CONSULTATION> OFFICIALS' ISSUES PAPER

Income tax treatment of software development expenditure and SaaS customisation and configuration costs

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An officials' issues paper

Inland Revenue
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Making a submission

Inland Revenue invites submissions on the issues raised in this document, including the specific questions asked and any other issues relevant for officials to consider. A complete list of these questions can be found in the Appendix to this issues paper.

Include in your submission a brief summary of the major points and recommendations you have made. Please indicate if officials from Inland Revenue can contact you to discuss the points raised, if required.

The closing date for submissions is 30 January 2026.

Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with "Income tax treatment of software development expenditure and SaaS customisation and configuration costs" in the subject line, or
- by post to:

  Income tax treatment of software development expenditure and SaaS customisation and configuration costs
  C/- Deputy Commissioner, Policy
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

Privacy of submissions

Submissions may be requested under the Official Information Act 1982. Please clearly indicate in your submission if you consider that any information should be withheld on the grounds of privacy, or for any other reason. Contact information such as an address, email, and phone number for submissions from individuals will be withheld. Whether any information is withheld will be determined using the Official Information Act 1982.

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Chapter 1 – Introduction

1.1 The development of technology, particularly with regard to software, has accelerated over the recent decades. With the advent of new technologies, the ways in which the software industry commercially exploits software have also changed. The current tax rules for certain expenditures relating to software may need updating.

1.2 We intend this consultation to form the initial part of an exercise in assessing whether current policy settings result in the correct outcomes. We understand that the application of certain provisions can result in high compliance costs, and we want to understand further where and how this burden can be reduced. We are also aware that there are several areas of uncertainty which could be improved and need to understand if there are others. Finally, we seek to ensure that the relevant expenditures are deductible and not "blackhole" expenditure.

1.3 The purpose of this issues paper is, accordingly, to better understand whether there are any policy problems relating to the tax treatment of expenditure on software by a business, in two primary circumstances:

- A software business's costs in developing software that will be sold or licensed to customers.
- Software configuration or customisation costs incurred by a taxpayer licensed to use a software as a service (SaaS) application owned by a third party.

1.4 As part of both these areas, this paper considers the provision that allows a deduction for research and development (R&D) expenditure.

1.5 This issues paper is primarily concerned with understanding current problems or uncertainties associated with software development costs, in particular where the current rules might result in undue compliance costs. It does not propose solutions but seeks the public's input into whether there are legislative issues that would benefit from further policy consideration. It is envisaged that any solutions developed in further consideration would be subject to further consultation.

1.6 This issues paper does not deal with:

- software purchased and used in a business where it will generally be a capital asset depreciable over a period of several years
- software developed in-house for use in the business rather than external distribution, or
- any tax issues arising from commercial exploitation of the software, such as royalty rules.

Chapter 2 – Software development expenditure

Overview

2.1 In this chapter, we examine the key rules currently used for determining deductibility for the commercial exploitation of software. The legislation should provide a straightforward set of rules flexible enough to address various forms of software development. We want to know whether there are any problems with these rules that would require a legislative response.

2.2 Several comments in this chapter concerning section DB 34 of the Income Tax Act 2007 also apply to the software as a service (SaaS) issues. However, we look at issues specifically affecting the customisation of SaaS products in Chapter 3.

2.3 This paper does not address software costs incurred in taxpayers commissioning or developing software for use in their business. Guidance in that respect can be found in IS 16/01 "Income tax – computer software acquired for use in a taxpayer's business".

Do existing rules provide appropriate basis for deductibility or depreciation of software development expenditure

2.4 This issue relates to whether the existing rules provide an appropriate basis for the deductibility or depreciation of software development expenditure. In considering this point, we describe three approaches to software development expenditure. We invite your views on the impact of these approaches.

Legislative and interpretative summary

2.5 The most complete current Inland Revenue interpretation of the existing rules is issues paper "Income tax treatment of software development expenditure" (IRRUIP10) published 13 July 2016. However, this view was not finalised.

2.6 The previous statement from 1993 (published in the appendix to *Tax Information Bulletin* Vol 4, No 10, May 1993), was formally withdrawn in 2024. The approach set out in the 1993 statement treated all software development expenditure as immediately deductible as the cost of producing trading stock, provided the expenditure demonstrated the required nexus with deriving income. This treatment applied regardless of how the software was to be commercially exploited.

2.7 IRRUIP10 has already cast doubt on the validity of that earlier position. It concluded that trading stock treatment was only appropriate when the software was developed for outright sale, which is less common these days.

2.8 When software was developed for licensing, IRRUIP10 suggested that the correct treatment was to treat the development expenditure as capital expenditure. The

expenditure could also be treated as the cost of an item of depreciable intangible property, for which depreciation deductions may be available.

2.9 There is also the option for taxpayers to treat some software development expenditure that meets the definition of "research" or "development" as fully deductible expenditure under section DB 34 of the Income Tax Act. This provision, based on accounting principles, overrides the capital limitation up to the point when the applicable accounting treatment requires the recognition of an intangible asset. The appropriateness of the section DB 34 treatment is considered further below.

Use of trading stock approach

2.10 The Commissioner of Inland Revenue's view on the tax treatment of software development costs in 1993 is set out in in *Tax Information Bulletin* Vol 4, No 10. That item includes a discussion on the deductibility of the costs of developing software.

2.11 Under the 1993 statement, emphasis was placed on the way that the general principles of deductibility, including the capital limitation, applied to software development. The primary principle was an assumption that the product of the expenditure would be trading stock, that is, something produced for on-sale. This may have been a fair working approach in 1994, when software was commonly distributed in a physical format. However, even then, from a legal perspective the underlying approach was technically one of licensing.

2.12 The Commissioner's current view is that software development expenditure, when developed for use in non-exclusive licensing (including SaaS arrangements), will not constitute the cost of trading stock.

2.13 When software is developed for sale or exchange, such as by way of an exclusive assignment of all copyright interests, treating it as trading stock may still be appropriate. However, in most other cases when the software is licensed or provided as a service, the Commissioner regards the trading stock approach as inappropriate.

2.14 It is not known how many developers are likely to use the trading stock approach currently. The trading stock model is unlikely to be of assistance even to businesses that manufacture and sell physical media (as was common in the past) because the cost of the copies is likely to be a minimal extra production expense, the development cost of the software would remain capital in nature.

2.15 A taxpayer who can apply the trading stock approach will receive a deduction for the development expenditure in the income year the software is sold. The sale proceeds arising from an outright sale of the software will be revenue in nature and assessable income of the developer.

Depreciation approach

2.16 Software development expenditure may, instead of generating a trading stock deduction, give rise to a depreciation allowance in certain circumstances when it results in an asset. The Income Tax Act ensures that the amount of expenditure incurred in developing the software is part of the cost of the copyright in the software.

2.17 An intangible copyright asset can result from the expenditure on development. Once an asset is available for use in the business, it will qualify for depreciation at either 50% (diminishing value) or 40% (straight line) of the total capitalised expenditure. Upgrades to the software can also be capitalised and depreciated.

2.18 Depending on the depreciation method chosen by the taxpayer, deductions for the cost of the software once an asset is recognised may be spread over a minimum of three income years. Revenue from licensing is assessable income of the developer.

2.19 Software development expenditure on projects that are commenced but subsequently abandoned can be deducted under section DB 40B of the Income Tax Act.

2.20 Several general criteria must be met for an asset to be depreciable. For example, an asset must reasonably be expected to decline in value over time.

2.21 Also, the costs in question must not be deductible under other provisions of the legislation (such as the R&D rules discussed below). In that context, it is important that the point at which the R&D phases are completed can be accurately determined, because, in effect, only the development expenditure incurred after that point will qualify as part of the depreciable cost of the software.

2.22 However, when the R&D rules are not utilised (this is an election that taxpayers may make), all costs will form part of that cost base and can be depreciated once an asset is recognised, and available for use in the business. The sale proceeds arising from an outright sale of the software will be capital in nature and assessable income of the developer to the extent of any depreciation recovered.

R&D treatment

2.23 Some software development expenditure may be deducted under the R&D provision (section DB 34, enacted in 2001 as section DJ 9A of the Income Tax Act 1994). The use of this provision is optional under section DB 34(8). The provision aligns with the accounting treatment directly based on international financial reporting standards (IFRS).

2.24 The policy intent of section DB 34 is to clarify the R&D capital/revenue boundary. Section DB 34 does this by using the tests that accountants employ to establish whether an asset with sufficiently certain future economic benefits has been created. This is intended to make the deductibility of R&D expenditure less complex. Reducing the uncertainty and complexity in the income tax treatment supports the broader objective of incentivising businesses to undertake R&D activities.

2.25 Section DB 34 requires consideration of the meaning of the terms used in NZ IAS 38 "Intangible Assets", issued by the External Reporting Board (XRB) under the Financial Reporting Act 2013. NZ IAS 38 is based on IAS 38 "Intangible Assets", issued by the International Accounting Standards Board.

2.26 NZ IAS 38 outlines how to account for non-monetary assets that do not have a physical form. It broadly covers:

- Recognition: When to recognise an intangible asset, including accounting for acquisitions and disposals of assets.
- Measurement: How to measure the reported value of an intangible asset.
- Disclosure: What information to disclose about intangible assets.

2.27 Intangible assets are assets that are identifiable, non-monetary, and without physical substance, such as computer software, licenses, patents, trademarks, plant variety rights, copyrights and goodwill.

2.28 NZ IAS 38 paragraph 8 defines:

- **Research** as "original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding".
- **Development** as "the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use".

2.29 The Commissioner accepts that software development can meet the definition of R&D for the purpose of applying section DB 34. When section DB 34 applies, the taxpayer can deduct the expenditure in the income year they incur it or carry it forward to later income years. The depreciation treatment then applies to any remaining part of the capital expenditure that does not meet these specific tax entitlements.

2.30 The bar for recognising an internally generated intangible asset under NZ IAS 38 is high. Research (and expenditure incurred in the research phase of an internal project) cannot give rise to an intangible asset and the expenditure is recognised as an expense when it is incurred. To recognise an intangible asset arising from development, a taxpayer must demonstrate all the following:

- The technical feasibility of completing the intangible asset so it will be available for use or sale.
- Their intention to complete the intangible asset and use or sell it.
- Their ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits.
- The availability of adequate technical, financial and other resources to complete the development and to then use or sell the intangible asset.

- Their ability to reliably measure the expenditure attributable to the intangible asset during its development.

2.31 Further, applying NZ IAS 38's high bar for asset recognition in a tax context may result in taxable income being understated, which could undermine the objective of tax to accurately measure taxable income.

2.32 The provision that became section DB 34 clearly contemplated the inclusion of some software development as constituting research and/or development because NZ IAS 38's principles-based approach requires judgement-heavy decisions from a financial reporting perspective. However, we understand companies face challenges in consistent application, cost classification, and justifying capitalisation. Regulators and auditors often scrutinise these areas, increasing compliance risks. To the extent that section DB 34 imposes compliance costs that disincentivise the intended use of the section, it does not achieve its policy intent of reducing uncertainty and complexity in determining the R&D capital/revenue boundary.

Closing statement

2.33 Absent any specific feedback from the software development industry, we consider that, from a tax perspective, the approaches described above provide an appropriate basis for determining deductibility.

2.34 However, we are interested in hearing whether the specific nature of software development could mean that the approaches described above are not likely to result in correct outcomes. And, if so, what are the key considerations that should inform the tax treatment of software development expenditure and what that approach might look like.

Questions for submitters

Q1. What is your current approach to determining the tax treatment of software development expenditure?

Q2. Do you consider that the approaches described above (that is, the trading stock, depreciation, and R&D treatments) are likely to result in the correct outcomes for tax purposes? What issues arise with applying a given approach?

Q3. We understand that the timing of deductions may be a particular concern. If so, how significant for you is the difference in the timing of deductions allowed under each approach?

Q4. When a software product is developed to be sold rather than licensed, is it still appropriate to apply the trading stock rules? Should the tax principles be standardised across all forms of software development?

Q5. Are the asset recognition criteria under NZ IAS 38 suitable for identifying when a software development project has generated a recognisable asset, in the context of determining appropriate tax treatment?

Q6. Do any aspects of applying NZ IAS 38 cause escalated compliance costs in the context of claiming tax deductions under section DB 34? Do the compliance costs affect your decision to use section DB 34 to calculate appropriate deductions?

Q7. Is the nature of software R&D sufficiently distinct to justify a case for simplifying the approach for software development by addressing software R&D in a standalone provision instead of section DB 34?

Non-IFRS taxpayers and section DB 34

2.35 Another question relates to companies that are not required to apply IFRS-based standards at all (generally SMEs, an international standard for SMEs exists but New Zealand has not adopted it). If a for-profit entity is required by legislation to report in accordance with standards issued by the XRB (often referred to as "generally accepted accounting practice" in legislation), the entity must apply New Zealand equivalents to IFRS Accounting Standards (NZ IFRS) in full if it is in Tier 1, or apply NZ IFRS with reduced disclosure requirements (NZ IFRS RDR) if it is in Tier 2.

2.36 A for-profit entity is in Tier 1 if it has "public accountability" as defined in the standard XRB A1, or if it is a public sector for-profit entity that has expenses of more than $30 million in the accounting year. All other for-profit entities that are required by legislation to report in accordance with XRB standards are eligible to be in Tier 2. The only concessions from full NZ IFRS that Tier 2 entities are eligible for are disclosure concessions. Therefore, in the case of R&D reporting, the recognition criteria for Tier 1 and Tier 2 are the same.

2.37 Public benefit entities that are required by legislation to report in accordance with standards issued by the XRB report under the applicable standards for public benefit entities rather than NZ IFRS or NZ IFRS RDR. Some entities (for example, some companies that are not considered "large" under the Companies Act 1993 and are not "FMC reporting entities" under the Financial Markets Conduct Act 2013) are not required by legislation to report in accordance with standards issued by the XRB.

2.38 Smaller companies not required to use IFRS reporting can choose to apply NZ IAS 38 for tax purposes to apply section DB 34. Effectively, this is done as a precondition to tax reporting to appropriately identify expenditure. This creates a compliance burden. In particular, the record-keeping and other requirements for the recognition criteria may represent a significant compliance cost.

Question for submitters

Q8. Are the compliance costs for non-IFRS taxpayers of using NZ IAS 38-based requirements in section DB 34 prohibitive to the use of that section? If so, what alternative approaches would result in appropriate outcomes for both IFRS and non-IFRS taxpayers?

Asymmetric results possible under section DB 34

2.39 Under current tax settings, gains from the sale of assets created from R&D are not always taxed. This can contribute to an asymmetrical outcome when R&D expenditure has been deducted under section DB 34.

2.40 The application of section DB 34 means that R&D expenditure is generally deductible when incurred. However, once development moves beyond the R&D phase and is recognised as an asset, to the extent that expenses are capital in nature, these costs are required to be capitalised as intellectual property and depreciated over the useful life of the software.

2.41 Currently, if that intellectual property is later sold or disposed of, a permanent tax benefit arises because in most cases the disposal represents a non-taxable capital gain. That is, the deducted section DB 34 expenditures are not then required to be recognised or recovered as clawed-back depreciation or otherwise treated as income. Only capital expenditure arising after the R&D stage of development can be subject to depreciation recovery.

2.42 The result of this is potential tax asymmetry, with R&D expenditure (which under a non-section DB 34 regime would be capitalised) being deductible but the sale of the resulting R&D outputs untaxed.

2.43 This has the effect of treating assets that have been supported by deductions made under section DB 34 (but which would otherwise be depreciable) differently from other assets that, if sold for greater than their tax book value, are subject to normal depreciation recovery. The policy intent of section DB 34 is to clarify the R&D capital/revenue boundary. That section DB 34 creates a category of capital expenditure for the cost of an asset that is treated as revenue but not then recovered is beyond this intent, and we believe that a more balanced approach may be justified.

Question for submitters

Q9. Do you agree that an equitable treatment would ensure that assets supported by deductions made under section DB 34 are not treated differently from other assets that, if sold for greater than their tax book value, are subject to normal depreciation recovery? What justification might there be for a differential treatment?

Chapter 3 – Software as a service

Overview

3.1 This chapter is primarily concerned with the income tax treatment of software as a service (SaaS) configuration and customisation (C&C) costs. Since cloud technology did not exist at the time that the current rules were enacted, we want to ensure that these rules are resulting in appropriate outcomes.

3.2 Further, consideration is given to two minor technical issues relating to the depreciation of SaaS arrangements and potential black hole expenditure in some circumstances.

Income tax treatment of SaaS C&C costs

3.3 SaaS is a cloud-based software licensing and delivery model. Generally, a customer enters an arrangement with a SaaS provider that gives the customer a right to access the provider's software which runs on the provider's cloud infrastructure. The customer accesses the software on an as-required basis over the internet or a dedicated line. The customer does not manage or control the underlying cloud infrastructure.

3.4 The contractual terms of SaaS arrangements can vary significantly. Some SaaS arrangements provide a periodic subscription, whereas others may be for an agreed initial fixed term with rights of renewal.

3.5 When implementing a SaaS application, a customer may need help to integrate the application with their existing systems or may require additional features or functionalities that are not included in the "off-the-shelf" SaaS application. These additional integration activities are commonly referred to as "configuration" and "customisation".

3.6 The IFRS Interpretations Committee (IFRIC) Agenda Decision discussed below describes the two terms as follows:

- **Configuration:** The setting of various "flags" or "switches" within the application software, or defining values or parameters, to set up the software's existing code to function in a specified way.
- **Customisation:** Modifying the software code in the application or writing additional code. Customisation generally changes, or creates additional, functionalities within the software.

IFRIC agenda decisions

3.7 IFRIC has issued two decisions, the first in 2019 and the second in 2021, on the accounting treatment of SaaS arrangements.

3.8 The first of these considered whether a customer receives a software asset at the start of the arrangement or a service over the term of the arrangement. The decision clarified that a customer receives a software asset if either:

- the contract contains a software lease, or
- the customer otherwise obtains control of software.

3.9 The second decision considered whether a customer, applying NZ IAS 38, should recognise an intangible asset in relation to SaaS C&C expenditure; and, if an intangible asset is not recognised, how this expenditure should be accounted for.

3.10 The decision clarified that whether configuration or customisation of that software results in an intangible asset for the customer depends on the nature and output of the configuration or customisation performed:

- If the customer does not control the software being configured or customised and those configuration or customisation activities do not create a resource controlled by the customer that is separate from the software, the customer would not recognise an intangible asset.
- If the arrangement results in, for example, additional code from which the customer has the power to obtain the future economic benefits and to restrict others' access to those benefits, the customer would need to assess if the additional code is identifiable and meets the recognition criteria in NZ IAS 38.

3.11 In most cases, when an intangible asset is not recognised, the costs will be expensed.

Inland Revenue guidance

3.12 In September 2023, Inland Revenue released an interpretation guideline (IG 23/01) considering the deductibility of the costs incurred by taxpayers in configuring or customising a supplier's application software in a SaaS arrangement.

3.13 IG 23/01 addressed issues raised following the IFRIC Agenda Decisions on the accounting treatment of SaaS arrangements. IG 23/01 clarified that, depending on the circumstances, the SaaS C&C costs may be deductible as development expenditure (section DB 34 of the Income Tax At 2007) or as relating to depreciable intangible property.

3.14 Since the release of IG 23/01, several issues have been identified with the application of the relevant provisions to SaaS C&C costs. This chapter outlines a problem definition for these issues and invites responses to several consultation questions.

General permissions/capital limitation

3.15 Section DA 1 of the Income Tax Act sets out the general permission for whether an expenditure or loss is deductible. This usually requires that an expenditure or loss is incurred in deriving assessable income or in the course of a business carried on to derive assessable income. IG 23/01 sets out the view that a taxpayer will have the required

nexus between the SaaS C&C costs and the derivation of income from an existing business to satisfy the criteria outlined by section DA 1 of the Income Tax Act.

3.16 However, IG 23/01 continues that, generally, the SaaS C&C costs will not be deductible under s DA 1. This is because it is likely that the capital limitation, set out in section DA 2(1), will override the general permission and disallow a deduction under section DA 1 for the SaaS C&C costs. This will occur when the taxpayer incurs the SaaS C&C costs to transform or enhance the taxpayer's business structure and, by incurring the SaaS C&C costs, the taxpayer has received an enduring benefit. This enduring benefit is linked to the business structure and is not part of the day-to-day operations.

Depreciation approach

3.17 The depreciation rules may apply to the extent that the taxpayer cannot deduct the C&C costs under either section DA 1 (or section DB 34, as discussed below).

3.18 Generally, under a SaaS arrangement, the taxpayer receives the right to use or access the SaaS software. The right to use software is depreciable intangible property. Depending on the terms of their SaaS arrangement, a taxpayer may be able to depreciate the right to use software under either the depreciable intangible property or fixed life intangible property rules.[1] The capital SaaS C&C costs will be part of the cost base of either the depreciable intangible property or fixed life intangible property.

Use of section DB 34

3.19 IG 23/01 further clarifies that a deduction for SaaS C&C costs might be available to the taxpayer under section DB 34 of the Income Tax Act 2007. Section DB 34 allows a deduction for research or development expenditure if the taxpayer has recognised the expenditure as an expense under paragraph 68(a) of NZ IAS 38. In this case, section DB 34 will override the capital limitation, and the SaaS C&C costs will be deductible in the year the taxpayer incurs them or as determined under section DB 34(7).

3.20 A deduction under section DB 34 requires that the costs are:

- either "research" or "development" as defined in paragraph 8 of NZ IAS 38
- internally generated and within the scope of paragraphs 54 to 67, and
- expensed under paragraph 68(a).

3.21 Section DB 35 incorporates the definitions of "research" and "development" contained in NZ IAS 38 into section DB 34:

[1] When the legal life of a SaaS arrangement is less than four years, it is fixed life intangible property and depreciated over the length of its legal life. When there was no fixed legal life or the legal life is greater than four years, it is depreciated according to the general provisions on depreciable intangible property.

- **Research** – "original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding".
- **Development** –"the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use".

3.22 The second IFRIC Agenda Decision does not comment on whether the SaaS C&C costs are research or development as defined in NZ IAS 38 because this distinction is not the focus for accounting purposes in terms of the decision to expense or not. For this reason, it will be necessary for a taxpayer to clearly demonstrate that the SaaS C&C costs are either "research" or "development" as defined by paragraph 8 and not merely expensed under paragraph 68(a).

3.23 IG 23/01 concludes that it is unlikely that SaaS C&C activities will be research as defined in section DB 35. This is because, generally, SaaS C&C activities will not involve devising new and original coding or producing some other new knowledge or understanding.

3.24 Regarding whether SaaS C&C costs meet the definition of "development", IG 23/01 takes the view that SaaS configuration activities could qualify depending on the nature of the work undertaken.

3.25 When section DB 34 was originally enacted in 2001 (as section DJ 9A of the Income Tax Act 1994), the section depended on the accounting standard FRS-13 for its definition of R&D. The explanatory commentary to FRS 13 included a concept of innovation in relation to R&D. The underlying standard has since changed to NZ IAS 38, which does not contain the concept of innovation.

3.26 This absence is reflected in IG 23/01. According to the definition of "development", (above) the element of novelty required for SaaS C&C activities relates to the taxpayer, and not in general, as implied by innovation. IG 23/01 clarifies that:

- configuration activities must involve the application of techniques that are complex and new to the taxpayer, and
- customisation work must involve applying knowledge to a design of a new or improved system or process for the taxpayer.

3.27 IG 23/01 further clarifies that the reference to "applying paragraphs 54 to 67" in section DB 34 narrows the scope to internally generated research or development:

- If the taxpayer carries out the SaaS C&C activities in-house, the costs likely relate to an internally generated intangible item.
- When SaaS C&C work is undertaken by the SaaS provider or a third party, if the SaaS C&C costs are not within the scope of paragraphs 54 to 67, they are outside the scope of section DB 34(2).

3.28 This has the effect that the ability to apply section DB 34 to SaaS C&C costs will vary based on whether the taxpayer carries out the SaaS C&C work in-house or not.

3.29 Further, we understand that determining whether section DB 34 applies to SaaS C&C costs entails significant compliance costs to review the underlying data to determine the correct tax treatment.

Closing statement

3.30 From a tax policy perspective, it does not seem tenable that SaaS C&C costs should be deductible under section DB 34. Moreover, the difficulties in applying this provision — in particular the compliance burden — reflect that this approach achieves suboptimal outcomes in practice.

3.31 However, it should be noted that applying section DB 34 is optional. The taxpayer may choose to return their income on the basis that section DB 34 does not apply to the expenditure. For example, a taxpayer may choose to apply the depreciation rules and opt not to use section DB 34 to reduce compliance costs.

3.32 As such, we want to hear, from your perspective, what an appropriate outcome for the tax treatment of SaaS C&C costs might look like. We understand that businesses are likely to prioritise rules that minimise compliance costs. However, as there are options to minimise compliance costs under the status quo (i.e., the depreciation approach), we need to understand why the current rules may not be appropriate and what other concerns may influence your views.

Questions for submitters

Q10. Do you agree that the approaches to the income tax treatment of SaaS C&C costs described above lead to the correct outcome for tax purposes? If not, what do you consider are the problems?

Q11. If innovation were part of the test for section DB 34, do you consider SaaS C&C costs would likely meet this criterion? If SaaS C&C costs cannot meet the criterion of innovation, is it justifiable that these costs meet the definition of R&D for tax purposes?

Q12. Is it the correct outcome that the tax treatment of SaaS C&C costs varies depending on whether a taxpayer carries out the SaaS C&C work in-house or through the SaaS provider or a third party? If not, what problems arise from this outcome?

Q13. Do you consider the compliance cost of applying section DB 34 to SaaS C&C costs a significant impediment to applying the section? If so, is your main concern rules that minimise compliance costs or are there other concerns that we need to consider?

Q14. Do you consider applying the depreciation rules a suitable alternative to a deduction under section DB 34? If not, what problems would arise from this approach?

Depreciation of SaaS arrangements

3.33 A SaaS arrangement with a contract under four years may be depreciated over a longer period than a SaaS arrangement with contracts greater than four years.

3.34 This is because when the legal life of a SaaS arrangement is less than four years, it is fixed life intangible property and depreciated over the length of its legal life. When there was no fixed legal life or the legal life is greater than four years, it is depreciated according to the general provisions on depreciable intangible property. Depending on the depreciation method chosen, this can be as short as three years.

3.35 We understand that it is not uncommon that there are multiple contracts for a single project. We want to understand if this causes any practical issues for taxpayers. For example, to the extent that different contracts have different terms and therefore different depreciation treatments, could this increase compliance costs.

Questions for submitters

Q15. Does this issue cause you any practical issues? For instance, does inconsistency in the period over which SaaS arrangements of different legal lives are depreciated create higher compliance costs for you?

Q16. If you experience negative outcomes, do you think this issue requires a solution? Or is this issue not significant enough for you to require remediation?

Black hole expenditure on some abandoned SaaS arrangements

3.36 We consider there to be a risk that expenditure incurred on SaaS arrangements that have no fixed legal life or a legal life of greater than four years is non-deductible, or "blackhole" expenditure, when the project is abandoned.

3.37 Section DB 40B of the Income Tax Act allows an immediate deduction for expenditure incurred on unsuccessful software development projects in the year that the development is abandoned. The policy intent of this provision is to avoid blackhole expenditure, which could discourage firms from undertaking otherwise sensible investment.[2]

3.38 To make use of this provision, section DB 40B(1)(b) requires that the taxpayer would have acquired the copyright in the underlying software, if the development had been completed. This does not occur in SaaS arrangements, however, when businesses instead merely acquire the rights to access and use the software.

3.39 A taxpayer might also look to sections DB 66 and DB 67 of the Income Tax Act, which apply to feasibility expenditure. These provisions set out the circumstances when expenditure related to business innovation and asset development can be deducted for

[2] Tax treatment of expenditure on unsuccessful software development.

property that, if completed, created or acquired, would be depreciable property or revenue account property.

3.40 Sections DB 66 and DB 67 do not, however, apply to intangible property, unless it is fixed life intangible property.[3] A SaaS arrangement is fixed life intangible property if it has a legal life of less than four years, which is the Commissioner's view of the estimated maximum useful life of software; when there was no fixed legal life or the legal life is greater than four years, it is depreciated according to the general provisions on depreciable intangible property.[4] Therefore, while these sections could apply to SaaS arrangements that are fixed life intangible property, they will not apply to SaaS arrangements that are not. Thus, there is a risk of black hole expenditure for SaaS arrangements with no fixed legal life or a legal life of greater than four years.

Question for submitters

Q17. Do you agree that there is a risk of black hole expenditure in relation to abandoned SaaS arrangements that have no fixed legal life or a legal life of greater than four years?

Q18. If you consider this risk to be a potential issue, do you consider that it requires remediation?

[3] Sections DB 66(2)(c) and DB 67(2)(c).

[4] Cf. IG 23/01: Deductibility of software as a service (SaaS) configuration and customisation costs, pp 41–44.

Appendix – Questions for submitters

Chapter 2 – Software development expenditure

Do existing rules provide appropriate basis for deductibility or depreciation of software development expenditure

Q1. What is your current approach to determining the tax treatment of software development expenditure?

Q2. Do you consider that the approaches described above (that is, the trading stock, depreciation, and R&D treatments) are likely to result in the correct outcomes for tax purposes? What issues arise with applying a given approach?

Q3. We understand that the timing of deductions may be a particular concern. If so, how significant for you is the difference in the timing of deductions allowed under each approach?

Q4. When a software product is developed to be sold rather than licensed, is it still appropriate to apply the trading stock rules? Should the tax principles be standardised across all forms of software development?

Q5. Are the asset recognition criteria under NZ IAS 38 suitable for identifying when a software development project has generated a recognisable asset, in the context of determining appropriate tax treatment?

Q6. Do any aspects of applying NZ IAS 38 cause escalated compliance costs in the context of claiming tax deductions under section DB 34? Do the compliance costs affect your decision to use section DB 34 to calculate appropriate deductions?

Q7. Is the nature of software R&D sufficiently distinct to justify a case for simplifying the approach for software development by addressing software R&D in a standalone provision instead of section DB 34?

Non-IFRS taxpayers and section DB 34

Q8. Are the compliance costs for non-IFRS taxpayers of using NZ IAS 38-based requirements in section DB 34 prohibitive to the use of that section? If so, what alternative approaches would result in appropriate outcomes for both IFRS and non-IFRS taxpayers?

Asymmetric results possible under section DB 34

Q9. Do you agree that an equitable treatment would ensure that assets supported by deductions made under section DB 34 are not treated differently from other assets that, if sold for greater than their tax book value, are subject to normal depreciation recovery? What justification might there be for a differential treatment?

Chapter 3 – Software as a service

Income tax treatment of SaaS C&C costs

Q10. Do you agree that the approaches to the income tax treatment of SaaS C&C costs described above lead to the correct outcome for tax purposes? If not, what do you consider are the problems?

Q11. If innovation were part of the test for section DB 34, do you consider SaaS C&C costs would likely meet this criterion? If SaaS C&C costs cannot meet the criterion of innovation, is it justifiable that these costs meet the definition of R&D for tax purposes?

Q12. Is it the correct outcome that the tax treatment of SaaS C&C costs varies depending on whether a taxpayer carries out the SaaS C&C work in-house or through the SaaS provider or a third party? If not, what problems arise from this outcome?

Q13. Do you consider the compliance cost of applying section DB 34 to SaaS C&C costs a significant impediment to applying the section? If so, is your main concern rules that minimise compliance costs or are there other concerns that we need to consider?

Q14. Do you consider applying the depreciation rules a suitable alternative to a deduction under section DB 34? If not, what problems would arise from this approach?

Do you consider applying the depreciation rules a suitable alternative to a deduction under section DB 34? If not, what problems would arise from this approach? Depreciation of SaaS arrangements

Q15. Does this issue cause you any practical issues? For instance, does inconsistency in the period over which SaaS arrangements of different legal lives are depreciated create higher compliance costs for you?

Q16. If you experience negative outcomes, do you think this issue requires a solution? Or is this issue not significant enough for you to require remediation?

Black hole expenditure on some abandoned SaaS arrangements

Q17. Do you agree that there is a risk of black hole expenditure in relation to abandoned SaaS arrangements that have no fixed legal life or a legal life of greater than four years?

Q18. If you consider this risk to be a potential issue, do you consider that it requires remediation?