Inland Revenue
Te Tari Taake

PUBLIC RULINGS UNIT

ISSUES PAPER No. 10

Income tax treatment of software development expenditure

Office of the Chief Tax Counsel
Inland Revenue

Deadline for comment: 25 August 2016. Please quote reference: IRRUIP10.

ISSUES PAPERS

Inland Revenue's Public Rulings Unit is responsible for developing and publishing binding public rulings and other public statements on aspects of tax law.

Occasionally, the technical and practical issues involved in these statements mean it is necessary or useful for us to seek comments and submissions from external parties before preparing a draft statement. This is done by researching and preparing an issues paper. The purpose of an issues paper is to stimulate discussion and invite submissions from interested parties. The purpose of this issues paper is explained in [1] and [2] below.

The matters considered in this issues paper may form the basis of a future public statement that we would circulate to interested parties for comment in the usual manner.

STATUS OF ISSUES PAPERS

Issues papers produced by the Office of the Chief Tax Counsel represent the initial views of the Commissioner of Inland Revenue. These items may not be relied on by taxation officers, taxpayers or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

SUBMISSIONS

To assist our consideration of the issues involved, we are seeking submissions from interested parties. The Commissioner is interested in receiving written submissions on the interpretation, practical issues and policy outcomes raised in this paper.

As stated, the views expressed in this issues paper represent the initial views of the Commissioner. No change in the Commissioner's current position or practices will occur until Public Rulings' usual public consultation process is completed and all issues are identified and thoroughly considered, including determining what transitional arrangements (if any) are required.

Email your submission to **public.consultation@ird.govt.nz**

We would appreciate receiving your submission by 25 August 2016.

Please quote reference: IRRUIP10

ISSUES PAPER: IRRUIP10

Income tax treatment of software development expenditure

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this issues paper.

Contents

Introduction

Purpose and scope of this issues paper

1. The purpose of this issues paper is to seek comments and submissions from external parties on the topic of how software development expenditure should be treated for income tax.

2. In this issues paper, "software development expenditure" means expenditure incurred by taxpayers in developing software for the purposes of commercial exploitation as part of a business or other income-earning activity carried on by them. It does not include costs incurred in obtaining software developed by others for resale (ie, retailers acquiring shrink-wrapped software for resale). Software in this context is

software that has an independent form, as opposed to software that is an integral part of a tangible asset. It includes bespoke software commissioned primarily for a single client or product-based software developed for general exploitation.

3. This issues paper discusses the income tax treatment of software development expenditure, including the specific provisions concerning the deductibility of research and development (R&D) expenditure. It does not discuss the R&D loss tax credit rules that allow some taxpayers to "cash out" their tax losses caused by qualifying R&D expenditure.

Background

4. The Commissioner's current policy concerning the income tax treatment of software development expenditure is set out in Section 3 of "Income Tax Treatment of Computer Software" published in the Appendix to *Tax Information Bulletin* Vol 4, No 10 (May 1993) (the TIB item).

5. The TIB item provides that software developed for sale or licence is treated for income tax purposes as trading stock. This means that taxpayers incurring software development expenditure are able to deduct the expenditure when it is incurred but must, at balance date, take into account the value of any software on hand as trading stock.

6. The way software is commercially exploited has changed considerably since 1993, when the TIB item was published. For instance, the TIB item does not consider cloud-based computing, including the provision of software as a service (SaaS), which the Commissioner understands has become more common in recent years. Accordingly, the Commissioner acknowledges that this policy is outdated.

7. The Commissioner will continue to apply the policy in the TIB item until she finalises her view through the process described in this paper. If there is a change in her position, it will be published in a public item. Any change in position will be applied prospectively, for example, from the date any public item is published. The Commissioner will not challenge tax positions taken in previous years. Transitional measures for taxpayers who have relied on the previous position will be worked through so that taxpayers have time to adjust their arrangements where necessary.

Summary of analysis

8. Software development expenditure will generally result in an item of property that is an asset. This means that, unless the expenditure is the cost of producing trading stock, the capital limitation in s DA 2(2) will generally apply to prevent the expenditure being deducted when incurred.

9. The Commissioner's initial view is that software development expenditure is not the cost of producing trading stock where software is being developed for use in providing SaaS or non-exclusive licensing. The software may be trading stock where it is being produced for sale by way of assignment of all or part of the copyright rights. Any change in trading stock treatment does not, however, affect the treatment of software development expenditure under the R&D provisions of the Act.

10. Where software development expenditure is not the cost of producing trading stock, there are two potential ways the expenditure could be treated for income tax purposes.

11. The first is to treat the software as a depreciable asset, as follows:

- Generally, the expenditure is non-deductible in the income year the expenditure is incurred.
- The expenditure is treated as the capital cost of producing an intangible asset, being "the copyright in software".
- Software development expenditure does not include feasibility expenditure. Feasibility expenditure is incurred to determine whether to proceed with developing a capital asset. Under the Commissioner's current view of feasibility expenditure, such expenditure will usually be deductible.
- The total capitalised software development expenditure will be all the expenditure incurred in developing the software after a decision is made to proceed with the project.
- Once the development of the software has reached a state where the software is either used or available for use in the manner the developer intends to commercially exploit the software, a depreciation deduction is permitted. Software will be available for use when it is capable of being used for the purpose that it was developed.
- The depreciation deduction will be calculated at either 50% (DV) or 40% (SL) of the total capitalised software development expenditure.
- Expenditure on maintenance of the software is deductible in the year incurred, provided the software is not upgraded so as to improve its capital value.
- Expenditure incurred on upgrading the software, so that the software's capital value increases, is capitalised and depreciated in accordance with s EE 37.
- Software development expenditure may be deductible under s DB 40B if the project is abandoned before an item of depreciable property is produced.

12. The other potential income tax treatment arises under the research and development (R&D) provisions of the Act. If the R&D provisions apply, a different income tax treatment can arise, as follows:

- Feasibility expenditure in relation to software development may also be "research" expenditure under s DB 34. While already deductible under ordinary rules, as R&D expenditure it could be carried forward to later income years.
- Some capital software development expenditure may also be "development" expenditure under s DB 34, in which case the taxpayer can opt to deduct or carry forward the expenditure.
- Where an asset has been recognised under the relevant accounting reporting standard, any further software development expenditure is not deductible. Any further software development expenditure incurred is instead treated as the cost of a depreciable intangible asset for which a deduction for depreciation will be permitted, as outlined in [10] above.
- Smaller businesses may be able to deduct or carry forward capital software development expenditure, provided it is expensed for accounting purposes, is immaterial and is $10,000 or less for the income year.

Questions for submitters

Any conclusions in this paper are the Commissioner's initial views. To assist with our further consideration of these issues, we are inviting submissions from interested parties. Submissions may relate to legal interpretation, the appropriate policy outcomes, practical aspects or any further issues or considerations not dealt with in this paper.

The Commissioner particularly welcomes submissions in response to the following questions:

- Do you agree that the TIB item's approach to treat software as trading stock is outdated and inappropriate? If not, why not?
- Are there circumstances (other than those of an assignment of copyright rights or a sale of a tangible copy of software) where software or a copy of software should be treated as trading stock?
- What practical issues arise if software development expenditure is treated for income tax as:
  - the cost of producing trading stock; or
  - the cost of producing intangible depreciable property; or
  - R&D expenditure?
- What transitional arrangements should apply for taxpayers that have treated software development costs as the costs of producing trading stock should this treatment cease to be considered appropriate? (eg, what treatment should apply if the software is subsequently disposed of?)
- Have you encountered any issues with leasing software or the application of the finance lease regime to software licences (ie, licences to use intangible property)?
- Are there any implications for the issues discussed that go beyond income tax?

Issues

13. As stated, the Commissioner acknowledges the position taken in the TIB item regarding the income tax treatment of software requires updating. The TIB item was published more than 20 years ago and since then the way software is commercially exploited has changed with the development of new approaches, such as SaaS. Accordingly, the reconsideration of the income tax treatment of software development expenditure requires reconsidering first the TIB item's conclusions, and then the application of other relevant provisions in the Act.

14. Therefore, this paper first briefly looks at the TIB item's conclusion that software development expenditure is the cost of producing trading stock when the software is sold or first licensed. This requires considering the meaning of "trading stock" in the Act and how that aligns with the range of circumstances under which software might now be commercially exploited as part of a business (including sales, licences and SaaS).

15. Where software development expenditure does not give rise to trading stock, this paper will consider the implications of specific provisions in the Act that may be of particular relevance. The Commissioner considers that, in the case of software, the provisions dealing with depreciable property and R&D expenditure have particular relevance.

Analysis

16. Software development expenditure, if successful, will generally result in an item of property that is an asset. This means that, unless the expenditure is the cost of producing trading stock or otherwise is the cost of revenue account property (see discussion from [36]), the capital limitation in s DA 2(2) will generally apply to prevent the expenditure being deducted when incurred.

17. This paper first looks at when software development expenditure might give rise to trading stock (so the capital limitation does not apply and a deduction is available when expenditure is incurred). This is the treatment adopted under the TIB item.

18. The paper then considers what happens when software development expenditure does not give rise to trading stock. This involves the appropriate income tax treatment under the depreciation rules and the R&D rules.

When does software development expenditure give rise to "trading stock"?

19. The following analysis will address why the TIB item's approach is no longer appropriate. It considers what is trading stock and the various ways software may be commercially exploited. The way the software is, or is intended to be, exploited generally determines the tax treatment of the development expenditure. In most cases, it would be expected that the characterisation of the expenditure adopted during the development of the software is consistent with the way the software is ultimately commercially exploited. The analysis then considers the ways software development expenditure could be treated for income tax purposes.

What is trading stock?

20. "Trading stock" is primarily defined in s EB 2, the relevant portion of which states:

> (1) **Trading stock** means property that a person who owns or carries on a business has for the purpose of selling or exchanging in the ordinary course of business.

21. The definition requires that trading stock is:

- "property"
- held for the purpose of "selling or exchanging" it
- "in the ordinary course of business".

22. The first and last of these requirements do not appear to create any particular difficulties. It is reasonably arguable that software can be considered "property". Software would be either tangible property (ie, when embodied on a tangible medium, such as a disk) or intangible property (ie, in terms of the copyright rights in the software).

23. It is also reasonable to expect that in many cases the software arising from the software development expenditure may be sold in the ordinary course of a software developer's business. Determining this requires an objective factual enquiry, based on all the circumstances, as to:

- what the ordinary course of the software developer's business involves; and
- whether the software arising from the software development expenditure in question will be sold in the ordinary course of that business.

24. The main difficulties with treating software development expenditure as giving rise to trading stock relate to the requirement that the software is held for the purpose of sale or exchange. The TIB item accepted that this requirement was met when the software was sold or first licensed. However, the Commissioner has identified some potential problems with this approach.

When might software be treated as being sold or exchanged?

25. An outright sale or exchange of the software would seem possible where there is an assignment of all copyright rights in the software. It would also be possible to make a series of partial assignments of the software, each resulting in a partial sale or exchange of the software. A partial assignment or sale of copyright rights in the software might, for instance, arise on a temporal or geographical basis.

26. In either case, the TIB item's approach to treat such software as trading stock appears to be appropriate. That is, there is "property" being held for the purpose of "selling or exchanging" it and this could occur "in the ordinary course of [a developer's] business".

27. In addition, it appears that some exclusive licensing arrangements involving all or part of the copyright rights in the software may, in some limited cases, more correctly be characterised as a full or partial assignment and treated as a sale or exchange.

28. A copy of the software may also be sold or exchanged when embodied on a tangible medium, such as a disk (eg, "shrink-wrapped" software). However, arguably, what is being sold (and is the "trading stock") is just the copy of the software on the disk, and not the software developed as a result of the software development expenditure. Similarly, the software developed is not itself sold where the developer's business involves providing copies of the software by way of digital download. Arguably, this type of transaction may not be a "sale" due to the lack of a tangible item, and would instead involve a licence, as will be discussed below.

What problems arise with treating software as trading stock?

29. Treating software as trading stock where there is a partial sale by way of a partial assignment appears problematic. It seems to give rise to potential compliance cost issues. This is because of the need to value the software developer's remaining interests in the software at balance date under the trading stock rules. This may raise difficult valuation or calculation issues in determining what interests the developer retains in the software at balance date. There may also be the issue of how to deal with the expiry of any partial assignments made on a temporal basis.

30. The Commissioner also considers that treating the software as trading stock where a copy of the software is sold or exchanged on a tangible medium, or by digital download, seems inappropriate. This is because the software would remain perpetually on hand, despite copies being repeatedly sold. Again, difficult valuation or calculation and compliance cost issues appear to arise if this is treated as a situation where the trading stock rules apply.

31. Where software is developed for the purpose of licensing, it appears the TIB item's treatment is inappropriate. This is because licensing the copyright in software does not seem to result in a sale or exchange of the software at all. While a licence involves the creation of legal rights, it does not involve the passing of legal rights as occurs in a sale or exchange transaction (provided the software is non-exclusively licensed

or exclusively licensed but not characterised as an assignment, as mentioned above).

32. A sale or exchange of the software does not arise if access to use a copy of the software is provided as a service.

33. Finally, if a copy of the software is provided under a lease, there is a possibility that the lease may be treated as a "finance lease" under the Act. This would mean that, amongst other things, the lease asset is deemed to be sold. However, the same issues as mentioned above arise — whether the original software or merely a copy of the software is being leased, and how the developer would treat any remaining interests in the software at balance date.

34. In these circumstances, where there is no outright sale or exchange of the software developed, treating the development expenditure as the cost of producing trading stock seems inappropriate. This is partly because, in many cases, the trading stock definition is not satisfied, but also because this treatment seems to cause valuation, calculation and compliance cost issues regarding the value of the developer's remaining interests in the software as at balance date.

35. The question then arises as to what should be the correct income tax treatment of the software development expenditure in these circumstances.

Could software otherwise be revenue account property?

36. The trading stock definition applies where there is a business. The Commissioner acknowledges that software might be developed in circumstances where the software gives rise to assessable income if disposed of, rather than as part of a business. If so, the software development expenditure cannot be treated as a cost of producing "trading stock". However, in these circumstances the development expenditure could potentially be treated as the cost of producing "revenue account property".

37. The cost of revenue account property that is not trading stock is deductible when the software is disposed of or when it ceases to exist (in contrast to trading stock where this occurs on the "sale" or "exchange" of the trading stock). This may mean, in the case of non-exclusive licences where the software is never disposed of, that no deductions for the software development expenditure are permitted until the developer destroys the software. In practice, it may be uncommon or difficult to entirely destroy software.

Summary of when software development expenditure gives rise to "trading stock"

38. Where software is developed for sale or exchange, such as by way of an exclusive assignment of all copyright interests, treatment as trading stock seems appropriate. However, in most other cases, where copies of the software are licensed, provided as a service, or potentially leased, treatment as trading stock appears to be inappropriate.

What treatment should apply where software development expenditure does not give rise to "trading stock"?

39. As noted above, software development expenditure, if successful, will generally result in an item of property that is an asset. Because the Commissioner considers that most software development expenditure will

not be the cost of trading stock, the capital limitation in s DA 2(2) is likely to apply to prevent the expenditure being deducted when incurred.

40. Deductibility of the expenditure is then available:

- if the costs are treated as the cost of producing depreciable property, in which case a deduction is provided under the depreciation rules, or
- if the R&D rules apply.

When will the depreciation regime apply?

41. To be depreciable, property must be property that, in normal circumstances, might reasonably be expected to decline in value while it is used (or available for use) in a business (s EE 6).

42. Also, the property must not be subject to any of the exclusions in s EE 7 (for example, property for which a deduction has been allowed under another provision of the Act, such as the R&D provisions).

43. Intangible property must also be listed in sch 14 to be depreciable. Schedule 14 includes the copyright in software, the right to use the copyright in software, and the right to use software (such as under a licence).

44. Accordingly, it seems possible for software development expenditure to give rise to depreciable intangible property under the Act. This means that a developer would be entitled to depreciation deductions in place of deducting the software development expenditure itself.

How would feasibility expenditure be treated?

45. The costs incurred in software development may differ in the different phases of the software's development. More detailed principles relating to the deductibility of expenditure incurred in developing or acquiring a capital asset are set out in the Commissioner's interpretation statement IS 08/02: "Deductibility of Feasibility Expenditure" (*Tax Information Bulletin* Vol 20, No. 6 (July 2008):12). The Commissioner acknowledges that comments in the recent Court of Appeal decision in *CIR v Trustpower Ltd* [2015] NZCA 253 have questioned some aspects of IS 08/02. However, until that litigation is finally resolved, the Commissioner will continue to apply the position set out in the interpretation statement (and taxpayers may continue to rely on that position).

46. In summary, IS 08/02 provides that expenditure incurred in undertaking feasibility studies to determine whether to develop a capital asset will generally be deductible under s DA 1(1) (assuming the asset is to be used in the developer's business). In the context of software development, this means that expenditure incurred in analysing the feasibility of developing a piece of software for use in a business will be deductible. That is, expenditure incurred principally for the purpose of placing a person in a position to make an informed decision about the development of some software will not generally be expenditure incurred in relation to that software.

47. Once a decision has been made to proceed with the development, any expenditure incurred beyond that point will relate to the software. From that point on, expenditure should be capitalised until the software is either completed or abandoned. This includes both direct costs (such as personnel costs directly attributable to the project) and indirect costs (such as overhead costs that are attributable to the software development).

How would software be treated under the depreciation rules?

48. The relevant depreciable property is the copyright in the software (see sch 14 of the Act). Section EE 18B (as inserted by s 117 of the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Act 2016) ensures that the amount of expenditure incurred in developing the software is considered part of the cost of the copyright in the software.

49. The depreciation rate for the copyright in software, the right to use the copyright in software, and the right to use software is 50% diminishing value or 40% straight line. If a developer has a number of low value items of depreciable property (each item being below the maximum pooling value in s EE 65 (generally $5,000)), they may be able to use the pool method to depreciate the group of items. The requirements for using the pool method are set out in ss EE 20 to EE 24, EE 65 and EE 66.

50. If a developer believes that their particular software should have a higher or lower rate than that set by the Commissioner, they can apply to the Commissioner for a special rate under s 91AAG of the Tax Administration Act 1994. For a special rate to be given, a developer will need to demonstrate that the economic life of their software is either greater or less (as the case may be) than four years. Four years is the economic life on which the 50% diminishing value and 40% straight line rates are based.

51. The depreciation deduction will only be allowed once the software is used or is available for use in the developer's business. In the Commissioner's view, a piece of software will be available for use when it is capable of being used for the purpose that it was developed. This is likely to be after it has been tested to determine that it works as intended and when it is ready (or materially ready) to "go live".

How is unsuccessful software development expenditure treated?

52. If the software is abandoned before there is an item of depreciable property, s DB 40B may allow a deduction for the software development expenditure. Section DB 40B overrides the capital limitation and provides a deduction for expenditure incurred on unsuccessful software development (to the extent that a deduction has not already been allowed). It only applies where the software was being developed for use in a business (in this instance, a software development business). Section DB 40B also requires that the copyright in the software would have been depreciable property if the development had been completed. The development of the software must be abandoned at a time when the software is not depreciable property. If the requirements of s DB 40B are met, a deduction is allowed in the income year in which the development of the software is abandoned.

How are maintenance and upgrades treated?

53. Expenditure incurred in maintaining the software once it has been completed will generally be revenue in nature and deductible under s DA 1. This includes expenditure such as fixing programming bugs, providing help desk facilities and making minor changes to the software - that is, routine changes that do not materially increase the capacity or performance of the software.

54. However, expenditure on upgrades (or improvements) to the software will be capital in nature. An upgrade or improvement occurs when it adds new features to the software, or increases its capacity, performance or life such as to improve the software's capital value.

55. The cost of software upgrades (improvements) must be capitalised and depreciated (at 50% diminishing value or 40% straight line). Section EE 37 sets out how improvements should be depreciated. It provides for improvements to be treated as separate items of depreciable property from the item being improved.

When will the research and development expenditure rules apply?

56. An alternative to the above treatment, if applicable, is the rules relating to R&D expenditure.

How do the R&D expenditure rules apply?

57. The main provision of the Act applicable to R&D expenditure is s DB 34. To the extent that this provision applies, it could alter the income tax treatment of software development expenditure outlined above.

58. Section DB 34 allows a deduction for expenditure incurred on R&D by those persons who:

- recognise the R&D expenditure as an expense for financial reporting purposes under either of two designated financial reporting standards (s DB 34(2));
- recognise the R&D expenditure as an expense for financial reporting purposes because it is written off as an immaterial amount but, had it been material, would have been required to recognise it as an expense for financial reporting purposes under either of the two designated financial reporting standards (s DB 34(4)); or
- incur R&D expenditure of $10,000 or less in an income year, have recognised it as an expense for financial reporting purposes (but not necessarily under either of the designated reporting standards) and have written the amount off as immaterial (s DB 34(5)).

59. Significant terms used in s DB 34 are defined in s DB 35(1) as follows:

> (1) In this section, and in section DB 34,—
>
> **development** is defined in paragraph 8 of the new reporting standard
>
> **new reporting standard** means the New Zealand Equivalent to International Accounting Standard 38, in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place
>
> **old reporting standard** means Financial Reporting Standard No 13 1995 (Accounting for Research and Development Activities) being the standard approved under the Financial Reporting Act 1993, or an equivalent standard issued in its place, that applies in the tax year in which the expenditure is incurred
>
> **research** is defined in paragraph 8 of the new reporting standard.

60. The deduction is not allowed for expenditure on property to which all of the following apply:

- it is used in carrying out R&D;
- it is not created from the R&D expenditure; and
- it is one of the following kinds of property:
  - property for which the taxpayer claims depreciation;
  - property the cost of which is allowed as a deduction by way of amortisation under provisions of the Act aside from the depreciation provisions;

- land;
- intangible property (other than depreciable intangible property); or
- property the taxpayer elects not to depreciate.

However, depreciable property used in R&D may give rise to a depreciation deduction that the taxpayer can choose to allocate under s EJ 23 (see [62] below).

61. Taxpayers who incur R&D expenditure (excluding interest) can claim the deduction in the income year the expenditure is incurred or they can choose to allocate the expenditure to a later income year under s EJ 23. A deduction can only be made in a later income year if there is income that arises as a result of the R&D expenditure in that year (R&D income). The amount of R&D expenditure allocated to a later income year is the lesser of the amount of R&D income and the amount of R&D expenditure not already allocated to an income year.

62. In addition, s EE 1(5) provides that a person who uses an item for R&D or for market development that gives rise to a deduction under s EJ 22 and therefore has a depreciation loss for the item, can choose to allocate the depreciation deduction to a later income year in the way required by s EJ 23.

63. Where a person incurs expenditure (excluding interest expenditure) on market development for a product that has resulted from R&D expenditure, s EJ 22 may apply. The market development expenditure must be incurred prior to the person beginning commercial production or use of the product. Section EJ 22 gives the person the choice to allocate the market development expenditure to a later income year in the way required by s EJ 23.

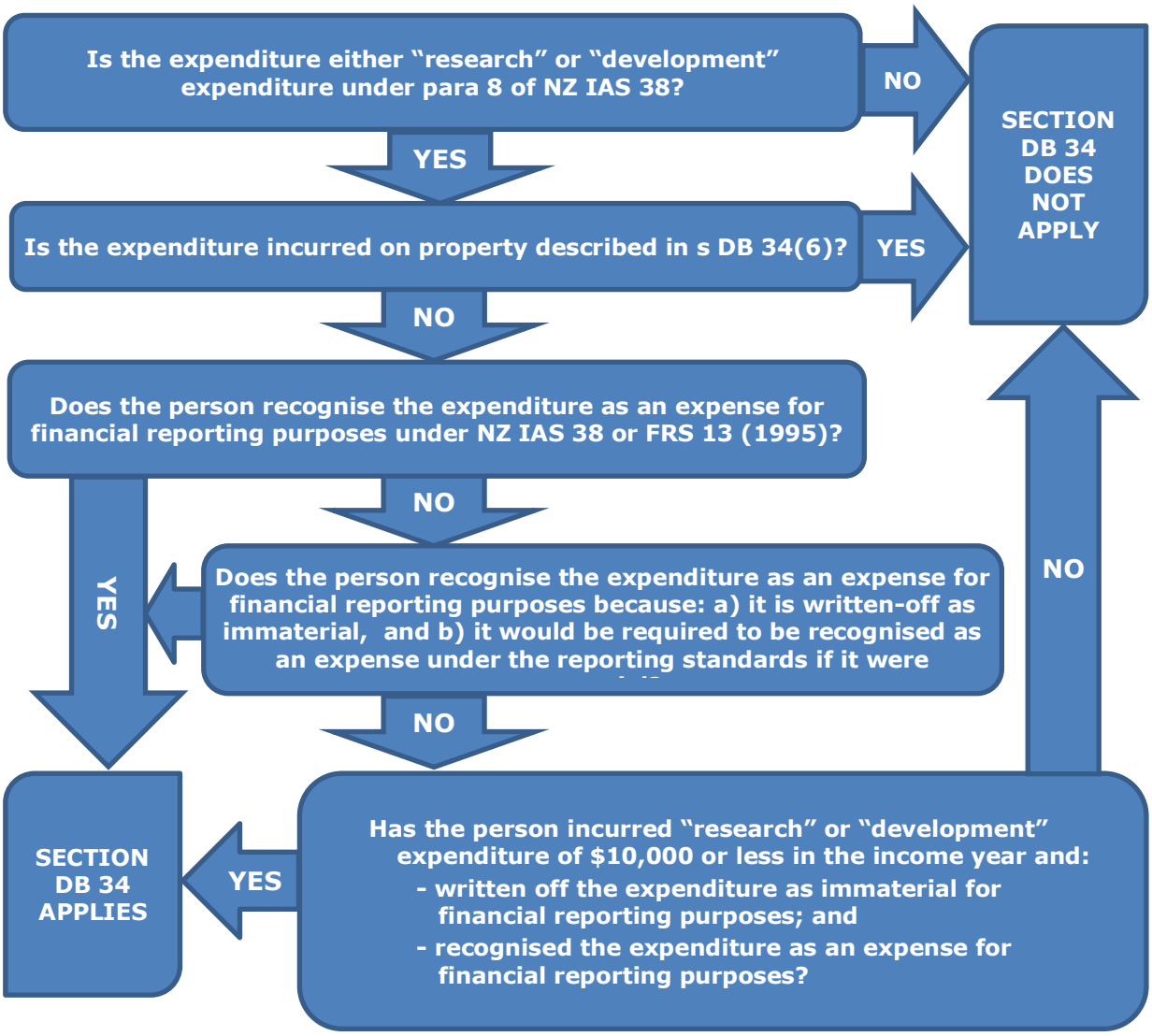
64. A taxpayer who is eligible for a deduction under s DB 34 has the option of not taking the deduction. They may return their income and expenditure on the basis that the section does not apply (s DB 34(8)).

65. If applied, the R&D rules override the capital limitation, but the general permission and other general limitations still apply (s DB 34(10)).

66. In summary, there are currently three types of R&D deductions:

- expenditure allowed under s DB 34;
- depreciation losses from property used either for R&D or for market development of a R&D product; and
- market development expenditure allowed as a deduction and able to be allocated under s EJ 22.

67. In summary, s DB 34 applies in the following way:



Is software development expenditure "research" or "development" expenditure?

68. The linking of the definitions of "research" and "development" in the Act to those in the new reporting standard means applying the R&D rules requires interpreting the reporting standard.

Development

69. "Development" is defined in paragraph 8 of the new reporting standard as follows:

> Development is 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.

70. It appears likely that software development expenditure involves "development" as defined in the reporting standard. Software development expenditure appears to involve "the application of ... knowledge to a plan or design for the production of new or substantially improved ... processes, systems or services ...".

71. Examples of development activities that could apply to software provided in NZ IAS 38's commentary (at [59]) include:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

...

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Research

72. "Research" is defined in paragraph 8 of the new reporting standard as follows:

> Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

73. Looking at the definition of "research", software development expenditure could also result, at least in the feasibility stage of a planned development, in "new ... technical knowledge and understanding". To the extent the expenditure was also feasibility expenditure, it would be deductible under ordinary concepts without need to use the R&D rules to establish deductibility. However, if it is treated as R&D expenditure there is the additional advantage of being able to carry the expenditure forward.

74. Commentary to NZ IAS 38 (at [56]) provides the following examples of research activities, all of which could apply to software development expenditure:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Research and development

75. It appears that a degree of innovation must still be present for software development expenditure to be either "research" or "development". Exactly what degree of innovation is necessary would have to be determined on a case-by-case basis.

What is an intangible asset?

76. An overriding requirement under the reporting standards is that the expenditure on research or on development relates to an "intangible asset". There seems to be no particular issues with software development expenditure being related to an intangible asset and for it to meet this requirement of the standards. An "intangible asset" is defined in NZ IAS 38 as "... an identifiable non-monetary asset without physical substance". An "asset" is defined as follows:

> An asset is a resource:
>
> (a) controlled by an entity as a result of past events; and
>
> (b) from which future economic benefits are expected to flow to the entity.

77. Paragraph 12 of NZ IAS 38 states that an asset is "identifiable" if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

78. Under the new standard, an "intangible asset" must be identifiable, non-monetary and lack physical substance. It must also be controlled by the entity as a result of past events and be something from which future economic benefits will flow to the entity. As stated, there seems to be no particular issues with software development expenditure meeting these requirements.

When are deductions available?

79. If the software development expenditure does fall within the scope of the reporting standards, a deduction is only available if the taxpayer is a person to whom ss DB 34(2) to DB 34(5) apply. Subsection (3) is a special case for derecognised assets, so can be disregarded for present purposes. (Assets are "derecognised" under NZ IAS 38 on disposal or when no future economic benefits are expected from their use or disposal (at paragraph 112).)

80. Under ss DB 34(2) or DB 34(4) the taxpayer must be able to recognise the software development expenditure as an expense under the relevant reporting standard. For present purposes it is necessary only to set out the provisions of the new reporting standard, NZ IAS 38, as the criteria in the old reporting standard are essentially the same. Paragraph 68(a) of NZ IAS 38 provides that expenditure is recognised as an expense "unless it forms part of the cost of an intangible asset that meets the recognition criteria". Recognition of an item as an intangible asset under NZ IAS 38 requires meeting the following recognition criteria:

> 21 An intangible asset shall be recognised if, and only if:
>
> (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
>
> (b) the cost of the asset can be measured reliably.

81. In addition, NZ IAS 38 acknowledges that where intangible assets are internally generated it is sometimes more difficult to assess whether the recognition criteria have been met. Therefore, NZ IAS 38 requires entities to apply additional requirements for internally-generated intangible property. Primarily, these are:

> 52 To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:
>
> (a) a research phase; and
>
> (b) a development phase.
>
> Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.
>
> 53 If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.
>
> **Research phase**
>
> 54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

...

Development phase

57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

82. Accordingly, taxpayers described in ss DB 34(2) or DB 34(4) are able to deduct all software development expenditure that falls within the "research phase" and such expenditure that falls within the "development phase" until such time as the recognition criteria are met. Following that, any further expenditure incurred forms part of the cost of the intangible asset that is able to be depreciated. However, under s EE 7(j), depreciable property does not include any property the cost of which has been allowed as a deduction. This means there is no double deduction for any capital expenditure allowed as a deduction under the R&D rules.

83. The remaining avenue for taxpayers to claim deductions for R&D expenditure is s DB 34(5). Under this provision, the taxpayer must have $10,000 or less R&D expenditure in the income year, have recognised the expenditure as an expense and written it off as an immaterial amount for financial reporting purposes. In *Tax Information Bulletin* Vol 13, No 11 (November 2001):32, when referring to the precursor to this subsection (s DJ 9A(2) Income Tax Act 2004), the Commissioner stated:

> This subsection exempts from the core rule those taxpayers who have total annual R&D expenditure of $10,000 or less, and who write off the expenditure as immaterial for accounting purposes. These taxpayers can treat the expenditure as not being of a capital nature without being required to expense the amount after applying paragraphs 5.1, 5.2 or 5.4 of FRS 13.

84. Given the low level of the threshold, this exemption is likely to apply mainly to small-sized development entities. The expenditure sought to be deducted under s DB 34(5) must still meet the definitions of "research" or "development" in the new reporting standard and it must not be a material amount in relation to that taxpayer.

Comparison of income tax treatment: ordinary rules versus R&D rules

85. Given that it appears software development expenditure could fall under the R&D provisions of the Act, there are three possible income tax treatments for the expenditure depending on the relevant facts (ie, trading stock, capital asset, or R&D expenditure).

86. The following table compares these possible income tax treatments:

Phase	Trading stock	Capital asset	R&D
Feasibility	Not cost of producing trading stock. Deductible when incurred.	Not cost of producing asset Deductible when incurred.	"Research" expenditure Deductible when incurred or carried forward (by choice).
Coding and testing, Deployment	Deductible when incurred, added back at year end to extent included in value of trading stock on hand.	Not deductible when incurred. Capitalise and depreciate once asset completed at 50% DV or 40% SL.	"Development" expenditure Deductible when incurred or carried forward (by choice).
Post-deployment maintenance	Not cost of producing trading stock. Deductible when incurred.	Deductible when incurred.	Not R&D expenditure.
New versions/ upgrades	Separate item of trading stock.	Depreciate in accordance with s EE 37.	Separate R&D project.

87. Which income tax treatment is available in any case will depend on the developer's particular circumstances – in particular, how the software is intended to be commercially exploited in the ordinary course of the developer's business. For instance, where the software is to be exploited by providing access to use a copy of the software as a service, the development costs will be the costs of producing an asset and subject to the depreciation rules or R&D rules (as applicable). The same treatment will also apply where there are licences to use copies of the software, or where tangible copies of the software are sold. Treatment as trading stock may be appropriate where the software is to be exploited in the ordinary course of the software developer's business by way of a full assignment of the copyright rights.

Appendix – Legislation

General permission and general limitation

1. Sections DA 1 and DA 2 state:

DA 1 General Permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

(2) Subsection (1) is called the **general permission**.

Avoidance arrangements

(3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

Private limitation

(2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

Exempt income limitation

(3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

Employment limitation

(4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.

Withholding tax limitation

(5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive

income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the **withholding tax limitation**.

Non-residents' foreign-sourced income limitation

(6) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the **non-residents' foreign-sourced income limitation**.

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

Trading stock

2. Trading stock is defined in s YA 1 as:

trading stock—

(a) is defined in section EB 2 (Meaning of trading stock) except for the provisions to which paragraphs (b) and (d) apply:

...

EB 2 Meaning of trading stock

Meaning

(1) **Trading stock** means property that a person who owns or carries on a business has for the purpose of selling or exchanging in the ordinary course of the business.

Inclusions

(2) **Trading stock** includes—

(a) work of the following kinds that would be trading stock under subsection (1) if it were completed:

(i) partly completed work:

(ii) work in progress:

(b) materials that the person has for use in producing trading stock:

(c) property on which the person has incurred expenditure, when the property would, if they had it, be trading stock under subsection (1) or paragraph (a) or (b):

(d) property leased under a hire purchase agreement when the property—

(i) is treated as having been acquired by the lessor under section FA 15 (Treatment when agreement ends: seller acquiring property); and

(ii) is an asset of a business that the lessor carries on.

...

Revenue account property

3. Section YA 1 defines "revenue account property" as:

revenue account property, for a person, means property that—

(a) is trading stock of the person:

(b) if disposed of for valuable consideration, would produce income for the person other than income under section EE 48 (Effect of disposal or event), FA 5 (Assets acquired or disposed of after

deductions of payments under lease), or FA 9 (Treatment when lease ends: lessee acquiring asset):

...

4. Section DB 23 provides for the deductibility of the cost of revenue account property:

DB 23 Cost of revenue account property

Deduction

(1) A person is allowed a deduction for expenditure that they incur as the cost of revenue account property.

...

Link with subpart DA

(3) Subsection (1) overrides the capital limitation but the general permission must still be satisfied. Subsection (2) overrides the general permission. The other general limitations still apply.

5. Section EA 2 deals with the timing of deductions for revenue account property that is not trading stock:

EA 2 Other revenue account property

When this section applies

(1) This section applies to revenue account property that is not—

(a) trading stock valued under subpart EB (Valuation of trading stock (including dealer's livestock)):

...

Timing of deduction

(2) A deduction for the cost of revenue account property of a person is allocated to the earlier of—

(a) the income year in which the person disposes of the property; and

(b) the income year in which the property ceases to exist.

Unsuccessful software development

6. Section DB 40B provides:

DB 40B Expenditure in unsuccessful development of software

When this section applies

(1) This section applies when a person incurs expenditure in the development of software for use in the person's business if—

(a) the development of the software is abandoned when the copyright in the software is not depreciable property of the person; and

(b) the copyright in the software would have been depreciable property of the person if the development had been completed.

Deduction

(2) The person is allowed a deduction for expenditure incurred in the development of the software to the extent to which no deduction has been allowed for the expenditure under another provision of this Act or under another Act.

Timing of deduction

(3) The deduction is allocated to the income year in which the development of the software is abandoned.

Link with subpart DA

(4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

Depreciation

7. Section YA 1 definitions:

depreciable intangible property is defined in section EE 62 (Meaning of depreciable intangible property)

depreciable property is defined in sections EE 6 (What is depreciable property?) and EE 7 (What is not depreciable property?)

8. Section EE 6 provides:

EE 6 What is depreciable property?

Description

(1) **Depreciable property** is property that, in normal circumstances, might reasonably be expected to decline in value while it is used or available for use—

(a) in deriving assessable income; or

(b) in carrying on a business for the purpose of deriving assessable income.

Subsections (2) to (4) expand on this subsection.

Property: tangible

(2) An item of tangible property is depreciable property if—

(a) it is described by subsection (1); and

(b) it is not described by section EE 7.

Property: intangible

(3) An item of intangible property is depreciable property if—

(a) it is within the definition of **depreciable intangible property**; and

(b) it is described by subsection (1); and

(c) it is not described by section EE 7.

...

9. Section EE 7 provides:

EE 7 What is not depreciable property?

The following property is not **depreciable property:**

...

(b) trading stock:

...

(i) property for whose cost a person other than the property's owner is allowed a deduction:

(j) property for whose cost a person is allowed a deduction under a provision of this Act outside this subpart or under a provision of an earlier Act, except for an asset to which section DU 6(4) (Depreciation) applies.

10. Section EE 18B (as inserted by s 117 of the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters)Act 2016 provides as follows for the 2011-12 to 2014-15 income years:

> **EE 18B Cost: some depreciable intangible property**
>
> For the purposes of **section EE 16** and this subpart, the cost to a person for an item of depreciable intangible property (the **amortising item**) includes an amount of expenditure incurred by the person for an item of intangible property (the **underlying item**) if—
>
> (a) the underlying item gives rise to, supports, or is an item in which the person holds, the amortising item; and
>
> (b) the amortising item is none of—
>
> (i) a patent:
>
> (ii) a patent application with a complete specification lodged on or after 1 April 2005:
>
> (iii) plant variety rights; and
>
> (c) the person is denied a deduction for the expenditure under a provision outside this subpart.

11. For the 2015-16 and later income years, s EE 18B (as amended by s 118 of the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Act 2016) provides:

> **EE 18B Cost: some depreciable intangible property**
>
> For the purposes of **section EE 16** and this subpart, the cost to a person for an item of depreciable intangible property (the **amortising item**) includes an amount of expenditure incurred by the person for an item of intangible property or a plant variety rights application (the **underlying item**) if—
>
> (a) the underlying item gives rise to, supports, or is an item in which the person holds, the amortising item; and
>
> (b) the amount of expenditure is incurred by the person on or after 7 November 2013, if the amortising item is 1 of—
>
> (i) a patent or a patent application with a complete specification lodged on or after 1 April 2005:
>
> (ii) plant variety rights:
>
> (iii) a plant variety rights application:
>
> (iv) a design registration:
>
> (v) a design registration application:
>
> (vi) industrial artistic copyright; and
>
> (c) the person is denied a deduction for the expenditure under a provision outside this subpart.

12. Section EE 37 provides:

> **EE 37 Improvements**
>
> *When this section applies*
>
> (1) This section applies when a person makes an improvement to an item of depreciable property.
>
> *Income year in which improvement made*
>
> (2) In the income year in which the person makes the improvement, the provisions of this subpart apply to the improvement, as if it were a separate item of depreciable property, in the period that—

(a) starts at the start of the month in which the person first uses the improvement or has it available for use; and

(b) ends at the end of the income year.

Following income years

(3) For income years following the income year in which the person makes the improvement,—

(a) a person who uses the diminishing value method or the straight-line method for the item that was improved may choose to apply subsection (4) or (5), if paragraph (ab) does not apply:

(ab) a person who uses the diminishing value method or the straight-line method for the item that was improved must use subsection (3B) if—

(i) treating the improvement as an item, section EE 31(2A) does not apply, but section EE 31(3A) does apply; and

(ii) the item that was improved is a grandparented structure, or is not a building, is not a used import car, is not an international aircraft, or has not been used or held for use in New Zealand as an item of depreciable property before the date on which the person acquires it:

(b) a person who uses the pool method for the item that was improved must apply subsections (6) and (7).

Improvement compulsorily treated as separate item

(3B) For the purposes of subsection (3)(ab), a person must treat the improvement as a separate item of depreciable property.

Improvement treated as separate item

(4) For the purposes of subsection (3)(a), a person may choose to treat the improvement as a separate item of depreciable property.

Improvement treated as part of item

(5) For the purposes of subsection (3)(a), a person may choose to treat the improvement as part of the item of depreciable property that was improved. They must do 1 of the following for the first income year, after the income year in which they made the improvement, in which they use the improvement or have it available for use:

(a) if they use the diminishing value method for the item, add the improvement's adjusted tax value at the start of the income year to the item's adjusted tax value at the start of the income year:

(b) if they use the straight-line method for the item,—

(i) add the improvement's adjusted tax value at the start of the income year to the item's adjusted tax value at the start of the income year; and

(ii) add the improvement's cost to the item's cost.

Pool method

(6) For the purposes of subsection (3)(b), a person who uses the pool method for the item that was improved must treat the improvement as a separate item of depreciable property. If its cost is equal to or less than its maximum pooling value, they must include it in a pool in the first income year, after the income year in which they made the improvement, in which they use the improvement or have it available for use.

Adjustment of pool's value

(7) When an improvement is included in a pool under subsection (6),—

(a) the pool's adjusted tax value is increased by the improvement's adjusted tax value on the date it is included in the pool; and

(b) the improvement's adjusted tax value at the end of the previous income year is included in **starting adjusted tax value** in section EE 21(5).

13. Section EE 62 provides:

EE 62 Meaning of depreciable intangible property

Meaning

(1) **Depreciable intangible property** means the property listed in schedule 14 (Depreciable intangible property).

Criteria for listing in schedule 14

(2) For property to be listed in schedule 14, the criteria are as follows:

(a) it must be intangible; and

(b) it must have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its acquisition.

Schedule 14 prevails

(3) Property that is listed in schedule 14 is depreciable intangible property even if the criteria are not met.

14. Section EE 63(1) provides:

EE 63 Meaning of estimated useful life

Meaning for item of depreciable property, except for copyright in sound recording

(1) **Estimated useful life**, for an item of depreciable property, other than a copyright in a sound recording, means the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account—

(a) the passage of time, likely wear and tear, exhaustion, and obsolescence; and

(b) an assumption of normal and reasonable maintenance.

15. Section EE 67 provides other definitions, including:

fixed life intangible property means property that—

(a) is depreciable intangible property; and

(b) has a legal life that could reasonably be expected, on the date of the property's acquisition, to be the same length as the property's remaining estimated useful life

improvement means an alteration, extension, or repair of an item of depreciable property that increases its capital value.

16. Schedule 14 relevantly provides:

Schedule 14

Depreciable intangible property

ss DZ 11, EE 43, EE 2, EZ 12

...

7. the copyright in software, the right to use the copyright in software, or the right to use software

...

Research and Development

17. Section DB 34 provides

DB 34 Research or development

Deduction

(1) A person is allowed a deduction for expenditure they incur on research or development. This subsection applies only to a person described in any of subsections (2) to (5) and does not apply to the expenditure described in subsection (6).

Person recognising expenditure as expense

(2) Subsection (1) applies to a person who recognises the expenditure as an expense for financial reporting purposes—

(a) under paragraph 5.1 or 5.2 of the old reporting standard or because paragraph 5.4 of that standard applies; or

(b) under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard.

Expenditure on derecognised non-depreciable assets

(3) Subsection (1) applies to a person who—

(a) incurs expenditure, on the development of an intangible asset that is not depreciable intangible property,—

(i) on or after 7 November 2013; and

(ii) before the intangible asset is derecognised or written off by the person as described in paragraph (b); and

(b) derecognises or writes off the intangible asset for financial reporting purposes under—

(i) paragraph 112(b) of the new reporting standard; or

(ii) paragraph 5.14 of the old reporting standard.

Person recognising expenditure otherwise

(4) Subsection (1) also applies to a person who—

(a) recognises the expenditure as an expense for financial reporting purposes because it is an amount written off as an immaterial amount for financial reporting purposes; and

(b) would be required, if the expenditure were material, to recognise it for financial reporting purposes—

(i) under paragraph 5.1 or 5.2 of the old reporting standard or because paragraph 5.4 of that standard applies; or

(ii) under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard.

Person with minor expenditure

(5) Subsection (1) also applies to a person who—

(a) incurs expenditure of $10,000 or less, in total, on research and development in an income year; and

(b) has written off the expenditure as an immaterial amount for financial reporting purposes; and

(c) has recognised the expenditure as an expense for financial reporting purposes.

Exclusion

(6) Subsection (1) does not apply to expenditure that the person incurs on property to which all the following apply:

(a) the property is used in carrying out research or development; and

(b) it is not created from the research or development; and

(c) it is 1 of the following kinds:

(i) property for which the person is allowed a deduction for an amount of depreciation loss; or

(ii) property the cost of which is allowed as a deduction by way of amortisation under a provision of this Act outside subpart EE (Depreciation); or

(iii) land; or

(iv) intangible property, other than depreciable intangible property; or

(v) property that its owner chooses, under section EE 8 (Election that property not be depreciable) to treat as not depreciable.

Choice for allocation of deduction

(7) A person who is allowed a deduction under this section for expenditure that is not interest and is described in subsection (2),(4), or (5) may choose to allocate all or part of the deduction—

(a) to an income year after the income year in which the person incurs the expenditure; and

(b) in the way required by section EJ 23 (Allocation of deductions for research, development, and resulting market development).

Allocation of deduction for derecognised non-depreciable assets

(7B) A person who is allowed a deduction as provided by subsection (3) must allocate the deduction to the income year in which the relevant intangible asset is derecognised or written off by the person for financial reporting purposes under—

(a) paragraph 112(b) of the new reporting standard; or

(b) paragraph 5.14 of the old reporting standard.

Section need not be applied

(8) A person may return income and expenditure in their return of income on the basis that this section does not apply to expenditure incurred on research or development in the income year to which the return relates.

Relationship with section EA 2

(9) If expenditure to which this section applies is incurred in devising an invention that is patented, the expenditure is not treated as part of the cost of revenue account property for the purposes of section EA 2 (Other revenue account property).

Link with subpart DA

(10) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

18. Section DB 35 provides definitions of terms used in s DB 34:

> **DB 35 Some definitions**
>
> *Definitions*
>
> (1) In this section, and in section DB 34,—
>
> **development** is defined in paragraph 8 of the new reporting standard
>
> **new reporting standard** means the New Zealand Equivalent to International Accounting Standard 38, in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place
>
> **old reporting standard** means Financial Reporting Standard No 13 1995 (Accounting for Research and Development Activities) being the standard approved under the Financial Reporting Act 1993, or an equivalent standard issued in its place, that applies in the tax year in which the expenditure is incurred
>
> **research** is defined in paragraph 8 of the new reporting standard.
>
> *Meaning of research or development: modification by Order in Council*
>
> (2) The Governor-General may make an Order in Council specifying—
>
> (a) a kind of expenditure that is not expenditure on research or development for the purposes of section DB 34:
>
> (b) an activity that is neither research nor development for the purposes of section DB 34:
>
> (c) the date from which the expenditure or the activity is excluded from being research or development.

19. Depreciation of assets used for R&D is provided for in s EE 1(5):

> **EE 1 What this subpart does**
>
> ...
>
> *Allocation of deduction for depreciation loss*
>
> (5) A person who in an income year uses an item for research or development or for market development that gives rise to a deduction allocated under section EJ 22 (Deductions for market development: product of research, development), and as a result has an amount of depreciation loss for the item for the income year, may choose to allocate all or part of the deduction for the depreciation loss—
>
> (a) to an income year after the income year for which the person has the depreciation loss; and
>
> (b) in the way required by section EJ 23 (Allocation of deductions for research, development, and resulting market development).

20. Section EJ 23 provides:

> **EJ 23 Allocation of deductions for research, development, and resulting market development**
>
> *When this section applies*
>
> (1) This section applies when a person has—
>
> (a) a deduction for expenditure incurred on research or development that the person chooses to allocate under section DB 34(7) (Research or development):

(b) a deduction for an amount of depreciation loss for an item used for research or development, that the person chooses to allocate under section EE 1(5) (What this subpart does):

(c) a deduction for expenditure incurred on market development for a product that has resulted from expenditure incurred on research or development that the person chooses to allocate under section EJ 22(2).

Timing of deduction

(2) The person must allocate the deduction to an income year—

(a) in which the person derives an amount of income that is assessable income that the person would not have derived but for—

(i) expenditure that gives rise to a deduction that may be allocated under this section:

(ii) the use or disposal of an item for which the person has an amount of depreciation loss that may be allocated under this section:

(b) to which under Part I (Treatment of tax losses) a loss balance is carried forward for the income year in which the expenditure or depreciation loss was incurred.

Minimum amount of deduction allocated to income year

(3) The person must not allocate to an income year (the **current year**) an amount of deductions referred to in subsection (1) that is less than the lesser of—

(a) the amount of assessable income referred to in subsection (2)(a) that the person derives in the current year:

(b) the amount of the deductions that have not been allocated to an income year before the current year.

Maximum amount of deduction allocated to income year

(4) The person must not allocate to an income year (the **current year**) an amount of deductions referred to in subsection (1) that is more than the greater of—

(a) the amount of assessable income referred to in subsection (2)(a) that the person derives in the current year:

(b) the amount of the deductions that—

(i) arise in other income years from which a loss balance may be carried forward under Part I to the current year; and

(ii) have not been allocated to income years before the current year.