IRRUIP10: Income tax treatment of software development expenditure

NZRise is a community of New Zealand Owned Digital and Technology Businesses with a specific focus on strengthening the economy and raising the productivity of New Zealand. This submission was prepared in consultation with many of our 50 member companies.

NZRise have collaborated with NZTech and specific businesses AMS and CatalystIT who are also submitting feedback on the proposal from Inland Revenue.

NZTech is a Digital and Technology industry group focused on the prosperity of New Zealand through better use of technology. NZTech members are drawn from NZ owned and operated companies, alongside multi-national companies operating in NZ, with over 300 member companies.

NZRise Specific Feedback

NZRise members would like to thank Inland Revenue for taking this consultative approach to considering the future of income tax treatment of software development expenditure. The approach taking to explain your thinking is also to be commended.

For better or worse we consider these changes will only impact the New Zealand owned and operated Software Development industry, with little or no impact on Multi-National companies who sell software in New Zealand. New Zealand owned companies tend to develop software out of cash flow, which differs from Multi-National companies who are often funded via Venture Capital vehicles.
NZRise is concerned this could lead to a potential disadvantage for NZ owned companies and would seek to discuss this specific concern further.

NZRise have added the initial feedback verbally given to IR as Appendix A: we seek this also be taken into consideration.

NZRise members agree with and support both the AMS submission and NZTech feedback included within this document and seek that all of this feedback is logged and considered by Inland Revenue.

NZTech Specific Feedback

In response to the questions for submitters on page 6 of the issues paper:

1. Do you agree that the TIB item's approach to treat software as a trading stock is outdated and inappropriate?

Yes, the TIB item's approach is outdated.

Furthermore, The working group would like to note that even when produced in 1993 the TIB item was outdated as it assumes that software is created as a tangible good that is "finished" such as a piece of software on a CD. However, even by 1993 other delivery models were emerging beyond CD delivered software making it challenging to identify a finished product. For most software companies it has always been near impossible to say when the software is finished as in almost all cases of software, without ongoing product development the market would disappear given the speed of change in technology.

IRD's assumption that software development creates an asset that will have significant standalone value over several years does not reflect the nature of modern software that requires a programme of continuous improvement and enhancements providing additional functionality. Without continuous development a "completed" piece of software would be better likened to a perishable good that has a very short shelf life.

The working group thought it also worth noting the emergence of cloud delivery models didn't make this change necessary as this is simply another form of distribution. However, cloud and SAAS distribution models have enabled new software business models to evolve that have increased the difficulty of applying the current laws in a consistent way. The development of multiple business models (described below) mean that software development is now so variable that any method for the tax treatment of software development expenditure should provide enough flexibility to be applied across multiple disparate software models.

2. Are there circumstances (other than those of an assignment of copyright rights of a sale of a tangible copy of software) where software or a copy of software should be treated as trading stock?

No. In fact, in most cases now days it would be very rare for there is assignment of the copyright rights of a piece of software. Almost all software developers would provide licence to use the software but few would transfer copyright. Even in cases where the software developer was undertaking a custom application development project for a client who may wish to own the copyright, in most cases the software developer would be integrating third party software or code to create the solution. As such they would not be able to transfer the copyright of third party code, merely extend the licence to use.

3. What practical issues arise if software development expenditure is treated for income tax as:

a) The cost of producing trading stock?
This is the current situation and it is an ongoing compromise. Administratively it is onerous as there is no clear finished product, requiring subjective criteria being put in place and it has a significant impact on business cash flows. Additionally, this model is in conflict with the government's Callaghan Innovation growth grant criteria.

b) The cost of producing intangible depreciable property?
The major practical issue would be a massive negative effect on cash flows for a software business as taxes would need to be paid on illusory profits. This method also continues to create conflict with the Callaghan Innovation growth grants criteria. There would also remain a high level of subjective interpretation to identify the difference between maintenance activity and upgrade. In most modern software development models there is the constant requirement for continuous improvement - is this maintenance or upgrade. This issue is highlighted further in the examples of software business included at the end of these notes.

c) R&D expenditure?
This would be the best scenario as it should allow an approach that is more simple for accounting and administration while also allowing cash flows to better reflect the real world where tax deductible expenditures equate to recognisable business costs.

4. not answered

5. not answered

6. Are there any implications for the issues disclosed that go beyond income tax?
The working group identified two main issues beyond income tax:

1. The 3 options summarised in the table on page 18 of the Issues paper all have significantly different impacts on business cash flow. A capital asset model would be so detrimental from a cash flow perspective that it has the potential to destroy small businesses.

2. This review provides an opportunity to better align the tax accounting requirements of with the grant requirements of Callaghan Innovation.

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EXAMPLES

The working group identified that the main challenge for any tax treatment regime for software development expenditures will be the fact that there are now a number of very different business models for software developers. The business models are in fact so extremely different that any new proposed tax treatment model would work best if it was able to provide enough flexibility to cover all software development models.

Examples of different software development models (using real world examples):

1. A mature software development firm with large NZ government clients.
   - An enterprise level payroll system that has been extended over the years to include new modules such as HRMIS, rostering, award interpretation
   - There is a single version of the software run across multiple site - delivered in different ways for different clients - on premise, in hosted environments and as a SaaS solution.
   - Formal product upgrades occur every six months to deliver new modules related to legislative changes
   - There is a continuous R&D programme to ensure new modules are developed to maintain the viability of the product
   - The licence structure doesn't transfer copyright
   - The licence provides product access & upgrades

Preferred Tax Treatment Model - the R&D model - as it supports cash flow management

2. A fast growing SAAS software firm with predominantly export clients.
   - A cloud based big data and analytics platform that is moving from startup to high growth phase and currently has 25% of its global market share
   - There are two cloud hosted products provided globally via a cloud access model
   - Product development is continuous with an iterative development resulting in weekly product releases
   - Customers do not obtain any copyright rights
   - Customers purchase on demand and via subscription

Preferred Tax Treatment Model - the R&D model - as it supports a rapidly changing full time R&D business model

3. A game development firm that creates and sells Apps via mobile phone App Stores
   - Produced over 400 game applications in past 2 years & deployed to App Stores for free download with in-game purchases

- Each game considered "perishable", with a short shelf life most are not put into upgrade cycles. Games with temporary high in-game purchase rates may qualify for upgrade, but this is often temporary as most games have limited attention capturing span.
- With rapidly changing platforms (IoS & Android versions) R&D is constant to ensure next game maximises the platform & encourages purchases
- There is no licence structure & copyright is protected via App Stores
- Customers download apps for free and revenues generated via in-game purchases.

Preferred Tax Treatment Model - the R&D model - as it supports cashflow management & full time R&D

4. **No examples.**

5. **No examples.**

AMS Specific Feedback

Overview

IR are to be congratulated for "sharing their thinking" in such detail, around what is quite a complex and potentially contentious subject. Depending on the approach IR adopts, the implications for the growing SW industry, that is supported and encouraged by Gov't, and that contributes a lot more than has been recognised* to the NZ economy, could be profound (positive or negative).

Interestingly, at a time when Gov't wants to encourage more employment in IT and other high-tech industries, it is NZ-owned businesses that conduct SW R&D here in NZ and file comprehensive tax returns in this country, that would be impacted, while companies filing in overseas jurisdictions (and possibly benefitting from incentives in those other countries) would probably be unaffected.

General

It's encouraging to see the paper provides a possible basis for all SW development expenditure to be expensed, under the R&D provisions, if maintenance can be expensed as well.

That would be an ideal outcome for the sector; allowing costs to be expensed for tax purposes, regardless of how they are treated in companies' financial accounts, with capitalisation for tax purposes (to create a depreciable asset) as an optional alternative. It should also alleviate any concerns that IR's rules/interpretation of IAS 38 could cause a conflict with Callaghan's Growth Grant ruling, that excludes funding for R&D work that is capitalised.

As a body representing NZ-owned businesses, most of which conduct their R&D in NZ employing NZers (who also contribute PAYE to the economy), NZRise contends that IR has the opportunity to contribute to the sector's growth by allowing NZ businesses to file returns based on a "maintenance-included R&D path" rather than the "capitalise and depreciate path".

Comparison of SW Dev at 35% R&D of Rev

Project takes just over 2 years and costs $700K

"R&D" expense option ("the real world" in terms of costs and cashflow)

	Y1	Y2	
Revenue	1,000,000	1,000,000	
Costs incl R&D	-900,000	-900,000	
Profit	100,000	100,000	
Tax	-28,000	-28,000	
NPAT	72,000	72,000	
Cash available	72,000	72,000	144,000

Forced Capitalisation (2 year's R&D disallowed)

	Y1	Y2	Y3	Y4	Y5	
Revenue	1,000,000	1,000,000				
Costs excl R&D	-550,000	-550,000	-280,000	-280,000	-140,000	straight line depreciation
Profit	450,000	450,000				starts upon completion
Tax	-126,000	-126,000	78,400	78,400	39,200	
NPAT	324,000	324,000				
						Eventually!
Cash available	-26,000	-26,000	78,400	78,400	39,200	$144,000

assuming tax refunds are
availble quickly from Y3 onwards

(* - refer to NZTech's "Tech Sector to Digital Nation" published recently).

Best Solution for the NZ SW Industry

The table at the top of P18 provides an excellent summation of the alternatives being considered. From a SW industry perspective, the R&D option would provide an ideal outcome, if there was a way to have "post-deployment maintenance" recognised as completion of the "D" in R&D.

Response to "Questions for Submitters" at P6

1. SW treated as Trading Stock

We agree that the 1993 TIB document is outdated in some respects; for example it refers to mainframes as being the development computers, and it fails to recognise the "perishable" nature of modern SW development. Whether it is inappropriate would depend on what it would be replaced by. Definitely inappropriate if replaced by the R&D regime, but preferable to a capitalisation regime.

It is important to recognise that Section 3 of the 1993 TIB was effectively a compromise, introduced to acknowledge the concerns of the SW development industry at that time, when a "capitalisation regime" was being introduced to replace an "expense regime".

So, unless a better tax arrangement allowing immediate expensing of SW development costs for tax purposes is introduced (eg under the R&D provisions), then NZRise would not agree the 1993 TIB is inappropriate. That is because the SW development industry would be severely impacted by the introduction of a "capitalisation regime", because of its impact on cashflows and the associated administration costs.

IR's assumption (P4 – para 8) that SW development creates an asset that will have significant "stand alone" value over several years does not reflect the nature of modern software, that requires a programme of continuous improvement and enhancement providing additional functionality. Without a commitment to a roadmap, a completed piece of SW can be likened to perishable goods, with a very short "shelf life". SW development practices such as Agile and MVP (minimum viable product) should be acknowledged, as components in the trend (also driven by market demands) towards "build and continuously improve" software. In addition, there is no established market for intangible software assets, as there is for physical goods.

It should be pointed out that IR's more "technical" criticisms of the 1993 TIB (P4 – para 9) could just as readily have been applied at the time the TIB was introduced. Even back then, most developed SW was "sold" on a licence fee basis, so IR's suggestion now that SaaS and non-exclusive licence sales are not really "sales" because IP doesn't pass to the purchaser, ignores the reality back in 1993 (SaaS is really just a different delivery mechanism for licenced SW); licenced SW sales have always normally involved the developer retaining the IP.

2. Are there circumstances where SW, sold without copyright passing, should be treated as trading stock?

We would suggest the same circumstances as have prevailed since 1993 would still apply, if SW development costs can't be immediately expensed under R&D provisions; we submit that, just as was the case in 1993, a "capitalisation regime" today would be very damaging to the NZ SW development industry.

However, using 'assignment of copyright rights' to the software, as a means of identifying trading stock, is inappropriate for some classes of software.

Specifically, Open Source software released under a General Public License (GPL), uses copyright law to enforce 'copyleft' restrictions. GPL and copyleft specifically grants users of the software the right to use, copy, modify and re-distribute the software. In that sense, there is no asset that can be controlled and valued as described under NZ IAS 38 (referred to in point 76 of IRRUIP10).

The publisher of software under a GPL license has relinquished control of the software, and the license explicitly **cannot**[1] be used to generate revenue.

As such, it is very difficult to value GPL released software as an intangible asset, it is perhaps better thought of as creation of goodwill.

([1]"You may not impose any further restrictions on the exercise of the rights granted or affirmed under this License. For example, you may not impose a license fee, royalty, or other charge for exercise of rights granted under this License,.." GPL V3 Section 10)

3. What practical issues arise if SW development expenditure is treated for income tax as:

a. <u>Cost of producing trading stock</u>? This is a compromise situation that has prevailed for over 20 years. Administratively it can be onerous; however, it could possibly conflict with Callaghan Growth Grant eligibility

criteria. It does have an adverse impact on business cashflows, so adds to business costs in that sense. And it is inappropriate for Open Source SW.

b. Cost of producing intangible depreciable property? This would be disastrous as the impact on cashflows would be huge, because businesses would be paying taxes on illusory profits. It would also add administrative effort to separate "maintenance" from "upgrading" activity, that may well be subject to interpretation differences. Such an approach cannot be justified, in the modern world of SW products, where completed but "unimproved" product has a very short "shelf life". Also, it could be expected to create conflict with Callaghan Growth Grant eligibility criteria.

c. R&D expenditure? If post-deployment maintenance could be included as well, this would be a wonderful boost for the industry. Very simple accounting and administration, combined with business cashflows reflecting "the real world" where tax-deductible expenditures equate to a recognised business costs, and everything is "in sync". This approach also allows companies to choose to capitalise, if that suits their situation better. As a boost to the NZ industry, and to be consistent with Callaghan, IR should consider only allowing the "R&D" costs to be expensed for SW research, development and maintenance that is conducted in NZ.

Summary

Could software otherwise be revenue account property?

Similarly to 'trading stock', this seems like levering software development into an inappropriate existing tax framework. Software doesn't have an active market in the sense that simple commodities like gold or land do.

Treating software development as 'revenue account property' would be discouraging. It would pressure software development companies into 'disposing of' their assets quickly to cover short-term costs, rather than taking a longer-term view to further develop them, and develop a sustainable revenue stream.

Capitalising of software development costs

If stringent capitalisation of software development were to be enforced, the combination of no R&D tax deductions being available, along with limited ability to qualify for innovation grants - Callahan Innovation R&D grants cannot be applied to capital expenditure - would be severely stifling to innovation efforts.

This is especially true when compared with other tax jurisdictions which allow larger applicable R&D tax offsets.

The result would be software development companies increasingly looking offshore to establish innovation and development centres.

Conflicting with other Govt Agencies

Callaghan Growth Grants' criteria would be in direct conflict with the "capitalisation regime" being contemplated by IR.

Appendix A: NZRise Verbal Feedback prior to consultation

NZRise key concerns prior to seeing the consultation paper are still valid:

1. Callaghan grants with regards to their requirement for grant funds to not be capitalised vs IR's position software is more appropriately capitalised and depreciated - we ask that IR consider these conflicting perspectives from 2 x government agencies

2. We ask that IR note early stage and other companies in our industry specifically prefer to expense R&D out of cash flow and that the guidelines should accommodate this

3. We ask that IR consider treatment of Open Source software with regards to holding as an asset on books with no direct revenue attached.

4. We ask that IR consider modifications and enhancements with regards to application of depreciation rates

5. We asked IR what NZ's position would be with regards to alignment with trading partners, noting the NZ guidelines and treatment should be preferential for NZ Companies keeping their Software R&D in NZ vs moving to other more preferable jurisdictions

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