NZTech

NZ Tech Alliance Survey

Tax Accounting Treatment for Software Development

March 2021

Creating a prosperous New Zealand underpinned by technology

About NZTech

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NZTech is a purpose driven, not-for-profit NGO that brings together 22 technology associations with over 1,500 member organisations who collaborate to **help create a prosperous New Zealand underpinned by technology.**

We help members work together effectively, making connections, sharing insights, collaborating and enhancing New Zealand's ability to benefit from technology.

NZTech drives the national strategy for the **NZ TECH ALLIANCE**.

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NZTech is the producer and guardian of Techweek

techweek

NZ Tech Alliance

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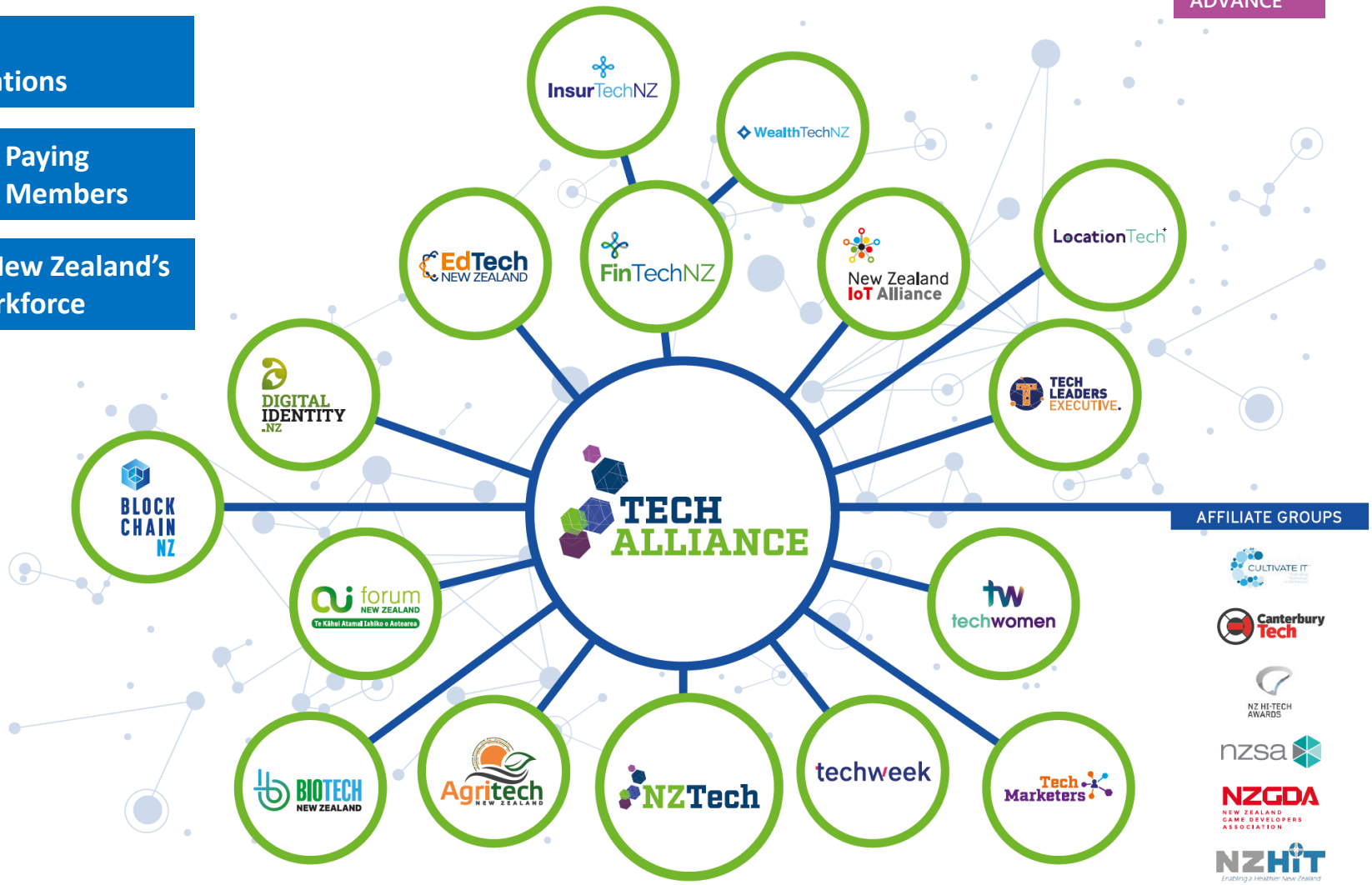
22 Tech Associations

1,500+ Paying Members

10% of New Zealand's Workforce



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Background

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BACKGROUND The Inland Revenue is 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.

The purpose 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;
- the broad-base low-rate tax framework underpinning the tax system in New Zealand.

This is a “first-principles” review of general income tax principles as they relate to the software development sector and it does not include within its scope any aspect of the R&D tax incentive or any other incentives promoting innovation in the sector.

SURVEY NZTech is supporting the Inland Revenue consultation phase by undertaking a survey across a broad range of member organisations that engage in software development. This survey, run in March 2021, had 60 responses. The sample size can only be treated as indicative and not statistically significant, however it does show the breadth of business models and approaches to tax treatment of software development currently used.

INTERVIEWS To further support the education of the Inland Revenue policy team with respect to the different software development business models and the resulting different approaches to tax, NZTech facilitated meetings with the financial leads in a range of software developers from the agritech, healthtech and game development sectors.

Demographics

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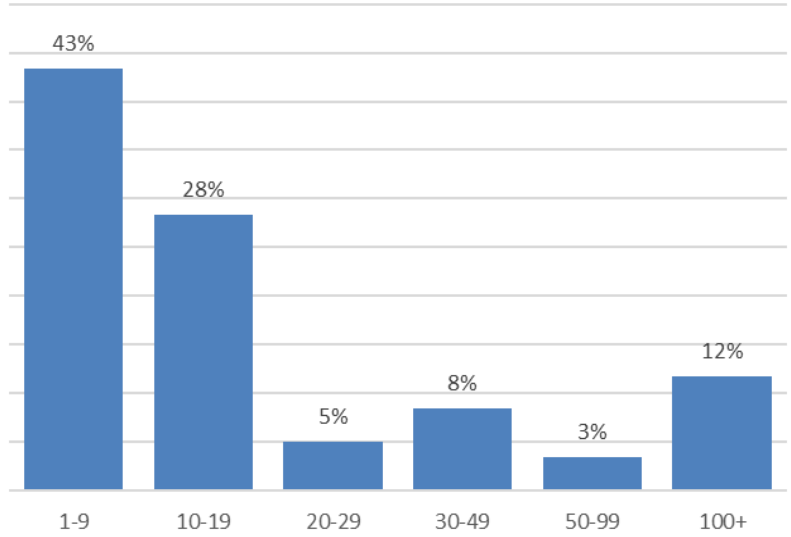
How many staff and/or contractors do you have engaged today developing software for use in a business (full-time equivalent basis)?

n = 60



Revenues & Expenses

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What percentage of your revenue comes from developing software for use in a business?

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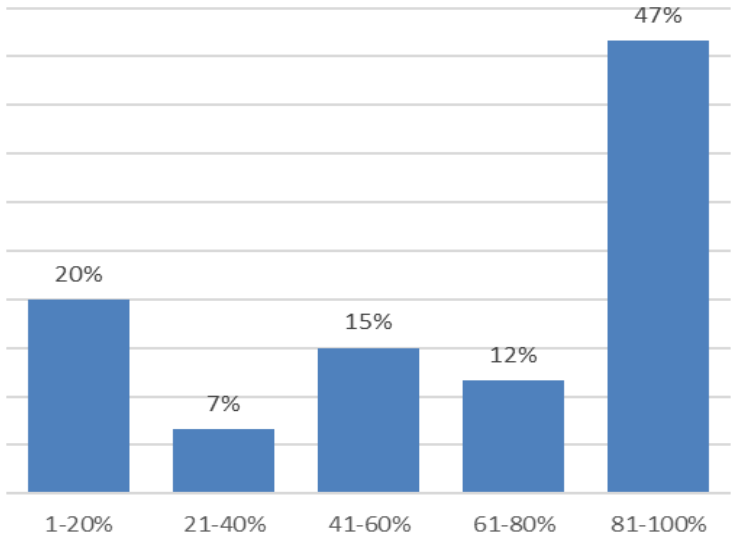
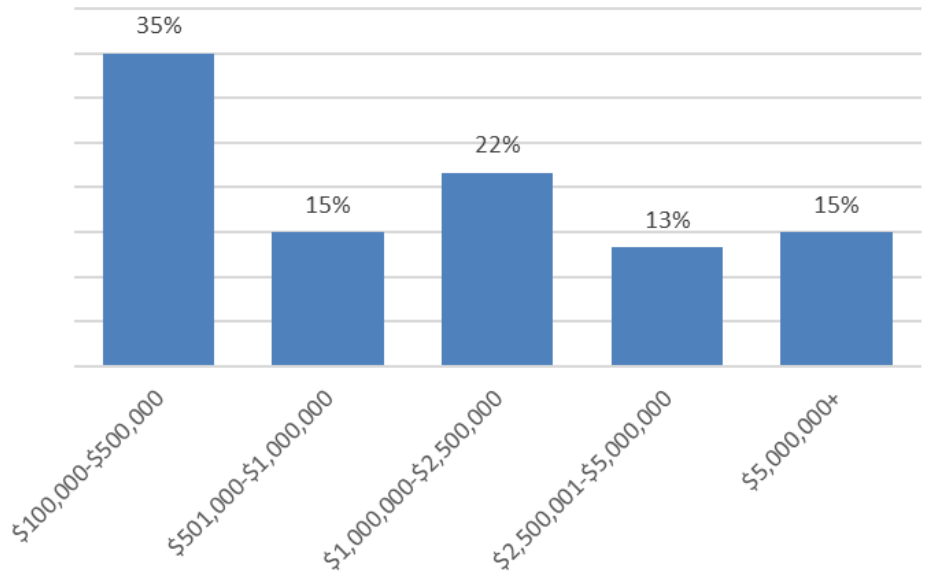


What has been your average annual expenditure for developing software over the past three financial years (or most recent financial year if less than three)?

n = 60



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Is tax on software development a significant issue?

Do income tax implications for developing software for use in a business pose a significant issue for your business?

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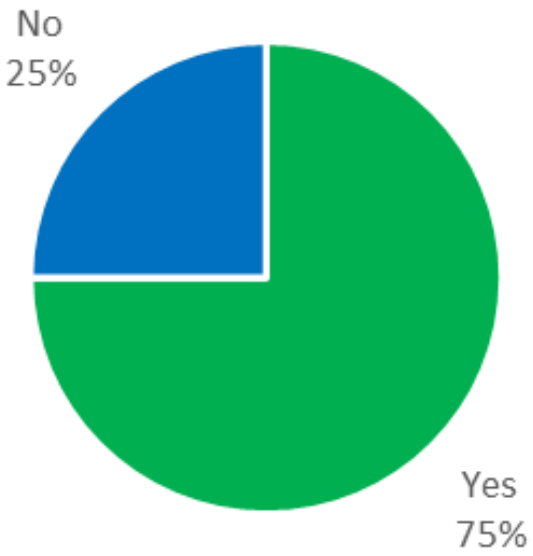

Expense or Capitalise?

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What accounting treatment is predominantly used when developing software?

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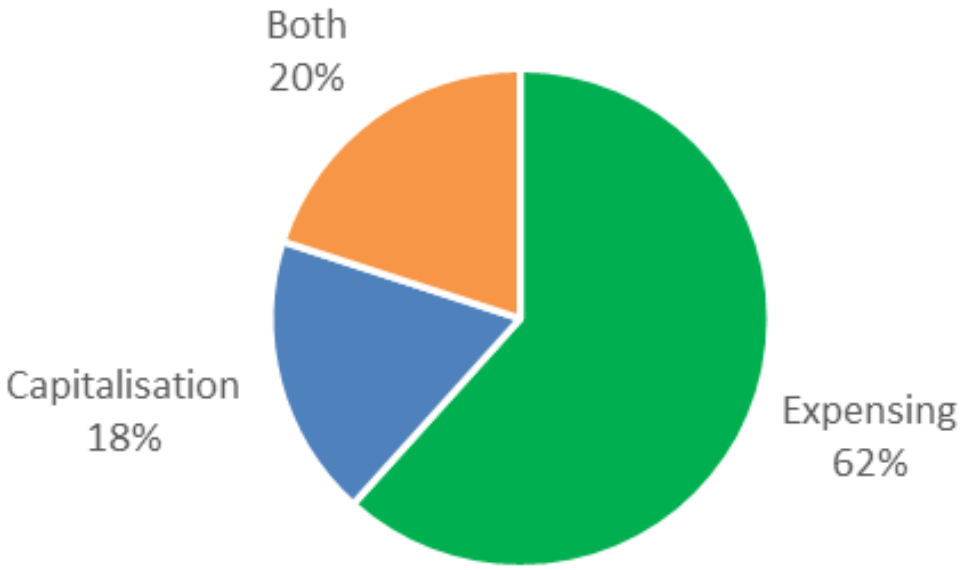

Comments: Expense or Capitalise?

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- A mix really. Development on and around as a service solutions is the biggest challenge.
- A mixture actually.
- Capitalisation for software dev would be a complete nightmare.
- Currently we expense more than we capitalise, but this may change as our product renews.
- Depending upon the nature of the project.
- If capitalise, have to count it as income, so pay tax, but little change to Company's actual value.
- Not all is able to be capitalised.
- Significant configuration work or product enhancements that don't drive additional revenue.
- Software development costs are expensed due to the uncertainty of the outcome.
- We expense to align with R&D cash out, RDTI and Callaghan reporting.

- Software development is partly new features and partly maintenance and various external synchronisations (supplier lists and pricing). Revenue flow is based on monthly subscriptions and customers can leave at short notice. So appropriate accounting is expensing.
- We and most of our customers capitalise significant development projects and expense maintenance work. The line is not always easy to draw but it can be done.
- We capitalized in the past and now have that asset on our balance sheet and it doesn't feel correct.
- We do both, but more Capex.

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Are current accounting rules adequate?

Are existing rules on the accounting treatment of developing software adequate or inadequate and why?

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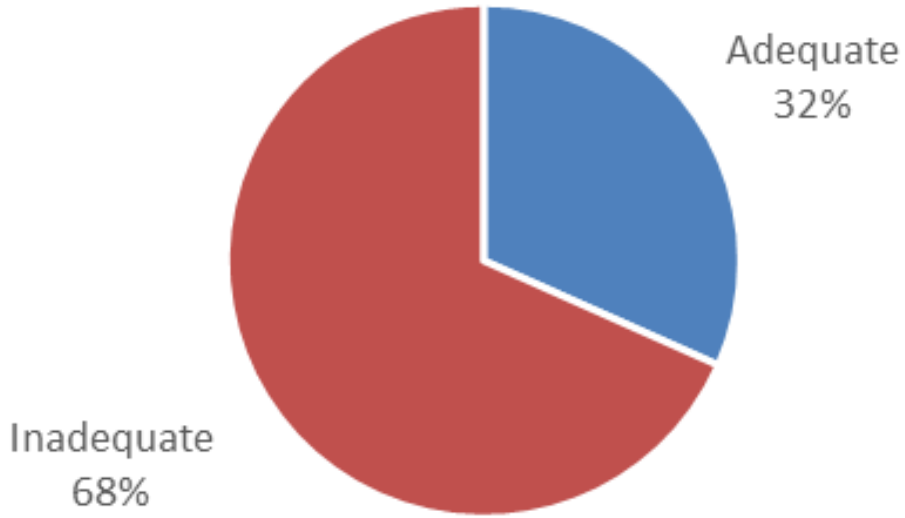

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Comments: Adequate rules?

- Accounts and addresses the practical situations that occur.
- Adequate, but just barely. There is no question that well developed software is a genuine capital item for a purpose. Maintaining and fixing legacy systems is definitely not, but might be of similar scale.
- Building IP on top of subscription platforms that require licensing tricky.
- Current rules are heavily focused on the traditional fixed asset-reach or service-based technology businesses, but poorly address the needs of information-based technology sector, which works mainly on the cloud Software As A Service or Platform As A Service Business Models (think PushPay, Xero, Message Media, Netflix, Twilio, Plexure) etc.
- Currently accounting policy is very grey and open to interpretation.
- Currently considered like any other expense rather than the creation of an asset with future value.

- Digital products do not follow the same rules as almost any other type of business. There is (in many cases) nearly zero marginal cost, and increasingly zero price as well.
- They haven't kept up with current trends.
- I am unsure what the rules are in some situations.
- Inconsistent with grant treatment.
- Not definitive enough and too narrow.
- Not sure what they are!
- NZ tax treatment for software development is out of step with Australia, Singapore, EU/Ireland where R&D Tax incentives are upto 40% for small businesses like ours. NZ is very tax unfriendly and as a result we're hiring resource overseas.
- Our expenditure is predominantly R&D or R&D related.
- Need to be able to better handle As A Service developments as capex.

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Comments: Adequate rules?

- Rules aren’t clear.
- Software by it's very nature is a continuously evolving product. Hence it is hard to define completion of a product. This poses dilemma on the accounting of the costs and deciding when to consider a product is final.
- 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. The rules are vague and difficult to apply. Software development is not like R&D in the primary industries sector, yet it seems the IRD want to treat it like it is.
- The gap between significant enhancements and the agile approach of continuous delivery isn't clear.
- Too many grey areas, capitalised assets turn over much faster in software so depreciation methods are not realistic.
- The new definition of R&D for purposes of RDTI do not make sense for software businesses.

- To some extent the accounting rules don't make sense. For example, I can contract a consultant to provide a service for me (say run a training course) for my clients. I can expense the cost. However, when I hire a software developer to provide another form of service for me (develop software), I can't expense this and have to capitalise it. Both people provide a service for me but the accounting rules are different.
- Too much ambiguity and outdated capitalisation incentives driving organisations to invest in large, slow technology programmes instead of agile, dynamic initiatives.
- Too uncertain when deductibility will be available.
- Typical approach with US companies is to capitalise, and so the fact we expense everything always raises questions with potential investors or acquirers.
- We can't expense everything under the 1993 TIB Rules (almost everything, but not quite).
- We do R&D and can't seem to qualify for tax credits.

Other countries?

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In your experience, are there other countries that have a superior accounting treatment of developing software for use in a business than New Zealand?

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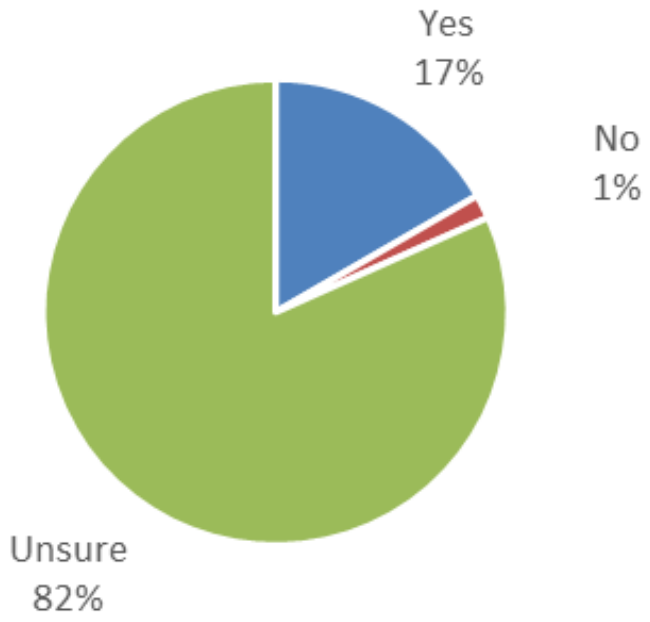

COMMENTS

- Australia
- Australia tried about 20 years ago or more, but dropped it.
- I do not know enough about other markets rules, other than the fact that the US and most other countries tend to capitalise R&D whereas we are encouraged to expense it to maximise R&D cash outs or RDTI access.
- IT does seem that places like Ireland and Belarus
- NZ follows IFRS as does the majority of the world - except US GAAP.
- US provides explicit R&D tax credits. They are far too complex and time-consuming, but the principle of R&D credits is right.
- Yes, we compete directly in the Australian market where competitors qualify for 40% R&D tax rebates vs none here (despite multiple approaches to Callaghan).

Development funding?

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How is the development of software primarily funded in your organisation?

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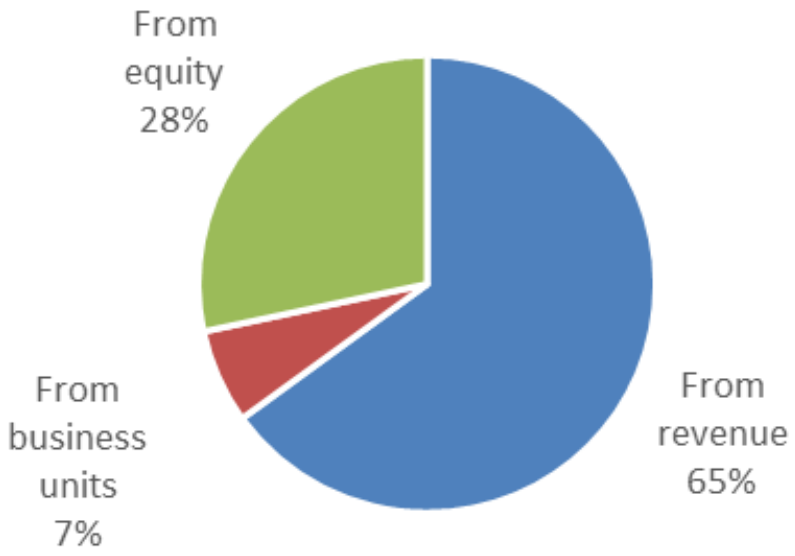

COMMENTS

- Combination of revenue, equity and business nit investments
- Platform required in the sale of goods to customers
- Previously cofunded from Growth Grant
- We are a loss making SaaS business but have access to equity funding. We are revenue generating but still rely on capital as well.
- We develop software for others that they own; this is primarily from revenue. Our own software is mostly (but not completely) equity funded.

Type of software?

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What best describes the software you develop?

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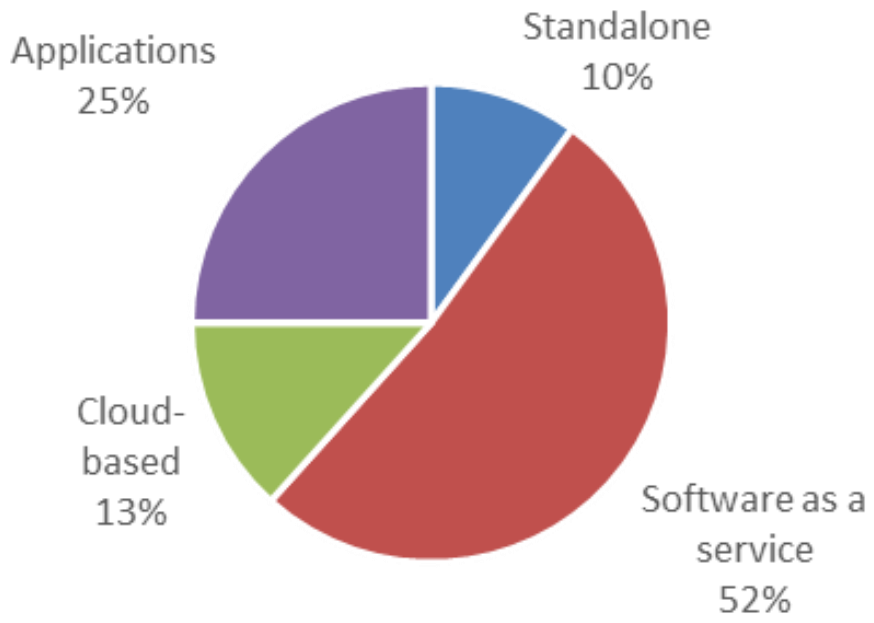

COMMENTS

- Standalone, SAAS, Cloud-based, Mobile.
- Developing our platform, which is then used by potential customers to access our services.

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Comments: What would improve the taxation treatment of developing software for use in a business?

- Clearer mechanism to classify software developed for R&D. At the moment, embedded software seems to be easy to classify as R&D, while its cloud equivalent does not - even if they are both part of the research and development process.
- Clearer guidance on what constitutes repairs and maintenance of existing software systems.
- 100% deduction where for the express purpose of revenue generation.
- All expenditure deductible immediately.
- Allow deductibility of software costs regardless of the accounting treatment would benefit companies.
- Allow faster depreciation, or more generous rules for expensing.
- Appreciate that software development does not always involve inventing completely new code, but is more usually pulling together existing code, languages, services and data in a novel way to solve a business problem or deliver an innovative service.

- Be able to expense the contracting of a software developer.
- Being able to capitalize smaller ongoing small incremental enhancements.
- Better definition of R&D to more explicitly INCLUDE more software development.
- Black hole costs Updates to aging systems Maintenance and repairs vs new creation Confusing and arbitrary treatment of content creation (highly perishable) with software (3-5 year life)
- Clarity and alignment.
- Clear guidelines on when and how human effort can be bundled in development projects and therefore expended as capital.
- Clear understanding of the rules and how we can leverage incentives to grow this sector.
- Don't know. Is it broken? NB. Our income is from licence fees, work is to keep getting them, so reckon they are expense.

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Comments: What would improve the taxation treatment of developing software for use in a business?

- Drop the IRD/Callaghan Frascati model and apply the same rules as Australia. And back date this to the beginning of the R&D Tax Incentive in the interests of being fair. The current RDTI is badly tilted towards high risk start-ups and effectively penalises business currently transforming their platforms to cloud service delivery. Callaghan says is just maintenance which is insulting and incorrect. We're completely rewiring/reinventing our platform.
- Easily enabling a higher level of tax relief on software development and the research which goes into software development, so more can be put back into the company and larger investments made.
- Eligible for R&D tax credits.
- Enable us to claim a tax credit on development of software.
- Existing rules are fit for purpose. Alignment of tax and accounting is critical.
- I'm unsure I have the Tax knowledge to be able to answer this question.

- Having a detailed framework written specifically for software development that distinguishes between the SAAS Cloud developers (e.g. Xero), Complex Client Related IT Development (e.g. health and finance industry) and inhouse software development (e.g. Telcos).
- Having it recognised as R&D - the IRD definition of R&D is to scientific focused and could exclude software development.
- If we could deduct ALL expenditure on salaries & wages + contractor costs (at the moment, it's nearly everything).
- More focus on Cloud-Bases SaaS (Software as a Service) and CPaaS (Communication Platform as a Service) businesses. Traditional accounting and tax rules do not adequately address the true commercial nature of these business models.
- No blackhole expenditure risk.

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Comments: What would improve the taxation treatment of developing software for use in a business?

- Provide tax credits instead of deductions, a lot of IT firms take a while to be in a position to use the deductions but do need cash up front
- Simplified R&D tax exemption applications
- Software development usually involves significant R&D to maintain technological and market share advances. The SaaS revenue is usually exponential growth but only after continual longer periods in software development. Access to R&D tax relief at all stages of growth is key to meeting that need.
- Tax rebates for development and government recognising it as R&D.
- The ability to tax-free develop IP and products when paid for by profits.
- The requirements for getting the R&D tax credit for developing software.

- The switch from Growth Grant via CI to RDTI does not work for loss making software businesses. We rely on the cashflow to help cofund R&D. We are extremely concerned about how much investment we can make going forward.
- Unsure if the RDTI supports this.
- Unsure, we just never seem to be treated the same way that tangible asset companies do.
- Updated guidance that enables consistent treatment in an agile environment.
- Would be good to widen criteria for R&D incentives not to be simply based on new novel technology. Improvements to existing tech should be considered.

Next Steps

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PROVIDE INLAND REVENUE WITH DIRECT ACCESS TO A BROAD VARIETY OF SOFTWARE DEVELOPMENT FIRMS

- Help the Inland Revenue policy team better understand the variety of business models that software developers use by facilitating direct conversations with the CFO's of a broad number of different software firms.

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