

17 December 2013

Black Hole R&D Expenditure Proposals
C/- Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue Department
WELLINGTON

policy.webmaster@ird.govt.nz

Dear Sir/Madam

Re: Black Hole R&D Expenditure Proposals

I am writing to you regarding the IRD discussion document entitled '*Black Hole R&D Expenditure*' (referred to as 'the Document'), released in November 2013. Overall, BusinessNZ supports the recommendations in the Document, as they fit with the Government's Business Growth Agenda of building a more productive and competitive economy. Indeed, one of the BGA's 'building innovation' actions involves investigating whether the tax treatment of R&D is discouraging firms from undertaking R&D. Encouraging R&D is the reason for examining black hole expenditure.

Background & Proposal

Overall, BusinessNZ supports moves by the Government to lift the level of R&D in New Zealand, particularly within the private sector. Government's efforts to remove any impediments that might deter businesses from undertaking R&D are generally a step in the right direction. Latest figures from StatisticsNZ show businesses spending \$1.2b on R&D in 2012, an increase of around 23% since 2010. In other words, this represents a rise from 0.51% of GDP to 0.58% of GDP. More positive and practical policy work should further enhance R&D expenditure by the private sector.

The Document outlines proposals to address black hole expenditure on successful R&D on patents and plant variety rights, as well as on software development. Proposals are also outlined to address black hole expenditure on unsuccessful R&D involving capitalised expenditure based on a number of qualifiers.

As paragraph 2.5 of the Document rightly points out, the potential for R&D expenditure to be treated as black hole expenditure results in economic distortions,

often leading to a risk averse/neutral investor choosing an investment option that does not carry a risk of black hole expenditure occurring.

While the Document asks a series of specific questions relating to R&D expenditure, BusinessNZ would like to take the opportunity to provide some brief general views on its proposals.

Black hole expenditure on successful R&D

Overall, BusinessNZ supports the proposed changes to patents, plant variety rights and software development.

Regarding proposed changes to patents and plant variety rights, we note that three options have been outlined in the Document. While we have no strong view as to the best option given all are an improvement on the current situation, we acknowledge the fact that the options 2 and 3 will have a larger fiscal cost for Government. However, we hope that potential risk to the revenue base will not be such an overriding issue that the benefits of these options are not considered in their entirety.

Regarding development costs associated with internally generated software, we strongly endorse the proposed legislative clarification that these can be fully depreciated, and the amendment made retrospective to the statutory time-bar. As noted in paragraph 3.14 of the Document, this change will reflect the correct policy position, as well as the practical approach taken by many businesses; given the policy statement was released in 1993.

Black hole expenditure on unsuccessful R&D

While we consider the proposed changes for black hole expenditure on successful R&D as important, we believe the proposal to address black hole expenditure on unsuccessful R&D as a more pressing matter that needs rectifying.

While we broadly agree with the view taken by the Government that there are various issues and risks associated allowing deductions for unsuccessful development expenditure, we nevertheless believe the Government is taking appropriate steps, based on the following three conditions:

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

in deriving income; or
in carrying on a business for the purpose of deriving income.*
- *The person intended that the expenditure would lead to an item of “depreciable intangible property” (that is, an asset listed in schedule 14 of the Income Tax Act 2007) of the person.*
- *No deduction has been allowed for the expenditure under any other provision.*

Regarding the two policy options outlined in the Document for allowing deductions for black hole expenditure on unsuccessful R&D, we generally agree that the policy option chosen to address black hole expenditure on successful R&D should guide the choice of policy option for addressing unsuccessful R&D. However, we reiterate our view expressed above in relation to patent and plant variety rights that the fiscal cost to the Government should not be the overriding factor in choosing the future best policy option.

Broader comments

Apart from our overall view on the proposals, we wish to point out two issues that we believe IRD need to be conscious of when making final recommendations on the issue of R&D black hole expenditure.

Masking the true level of R&D

First, if R&D takes place in a business that does not qualify under existing or proposed IRD rules, it will often get moved into general expenditure. Therefore, the true measurement of R&D expenditure will not be accurate given such measures will mask the full extent of R&D expenditure.

Obviously, this has implications as far as a national understanding of how much R&D is actually occurring. This will flow through to how accurate our overall spending is compared with our countries, and the need or otherwise for future changes to the R&D expenditure regime that is often based on aggregated statistics.

Getting the incentives right

Last, on the section that outlines issues relating to perverse incentives for marginal projects. Specifically, paragraph 4.27 states that:

“Allowing immediate deductibility of unsuccessful capitalised development expenditure would create a perverse incentive for taxpayers not to complete marginal projects because, when the value of exploitation is low or uncertain, immediate deductibility of unsuccessful capitalised development expenditure may be preferred by the taxpayer over depreciation of successful capitalised development expenditure.”

While this is a possibility, the possibility needs to be weighed up against the point raised in paragraph 2.5 that states:

“Furthermore, businesses may be incentivised to complete projects that (ignoring tax) have been discovered to be inefficient, simply to avoid black hole treatment of sunk capital expenditure”.

From BusinessNZ’s viewpoint, the main reason most businesses undertake activities such as R&D is the potential to grow their business and provide for increased

returns. Therefore, if a project only has a marginal chance of success, it is generally better for both the business and the wider economy to abandon it, and we would not view this as a perverse outcome. Completing projects discovered to be inefficient simply to avoid black hole treatment of sunk capital expenditure is the worst outcome for all.

Thank you for the opportunity to comment.

Kind regards,

A handwritten signature in black ink, appearing to be 'PO'Reilly', with a stylized, sweeping flourish extending from the end.

Phil O'Reilly
Chief Executive
BusinessNZ