely to not comply with any new law.'

Thomas

Thomas Minot | *Policy Advisor* | Kaitohutohu Kaupapa
Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture
Inland Revenue | Te Tari Taake
s 9(2)(a)

From:	David Cuellar
To:	Emma Grigg
Cc:	Craig Phillips; Benjamin Hammond
Subject:	FW: TGC Action points
Date:	Thursday, 15 April 2021 12:11:00 PM
Attachments:	2021-03-15 - Memo - Tax treatment of the software development sector (3) docx

Hi Emma,

Responding on your action point re: software developers.

This looks like a reference to a survey that was undertaken by NZTech on their own initiative. In the preamble to the survey, NZTech stated that "the results will be used to produce industry facts to support the development of a tax policy that benefits the majority of software companies". This is not what we have been saying to the sector in our initial consultation. We have been consistent in stating that we are coming at the review from a tax neutrality perspective and to provide certainty to the sector – I think this is what you are looking for regarding "what we've said to people externally".

Please let us know if you have any more questions. I've attached a memo that has more detail on the background of the project and the survey itself.

Cheers,
David

From: Graeme Morrison <s 9(2)(a) @ird.govt.nz>
Sent: Tuesday, 13 April 2021 5:07 pm
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Cc: Sam Rowe <s 9(2)(a) @ird.govt.nz>
Subject: Fwd: TGC Action points

Hi Craig - any ideas on the question re software in Emma's email below?

Cheers
G

Graeme Morrison| Policy Lead | Kaihautū Here
Policy & Strategy | Kaupapa Here me te Rautaki
Inland Revenue | Te Tari Taake
DDI. s 9(2)(a)
E. s 9(2)(a) @ird.govt.nz

From: Emma Grigg <s 9(2)(a) @ird.govt.nz>
Sent: Tuesday, April 13, 2021 2:43 PM
To: Phil Whittington; Peter Frawley; Graeme Morrison; Stewart Donaldson
Cc: Karen McKinnon; Kerryn McIntosh-Watt; David Carrigan
Subject: FW: TGC Action points

[UNCLASSIFIED]

Hi all,

Not in scope

On software developers – Graeme are you aware of the survey response referred to and what they mean by referred to externally.

Not in scope

Thanks

Emm

Hi

Please see your action points below.

Not in scope

a.	Software Developers	Clarify what the survey mentioned in the List column entitled "what we've said to people externally" concerns.	Emma	

Not in scope

Cheers
M

Megan Tayler
EA to Michelle Redington, Chief Tax Counsel | Inland Revenue Department |
DDI: s 9(2)(a)

From: Benjamin Hammond
Sent: Thursday, 22 April 2021 5:20 PM
To: David Cuellar
Subject: RE: Software meetings + potential bill timeline

Yes good point – I was just thinking about what we should put in the summary comments and thought that their processes up to release is comparable to a standard manufacturer (waterfall type model, no MVP) but then after release you get into the difficulties regarding whether the "improvements" to the asset are capital or expenses (R&M). s 9(2)(b)(ii)

But the question of ongoing expenses is closer to the age-old capital/revenue tension - how they apply the rules are unlikely to be different from any other sector.

In might just be the small sample of businesses and groups we have heard from but there appears to be many businesses that are not comparable to a standard manufacturer s 9(2)(ba)(i) - when the asset became available it was largely complete). I wonder what type of sector we should look into to get the other side of the story where they release a MVP quite early… I guess s 9(2)(ba)(i) might be good, not because they necessarily had a short gestation period but the period before release would be dwarfed by the ongoing development period.

From: David Cuellar <s 9(2)(a) @ird.govt.nz>
Sent: Thursday, 22 April 2021 4:58 pm
To: Benjamin Hammond <s 9(2)(a) @ird.govt.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software meetings + potential bill timeline

Thanks heaps Ben. You have captured it in your detailed notes but I found the conversation about their revenue streams interesting. Given that games have to be finished before being released, it may be easier to contemplate the capital/revenue distinction for the game development sector compared to other software sectors where products become available for use much earlier.

Cheers,
David

From: Benjamin Hammond <s 9(2)(a) @ird.govt.nz>
Sent: Thursday, 22 April 2021 12:16 pm
To: David Cuellar <s 9(2)(a) @ird.govt.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software meetings + potential bill timeline

Apologies, link to notes: s 9(2)(ba)(i) note (WIP).docx

From: Benjamin Hammond
Sent: Thursday, 22 April 2021 12:15 pm
To: David Cuellar <s 9(2)(a) @ird.govt.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software meetings + potential bill timeline

Hey David, these documents look really good.

Timeline: No comment looks good.
Stakeholder summary: Framework is good, I might add a column for contact details this afternoon. Have made a few tweaks to the comments but nothing major.

Below are my notes from s 9(2)(ba)(i) .

Key takeaways:
s 9(2)(ba)(i)
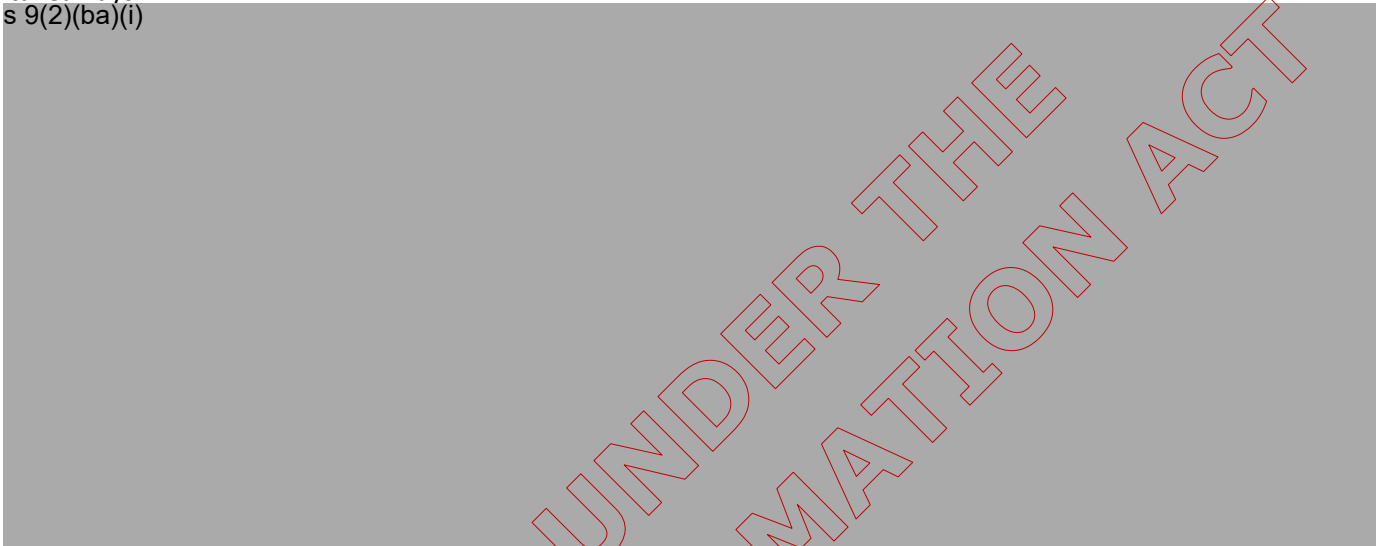
Keen for thoughts you both had.

Ben

From: David Cuellar <s 9(2)(a)   @ird.govt.nz>
Sent: Wednesday, 21 April 2021 3:31 pm
To: Craig Phillips <s 9(2)(a)   @ird.govt.nz>; Benjamin Hammond <s 9(2)(a)   @ird.govt.nz>; Sam Rowe <s 9(2)(a)   @ird.govt.nz>
Subject: Software meetings + potential bill timeline

Not in scope

Hi all,

I've created a new document to log all the meetings we are having with stakeholders – I'm struggling to keep tabs on them all mentally so hopefully this is helpful for knowing who we need to follow up with as the project progresses. Please feel free to update it as we have meetings and revise the comment boxes/insert any meetings I've missed.

I have also updated the timeline to presume that any proposals arising from this project will make the next known bill, which will be the 2022 annual rates omnibus Bill. I talked to Carl as he was involved in the bill bids for this term of Government and (apart from Budget-related bills which I assume we cannot rely on using as a vehicle for legislation) this is the next known bill for our project to go into.

Happy to discuss.

Cheers,
David

David Cuellar | *Policy Advisor* | Kaitohutohu Kaupapa
Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture

From:	Benjamin Hammond
To:	David Cuellar; Craig Phillips
Subject:	FW: Software development sector
Date:	Thursday, 22 April 2021 3:23:38 PM
Attachments:	image001.png
	ETR Software companies - Update.xlsx

Hey David and Craig,

I was speaking to Vincent the other day about the software project and he is happy to do further work extracting data for us.

I have put together a few further questions (see live document) that I am interested in knowing. Feel free to add any questions either of you had within the live document and then I will fire it off to Vincent after next week's Wednesday catchup.

Cheers,
Ben

From: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Sent: Wednesday, 14 April 2021 4:50 pm
To: Benjamin Hammond <s 9(2)(a) @ird.govt.nz>
Subject: FW: Software development sector

Here is the update Ben for 2020 data. It's a bit different than the old analysis. Happy to run with most up to date data if you like.

Vincent

From: Vincent Kleinbrod
Sent: Tuesday, 17 November 2020 5:10 pm
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software development sector

Hi Craig,

Please find attached an updated version of the analysis. I kept the previous structure:

The tab denoted 'IR4' shows ETR, taxable income, residual income tax, etc. for companies that filed an IR4 and IR10. The tab denoted 'IR3' shows ETR , taxable income and tax paid for persons that received schedular payments and persons that were self-employed. In both tabs you find two tables, one showing the data for all industries (total, including software companies) and one for persons/companies in the software industry.

As said previously, please note that the ETR for schedular payments recipients and self-employed is calculated using a different formula than for companies (the reason is that IR10 info is problematic for persons with schedular payments). Also note that the data for the 2019/20 year

is not yet complete (as taxpayers still file returns).

I am also happy to come by your place and go over the data in person after we finish of forecasting on Thursday . In case you have any questions /would like some additional info please do not hesitate to contact me.

Best,

Vincent

From: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Sent: Wednesday, 11 November 2020 11:58 am
To: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Yes please

Nga mihi, kia pai tōu rā | Kind regards, have a nice day

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

s 9(2)(a)
Email @ird.govt.nz

From: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Sent: Wednesday, 11 November 2020 11:46 AM
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: FW: Software development sector

Hi Craig,

I had a look over the excel file previously sent. The analysis stops in 2018/19 and notes that the data for the 2018/19 year is not yet complete.
I am happy to provide an update (and include companies that already filed for 20/21) if you like, please let me know.

Best,

Vincent

Not in scope

Hi Craig,

Hope you well. I believe the attached excel sheet has the information you are after. Please note the following:

The spreadsheet contains four tabs. The tab denoted 'IR4' shows ETR, taxable income, residual income tax, etc. for companies that filed an IR4 and IR10. The tab denoted 'IR3' shows ETR , taxable income and tax paid for persons that received schedular payments and persons that were self-employed. In both tabs you find two tables, one showing the data for all industries (total, including software companies) and one for persons/companies in the software industry. The tab 'IR4 names' shows you the names of the 'biggest' software companies in terms of accounting profit (A list of software companies with more than 500,000 NZD accounting profit).

The notes below the tables provide more detail where the data is from, the calculation methodology, etc. Note that the ETR for schedular payments recipients and self-employed is calculated using a different formula than for companies (the reason is that IR10 info is problematic for persons with schedular payments). Also note that the data for the 2018/19 year is not yet complete (as taxpayers still file returns).

I am also happy to come by your place and go over the data in person . In case you have any questions /would like some additional info please do not hesitate to contact me.

Best,

Vincent

Not in scope

I would like data from both because an individual is likely to be a business in this context.

Kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

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From: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Sent: Monday, 2 March 2020 1:01 PM
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Hi Craig,

Hope you well. I am currently working on your request and the following question came up:

Is data from companies (e.g. those that file an IR 4 and IR10) sufficient for your request or would you like data from companies as well as data from contractors ?

Please let me know. Thank you

Vincent

From: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Sent: Thursday, 27 February 2020 10:58 am
To: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Yes all the data by business code, by company and an aggregate list summing all the data forf all business codes (by company)

Kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*

From: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Sent: Thursday, 27 February 2020 10:37 AM
To: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Thank you Craig,

I will get onto your request now. Let me confirm one thing please, however, where I am not sure at the moment:

You would like 5 years of data for a) all companies corresponding to industry code M700xxx and J542xxx and b) for all existing companies on aggregate?

Thank you

Vincent

From: Craig Phillips <s 9(2)(a) @ird.govt.nz>
Sent: Thursday, 27 February 2020 10:16 am
To: Vincent Kleinbrod <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Thanks Vincent,

That seems to be a good coverage of the class of business activities I am interested in determining the effective tax rates.

Am I able to get for each of the most recent 5 years filed for the different sectors (business codes) and in aggregate:

- the taxable income,
- the income tax liability,
- tax credits used

- the terminal tax/refund
- the effective tax rate; and
- the quantum of available losses

And a list of the names and IR numbers of each taxpayer in each category – this will allow me to look at any published financials and judge how the tax rate relates to financial reporting results.

Thanks in anticipation

Kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

s 9(2)(a)
Email ▓▓▓▓▓@ird.govt.nz

From: Vincent Kleinbrod <s 9(2)(a) ▓▓▓@ird.govt.nz>
Sent: Thursday, 27 February 2020 10:10 AM
To: Craig Phillips <s 9(2)(a) ▓▓@ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Hi Craig,

I found a classification for website developers which might fit:

Internet website design service (M700040): This includes website development and website design consulting services.

Given that the codes fall around M700xxx and J542xxx , we could use all codes belonging to the level 4 categories are 'Computer Systems Design and Related Services' and 'Software Publishing' ? Maybe easiest to chat in person?

Thanks

Vincent

From: Craig Phillips <​s 9(2)(a)​ @ird.govt.nz>
Sent: Thursday, 27 February 2020 9:44 am
To: Vincent Kleinbrod <​s 9(2)(a)​ @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Thanks Vincent,

I am not familiar with how we classify businesses so I have two questions:

Would these categories also include website developers and developers that use/support open source technologies?

Thanks

Kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

s 9(2)(a)
Email @ird.govt.nz

From: Vincent Kleinbrod <​s 9(2)(a)​ @ird.govt.nz>
Sent: Wednesday, 26 February 2020 5:09 PM
To: Craig Phillips <​s 9(2)(a)​ @ird.govt.nz>
Cc: Sandra Watson <​s 9(2)(a)​ @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

Hi Craig,

I had a look on industry classifications for software to narrow it down and I think the following 3 categories would fit :

Development of computer software for mass production (J542005) : This includes developing and publishing non-customised (off-the-shelf) computer software. Excludes developing computer software on behalf of publishers

Development of customised computer software not elsewhere classified (M700050): This includes customised software development, database development, software testing, and computer systems design and related services not covered by any other code.

Computer Software publishing (J542010): This also includes leasing software, and developing and publishing non-customised mobile apps.

Please let me know what you think. Happy to come by to talk in person if you like.

Best,

Vincent

From: Sandra Watson <s 9(2)(a)   @ird.govt.nz>
Sent: Wednesday, 26 February 2020 3:59 pm
To: Craig Phillips <s 9(2)(a)   @ird.govt.nz>
Cc: Vincent Kleinbrod <s 9(2)(a)   @ird.govt.nz>
Subject: RE: Software development sector

Not in scope

I've got Vincent looking at this
At some point he will come to talk to you to narrow down the industry code selection (BIC code). There's a few possible categories.

Regards

Sandra

From: Craig Phillips <s 9(2)(a)   @ird.govt.nz>
Sent: Wednesday, 26 February 2020 9:05 AM
To: Sandra Watson <s 9(2)(a)   @ird.govt.nz>
Cc: Benjamin Hammond <s 9(2)(a)   @ird.govt.nz>; Chris Gillion <s 9(2)(a)   @ird.govt.nz>
Subject: Software development sector

Not in scope

Hi Sandra

I am working on a project looking at the tax treatment of software development expenses for businesses that develop software for sale or licencing.

Do we have any information that would tell me what the effective rate of tax is for this sector/group of taxpayers for the last, say, 5 years.

Timing – is it possible that your answer to the question could be given by the end of the 2nd week in March?

Thank you in anticipation

Kia pai tōu rā

Craig Phillips | Principal Policy Advisor | *Kaitohutohu Kaupapa Here*
Policy & Strategy | *Kaupapa Here me te Rautaki*
Inland Revenue | *Te Tari Taake*

s 9(2)(a)
Email ▮▮▮▮▮▮▮▮@ird.govt.nz

Schedular payments & self-employed , all industries

	Self-employed				Schedular payments			
	N	Taxable Income ($m)	Income Tax Liability ($m)	Average Tax rate (%)	N	Taxable Income ($m)	Income Tax Liability ($m)	Average Tax rate (%)
2014/15	140,292	4,340.41	1,060.59	24.44%	112,070	2,389.64	580.99	24.31%
2015/16	146,376	4,609.49	1,134.75	24.62%	114,095	2,730.35	683.59	25.04%
2016/17	151,951	4,939.43	1,222.81	24.76%	117,769	2,863.91	719.18	25.11%
2017/18	152,775	4,792.55	1,185.22	24.73%	125,997	3,249.15	828.91	25.51%
2018/19	153,652	4,867.30	1,211.57	24.89%	111,159	3,373.00	871.92	25.85%
2019/20	112,685	3,244.23	800.27	24.67%	50,502	2,116.82	567.82	26.82%

Schedular payments & self-employed from selected industries (NAICS = M7000-M7210 & J5420-J5510)

	Self-employed				Schedular payments			
	N	Taxable Income ($m)	Income Tax Liability ($m)	Average Tax rate (%)	N	Taxable Income ($m)	Income Tax Liability ($m)	Average Tax rate (%)
2014/15	4,826	328.36	89.97	27.40%	654	20.99	5.59	26.63%
2015/16	5,145	359.93	98.47	27.36%	707	23.59	6.37	27.00%
2016/17	5,449	390.85	107.54	27.51%	686	25.11	6.67	26.56%
2017/18	4,603	245.14	68.06	27.76%	2735	245.15	68.08	27.77%
2018/19	3,927	221.37	61.02	27.56%	2872	253.53	72.37	28.54%
2019/20	3,385	183.31	50.98	27.81%	2285	227.38	66.12	29.08%

17/18   many new contractors

Notes:

Taxable Income - Schedular payments for contractors (Field 12D in IR3) , self employment income for self-employed (Field 23 in IR3)
Income Tax liability for recipients of schedular payments is calculated as : (Calculated Tax on Total Income - Calcuulated Tax on sum of Total Income -Schedular Payments)
Income Tax liability for self-employed is calculated as : (Calculated Tax on Total Income - Calcuulated Tax on sum of Total Income -Self-employed Income)
N denotes the number of a) schedular payments reciepients and b) the number of persons with income derived from self-employment

Average Tax Rate (%)=Income Tax Liability ($m)/Taxable Income ($m)

ETR Comparison (All Contractors/Self-employed vs. Contractors/Self-employed in software industry)
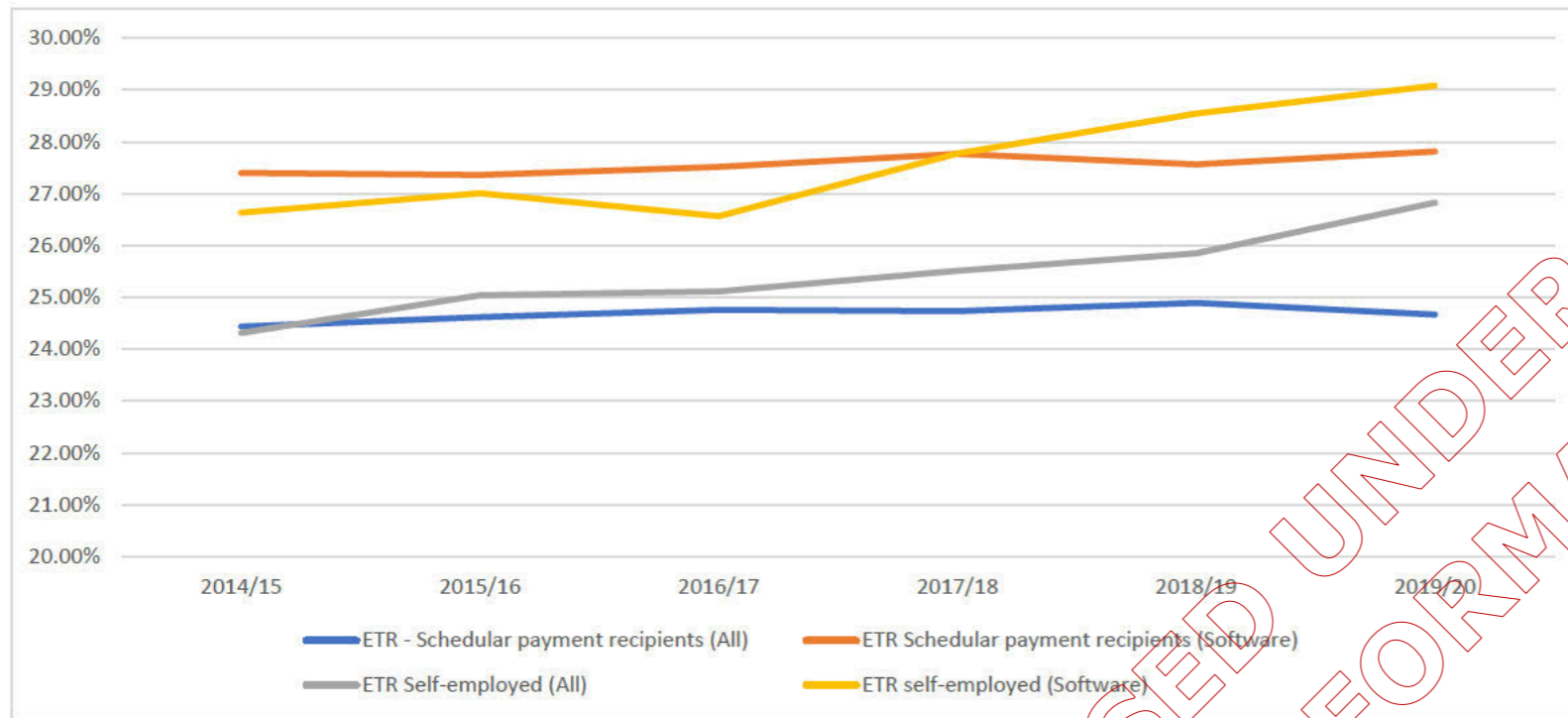
All Companies, All Industries						
	Taxable Income		Tax Credits used	Residual Income Tax	Effective Tax rate	
N	($m)	Income Tax liability ($m)	($m)	($m)	(%)	Losses claimed($m)
2014/15	151,170	16,578.90	4,646.50	467.81	4,155.68	25.47	1,539.00
2015/16	159,476	16,695.46	4,680.53	525.36	4,155.31	26.12	1,592.42
2016/17	178,485	20,517.15	5,740.44	671.57	4,919.04	26.17	2,126.19
2017/18	189,539	21,544.80	6,031.40	637.19	5,394.21	26.30	2,441.35
2018/19	194,457	22,930.29	6,445.34	756.33	5,689.01	25.41	2,390.15
2019/20	95,983	9347.42	2619.2	253.2	2365.99	25.85	702.17

Companies from selected industries (NAICS = M7000-M7210 & J5420-J5510)						
	Taxable Income		Tax Credits used	Residual Income Tax	Effective Tax rate	
N	($m)	Income Tax liability ($m)	($m)	($m)	(%)	Losses claimed($m)
2014/15	4,308	318.89	89.29	9.59	79.90	27.44	37.98
2015/16	4,491	344.02	96.38	10.47	86.24	27.25	44.46
2016/17	4,959	367.73	102.96	6.44	94.38	25.62	37.73
2017/18	5,271	403.21	112.84	13.09	101.03	27.44	38.59
2018/19	5,393	416.23	117.80	14.26	103.57	26.57	43.91
2019/20	3,155	191.5	53.785	7.928	45.857	27.42	16.61

Data sources:

Taxable Income - From IR4 (Field 28)

Income Tax liability - From IR4 (Field 29B): Based on Taxable Income (28%)

Tax Credits used - Difference between Income Tax liability and residual Income Tax

Residual Income Tax - From IR4 (Field 29J) - Tax after tax credits used

Effective Tax rate : 28*(Net profit before Tax / current year taxable profit); This is from the IR10; Net profit before tax is field 27 on IR10

Current year taxable profit is field 29 on IR10. The difference between both is due to tax adjustments (field 28 on IR10).
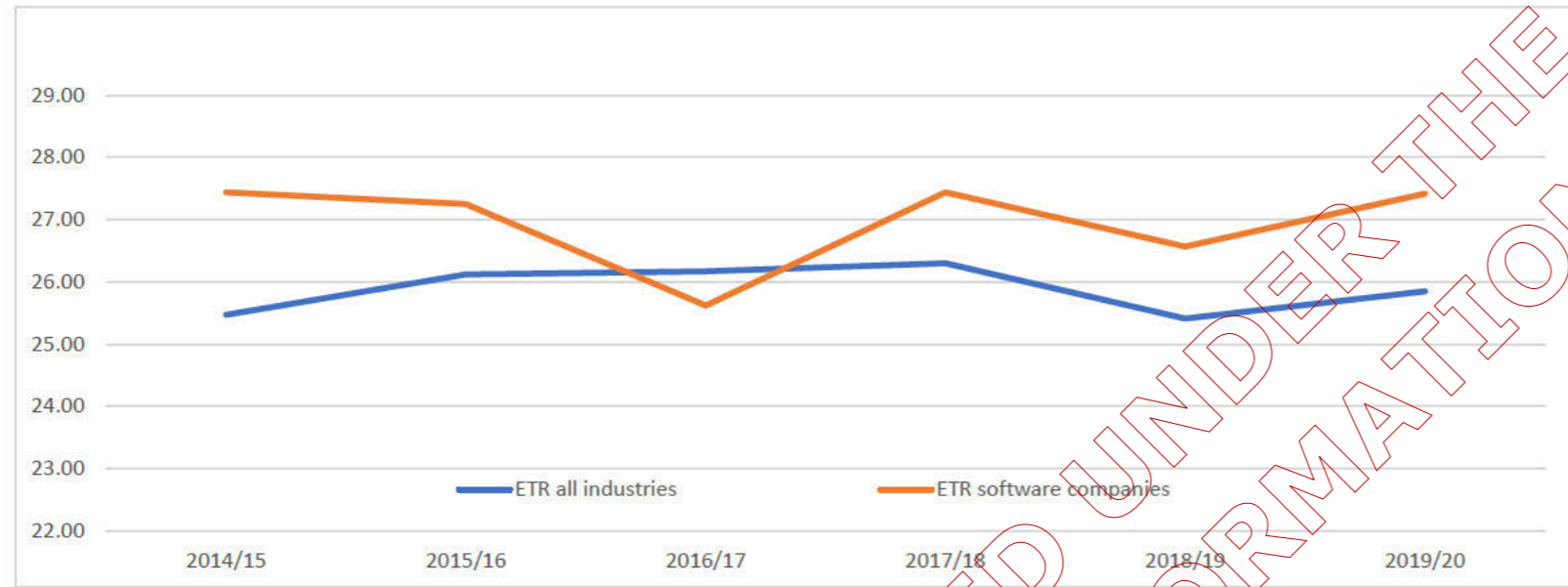
Losses claimed - From IR4 (field 25B)

Notes:

The aggregates are for companies that filed both an IR4 and an IR10 in the year

Only includes companies that had net profit b4 tax >=0 and current year taxable profit>=0

Findings:

Software industry has a higher effective tax rate than benchmark (all industries).

Effective Tax Rate - All Industries vs. Software Industry

From:	Joshua Fowler
To:	David Cuellar
Subject:	Re: Re: Projects for consultation
Date:	Thursday, 13 May 2021 4:12:26 AM
Attachments:	image002.png
	image003.png

That is excellent. Ta sir

Get Outlook for Android

From: David Cuellar <s 9(2)(a) @ird.govt.nz>
Sent: Wednesday, May 12, 2021 6:21:05 PM
To: Joshua Fowler <s 9(2)(a) @ird.govt.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>
Cc: Emma Grigg <s 9(2)(a) @ird.govt.nz>; Stewart Donaldson
<s 9(2)(a) @ird.govt.nz>
Subject: RE: Re: Projects for consultation

Not in scope

Hi Josh,

In response to the questions in relation to software development expenditure:

a. Officials are currently reviewing the tax treatment of software development
   expenditure. This is motivated by an OCTC draft issues paper that was released in
   2016 indicating a shift toward capitalisation and depreciation of software
   development expenditure (as opposed to trading stock treatment which has
   largely been applied to date). The project is intended to be a first-principles review
   to consider what the appropriate tax treatment of software development
   expenditure should be. Part of the project's aim is to provide clarity/certainty for
   software developers as there are inconsistencies in how they treat software
   expenditure for tax purposes (some expense and some depreciate the same type
   of expenditure).

b. At this stage, we have not formulated any options or recommendations, and it is
   not guaranteed that we will recommend any legislative changes (we may consider
   that any issues are better dealt with from a compliance or educational viewpoint,
   for example). To date, officials have mostly talked to industry bodies and
   individual software developers, as well as other Government agencies (MBIE,
   NZTE, CI). At the moment, we are seeking to understand software, software
   businesses, and any business/process reasons that the sector would require
   different tax rules from other sectors (if any). This is part of the first stage of
   consultation (a discovery phase), which is ongoing and expected to be completed
   within the next month. Next steps will be to consider whether any issues identified
   are best addressed by a legislative solution. We will engage in a second stage of
   consultation with the industry and tax practitioners over the second half of 2021
   to outline possible options and seek feedback, with any recommendations going to
   Ministers in early 2022.

c. This project has already been discussed with software industry bodies (e.g.

NZTech, s 9(2)(ba)(i)), some individual software developers, and briefly with tax bodies (CTG and CA ANZ). The NZLS Tax Law Committee has been notified of the project. There is no issue with this project being released as one of the upcoming projects for consultation, though I have noted that consultation is targeted so we are not expecting a consultation document to go on the Tax Policy website (consultation on options will occur via a targeted consultation letter).

d. A memo is attached regarding a survey that NZTech undertook in relation to this project. The survey landing page had already publicly indicated that IR officials are reviewing the tax treatment of software development expenditure.

Let me know if you need anything else.

Cheers,
David

David Cuellar | *Policy Advisor* | Kaitohutohu Kaupapa
Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture
Inland Revenue | Te Tari Taake
E: s 9(2)(a) @ird.govt.nz
DDI:

From: Joshua Fowler <s 9(2)(a) @ird.govt.nz>
Sent: Wednesday, 12 May 2021 5:50 pm
To: David Cuellar <s 9(2)(a) @ird.govt.nz>; Gordon Witte <s 9(2)(a) @ird.govt.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>
Cc: Emma Grigg <s 9(2)(a) @ird.govt.nz>; Stewart Donaldson <s 9(2)(a) @ird.govt.nz>
Subject: Re: Projects for consultation

Not in scope

Hi Both,

You may be aware we are working on providing external stakeholders with a list of upcoming items for consultation.

Emma has asked whether we could have some further information about the items below, for example:

a. What is the issue or problem we are seeking to address?
b. How far progressed is the work?
c. How much discussion, if any has occurred with external stakeholders to date?
d. Anything else that might be helpful or relevant in determining whether the consultation schedule should be published.

Not in scope						
4	Software development expenditure		Craig Phillips, David	Targeted	January/December 2021	

Let me know if you need anything

Best
Josh

Joshua Fowler | *Policy Advisor* | Kaitohutohu Kaupapa
Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture
DDI. s 9(2)(a)
E. s 9(2)(a) @ird.govt.nz

Good morning s 9(2)(a) ,

Weekend was largely sheltered inside, lets hope for a better Queen's Birthday.

Yes, we have had several helpful discussions with a number of tech firms and other Government agencies. Thank you again for referring us to many of the firms we have spoken to.

The consultation to date as been about understanding the software sector with a particular focus on business processes, commercialisation and product life-cycles. It was not our intention to be consulting on specific tax options, instead we were trying to understand the sector and subsequently identify if the tax rules for software development expensing were appropriate.

Throughout the consultation we have referred to the IR Ruling Unit's issues paper, that you identify below, this was as a way of introducing why we (Policy) were looking into the tax treatment of software development expenses. In short, the topic had been referred to us by our colleagues in the Rulings Unit following that draft paper. As referred to above, it was our goal to look at the tax treatment from a first-principles review – taking a step back and trying to understand the sector and whether a problem existed before thinking of whether changes were necessary (and what those changes could be).

In terms of where we are up to with the review, we are currently going through an internal refresh of our work-programme so have put further consultation on hold until this refresh is finalised. We should have a greater understanding on what this refresh means for the project in the coming weeks. We will keep you updated, alongside other stakeholders, on where this gets to.

I would like to thank you for the offer though (and your ongoing support on this project).

Warm regards,
Ben

Benjamin Hammond (he/him) | *Policy Advisor* | Kaitohutohu Kaupapa
Policy & Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture
s 9(2)(a)
E. s 9(2)(a)   @ird.govt.nz | W. taxpolicy.ird.govt.nz

To: David Cuellar <s 9(2)(a) @ird.govt.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>; Benjamin Hammond <s 9(2)(a) @ird.govt.nz>; Chris Gillion <s 9(2)(a) @ird.govt.nz>

Cc: s 9(2)(a) @techalliance.nz>; s 9(2)(a) @nztech.org.nz>

Subject: RE: Software Sector consultation

Good Morning Gents

I hope you had a relaxing weekend.

How have your conversations been going with the various tech firms? The reason I ask is that I have had some of them coming back to me very concerned that things might be tracking the wrong way. The impression they got was that IR was very focused on pushing to a capitalisation model. They referred me to the 2016 discussion paper (https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/consultations/issues-papers/irruip10.pdf). Are you still using this as the basis of your thinking or are you developing a new approach that better aligns with the reality that software development is not a vanilla exercise? If IRRUIP10 is out of date maybe we can help with the comms on any new papers or thinking.

Would it be valuable if we organised a zoom call with a broader number of tech firms where we can discuss this? We often run what we call NZTech Inform member zoom calls where I have a chat with an agency on a subject, they share their latest thinking, and then we open up for questions.

Keen to catch up to hear your latest thinking.
Best regards
s 9(2)(a)
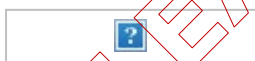
s 9(2)(a) ZTech

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From: David Cuellar <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 19 February 2021 12:11 pm
To: s 9(2)(a) @nztech.org.nz>; Craig Phillips <s 9(2)(a) @ird.govt.nz>; Benjamin Hammond <s 9(2)(a) @ird.govt.nz>; Chris Gillion <s 9(2)(a) @ird.govt.nz>
Subject: RE: Software Sector consultation

[IN CONFIDENCE RELEASE EXTERNAL]

Hi s 9(2)(a) ,

Thanks again for your time this morning and for providing this update on your survey so far. We will be in touch again soon but feel free to contact us in the meantime if you see fit.

Cheers,
David

David Cuellar | *Policy Advisor* | Kaitohutohu Kaupapa Here
Policy & Strategy | Kaupapa Here me te Rautaki
Inland Revenue | Te Tari Taake
E: s 9(2)(a)   @ird.govt.nz
DDI:

From: s 9(2)(a)   @nztech.org.nz>
Sent: Friday, 19 February 2021 11:57 AM
To: Craig Phillips <s 9(2)(a)   @ird.govt.nz>; David Cuellar <s 9(2)(a)   @ird.govt.nz>;
Benjamin Hammond <s 9(2)(a)   @ird.govt.nz>; Chris Gillion
<s 9(2)(a)   @ird.govt.nz>
Subject: RE: Software Sector consultation

Morning

It was good to be able to chat briefly this morning. I look forward to assisting where relevant as
you look into this complex issue.

In case it is useful a couple of data points from the respondents to our survey so far. While 78
have responded, only 45 have competed the full survey.

- 78% think there are issues with tax treatment of software development
- 70% expense and 30% capitalise, but in the comments about 10 said they use a mix, so we
  have added that as a new option.
- Pretty much no one thinks any other country is doing this better. Most are unsure.
- 64% fund software development from revenue, 29% from equity and 7% from other
  business units.
- 46% are developing SAAS solutions, 29% custom applications, 18% cloud solutions, 7%
  standalone software.
- The revenues from the software development as a proportion of all revenues is spread,
  but it was 100% for 30% of respondents.
- Most respondents have less than 20 software developers, but 3 had over 100.
- Most were spending up to $500K on development, with 5 spending over $5m a year.

Hope that is useful.
Will send a final version once the responses stop coming in.
Cheers
s 9(2)(a)

-----Original Appointment-----

From: Craig Phillips <s 9(2)(a)@ird.govt.nz>
Sent: Tuesday, 16 February 2021 1:29 pm
To: Craig Phillips; David Cuellar; Benjamin Hammond; Chris Gillion;
s 9(2)(a)@nztech.org.nz; WGN 8.4.60 Levy
Subject: Software Sector consultation
When: Friday, 19 February 2021 10:30 am-11:00 am (UTC+12:00) Auckland, Wellington.
Where:

As suggested by s 9(2)(a), meeting reduced to 30 minutes.

_____

—

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_____

—

From:	David Cuellar
To:	Joshua Fowler
Cc:	Craig Phillips; Benjamin Hammond; Sam Rowe; Emma Grigg
Subject:	RE: Re: Upcoming consultation
Date:	Friday, 2 July 2021 10:13:00 AM
Attachments:	image001.png

Not in scope

Hi Josh,

The software development expenditure item should be removed from this table, thanks.

Cheers,
David

From: Joshua Fowler <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 2 July 2021 10:08 am
To: PaRS All Staff <s 9(2)(a) @ird.govt.nz>
Subject: Re: Upcoming consultation

Not in scope

Hi All,

We're hoping to send out our revised schedule of upcoming consultation to external stakeholders early next week. This will be based on the **enclosed**.

Please let us know if there are any corrections or additions by COP, today.

Many thanks,

Josh

Joshua Fowler | *Policy Advisor* | Kaitohutohu Kaupapa
Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture
DDI. s 9(2)(a)
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That's fine – will take out the software item – Not in scope

Not in scope

Joshua Fowler | *Policy Advisor* | Kaitohutohu Kaupapa
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From: Sam Rowe <s 9(2)(a) @ird.govt.nz>
Sent: Friday, 2 July 2021 10:14 am
To: Joshua Fowler <s 9(2)(a) @ird.govt.nz>; David Cuellar <s 9(2)(a) @ird.govt.nz>
Subject: Re: Upcoming consultation

Hi Josh

For software we are revisiting whether to continue this project in light or other government priorities so the consultation is on hold.

Not in scope

Happy to discuss

Cheers

Sam
Get Outlook for iOS

From: Joshua Fowler <s 9(2)(a) @ird.govt.nz>
Sent: Friday, July 2, 2021 10:07:45 AM
To: PaRS All Staff <s 9(2)(a) @ird.govt.nz>
Subject: Re: Upcoming consultation

Not in scope

Hi All,

We're hoping to send out our revised schedule of upcoming consultation to external stakeholders early next week. This will be based on the **enclosed**.

Please let us know if there are any corrections or additions by COP, today.

Many thanks,

Josh

Joshua Fowler | *Policy Advisor* | Kaitohutohu Kaupapa
Policy and Regulatory Stewardship | Kaupapa me te Tiaki i ngā Ture
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SCHEDULE OF EXPECTED TAX POLICY PUBLIC CONSULTATION: MAY – DECEMBER 2021

Project title (on Work Programme Register)	Project or reference on Work Programme Register	Policy lead / contact(s)	Targeted and/or Public	If Targeted, who are likely to be consulted	Can we notify external stakeholders now? (if not, why not)	Topic	Expected Month(s) Targeted	Expected Month(s) Public	Any other comments about consultation
Software development expenditure	2020-005-P	Craig Phillips, David Cuellar, Ben Hammond	Targeted	Software development industry	Yes – most already have been notified	Reviewing the settings for the tax treatment of software development expenditure	January-December 2021		

![Inland Revenue Te Tari Taake logo]

Memorandum

Date:

To: Project Prioritisation and Allocation Committee (PPAC)
From: Ben Hammond and Craig Phillips

Software Development Expenses

Purpose of this memorandum

1. This memo:

    a. responds to PPAC's request to consider the merits of commencing a policy project to develop appropriate tax policy settings for software development expenses that results in the sale, lease or licence of IP software;

    b. outlines the issues arising if the project does not proceed; and

    c. recommends that PPAC approves the commencement of this project (the relevant policy commissioning documents have been previously submitted to PPAC).

2. In support of the recommendation to initiate a full policy project on the tax treatment of software development expenses, this memo:

    a. recaps the policy problem referred to PAS by the Tax Counsel Office (TCO) following its release of of a proposed treatment for software development expenses under the current law (*IRRUIP 10: Income tax treatment of software development expenditure (IRRUIP 10)*);

    b. raises concerns that delaying policy action would be undesirable including issues identified by both our Tax Counsel Office and submitters in response to the propose treatment set out in IRRUIP 10; and

    c. summarises and comments on key policy issues raised by submitters in response to the proposed treatment set out in IRRUIP 10).

Background

3. In July 2016, the TCO released a draft interpretation statement IRRUIP 10 for external consultation. IRRUIP 10 was released as part of a review of an IR practice (published in TIB Vol 4, No 10 – May 1993) that that the trading stock rules should apply to software development expenditure that results in a sale, lease or licence of that software.

4. IRRUIP 10 suggested the current treatment may not be correct in most cases and suggested the expenditure should be treated as the cost of producing a depreciable asset, not trading stock.

5. Several submissions were received on IRRUIP 10, mostly adverse to the suggested capitalisation and depreciation proposal.

6. Consequently, the TCO did not progress the suggested treatment and instead referred the matter to PAS to consider fully.
7. The project was then considered for the Tax Policy work programme; a project to consider the treatment of software development expenses incurred in developing software for sale, lease or licence.
8. PPAC initially considered, at its 26 September 2019 meeting, a policy commissioning document titled "Deductibility of Software development expenditure (11 February 2019)."
9. After its October meeting, PPAC requested that research be undertaken on the risks arising from further delaying this policy project This memo responds to that request.

Delaying policy action

10. Delaying policy action would result in three major consequences, which are outlined below;
    a. Continued mistreatment of software development expenses continues;
    b. Continued uncertainty for software businesses;
    c. Continued non-recovery of previously deducted costs on a sale or assignment of copyright in software; and
    d. Potential ramifications if Inland Revenue change their treatment without considering policy considerations.

Continued mistreatment of software development expenses

11. As identified within IRRUIP 10 there are key practical issues with existing law. In summary these are:
    a. Inland Revenue's considers its long-standing practice for treating as trading stock software development expenses incurred to develop software for sale, lease or licence to be **outdated and inappropriate** for some forms of software business operations; and
    b. current practice appears inconsistent with the Income Tax Act 2007, that generally would require software development expenditure to be **capitalised and depreciated**.
12. These issues can be expanded, as follows:
    a. Uncertainty about what costs should be included in the tax cost base of the asset due to the changing nature of development processes in the software sector.
    b. Uncertainty about when the software asset should be recognised.
    c. Tension between the depreciation rules and deductibility under section DB 34 for certain research and development expenses.
    d. The relationship of recently enacted R&D tax credit rules (R&D tax credits) and possible further changes (R&D tax losses) to the depreciation rules. The question of feasibility expenditure also needs to be addressed.[1]
    e. Depreciation rates for software in New Zealand differ from those applying in our major trading partners, without clear reported justification.

Continued uncertainty for businesses

13. Although submitters, in general, agreed that the trading stock approach is inappropriate and that the depreciable asset approach is correct (in principle), they raised concerns on what impact the depreciable asset approach would have on the software market.[2]
14. Submitters suggested the proposed depreciable asset approach would have "severe", "very damaging", "massive" and "disastrous" consequences on the software market in New Zealand. Submitters said it would "undermine the growing [software] industry" or be "stifling to innovation efforts".

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[1] IRRUIP 10 precedes these changes and does not address these changes.

15. Failure for Inland Revenue (especially Policy) to fully consider the effects of shifting to the proposed depreciable asset approach would be inconsistent with our responsibilities as regulatory stewards of the tax system.

16. Furthermore, an interpretation that negatively impacts the software market in New Zealand would be inconsistent with the Government's priority, as recognised within their 2019 Economic Plan, to build a productive, sustainable, and inclusive economy. Software can be a key driver in shifting to "investing in new technology and being at the forefront of digital innovation".[3]

    a. Continued non-recovery of previously deducted costs on a sale or assignment of copyright in software; and

Continued non-recovery of previously deducted costs on a sale or assignment of copyright in software; and

17. The trading stock approach allows deductibility of development costs of software on the "as incurred" basis. This arises because the value of any work-in-progress at year end is nil and so no costs are carried forward from year to year as normally occurs under the trading stock principles.

18. As a result, on sale or assignment of the copyright in software, the proceeds are entirely untaxed because the copyright sold or assigned is a capital asset and there are no provisions that would recover the capital costs of developing the software.

Agile policy within an increasingly agile market

19. The development of software has changed rapidly over time, shifting from a traditional "waterfall" model to an agile "incremental" model. Submitters agreed that the incremental development business model is now commonplace in the industry. The incremental model has no clear beginning, middle and end.:

Potential ramifications if policy work is delayed

20. On the other hand, the depreciation model proposed is based on the increasingly outdated waterfall or linear model for developing software. Illustrated by TSL within Example 1.

21. Modern non-linear approaches to the software development life cycle (SLDC), often termed "agile methodologies", may result in the developed software never being a "finished" product as improvements are constantly being made based on customer feedback, see ZSL within example 1. Examples of this non-linear incremental approach, include:

    a. Software apps distributed through the google play store/apple store
    b. Adobe Photoshop and other creative cloud products; and
    c. MS Office 365.

22. One can consider the number of versions, updates and annual subscriptions when considering how widespread and popular incremental development models are. The incremental development models go hand-in-hand with the recent boom in "subscription business models". Where consumers receive products or services on a recurring basis often for an annual fee. According to consultancy company McKinsey, the subscription e-commerce market has grown by more than 100 percent a year over the past five years.[4]

23. Adopting the depreciation model, for businesses using the agile methodologies or the waterfall methodologies, would:

24. have an adverse cash flow impact on the software development industry; and

    a. consequently, have an adverse effect on innovation in New Zealand.

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[3] Government Economic Plan – For a productive, sustainable and inclusive economy, September 2019, at pg 6.
[4] https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/thinking-inside-the-subscription-box-new-research-on-ecommerce-consumers

25. The depreciation model would raise compliance costs because of the uncertainties about when and which costs are to be capitalised particularly under:
    a. agile methodologies for developing software; and
    b. differing business practices (e.g. non-exclusive licensing, services; websites),

26. Submitters also raised a number of technical issues mainly focusing on the lack of clear guidance as they relate to software development. Some of the key questions were:
    a. whether the traditional capital /revenue model is appropriate for agile SDLC methodologies;
    b. whether capitalisation of open-source software code is appropriate, particularly as this may not generate revenue.;
    c. the nature of revenue streams (relevant for withholding tax rules); and
    d. uncertain relationship between copyright and patent rules.

27. The depreciation model proposed is also inconsistent with R&D policies and practices of the Callaghan Institute.