

13 December 2013

Black Hole R&D expenditure proposals
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Black Hole R&D Expenditure

The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the discussion document *Black Hole R&D Expenditure* (discussion document). This submission has been prepared with assistance from the Law Society's Intellectual Property Law Committee.

General comments

In attempting to assist with making the tax regime more sensible and coherent, the Law Society considers that the areas of greatest incoherency are the list of depreciable intangible property in schedule 14 and the proposal to treat R&D differently, depending on whether it is to generate a patent and plant variety right or to generate know-how.

Schedule 14

The list of depreciable intangible property is in schedule 14 of the Income Tax Act 2007. If that list is not coherent and sensible, then the new policy will also not be coherent and sensible, whatever policy is adopted.

The Law Society considers that the omission of registered designs and of copyright which has been industrially applied, from the list of depreciable intangible property is not sensible. Both registered designs and copyright which has been industrially applied are comparable to the Intellectual Property (IP) on the current list. Both are intangible and have a statutory finite useful life (15 or 16 years). Accordingly, registered designs and copyright which has been industrially applied should be included in the list of depreciable intangible property.

The proposed policy for R&D leading to a patent or plant variety would then logically be applied to R&D leading to or intended to lead to the creation of a registered design, a registered design application or copyright which has been or is to be industrially applied.

Distinction in the purpose of the R&D

The fundamental distinction in the discussion document is between:

- R&D which leads to a patent or plant variety or which was intended to lead to a patent or plant variety; and

- R&D which leads to non-depreciable IP (essentially know-how) or which was intended to lead only to know-how.

R&D which leads to or was intended to lead to a patent or plant variety right would be depreciable. Issue could be taken with depreciation over an assumed 20 or 23 year term, but the principle is sound.

The principle that is not sound is the treatment of know-how as a non-depreciable asset because it does not decline in value over time nor has an indefinite useful life (paragraphs 3.15, 3.16, 3.18). Know-how is only a non-depreciable asset because it is perceived that know-how does not have an estimable finite legal life at the time of its creation or acquisition. Having decided know-how does not have an estimable finite legal life and is therefore non-depreciable, the discussion document says that a deduction for capital cost for know-how R&D is akin to a capital loss (paragraph 3.21).

In the Law Society's view the flaw in the reasoning is at the beginning, by assuming it is not possible to estimate the life of the know-how with a reasonable degree of certainty at the date of creation or acquisition. There is no set period defined by statute or contract, but the taxpayer will be able to assess properly how long that know-how is likely to be useable.

The problem is not that know-how does not have an estimable definable life span, but that the life span is almost invariably fact dependent and as a result varies from project to project and cannot just be set at a particular statutory period.

The proposed policy becomes incoherent because of the existing distinction between patents and know-how. The Law Society considers that the appropriate tax treatment for know-how would be to depreciate over its useful life as estimated by the taxpayer, not to classify it as a non-depreciable asset. If that change is made then R&D leading to the asset (know-how) can be treated the same way as the R&D leading to or intended to lead to a patent.

The concern about the deduction being akin to a deduction for capital loss (paragraph 3.21) is premised on know-how being non-depreciable. That concern will be resolved once the true nature of the finite life of know-how is understood. The asset is depreciated, not deducted for capital loss.

Logically, the sale of know-how should be treated as taxable income.

The advantage of consistent treatment of R&D, whatever its intended purpose, is that it will avoid the distortion of taxpayers wrongly classifying R&D as intended for a patent or filing unnecessary patent applications to make the R&D depreciable. It also addresses the reality that many taxpayers at the start of an R&D project will not have decided whether or not to pursue a patent application even if the R&D is successful.

Recommendation

It is recommended that IRD review the schedule 14 list and the assumption that know-how does not have an estimable life. The policy for deductibility of R&D for patents and plant varieties can then be properly applied to other R&D.

Chapter 3 – Black hole expenditure on successful R&D

Patents and plant variety rights

At the end of a patent's legal life, is ascribing a residual value of nil to the know-how underlying the patent a close approximation to commercial reality?

Yes. A published patent will disclose the best method of putting the know-how into effect. At patent expiry there will be some residual know-how and new know-how developed over time, but that is unlikely to be of significant value.

Do you agree with the Government's proposed solution to the problem of black hole development expenditure where a depreciable asset for tax purposes has been created? If not, can you provide your reasons and suggest a better alternative?

Yes. The Government's solution is appropriate to a depreciable asset for tax purposes. However:

- the Government should add registered designs/design applications and copyright which has been or will be industrially applied to the existing schedule 14 list of depreciable assets; and
- the Government should include know-how as a depreciable asset, with the life of the asset to be determined by the reasonable assessment of the taxpayer.

Software development

How would you suggest that capitalised development expenditure that has given rise to an intangible asset with an indefinite useful life should be dealt with?

The question assumes that the intangible asset has an indefinite useful life. Software has a useful life which can be reasonably estimated by the taxpayer. Know-how has a useful life which can be reasonably estimated by the taxpayer. As noted above, in our view the assumption that those intangible assets do not have an estimable useful life is flawed.

Are there any other instances of black hole expenditure on successful R&D not covered in this discussion document?

As already noted, the discussion document does not discuss registered designs or copyright which has been industrially applied. They should be treated the same as patents and plant varieties.

Chapter 4 – Black hole expenditure on unsuccessful R&D

Proposed solution

Do you agree with the Government's proposed solution to the problem of black hole development expenditure when no valuable asset has been created? If not, can you provide your reasons and suggest a better alternative?

The Government's proposal with regard to unsuccessful R&D intended to generate a patent or a plant variety right is supported. The Government's proposal with regard to unsuccessful R&D for other purposes is not supported. With other unsuccessful R&D (know-how, registered designs, copyright for industrial design) the same policy as for patents and plant variety rights should be adopted.

Do you think that deductions for unsuccessful capitalised development expenditure should be immediate or spread over the estimated useful life of the asset the expenditure was aimed at creating? In particular, when we are talking of expenditure that, if successful, would have given rise to an asset with a 20 to 23-year life, do you think that giving immediate deductibility for unsuccessful expenditure is appropriate? Why or why not?

The Government's proposal assumes that if a patent or patent application is sought then the life of the project is 20 years. Many patent applications and patents even for successful R&D are abandoned before 20 years have passed because the technology is overtaken by more recent developments. With successful R&D the capital expenditure should be depreciated over the maximum patent term (20 years), until the patent is abandoned or not renewed. At that point the balance of the capital expenditure should be deducted.

For unsuccessful R&D the biggest stimulus for R&D would be to allow deductibility once the R&D is deemed unsuccessful.

There is a practical difficulty in ensuring the taxpayer is not still benefiting from R&D deemed unsuccessful. But if the R&D is depreciated in any event, the incentive to wrongly deem it unsuccessful is reduced.

Issues and risks with allowing deductions for black hole expenditure on unsuccessful R&D

Do you agree that allowable deductions for unsuccessful capitalised development expenditure should be confined to expenditure that would have led to an item of “depreciable intangible property” (that is, an asset listed on schedule 14 of the Income Tax Act 2007) if the R&D project had been successful?

Yes, but only if the items of “depreciable intangible property” are extended. The assets listed in schedule 14 are incoherent and incomplete. Registered designs and industrially applied copyright should be added to schedule 14. Know-how should also be depreciable.

Do you agree with using an intention test to determine whether expenditure would have led to an item of “depreciable intangible property” if the R&D project had been successful? If not, can you provide your reasons and suggest a better alternative?

The Law Society agrees, but the definition of “depreciable intangible property” should be extended as discussed above.

Conclusion

If you wish to discuss this submission further, please do not hesitate to contact the convenor of the Law Society's Intellectual Property Law Committee, Clive Elliott QC, through the committee secretary Jo Holland (04 463 2967, jo.holland@lawsociety.org.nz).

Yours faithfully



Chris Moore
President