Inland Revenue
Te Tari Taake

INTERPRETATION GUIDELINE | ARATOHU WHAKAMĀORI

Deductibility of software as a service (SaaS) configuration and customisation costs

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This interpretation guideline considers the deductibility of the costs the taxpayer incurs in configuring or customising a supplier's application software in a software as a service (SaaS) arrangement. Depending on the circumstances, the costs may be deductible under the general permission (s DA 1), as development expenditure (s DB 34) or as relating to depreciable intangible property.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

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Summary | Whakarāpopoto

1. This interpretation guideline sets out the Commissioner's approach to determining the deductibility of costs a taxpayer incurs in configuring or customising software as a service (SaaS) application. The following are the key points it discusses:

   - The income tax treatment of SaaS configuration and customisation costs (C&C costs) is complex due to the many variations in contractual arrangements and the nature of the services provided. As the tax outcomes under the specific provisions depend on the facts in each individual situation, the approach set out in this interpretation guideline is necessarily general in nature.
   - In the case of an existing business, it is highly likely that the required nexus between the C&C costs and a taxpayer's derivation of income exists, meaning that the costs satisfy the general permission in s DA 1. However, taxpayers will need to carefully consider whether they are denied a deduction for the C&C costs under s DA 1 due to the capital limitation (s DA 2(1)).
   - The configuration or customisation activities may be in-house "development" as defined in s DB 35, depending on their specific nature. If they are "development" activities, some IFRS reporting taxpayers may be able to claim an immediate deduction for C&C costs under s DB 34.
   - Section DB 34 overrides the capital limitation where the costs meet its criteria. It allows a taxpayer to make a deduction for "internally generated" research or development costs. Section DB 34 applies to costs recognised as an expense for financial reporting purposes under paragraph 68(a) of *New Zealand Equivalent to International Accounting Standard 38 Intangible Assets* (NZ IAS 38)[1] applying, for the purposes of that paragraph, paragraphs 54 to 67. Applying s DB 34 is optional and a taxpayer may decide to return their income on the basis that s DB 34 does not apply to the expenditure.
   - The right to use software under a SaaS arrangement is depreciable intangible property. If the taxpayer is unable to claim a deduction for the SaaS C&C costs under the general permission or s DB 34, it is likely they will be able to include the C&C costs as part of the cost base of their rights to use the software. A depreciation loss can be claimed on depreciable intangible property that is used or available for use in deriving income.

[1] *New Zealand Equivalent to International Accounting Standard 38 Intangible Assets* (New Zealand Accounting Standards Board of the External Reporting Board, issued November 2004 and incorporating amendments to 31 January 2022).

- In some situations, depending upon the terms of the particular SaaS arrangement, the right to use software may be fixed life intangible property (FLIP) and the C&C costs will be part of the cost base of the FLIP.
- Flow charts summarising the approach taken in this guideline are included at the end of the Item.

Introduction | Whakataki

2. This guideline clarifies the Commissioner's approach to the income tax treatment of SaaS C&C costs. "IS 17/04 Income Tax – computer software acquired for use in a taxpayer's business"[2] discusses the income tax treatment of software for taxpayers who purchase, lease or license software for use in their business. Where the discussion at [197] to [200] below differs from IS 17/04, the information in this guideline applies.

3. SaaS is a commonly used type of cloud service and provides high-level functionality and generally requires less user technical expertise but offers less user control[3]. The use of SaaS and other cloud computing technologies has increased significantly as businesses undertake digital transformation projects and move away from traditional on-premises software.

4. This guideline addresses issues raised after the International Financial Reporting Interpretation Committee (IFRIC) issued decisions on the accounting treatment of SaaS arrangements. The first IFRIC Agenda Decision[4] considered whether a customer receives a software asset at the start of the arrangement or a service over the term of the arrangement. The first IFRIC Agenda Decision clarified that a customer receives a software asset if either (a) the contract contains a software lease or (b) the customer otherwise obtains control of software. The second IFRIC Agenda Decision[5] considered whether a customer, applying IAS 38, should recognise an intangible asset in relation to SaaS C&C activities and if an intangible asset is not recognised, how the customer should account for the SaaS C&C costs. In many cases the second IFRIC Agenda Decision has resulted in SaaS C&C costs not being recognised as an intangible asset under NZ IAS 38 and being expensed.

5. It is important that taxpayers carefully consider their own accounting treatment given the complexity of SaaS arrangements. Taxpayers should confirm their accounting

[2] Interpretation Statement IS 17/04: "Income Tax – computer software acquired for use in a taxpayer's business" *Tax Information Bulletin* Vol 29 No 5 (June 2017): 173.

[3] CJ Millard (ed), *Cloud Computing Law* (2nd ed, Oxford University Press, Oxford, 2021) at 4.

[4] International Financial Reporting Interpretation Committee, *Customer's Right to Receive Access to the Supplier's Software Hosted on the Cloud* (IFRIC Agenda Decision IAS 38 Intangible Assets, March 2019).

[5] International Financial Reporting Interpretation Committee, *Configuration or Customisation Costs in a Cloud Computing Arrangement* (IFRIC Agenda Decision IAS 38 Intangible Assets, April 2021).

treatment with their financial accountant and/or independent auditor. (The purpose of this interpretation guideline is not to provide guidance on the correct accounting treatment for any taxpayer.)

6. The IFRIC Agenda Decisions highlighted that a level of uncertainty exists about the income tax treatment of SaaS C&C costs. That is, questions remain over whether the costs are:

- deductible under the general permission (s DA 1);
- deductible research or development expenditure (s DB 34);
- for depreciable intangible property (s EE 62);
- for fixed life intangible property (s EE 33); or
- non-deductible expenditure.

7. This guideline sets out how the Commissioner will approach issues relating to the deductibility of SaaS C&C costs. See **Figure | Hoahoa 1** at the end of item for an overview of the approach.

8. The guideline does not apply to SaaS C&C costs incurred by a non-resident related party where a portion is allocated and on-charged to a New Zealand entity. Further, it does not consider any potential withholding tax obligations that a taxpayer may have – for example, for payments to a non-resident software supplier, or for services provided by a non-resident contractor. However, the principles set out in this item are likely to be relevant to allocations of SaaS C&C costs made by a non-resident company to its New Zealand branch.

Analysis | Tātari

What is SaaS?

9. SaaS is a cloud-based software licensing and delivery model. The use of cloud technologies and services is growing as businesses look for innovative solutions in the digital space. At a basic level:

> … cloud computing is a way of delivering computing resources as a utility service via a network, typically the Internet, scalable up and down according to user requirements.[6]

10. Cloud computing services have different service models, including SaaS. This guideline focuses on SaaS user-oriented applications:

[6] *Cloud Computing Law* at 14.

> SaaS provides more high-level (i.e. more application/user-oriented) functionality, generally by way of pre-built (though often configurable) applications, and thereby generally requires far less technical expertise to use, but offers less customer control.[7]

11. Generally, in SaaS arrangements, the customer enters an arrangement with the SaaS provider. The arrangement gives the customer a right to access the provider's software that runs on the provider's cloud infrastructure. In contrast, with a pure service arrangement the customer transfers data to the cloud service provider and receives back the result of the provider's processing of the data. A pure service arrangement is outside the scope of this guidance.

12. The customer accesses the software on an as-required basis over the internet or a dedicated line. They do not manage or control the underlying cloud infrastructure.

13. The SaaS provider will incorporate regular updates into the SaaS application that are available to the customer.

14. A SaaS arrangement differs from a traditional on-premises software model in which the customer purchases hardware and a software licence. In traditional situations, the provider worked on the customer's premises (ie behind the customer's firewall). In a SaaS arrangement, however, the provider hosts the application in the cloud and the only rights the customer receives are to access and use the application software.

15. SaaS applications cover a wide range of uses. These include office and messaging software, payroll processing, customer relationship management (CRM), enterprise resource planning (ERP), human resources management, content management and database management systems.

16. 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.

17. A customer may undertake many types of activities to implement a SaaS application, including:

    - conducting a needs assessment;
    - developing a business case;
    - running a proposal process and selecting the provider;
    - developing bridging modules or application programming interfaces (APIs) to existing on-premises systems;
    - converting data;
    - training;

[7] *Cloud Computing Law* at 16.

- testing and undertaking ongoing maintenance; and
- configuring and customising the application.

18. Among these many areas of activity, most questions for the Commissioner have been about the deductibility of C&C costs. The following section describes the Commissioner's approach to determining the deductibility of C&C costs.

What are configuration and customisation costs?

19. A customer may need help to integrate the SaaS 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".

20. The second IFRIC Agenda Decision describes the two terms as follows:

    i. configuration involves 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.

    ii. customisation involves modifying the software code in the application or writing additional code. Customisation generally changes, or creates additional, functionalities within the software.

21. The above descriptions of "configuration" and "customisation" have been used as a reference when considering the issues in this guideline. However, the descriptions are not exhaustive. It is important for taxpayers to carefully consider the nature of the work being undertaken in determining whether the approach described in this guideline applies to the expenditure they are considering.

22. Generally, in these cases the customer can only access the added functionality through the SaaS licence and has no rights to the enhancements. The C&C activities differ from situations where activities (including customisation) are performed on the customer's on-premises system.

23. C&C activities may typically occur as part of a business undertaking a digital transformation project. As part of such a project, a taxpayer may incur significant costs in undertaking C&C activities. Further, a complex project may have a series of stages that continue over an extended period. SaaS providers usually charge fees for C&C activities based on completing delivery milestones.

24. Generally, where the C&C activities are part of a significant digital transformation project, the taxpayer will enter a SaaS arrangement for a fixed term of 3–5 years, or a shorter fixed term coupled with rights of renewal. Alternatively, before incurring substantial C&C costs, the taxpayer will undertake commercial due diligence of the

SaaS provider to be reassured that they are able to access the SaaS arrangement in the future.

25. The customer may undertake the C&C activities in-house, or the SaaS provider or a third-party contractor may do so. Alternatively, potentially some combination of all three may undertake the C&C activities.

26. To the extent that the SaaS provider (either directly or via a subcontractor) has agreed to help the customer with the implementation, the parties may enter into a master agreement that covers both the SaaS subscription arrangement and the implementation services.

27. Alternatively, the customer may opt to contract a third party directly to help with implementation or may undertake the implementation activities in-house.

General principles of deductibility

28. Generally, the SaaS C&C costs will not be deductible under s DA 1 because the capital limitation applies.

29. However, the courts have recognised that decisions as to whether expenditure is capital or revenue are complex and, as they have often emphasised, depend on the particular facts. The taxpayer's factual situation will determine how the capital tests apply to SaaS C&C costs. There may be cases where the SaaS C&C costs are revenue costs.

30. Where the C&C costs incurred are capital in nature, the taxpayer will be unable to claim a deduction for the costs under s DA 1. The next step will be to consider whether any specific deductibility provisions apply.

General permission

31. It is highly likely that the SaaS C&C costs will satisfy the general permission contained in s DA 1.

32. Section DA 1(1)(a) provides for the deductibility of expenditure that a taxpayer incurs in deriving assessable income (or excluded income, or a combination of the two). Section DA 1(1)(b) provides for the deductibility of expenditure they incur in the course of carrying on a business for the purpose of deriving assessable income (or excluded income, or a combination of the two). The first limb requires a nexus with the deriving of assessable income, and the second a nexus with the carrying on of a business.

33. It is a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and the deriving of income, or the carrying on of a business for the purpose of deriving income. In the context of start-up

entities, SaaS C&C costs may be undertaken preparatory to the commencement of a business and the general permission will not be satisfied.

34. Based on our understanding of a typical SaaS arrangement in a business context, the taxpayer receives access to software that they use as part of their ordinary business operations. SaaS applications are available for a number of common business tools. For examples of types of SaaS applications, see [15].

35. In the typical situation, the taxpayer incurs the C&C costs so that they can access the SaaS application using their existing systems or gain enhanced functionality. As such, it is very likely that a taxpayer will have the required nexus between the C&C costs and the deriving of income from an existing business to satisfy the s DA 1 criteria.

Capital limitation

36. Usually, the capital limitation will override the general permission and disallow a deduction under s DA 1 for C&C costs. This will occur where the taxpayer incurs the C&C costs to transform or enhance the taxpayer's business structure and, by incurring the C&C costs, the taxpayer has received an enduring benefit. However, each situation is determined on its own facts and there may be situations where the SaaS C&C costs are revenue in nature and deductible under s DA 1.

37. The capital limitation (s DA 2(1)) denies deductions for capital expenditure or losses. As the Act does not define the term "capital", case law helps in interpreting the scope of the capital limitation.

38. The general principles form the basis for the distinction between capital and revenue expenditure. Dixon J formulated these principles in *Hallstroms Pty Ltd v FCT*[8] at 647:

> … the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organisation and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.

39. In *BP Australia Ltd v FCT*,[9] the Privy Council set out several indicia to help determine whether expenditure is revenue or capital under the general principles. In summary, those factors are:

- the need or occasion that calls for the expenditure;
- whether the expenditure is recurrent in nature;

[8] (1946) 72 CLR 634 (HCA).

[9] [1965] 3 All ER 209.

- whether the expenditure is on the business structure or whether it is part of the income-earning process;
- whether the expenditure creates an identifiable asset or produces an advantage of enduring benefit;
- whether the source of the expenditure is fixed or circulating capital; and
- how the expenditure is treated under ordinary principles of commercial accounting.

40. Two Court of Appeal cases decided in 2018 confirmed that the New Zealand case law and approach on the capital limitation are settled. The Court of Appeal noted in *NRS Media Holdings Ltd v C of IR*[10] that:

> [72] The courts have also identified a number of relevant, but not determinative, indicators. These include the "enduring benefit test" [footnote 40: *Commissioner of Inland Revenue* v *Trustpower Ltd* [2015] NZCA 253, [2015] 3 NZLR 658 at [62]], the "fixed or circulating capital test" [footnote 41: *Commissioner of Inland Revenue* v *Inglis* [1993] 2 NZLR 29 (CA)], and whether the expenditure was recurrent. Ultimately, however, the focus must be on what the expenditure was calculated to effect from a practical and business point of view.

41. In *Easy Park Ltd v Commissioner of Inland Revenue*,[11] the Court of Appeal set out the following general principles:

> [21] The governing approach in New Zealand is summarised by the observations of Lord Pearce in *BP Australia Ltd v Cmr of Taxation* (Cth), adopted by this Court in *Commissioner of Inland Revenue v Thomas Borthwick & Sons (Australasia) Ltd*:
>
> > The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:

[10] (2018) 28 NZTC 23,079.

[11] (2018) 28 NZTC 23,066.

> "depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process":
>
> per Dixon J in *Hallstroms Pty Ltd v FCT*. As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.
>
> [22] The enquiry into whether a receipt is revenue or capital is intensely fact-specific. Therefore in approaching the authorities we acknowledge the oft-cited caution of Richardson J in *Commissioner of Inland v McKenzies (NZ) Ltd*:
>
> ... the capital income field is an intellectual minefield in which the principles are elusive and analogies are treacherous.

42. In considering how the capital tests apply to SaaS C&C costs, the first step is to gain a clear understanding of the terms of the arrangements, the activities undertaken and the fee structure. As the courts have recognised, decisions as to whether expenditure is capital or revenue are complex and, as they have often emphasised, depend on the particular facts.

43. The contractual terms of SaaS arrangements can vary significantly. Some SaaS subscription contracts are a periodic arrangement that either party may terminate by providing notice. In contrast, other SaaS arrangements are for a fixed-term period.

44. A taxpayer incurs the C&C costs to gain the use of the SaaS application in a way that effectively works with the taxpayer's existing system (configuration) and to secure additional bespoke improvements (customisation).

45. C&C activities may occur as part of a larger integration project. In addition to C&C costs a taxpayer may incur other types of expenditure such as for data migration, testing, training and support. In such cases, it will be necessary to determine the nature of each activity and whether the costs are capital.

46. Further, the taxpayer will also need to determine if the activities are part of one overall capital project. The courts have suggested that costs incurred as part of one overall capital project will likely take their nature from that project. In such cases, it is not appropriate to separate out the different costs of the project for tax purposes where that project is capital in nature. This principle applies regardless of whether that project concerns work done on a single asset or on a group of assets.[12] Again, taxpayers will need to consider the type of expenditure they have incurred and assess

[12] *Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361.

whether it is stand alone or part of a wider capital project. If the costs are capital, they will form part of the cost base of the DIP or FLIP.

47. There may be situations where SaaS C&C activities are abandoned. See "IS 17/01 Income Tax – Deductibility of Feasibility Expenditure"[13] and sections DB 66 and DB 67 for further guidance on how to treat SaaS C&C costs in these circumstances.

Need or occasion for the expenditure

48. The need or occasion factor focuses on the principal reasons why the taxpayer incurred the expenditure. In this context, the way to identify the object of the expenditure is to look at the reason or need for making the expenditure rather than what it actually achieved.

49. Generally, a taxpayer incurs C&C costs to ensure that the "off-the-shelf" SaaS application works efficiently and effectively for them, and that the taxpayer receives the benefit of bespoke improvements that enhance their digital processes and systems. The wider benefits of implementing a SaaS application typically include cost-efficiency, greater scalability, data security, enhanced collaboration, automatic software updates and improved data analytics.

Whether the expenditure is recurrent in nature

50. If the expenditure is recurrent and a taxpayer incurs it to meet a continuous demand, this suggests the payment is part of the cost of ordinary business operations and will be a revenue outlay. In contrast, when a taxpayer makes capital expenditure, that is once and for all.

51. However, the courts have cautioned about assuming that: if there are multiple payments, the amount is revenue; and if there is only one payment, the amount is capital in nature.[14]

52. Where the taxpayer buys in SaaS work, usually they pay SaaS C&C costs in a series of lump sum amounts as the project work proceeds. The payments may differ in both the amount involved and interval between payments.

53. To the extent that the C&C activities occur continuously during the term of the SaaS arrangement, and the taxpayer incurs regular costs (even if the amounts differ), this might suggest that the payments are recurrent and are revenue in nature. This contrasts with situations where the taxpayer makes a payment for initial C&C work and then later makes another for further improvements. This may suggest these are

[13] Interpretation Statement IS 17/01: "Income Tax – Deductibility of Feasibility Expenditure" *Tax Information Bulletin* Vol 29 No 3 (April 2017): 15.

[14] *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295 at 317.

multiple lump sum payments that are capital in nature. However, as noted the facts of any particular case must be considered closely and the timing and quantum of payments is not determinative.

Whether the expenditure relates to the income-earning process or business structure

54. The courts have commented that the distinction between capital and revenue expenditure corresponds with the distinction between the business structure and the process by which a taxpayer earns their income.

55. The taxpayer incurs C&C costs in making their core business systems and purposes more efficient, allowing them to operate competitively in their market. The expenditure is designed to enhance the business structure of the taxpayer's business in question, rather than being part of the process by which income is earned.

56. The expenditure is arguably not an ordinary operating expense but instead goes towards the structure of the business. The C&C costs enhance the functionality of the SaaS application and so link to the structure of the business. This kind of expenditure is comparable to SaaS application subscription or access costs that more naturally relate to the day-to-day operational running of the business.

Whether the expenditure is for an identifiable asset or an advantage of enduring benefit

57. This test involves the two aspects of whether the expenditure is for: an identifiable asset; or an advantage of enduring benefit. It is important to note that the absence of any identifiable asset for the taxpayer does not rule out the possibility that the arrangement provides an advantage of enduring benefit.

58. In this context, the C&C work does not create an identifiable asset for the taxpayer (in terms of ownership in any classic sense). It follows that the focus is on whether the taxpayer receives an advantage that has an enduring benefit.

59. The enduring benefit test looks to whether the expenditure gives rise to an advantage. If it does, it also asks whether the advantage provides an enduring benefit.

60. Case law supports the position that a taxpayer may gain an advantage from expenditure even if the expenditure is on an asset that someone else owns.[15]

61. In relation to the requirement that the asset or benefit is "enduring", in *Anglo Persian Oil Co Ltd v Dale (IT)*,[16] Rowlatt J explained that "an asset or an advantage for the

[15] *Ounsworth (Surveyor of Taxes) v Vickers Limited* [1915] 3 KB 267; *Harris-Daishowa (Australia) Pty Ltd* (1994) 94 ATC 5031.

[16] (1931) TC 253.

enduring benefit of a trade" means a benefit that endures in the way that fixed capital endures. This contrasts with a benefit that endures for a long period. Rowlett J stated:[17]

> But the fallacy is in the word "enduring". What Lord Cave is quite clearly speaking of is a benefit which endures in the way that fixed capital endures; not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. It means a thing which endures in the way that fixed capital endures. It is not always an actual asset, but it endures in the way that getting rid of a lease or getting rid of onerous capital assets … endures.

62. Whether an effect or benefit is deemed to be enduring in character depends on the particular facts of each case. The legal terms of an arrangement can be a useful guide in determining whether the advantage provides an enduring benefit. However, the legal terms of the arrangement are just one aspect of the enduring benefit test. The focus is on what is the effect of the expenditure from a practical sense and whether the expenditure creates conditions that are likely to benefit the taxpayer in the long term.

63. Entering a SaaS arrangement has advantages over an on-premises software solution. SaaS providers are continually making updates to the SaaS application to take advantage of technical advancements. Due to the SaaS arrangement, the taxpayer receives the immediate benefit of any updates without needing to acquire a new on-premises software system when the previous system has become obsolete. Being able to take an "off-the-shelf" product that has all the advantages of ongoing upgrades and, through C&C, fully integrate it into their existing system increases the appeal of the SaaS application to the taxpayer. If they were unable to customise standard SaaS applications, a taxpayer could end up with a fragmented system consisting of many isolated components that are poorly integrated. Given the pace of digital and technological advancements, being able to access periodic upgrades without losing any advantages from a customised application may provide an enduring benefit.

64. If the SaaS arrangement provides access for a periodic term (eg either party can terminate it by providing a month's notice), arguably the taxpayer does not receive an enduring benefit when incurring the C&C costs. In these situations, the C&C costs – in some cases, reasonably substantial amounts – are incurred with no legal certainty that the SaaS provider will continue to supply access to the SaaS application. However, the decision in *Anglo Persian* clarifies that an "enduring benefit" is not limited to a benefit that endures for a long period but includes a benefit that endures in the way that fixed capital endures. Generally, the reason why the taxpayer has chosen to incur the C&C costs is to achieve efficient / improved integration between its current IT systems and the SaaS application for a future period. Under this arrangement, the taxpayer does not anticipate that they will only have access to the SaaS application for a short month-

[17] *Anglo Persian* at 262.

by-month period. In these circumstances, while it may appear that having the SaaS arrangement for an indefinite periodic term has no enduring benefit, that is not necessarily the case. The wider factual circumstances also need to be considered.

Whether the source of the expenditure is fixed or circulating capital

65. This factor focuses on whether the source of the expenditure was from fixed or circulating capital. However, the New Zealand courts[18] have suggested that this factor is of limited assistance and any decision on tax treatment should focus on the purpose of the expenditure more than on its source.

How the expenditure is treated under ordinary principles of commercial accounting

66. The treatment of the expenditure under ordinary principles of accounting may help somewhat in determining whether expenditure is capital or revenue for tax purposes. However, the Court of Appeal in *Commissioner of Inland Revenue v Trustpower Limited*[19] suggested that this factor is unlikely to be particularly significant or conclusive.

67. Following the second IFRIC Agenda Decision, taxpayers who apply NZ IAS 38 for financial reporting purposes will commonly be recognising the C&C costs as an expense.[20] This might suggest that the C&C costs are also revenue in nature for tax purposes.

68. The accounting tests are different from the considerations of whether there is a capital expense for tax purposes. In the context of C&C costs relating to a SaaS service contract, the accounting test contained in NZ IAS 38 for an asset will not be satisfied if:

- the C&C work does not create a separate resource that the customer controls; and
- the customer does not control the software being configured or customised.

69. The test of control when applying NZ IAS 38 has two broad aspects:

- the power to derive future economic benefits for more than a year; and
- the right to restrict the access of others to those benefits.

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[18] *Commissioner of Inland Revenue v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834 (HC).

[19] [2015] NZCA 253.

[20] The exception is where the SaaS provider (or a subcontractor of the SaaS provider) undertakes the C&C activities, and the services are not distinct because those services are not separately identifiable from the customer's right to receive access to the supplier's application software. In this situation, for accounting purposes an expense is recognised over the contract term of the SaaS arrangement.

70. Tax and accounting have different aims, and the treatment for one may differ from the treatment for the other. It follows that while the treatment of the expenditure under ordinary principles of accounting may provide guidance it is not determinative of whether an expense is capital or revenue in nature for tax purposes.

Timing of deduction

71. To the extent that the C&C costs are deductible under s DA 1, the taxpayer will need to confirm the timing of the deduction. If the C&C costs are deductible under s DA 1, the taxpayer will need to consider whether s EA 3 applies.

72. Section BD 4 provides that a deduction for an amount of expenditure is allocated to the income year in which the taxpayer incurred the expenditure unless a provision in parts D to I provides for allocation on another basis. To the extent that the taxpayer pays the C&C costs to a third party and those costs relate to multiple income years, s EA 3 should be considered.

73. Section EA 3 applies where the Act allows a taxpayer a deduction for expenditure and some or all of the expenditure is unexpired at the end of the taxpayer's income year. The effect of applying s EA 3 is that the unexpired portion of the taxpayer's expenditure at the end of an income year is added back as income for the income year and the taxpayer is allowed a deduction for that amount in the following income year.

Non-deductible under general principles of deductibility

74. As noted at [28], C&C costs will usually be non-deductible under general principles of deductibility due to the capital limitation. In most cases, by incurring the C&C costs the taxpayer has secured an advantage of an enduring benefit – that is, having access to a technologically advanced SaaS application that works with their existing systems and has been customised to meet their business needs. This enduring benefit is linked to the business structure and is not part of the day-to-day operations. The remaining sections of this guideline will consider the income tax treatment of C&C costs that are not deductible under s DA 1 as they are capital expenditure.

Research or development expenditure

75. If the SaaS C&C costs are for "research" or "development" and the taxpayer applies the IFRS accounting treatment for internally generated intangible items that s DB 34(2) prescribes, s 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 s DB 34(7).

76. A taxpayer that applies NZ IAS 38 for financial reporting purposes will be able to claim a deduction for SaaS C&C costs if the costs are for research or development and the

costs are recognised as an expense under paragraph 68(a) of NZ IAS 38 applying, for the purposes of that paragraph, paragraphs 54 to 67. **Figure | Hoahoa 2** sets out the steps that need to be considered when applying s DB 34(2).

What is the main rule?

77. Section DB 34 sets out the main rule of the research or development expenditure provision:

> **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.
>
> …
>
> *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.

78. The main rule is that a deduction is allowed for research or development expenditure if the taxpayer has recognised the expenditure as an expense under paragraph 68(a) of NZ IAS 38 applying, for the purposes of that paragraph, paragraphs 54 to 67 of NZ IAS 38.[21]

79. Following the main rule is optional. The taxpayer may choose to return their income on the basis that s DB 34 does not apply to the expenditure. For example, a taxpayer may choose to apply the depreciation rules and opt not to use s DB 34 to reduce compliance costs.

80. Under s DB 34(6), the main rule does not apply to expenditure that the taxpayer incurs on property they use in carrying out research or development, that is not created by the research or development and is one of the following:

- property for which the taxpayer is allowed a deduction for an amount of depreciation loss;

[21] Our discussion is focused on the new reporting standard, NZ IAS 38, on the basis that the old reporting standard, FRS 13, has been repealed.

- property for which the cost is allowed as a deduction by way of amortisation under a provision of the Act outside subpart EE;
- land;
- intangible property, other than depreciable intangible property; or
- property that its owner chooses, under s EE 8, to treat as not depreciable.

81. In our discussion of how s DB 34 applies to C&C costs, it is assumed that the exclusion contained in s DB 34(6) does not apply.

82. The aspects of the main rule discussed below are:

- who is able to claim a deduction under s DB 34 (from [99]);
- the meaning of "research" and "development" (from [101]); and
- the meaning of "under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard" (from [122]).

The purpose of the main rule

83. The research and development provision was introduced following a Government initiative in 2000 to encourage more spending on research and development. In his Budget speech, the Minister of Finance, the Hon Dr Michael Cullen, stated:

> This Government is committed to assisting the transformation of the economy from our current over-reliance on commodity production to the knowledge intensive industries of the future. The knowledge economy encompasses e-commerce but is bigger than that. It is about additional intelligence, creativity and technological sophistication to our production and export base.
>
> To make this new economy a reality, we need to invest much more in research, science, and technology.

84. In responding to the announcement, taxpayers and tax practitioners noted that the tax treatment of research and development expenditure was uncertain. At the time, research and development expenditure was deductible under general principles; a specific provision in s DJ 9 of the Income Tax Act 1994 that allowed a deduction for expenditure a taxpayer incurred in connection with scientific research (s DB 33 of the Income Tax Act 2007); or the depreciation rules.

85. When the Minister was making his announcement, "research and development" (R&D) generally meant original and innovative activities aimed at creating new knowledge or technology. At the time the most relevant TRA cases that considered research and

development revenue or capital issues involved a prototype four-wheel drive farm vehicle[22] and modifying safety helmets.[23]

86. The Government issued a discussion paper, *Research & Development Expenditure – Accounting Treatment for Tax Purposes*,[24] to address the uncertainty in the current tax treatment:

> 5. Practitioners we have spoken to have noted that the main area of uncertainty relates to distinguishing between capital and revenue R&D expenditure. The tax treatment depends on whether costs are classified as revenue or capital. In broad terms, expenditure is capital if it gives rise to an enduring benefit to the taxpayer. Otherwise, it is revenue expenditure.
>
> 6. Broadly, expenditure on *revenue* account is immediately deductible for tax if the required link with income is shown. Expenditure on *capital* account is not immediately deductible (unless it relates to "scientific research", which is treated more favourably than other capital expenditure). Instead, expenditure on capital account is either deductible over the life of an asset or, on occasion, may not be deductible at all. There is little case law in New Zealand on R&D expenditure to assist taxpayers in determining whether R&D costs are on capital or revenue account. It is, therefore, not clear in tax law when R&D expenditure will be immediately deductible and when it will not be.
>
> 7. We understand that, although the tax treatment of R&D expenditure is uncertain, taxpayers are immediately deducting almost all of their R&D costs. However, this carries the risk of potential disputes with Inland Revenue, and penalties and use of money interest that apply when tax is underpaid.
>
> [Emphasis in original]

87. The discussion paper contained a proposal to minimise the reliance on the general deductibility principles. The measure was to permit taxpayers to follow their accounting treatment to the extent that when they wrote off research or development expenditure for accounting purposes, it would be immediately deductible for tax.

88. The Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001 introduced s DJ 9A (the predecessor to s DB 34) into the Income Tax Act 1994 to help remedy the issue. The commentary to the Bill summarised the proposed amendment as:

> Taxpayers will be able to deduct for tax purposes the R&D expenditure that is recognised as an expense under Financial Reporting Standard 13, Accounting for Research and

[22] *Case N55* 13 NZTC 3,434.

[23] *Case P3* 14 NZTC 4,017.

[24] *Research & Development Expenditure – Accounting Treatment for Tax Purposes: Discussion Paper* (Inland Revenue, Wellington, November 2000).

> Development Activities (FRS 13).[25] FRS 13 requires all "research" costs to be expensed. "Development" costs must be expensed until five criteria are all met. These criteria are designed to approximate the point at which the R&D expenditure gives rise to a valuable asset.

89. As part of introducing s DJ 9A, the definitions of "research" and "development" contained in FRS 13 were incorporated into the tax legislation. Section DJ 9A(6) provided that "research" and "development" had the meanings set out in paragraphs 4.1 and 4.2 of FRS 13, as interpreted by paragraphs 4.3 to 4.7 of FRS 13.

90. In paragraphs 4.3 to 4.7, FRS 13 expanded on the meaning of the definitions and provided examples of research activities, development activities and activities that would not satisfy the definitions. For example, paragraph 4.4 referred to the concept of innovation:

> Research and development activity is distinguished from non-research based activity by the presence or absence of an appreciable element of innovation. If the activity departs from routine and breaks new ground it is normally to be included; if it follows an established pattern it is normally to be excluded.

91. Officials[26] stated clearly that the purpose in applying accounting tests was to remove the complexities in applying the capital/revenue boundary:

> The purpose of the new R&D rules was not to mirror the accounting rules. The purpose was instead to clarify the R&D capital/revenue boundary by using the tests that accountants employ to establish whether an asset with sufficiently certain future economic benefits has been created. There are a number of aspects of FRS 13 that are not useful to ascertaining this boundary. For example, paragraph 2.3 of FRS 13 (which allows non-material R&D to be automatically expensed) is not concerned with this issue.

92. Section DB 34 currently applies to taxpayers who use NZ IAS 38 for financial reporting. NZ IAS 38 replaced FRS 13 (and internationally IAS 38 replaced IAS 9) as part of the wider introduction of IFRS in the mid-2000s. However, FRS 13 remained available for reporting periods beginning on or before 30 November 2012. A key difference between the two standards is that FRS 13 dealt only with accounting for research and development activities, whereas the objective of NZ IAS 38 is broader in scope and prescribes the accounting treatment for intangible items.

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[25] *Financial Reporting Standard No. 13 1995 Accounting for Research and Development Activities* (Financial Reporting Standards Board, Institute of Chartered Accountants of New Zealand, February 1995).

[26] Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill, *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* (Inland Revenue, Wellington, 13 August 2001) at 21.

93. The Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill 2007 proposed changes to align references in the Income Tax Act 2004 to the new IFRS standards. The commentary to the Bill notes:

> Under IFRS, the treatment of research and development expenditure is dealt with under the general accounting standards on intangibles (NZ IAS 38). The core standards for capitalisation of development costs under NZ IAS 38 are substantially the same as the old accounting standards and should continue to be appropriate for taxation purposes. However, some provisions in the old standards (such as paragraphs 2.3 and 5.4 of FRS-13) are no longer applicable and have been amended accordingly.

94. The definitions of "research" and "development" in FRS 13 were similar to those contained in NZ IAS 38. However, NZ IAS 38 does not contain some of the interpretative guidance contained in paragraphs 4.4 to 4.7 of FRS 13. For example, NZ IAS 38 does not contain anything like the paragraph 4.4 reference to the presence of "an appreciable element of innovation". The definitions of "research" and "development" are considered further at [101].

95. The purpose in incorporating the accounting standard into the tax legislation was to make the deductibility of research and development expenditure less complex. In reducing the uncertainty and complexity in the income tax treatment, the intention was to help incentivise businesses to undertake research or development activities.

Other situations beyond the main rule

96. In addition to the main rule, a taxpayer is allowed a deduction for research or development expenditure in any of the following situations, where they:

- incur expenditure on the development of an intangible asset that is not depreciable intangible property and derecognise or write off the intangible asset under either NZ IAS 38 or FRS 13 (s DB 34(3));
- recognise the expenditure as an expense for financial reporting purposes because it is an amount written off as an immaterial amount but, had it been material, would have been required to recognise it as an expense under paragraph 68(a) of NZ IAS 38 applying, for the purposes of that paragraph, to paragraphs 54 to 67 of that standard (s DB 34(4)); or
- incur expenditure of $10,000 or less, in total, on research or development in an income year, have recognised the amount as an expense for financial reporting purposes and have written the amount off as immaterial (s DB 34(5)).

97. This guideline focuses on how the main rule contained in s DB 34(2) applies to C&C costs. However, the comments will provide guidance in applying s DB 34(3) to s DB 34(5) to C&C costs.

98. Along with s DB 34, s DB 33 provides a deduction for expenditure incurred in connection with "scientific research". Section DB 33 is unlikely to apply to SaaS C&C activities due to the absence of innovation.

Taxpayers who can claim a deduction under s DB 34

99. Section DB 34 applies to taxpayers that apply NZ IAS 38 for financial reporting purposes.

100. If a taxpayer does not use NZ IFRS for financial reporting purposes but opts to apply NZ IAS 38 in its entirety (ie in relation to all items within the scope of NZ IAS 38), they may be able to claim a deduction under s DB 34. They cannot claim a deduction under s DB 34 if they do not apply NZ IAS 38 for financial reporting purposes.

The meaning of "research" and "development"

101. Section DB 35 defines "research" and "development":

> **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.
>
> *Secondary legislation*
>
> (3) An Order in Council under subsection (2) is secondary legislation (*see* Part 3 of the Legislation Act 2019 for publication requirements).

102. Section DB 35 specifically incorporates the definitions of "research" and "development" contained in NZ IAS 38 into s DB 34. The definitions differ from the s LY 2 definitions that apply for the research and development tax credits regime.

103. As s DB 34(2) allows a deduction for research or development, the meaning of these words and how they apply to C&C work are considered separately. The following comments are offered as guiding principles on whether C&C activities are research or development. Taxpayers will need to consider each situation in light of the actual activities they undertake.

104. It is necessary to understand the level of complexity and specialist skills involved in performing the C&C work when determining whether the costs relate to research or development in the way the Act defines them.

The meaning of "research"

105. NZ IAS 38 defines "research" as follows:

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

106. Further, paragraph 56 of NZ IAS 38 lists examples of research activities:

> **56 Examples of research activities are:**
>
> (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.

107. The definition of "research" and list of examples focus on original investigation and activities that contribute knowledge and understanding.

108. Of relevance to this discussion, the *Oxford English Dictionary* (online edition, accessed 28 June 2022) defines the word "original" as:

> 1.a. That is the origin or source of something; from which something springs, proceeds, or is derived; primary.
>
> 2.a. Belonging to the beginning or earliest stage of something; existing at or from the first; earliest, first in time.
>
> 5.a. Created, composed, or done by a person directly; produced first-hand; not imitated or copied from another.
>
> 6.a. Having the quality of that which proceeds directly from oneself; such as has not been done or produced before; novel or fresh in character or style.

109. From this definition, it is evident that the ordinary meaning of "original" refers to something being created and novel, not imitated or copied. This suggests a level of innovation or creativity and is consistent with the list of examples of research activities in paragraph 56 of NZ IAS 38.

Configuration and customisation activities unlikely to be "research"

110. It is unlikely that SaaS C&C activities will be research as defined in s DB 35.

111. Generally, SaaS C&C activities will not involve devising new and original coding or producing some other new knowledge or understanding. Configuration activities tend to apply existing processes and know-how to set up a SaaS application to function with the taxpayer's existing systems in a particular way.

112. Similarly, while customisation may create a new functionality for the taxpayer, it usually involves applying existing techniques and knowledge. Work the SaaS provider or a third-party contractor undertakes to customise a SaaS application may be a copy of or very similar to other customisation work they carry out for other customers. These situations lack originality as an existing capability is merely being adopted.

What is the meaning of "development"?

113. NZ IAS 38 defines "development" 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.

114. Paragraph 59 of NZ IAS 38 contains a list of examples of development activities:

> **59 Examples of development activities are:**
>
> (a) the design, construction and testing of pre-production or pre-use prototypes and models;
>
> (b) the design of tools, jigs, moulds and dies involving new technology;
>
> (c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
>
> (d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

115. Essential to the definition of "development" is the concept of **applying research findings or other knowledge** with the aim of **producing new or improved** products, processes or systems.

116. The phrase "or other knowledge" widens the scope of development to include other activities that produce something new or improved. That is, development includes activities that draw on existing knowledge gained from either research or experience. However, development does not consist of ordinary or routine activities based on well-established competence or understanding. The examples of development activities in NZ IAS 38 paragraph 59 that refer to "prototypes", "pilot plant" and "new technology" suggest that development activities produce something new or improved for the taxpayer, in contrast to business-as-usual activities.

Configuration activities may be "development"

117. Decisions about whether or not SaaS configuration activities qualify as development will need to consider the context of the taxpayer's specific arrangement and the nature of the activities undertaken.

118. Generally, configuration type activities involve taking existing code and "turning a switch" to enable the customer to use the SaaS offering. The configuration activities apply existing processes and know-how to modify a SaaS application to function in a particular way. While configuration activities may be more routine in nature in some situations the configuration activities may require the application of techniques that are complex and new to the taxpayer.

Customisation activities may be "development"

119. SaaS customisation activities may qualify as development depending on the nature of the customisation work undertaken.

120. Customisation work involves modifying code or creating new code to provide the taxpayer with improvements or enhancements to the "off-the-shelf" SaaS offering. The customisation work will involve applying knowledge to a design of a new or improved system or process for the taxpayer. The customisation work is more likely to be "development" where it is not routine in nature or part of the taxpayer's business-as-usual activities.

121. The second IFRIC Agenda Decision does not comment on whether the 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 tax purposes, a taxpayer will need to carefully consider the nature of the activities undertaken and the outputs achieved to determine whether the configuration or customisation activities are "development" as defined in paragraph 8 of NZ IAS 38.

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

122. If the SaaS C&C costs are research or development, s DB 34 will allow a deduction if the taxpayer recognises the SaaS C&C costs as an expense for financial reporting purposes **under paragraph 68(a)** of NZ IAS 38 **applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard**. In view of this, the taxpayer will need to consider whether:

    - the SaaS C&C costs are within the scope of NZ IAS 38;
    - the SaaS C&C costs will be recognised as an expense under paragraph 68(a); and
    - in considering paragraphs 54 to 67 the SaaS C&C costs will be expensed under paragraph 68(a).

Are the SaaS C&C costs within the scope of NZ IAS 38?

123. As the taxpayer incurs SaaS C&C costs on intangible items, if the SaaS arrangement does not contain a lease under NZ IFRS 16[27], the costs will be within the scope of NZ IAS 38.

124. NZ IAS 38 prescribes the accounting treatment for intangible assets that no other NZ IFRS standard deals with specifically. The scope of NZ IAS 38 includes research or development activities for internally generated intangible assets (paragraph 5 of NZ IAS 38).

125. Further, paragraphs 9 and 10 of NZ IAS 38 clarify that, to the extent costs on intangible items do not meet the definition of an intangible asset, they are still within the scope of NZ IAS 38:

> 9 Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.

[27] *New Zealand Equivalent to International Financial Reporting Standard 16 Leases (NZ IFRS 16)* (New Zealand Accounting Standards Board of the External Reporting Board, issued February 2016 and incorporates amendments to 23 April 2021)

> 10 Not all the items described in paragraph 9 meet the definition of an intangible asset, ie identifiability, control over a resource and existence of future economic benefits. If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see paragraph 68).

126. Costs on intangible items where the definition of "intangible asset" is not satisfied or the entity will not recognise an intangible asset are within the scope of NZ IAS 38.

127. In the context of SaaS C&C costs, the IFRIC Agenda Decision specifically refers to the treatment of SaaS C&C costs under IAS 38:

> If the customer does not recognise an intangible asset in relation to configuration or customisation of the application software, it applies paragraphs 68–70 of IAS 38 to account for those costs.

128. IFRIC's comments support the view that the SaaS C&C costs are potentially within the scope of NZ IAS 38.

Will the SaaS C&C costs be recognised as an expense under paragraph 68(a)?

129. Paragraph 68(a) applies to costs a taxpayer incurs on intangible items, including the SaaS C&C costs, that do not satisfy the intangible asset recognition criteria.

130. Paragraph 68 provides:

> 68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:
>
> (a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18–67);

131. Paragraph 68(a) applies to all costs a taxpayer incurs on an intangible item and is not limited to research or development expenditure. As a result, not all costs expensed under paragraph 68(a) are within the scope of s DB 34.

132. If costs on an intangible item are not required to be recognised as an intangible asset for accounting purposes, the costs will be expensed. Paragraph 18 of NZ IAS 38 sets out the general requirements for recognising an intangible asset:

> 18 The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:
>
> (a) the definition of an intangible asset (see paragraphs 8-17); and
>
> (b) the recognition criteria (see paragraphs 21-23).

133. Further, specific paragraphs cover how the recognition criteria are applied for certain types of intangible items. Paragraphs 51–67 deal with the initial recognition and measurement of internally generated intangible assets.[28]

134. To the extent that expenditure on an intangible item does not meet the definition of intangible asset, the expenditure is recognised as an expense under paragraph 68(a). Further, if the expenditure meets the intangible asset definition, but not the recognition criteria, the expenditure will also be expensed under paragraph 68(a).

135. In its Agenda Decision on *Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38)*, IFRIC concluded:

> Applying paragraph 18 of IAS 38, an entity recognises an item as an intangible asset when the entity demonstrates that the item meets both the definition of an intangible asset and the recognition criteria in paragraphs 21–23 of IAS 38. IAS 38 defines an intangible asset as 'an identifiable non-monetary asset without physical substance'. IAS 38 notes that an asset is a resource controlled by an entity and paragraph 13 specifies that an entity controls an asset if it has 'the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits'.
>
> In the fact pattern described in the request, the supplier controls the application software to which the customer has access. The assessment of 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. The Committee observed that, in the SaaS arrangement described in the request, the customer often would not recognise an intangible asset because it 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. In some circumstances, however, the arrangement may result 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. In that case, in determining whether to recognise the additional code as an intangible asset, the customer assesses whether the additional code is identifiable and meets the recognition criteria in IAS 38.

136. Based on IFRIC's comments, where the taxpayer does not recognise the SaaS C&C costs as an intangible asset because the taxpayer does not have the required control of the resource,[29] the taxpayer will apply paragraphs 68–70 of NZ IAS 38 to account for the costs.

[28] Refer to paragraph 19 in NZ IAS 38.

[29] IFRIC noted that in some situations where the customer has control of the software code, the customer may be able to recognise an intangible asset under IAS 38.

137. Taxpayers should confirm their accounting treatment with their financial accountant and/or independent auditor. The facts and circumstances of each arrangement will determine the accounting outcomes.

How does a taxpayer apply paragraphs 54 to 67 in determining whether SaaS C&C costs are expensed under paragraph 68(a)?

138. As s DB 34 refers to costs that are expensed under paragraph 68(a) "applying, for the purposes of that paragraph, paragraphs 54 to 67", it is necessary to understand the meaning of this phrase.

139. Paragraphs 54 to 67 of NZ IAS 38 deal with the initial recognition and measurement of internally generated intangible assets. As s DB 34 specifically refers to applying paragraphs 54 to 67, s DB 34 applies only to costs relating to internally generated items.

140. Paragraphs 54 to 56 consider the research phase[30] of an internal project. Then paragraphs 57 to 64 consider the development phase of an internal project. Finally, paragraphs 65 to 67 determine the cost of an internally generated intangible asset.

Research phase

141. Generally, in the research phase of an internal project, a taxpayer will be unable to demonstrate that an intangible asset exists. Paragraph 54 provides:

> 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.

142. If a taxpayer incurs research expenditure within the scope of NZ IAS 38, pursuant to paragraphs 54 to 56, it will be expensed under paragraph 68(a).

Development phase

143. The key provision is paragraph 57. It provides:

> 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.

[30] Paragraph 52 states that although the terms 'research' and 'development' are defined, the terms "research phase" and "development phase" have a broader meaning for the purpose of NZ IAS 38.

(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.

144. What is essential to recognising an intangible asset during the development phase is that all six criteria must be demonstrated. If all these criteria can be demonstrated, the expenditure will not be recognised as an expense under paragraph 68(a).

145. The accounting treatment for expenditure the taxpayer incurs in the development phase is different from the treatment in the research phase because the development phase of a project is further advanced. In addition, in some instances, a taxpayer can:[31]

- identify an intangible asset; and
- demonstrate that the asset will generate probable future economic benefits.

Intangible asset definition

146. Paragraph [132] sets out the general requirements for recognising an intangible asset. Generally, for accounting purposes, costs on intangible items (including development costs) are expensed under NZ IAS 38 paragraph 68(a) until the time that the asset recognition criteria are satisfied. In these situations, if the costs are for research or development and are expensed by applying paragraphs 54 to 67, s DB 34 would allow a deduction for the costs. However, this treatment assumes that the definition of intangible asset in NZ IAS 38 has been satisfied.

147. An issue arises where, as in the case of SaaS C&C costs, the entity has no prospect of recognising an intangible asset because the customer has no control over the created resource, and the definition of intangible asset will not be met.

148. One suggestion might be that if an intangible asset as defined in paragraph 8 of NZ IAS 38 does not exist, then the costs are expensed under paragraph 68(a) without needing to apply the recognition criteria in paragraphs 54 to 67. For SaaS C&C costs, this would mean that because the taxpayer lacks control of the intangible item and so does not have an intangible asset, s DB 34(2) does not apply as the taxpayer need not apply paragraphs 54 to 67. However, on balance the Commissioner is satisfied that the reference to “applying paragraphs 54 to 67” in s DB 34(2) operates to narrow the scope

[31] Refer to paragraph 58 of NZ IAS 38.

of the provision to internally generated research or development but is not more restrictive.

149. The reference should not be interpreted to limit s DB 34 to instances where an intangible item meets the definition of "intangible asset", but the costs are expensed as the item does not meet the recognition criteria. In the case of research costs, NZ IAS 38 specifically provides that they will not result in an intangible asset, but research costs are within the scope of s DB 34(2). Further, the original proposal for s DB 34(2) as outlined in the Government's discussion paper contains support for aligning tax and accounting treatment:

> 8. ... Broadly, the proposal is to clarify the capital / revenue boundary by permitting taxpayers to follow accounting treatment to the extent that when R&D expenditure is immediately written off for accounting purposes, it will be immediately deductible for tax purposes.
>
> ...
>
> 69. The proposal is likely to reduce the amount of any R&D expenditure that is black hole. R&D costs that do not lead to an asset will be expensed for accounting. They will, therefore, be immediately deductible for tax.

150. Section DB 34(2) applies to costs that are capital in nature for tax purposes but are not recognised as an intangible asset for accounting purposes. The reason for the disparity in treatment is that the tests and definitions differ between tax and accounting. As noted in the discussion paper, the Government's intention was to allow a tax deduction for research or development expenditure that was expensed for accounting. It appears to be inconsistent with this intention to interpret s DB 34 as requiring expenditure to meet the intangible asset definition in NZ IAS 38. This would create a class of research and development costs where the accounting expense is not deductible for tax. In the context of C&C costs, the IFRIC Agenda Decision provides that an entity should expense them under paragraph 68 of IAS 38 if the entity is unable to recognise an intangible asset.

Summary of the application of s DB 34 to C&C costs

151. In some situations, s DB 34(2) may operate to allow a deduction for C&C costs.

152. A deduction under s 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).

153. Section DB 34(2) only applies to “research” or “development” as defined in paragraph 8 of NZ IAS 38. The IFRIC Agenda Decision does not refer to SaaS C&C costs as either “research” or “development” as defined in paragraph 8. 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).

154. The reference to “applying paragraphs 54 to 67” in s DB 34 narrows the scope to **internally generated research or development** and excludes costs incurred on separately acquired intangible items.

155. If the taxpayer carries out the SaaS C&C activities in-house, the costs likely relate to an internally generated intangible item. In situations where an intangible asset does not exist, it will not be possible to demonstrate the recognition criteria in paragraphs 54 to 67 and the amount will be expensed under paragraph 68(a). If an intangible asset does exist, the entity will need to determine whether they can demonstrate all six criteria in paragraph 57 and if not, the amount will be expensed under paragraph 68(a).

156. Where C&C work is undertaken by the SaaS provider or a third party, the taxpayer will need to consider whether the costs relate to an internally generated intangible item and whether paragraphs 54 to 67 guide the decision as to whether an intangible asset should be recognised. If the C&C costs are not within the scope of paragraphs 54 to 67, they are outside the scope of s DB 34(2) and the taxpayer should consider whether the C&C costs relate to an item of depreciable intangible property.

Timing of deduction

157. A taxpayer can claim a deduction under s DB 34 when they incur the expenditure. Alternatively, the taxpayer may choose to allocate the deduction in accordance with s DB 34(7).

158. Applying the allocation mechanism under s DB 34(7) is the taxpayer’s choice. To the extent that a taxpayer does not allocate the deduction in accordance with s DB 34(7), they may be subject to s EA 3 (unexpired expenditure) for any third-party costs. Refer to the discussion from [71].

159. Section DB 34(7) provides:

> *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).

160. The allocation mechanism in s EJ 23 allows a better match of timing between the recognition of income from research and development (if able to be determined) and the deduction for the expenditure.

Depreciable intangible property

161. The depreciation rules may apply to the extent that the taxpayer cannot deduct the C&C costs under either s DA 1 or s DB 34. **Figure | Hoahoa 3** shows the steps that need to be considered when determining if a depreciation loss can be claimed.

162. 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. The taxpayer will need to review the terms of their SaaS arrangement to determine whether they should depreciate the right to use software under either the depreciable intangible property or FLIP rules. The capital SaaS C&C costs will be part of the cost base of either the depreciable intangible property or FLIP.

What is "depreciable intangible property"?

163. Depreciable property is property that "in normal circumstances, might reasonably be expected to decline in value" while being used or available for use in an income earning activity (s EE 6(1)).

164. Depreciable property includes intangible property if it:

- meets the definition of "depreciable intangible property" in s EE 62;
- in normal circumstances might reasonably be expected to decline in value when in use or available for use in deriving assessable income or carrying on a business for the purpose of deriving assessable income; and
- is not excluded under s EE 7.

165. FLIP is depreciable intangible property with a "legal life" that is the same length as the property's "estimated useful life". It is important to consider the FLIP rules where the SaaS arrangement has a fixed term as some arrangements may be FLIP. If the SaaS arrangement does not have a fixed term, it cannot be FLIP. In this case, the

depreciable intangible property rules will apply, and the property can only be depreciated at the economic rates.

Definition of "depreciable intangible property"

166. Section EE 62 sets out the meaning of "depreciable intangible property":

> **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.

167. Depreciable intangible property, as defined in s EE 62, means property listed in sch 14. To remove all doubt, s EE 62(3) provides that if something is listed in the schedule, it is treated as depreciable intangible property even if it does not meet the criteria. As s EE 62(2) provides, these criteria are that the property is intangible and has a finite useful life that can be estimated with a reasonable degree of certainty.

168. Of relevance to this discussion, sch 14 includes:

> (7) the copyright in software, the right to use the copyright in software, or the right to use software

169. In most cases, the reason why the taxpayer has the right to access the SaaS provider's cloud infrastructure is to facilitate their right to use the software provided under the SaaS arrangement. In contrast, in a pure service arrangement the taxpayer does not receive any rights to use any piece of software but transfers data to the cloud provider and then receives the results of the SaaS provider's processing of the data. As [11] explains, this type of pure service arrangement is outside the scope of this guidance (and in practice is unlikely to involve configuration or customisation expenditure).

170. Under a SaaS arrangement, the taxpayer does not receive the "copyright in the software" or the "right to use the copyright in the software". The depreciable intangible property is not the software itself but the taxpayer's rights under the SaaS arrangement to use the software.

Decline in value when used or available for use

171. Intangible property will be depreciable property if, in normal circumstances, it might reasonably be expected to decline in value when used or available for use. The key consideration is whether the right to use the software granted under the SaaS arrangement declines in value when used or available for use.

172. Intangible assets with a fixed term are usually considered to have a useful life determined by their legal life and to decline in value as the remaining legal and useful life reduces over time. A right to use software under a SaaS arrangement with a fixed term will decline in value over the term of the arrangement.

173. A question arises as to whether a SaaS arrangement with no fixed term declines in value when used or available for use.

174. There is case law to support the view that property with no fixed term does not decline in value. In *Commissioner of Inland Revenue v Trustpower Limited*, the Court of Appeal held:

> [25] In the case of intangible property, this provision will apply if the three requirements of s EE 6(3) are met. As the cl 9 resource consents are "depreciable intangible property", the first requirement is met. The land use consents of unlimited duration are not within the definition of "depreciable intangible property" because without a fixed term they cannot be expected to decline in value" over time.

175. Further, in *Trustees in the CB Simkin Trust and the Trustees in the NC Simkin Trust v CIR*,[32] the Privy Council considered whether a trademark as opposed to a right to use a trademark would decline in value:

> 8. Their Lordships draw attention to what is not to be found in sch 17. Copyright, other than copyright in software or in a sound recording, is not depreciable intangible property. Nor is a trademark. What distinguishes these types of intangible property from those that are included is the longevity of the useful life of the omitted types. A trademark does not have a "finite useful life". Its useful life can continue indefinitely. The right to use a trademark, on the other hand, will last only for as long as the trademark owner has granted that right.

176. The above cases suggest that if the intangible property does not have a fixed term, then it does not decline in value. However, the cases do not consider software or the right to use software.

177. The New Zealand Parliament enacted the rules permitting the depreciation of intangible assets largely based on the recommendations of the Valabh Committee in

[32] (2005) 22 NZTC 19,001.

1991.[33] The Committee recommended, among other things, expanding depreciable assets to include all depreciating intangible assets:

> **8.5.3 The Exclusion of Intangible Assets**
>
> A notable exclusion from the class of depreciable property are intangible assets. Depreciation is not a phenomenon that is unique to tangible assets. Certain types of intangible assets can also be expected to decline in value over time. **Although intangible assets cannot, by definition, depreciate in value due to wear and tear, they may decline in value over time due to obsolescence brought about by the effluxion of time, changes in technology and changes in the tastes of consumers.**
>
> [Emphasis added]

178. The Valabh Committee also stated:

> **8.6.3 Rate-Setting Criteria**
>
> … The market value of an asset may decline in value as a result of:
>
> (a) a reduced quantity of the services to be provided by the asset. This may occur as a result of physical wear and tear in the case of tangible assets **or the effluxion of time in the case of intangible assets.** The amount of physical wear and tear is likely to be a function of the environment in which a particular asset is used (such as where assets are used in a corrosive environment, or where they are used for extraordinary hours during the day and will therefore decline in value at a greater rate than similar assets used in "normal" environments); and
>
> (b) a reduced secondary market price of the asset. This can result from obsolescence brought about by technological change (such as the introduction of new assets providing better quality services) and changes in consumer tastes.
>
> [Emphasis added]

179. The Committee considered a decline in value of some assets while they were used or available for use will be due to:

- reduced functionality of the asset (as determined in the case of intangible assets by the "effluxion" – or passing – of time); and
- obsolescence due to technological change or changes in consumer tastes.

180. In this way, some intangible assets may decline in value even though they have no fixed legal life because the effects of technological changes or changes in consumer tastes give them a finite useful life. As software is likely to decline in value due to

[33] Valabh Committee *Tax Accounting Issues* (Consultative Committee on the Taxation of Income from Capital, Wellington, February 1991).

obsolescence, it follows that a right to use software would also decline in value no matter whether the right has a fixed term or not.

181. More recently, the Court of Appeal in *Queenstown Airport Corp Ltd v CIR*[34] considered that the threshold for determining whether an asset might reasonably be expected to decline in value is quite low:

> [81] We make a number of points about the interpretation of the relevant part of s EE 6(1). First, the reference to normal circumstances refers to circumstances that might ordinarily be expected to affect the value of the relevant asset over time. Abnormal circumstances, of which an earthquake might be one, are excluded from consideration. Second, the assessment is ordinarily made at the time the relevant deduction is sought. Necessarily, this will involve a prediction of future events. Third, the test is objective in the sense that it would not be sufficient for a taxpayer to believe that the asset might deteriorate over time and therefore decline in value. There must be a reasonable basis for that expectation. **Fourth, the expression "might reasonably be expected to decline in value" sets a relatively low threshold. So long as there is a reasonable prospect that the asset might decline in value in the future, that is sufficient**. Fifth, it is not necessary that the asset is actually used, only that it is available for use. Finally, we agree with Mr Goddard that the test does not require that the asset in question would require complete replacement at the end of its useful life. Nevertheless, the extent, nature and cost of any work required to reinstate the relevant asset may have a material bearing on the assessment of whether a decline in value might reasonably be expected.

[Emphasis added]

182. In a SaaS arrangement, the taxpayer receives the right to use software but not the software itself (ie the underlying asset). The Commissioner considers that to the extent the software declines in value, a right to use that software also declines in value.

183. The high likelihood that software, such as a SaaS application, will decline in value due to obsolescence supports the view that a right to use software declines in value regardless of whether the right has a fixed term.

[34] [2017] NZCA 20.

Section EE 7 exclusions

184. Section EE 7 contains a list of items that are deemed not to be depreciable property. Of relevance is that the list of items includes financial arrangements. The finance lease and financial arrangement rules are discussed from [223].[35]

185. If the SaaS arrangement has a fixed term, a taxpayer should consider whether the depreciable intangible property is FLIP (refer to [206] below).

Calculating the depreciation loss

186. A taxpayer has the option of using either the diminishing value (DV) method or straight-line (SL) method to calculate their depreciation loss on depreciable intangible property (the rights to use software). The cost base of depreciable intangible property will include the SaaS C&C costs. To the extent that the taxpayer incurs any subsequent C&C costs, these costs are added to the cost base under s EE 37.

What is the cost base of depreciable intangible property?

187. The depreciation methods applied to depreciable property are calculated with reference to the "cost" of the item of depreciable property. Although the Act does not define "cost", its meaning is generally accepted as:[36]

> … [t]hat which must be given to acquire something

188. Depreciation losses are available on assets that are used or available for use. As such, the asset must be capable of use and all costs to bring the asset to a condition and location to enable its use are generally accepted as forming part of the cost of an asset. The cost of the depreciable intangible property includes all amounts of capital expenditure that a taxpayer incurs for that item of property up until it is in a condition for first use or availability for use.

189. For a SaaS arrangement, the cost of the depreciable property may include:

- C&C costs; and
- regular subscription payments.

[35] Our discussion on "Calculating the depreciation loss" is based on the position that the right to use software under a SaaS arrangement is depreciable property and not excluded under s EE 7.

[36] *Tasman Forestry Ltd v CIR* (1999) 19 NZTC 15,147 (CA) at 15,156.

SaaS C&C costs

190. C&C costs are costs for making specific alterations and improvements to the SaaS application from which a customer-specific version or iteration of the software is created.

191. To conclude that a SaaS arrangement can give rise to an item of depreciable intangible property (or FLIP), it is necessary to show that the C&C costs are capital in nature. It follows that these costs are part of the "cost" that the taxpayer incurs for the relevant intangible asset being the right to use software.

192. As this interpretation guideline has outlined, the taxpayer may incur the C&C costs in-house, with the SaaS provider or with a third party.

193. Where the taxpayer incurs the C&C costs with the SaaS provider, those costs are part of the cost of the rights they obtain under the SaaS arrangement. The costs are "for" the acquisition of the relevant intangible asset and so are part of the "cost" of the property.

194. Where the taxpayer incurs the C&C costs in-house or in paying a third party (no matter who engages the third party), the costs are likely to be part of the cost of the intangible asset, as long as the SaaS arrangement contemplates the C&C costs the taxpayer incurs. In these circumstances, the taxpayer would incur the costs in order to get the intangible asset for which they are acquiring the rights to use into a condition for their use.

195. If the taxpayer cannot use the SaaS application before the C&C activities are completed, the SaaS C&C costs they incur will be part of the initial cost of the depreciable property.

196. A SaaS C&C project may be carried out in a series of stages or phases. Depending on the facts, a later stage or phase may be a continuation of the original project or a separate stand-alone project. Any SaaS C&C costs the taxpayer incurs in later stages of the same project after they can use the SaaS application may constitute an improvement to their right to use the SaaS application. Under s EE 37, the taxpayer has the option to treat the improvement as:

- part of the item of depreciable property that was improved (ie part of their right to use the SaaS application); or
- a separate item of depreciable property.

Alternatively, SaaS C&C costs incurred after the taxpayer can use the SaaS application may be revenue in nature depending upon the taxpayer's factual circumstances. See IS 17/04 paragraphs [24] to [27] for further guidance.

Regular subscription payments

197. Regular subscription payments are not generally part of the cost of the depreciable intangible property unless the taxpayer incurs them before the depreciable intangible property is available for use.

198. To answer the question of whether the regular subscription payments are part of the cost base, it is necessary to consider what the payments are "for" and whether they are revenue in nature.

199. A taxpayer makes subscription payments at regular intervals throughout the life of the arrangement. Generally, these regular subscriptions payments are for the taxpayer's ongoing use of the version of the SaaS application created from the SaaS C&C costs they incurred, rather than for the cost of acquiring or creating the asset itself (ie they generally incur the subscriptions after the software is in a condition for first use or availability for use). For this reason, the payments for the use of and access to the SaaS application are deductible under general principles.

200. An exception to the revenue treatment of the subscription payments arises for regular subscription amounts the taxpayer pays during the period when the SaaS application is being configured or customised and is not yet available for use. Subscription payments they incur during this period are part of the overall project to improve the SaaS application from its off-the-shelf state. In these situations, the subscription payments are a necessary part of the taxpayer obtaining the right to use the software and will be included in the cost base of the right to use the software asset.

201. To the extent the discussion above differs from IS 17/04, then this guideline applies.

When can the taxpayer start claiming a depreciation loss?

202. The taxpayer will be able to depreciate the right to use software, provided they use it, or it is available for use to derive assessable income or carry on their business activities. The date from which the taxpayer will be able to calculate and claim depreciation losses will depend on their individual circumstances.

203. If the taxpayer cannot use the SaaS application before the C&C activities are completed, they cannot claim a depreciation loss until the date when they are able to use the SaaS application. This is because, in such circumstances where essentially the taxpayer's particular SaaS application is "under construction", the asset would not decline in value until it is completed. Where the SaaS arrangement has no fixed term, no item of depreciable intangible property exists until completion. Where the SaaS arrangement has a fixed term but cannot be treated as a FLIP, an item of depreciable intangible property likely exists from the date of the SaaS arrangement. However, practically, there will be no cost base on which the right to depreciate can be calculated until the C&C expenses are incurred and the SaaS application is able to be

used. As a result, there could be a significant lead time between the date of the contract(s) creating the SaaS arrangement and the date the SaaS application is fully implemented and available for use.

204. Alternatively, it may be that the SaaS application is available for the taxpayer to use even though it has not yet been fully customised or configured. In these circumstances, the taxpayer may claim a depreciation loss from the time that they started using the SaaS application.

205. Unless the depreciable intangible property meets the additional criteria to qualify as FLIP, the taxpayer's depreciation loss is calculated at an economic rate. The current economic rate for depreciating software is 50% DV or 40% SL.[37]

Fixed life intangible property

206. FLIP is depreciable intangible property with a "legal life" that is the same length as the property's "estimated useful life". A SaaS arrangement with a fixed term may be FLIP. In such cases, the taxpayer will need to calculate their depreciation loss under the FLIP rules.

What is "fixed life intangible property"?

207. FLIP is defined in s EE 67 as follows:

> **EE 67 Other definitions**
>
> In this Act,-
>
> …
>
> **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

208. The first key requirement in the definition of FLIP is that it involves an item of depreciable intangible property. As discussed from [161], the right to use software under a SaaS arrangement is depreciable intangible property.

209. The second requirement is that the legal life of the depreciable intangible property is expected to be the same as the estimated useful life of the depreciable intangible property. To establish whether property meets this requirement, it is necessary to consider the terms "legal life" and "estimated useful life".

[37] Depreciation rate finder and calculator (Inland Revenue, Wellington, 2023).

Meaning of "legal life"

210. Section EE 67 defines "legal life" as follows:

> **legal life,-**
> (a) for an item to which paragraphs (b) to (d) do not apply, means the number of years, months, and days for which an owner's interest in an item of intangible property exists under the contract or statute that creates the owner's interest, assuming that the owner exercises any rights of renewal or extension that are either essentially unconditional or conditional on the payment of predetermined fees:
> (b) for an item that is a patent application, a design registration application, a patent, or a design registration, means the legal life under paragraph (a) that a patent or design registration would have if granted when the relevant application is first lodged:
> (bb) for an item that is industrial artistic copyright, means the number of years, months, and days for which protection against copyright infringement is available as a result of section 75(1)(c) to (e) of the Copyright Act 1994:
> (c) for an item that is plant variety rights, means the total of-
> (i) the legal life that the rights would have under paragraph (a); and
> (ii) the number of whole calendar months during which the person owns the plant variety rights application in relation to which the rights are granted:
> (d) for a person and a right (a **land right**) that is a leasehold estate, or a licence to use land, means the number of years, months, and days for which the person or an associated person has an owner's interest in the land right, or in a consecutive or successive land right, under the contract or statute that creates the owner's interest, determined-
> (i) when the person acquires the owner's interest; and
> (ii) assuming that the person or associated person exercises rights of renewal, extension, or further grant that are either essentially unconditional or conditional on the payment of predetermined fees.

211. Subsections (b) to (d) in the definition of legal life are not relevant in the context of SaaS arrangements as they apply to specific types of depreciable intangible property that do not include a right to use software.

212. The start of the legal life for the SaaS arrangement is the date that the taxpayer's interest in the intangible property – that is, the right to use software – is created under contract.

213. The definition of "legal life" set out at [210] shows that the legal life is measured assuming the taxpayer exercises any rights of renewal or extension that are unconditional, or conditional only on the payment of a predetermined fee. Taxpayers will need to determine whether they must include any renewal or extension rights in calculating the legal life of the SaaS arrangement. This will be important because including renewal rights may extend the legal life of the SaaS arrangement beyond its estimated useful life, which rules out any treatment of it as FLIP.

Meaning of "estimated useful life"

214. Section EE 63(1) defines "estimated useful life" as follows:

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.

215. An asset's estimated useful life is the period over which the asset might reasonably be expected to be useful in deriving income or carrying on a business.

216. The taxpayer's item of depreciable property is their contractual rights under a SaaS arrangement (ie a chose in action). In these situations, the depreciable property, which here is the right to use software, "might reasonably be expected to be useful" in deriving income from the contract date. It is from this date that the taxpayer has secured the right to access the SaaS application and can configure or customise the SaaS application.

217. If the legal life and the estimated useful life of the right to use the software are the same, the SaaS arrangement will be FLIP. However, in situations where the estimated useful life is shorter than the legal life, FLIP treatment will not be available. Generally, the latter situations will occur if the legal life of the SaaS arrangement is longer than the estimated useful life.

218. The Commissioner considers the right to use software has an estimated useful life of 4 years.[38] Accordingly, where the legal life of the SaaS arrangement is longer than 4 years, the SaaS arrangement will not be FLIP and the taxpayer must calculate their depreciation loss under the general provisions on depreciable intangible property that is discussed at [186]. However, where the legal life of the SaaS arrangement is shorter than 4 years, the estimated useful life of the right to use software will align with the legal life. It follows that in these situations the SaaS arrangement will be FLIP.

219. Accordingly, determining the legal life of a SaaS arrangement is vital in determining if FLIP treatment is available. This requires considering the terms of the arrangement, whether there is a fixed term, whether there is only a minimum term, whether there are renewal rights and what conditions, if any, attach to any renewal rights (see previous discussion of the definition of "legal life"). It may be that an arrangement does not have a measurable legal life. For example, an arrangement may have an indefinite legal life if it runs at the will of the parties cancellable at any time with appropriate notice.

[38] Inland Revenue Department NZ *General Depreciation Rates* IR 265 (October 2022).

Calculating the depreciation loss

220. Section EE 12(2)(b) requires the straight-line method to be used for FLIP. Section EE 33(2) sets out the formula to use as follows:

1 ÷ legal life

221. As it is unlikely that a taxpayer will incur any C&C costs as at the contract date, it is necessary to consider the ability to add costs to the cost base of FLIP. Section EE 19 provides:

> **EE 19 Cost: fixed life intangible property**
>
> *When this section applies*
>
> (1) This section applies when—
> (a) a person owns an item of fixed life intangible property; and
> (b) the person incurs additional costs in an income year for the item; and
> (c) the person is denied a deduction for the additional costs other than a deduction for an amount of depreciation loss.
>
> *When this section does not apply*
>
> (1B) This section does not apply for additional costs incurred before 7 November 2013 for—
> (a) a design registration:
> (b) a design registration application:
> (c) industrial artistic copyright.
>
> *Additional costs for fixed life intangible property*
>
> (2) For the purposes of the formula in section EE 16, the item's cost at the start of the income year is treated as being the total of—
> (a) the item's adjusted tax value at the start of the income year; and
> (b) the additional costs the person incurs.

222. For s EE 19 to apply, the additional costs must be "for the item". That is, it must be an existing item of FLIP the taxpayer owns and for which they are denied a deduction. Where the taxpayer incurs the C&C costs and those costs are not deductible, the additional costs can be capitalised to the carrying value of the FLIP under s EE 19.

Finance lease rules

223. The Commissioner is satisfied that the rights arising under a typical SaaS agreement will be "rights to use software". At law, these rights are also likely to amount to a licence to use software.[39] A "licence" is merely a power or authority to do some act that could not be lawfully done without that authority. In *Russel v Ministry of Commerce for Northern Ireland*,[40] the High Court of Northern Ireland stated:

[39] Exceptions may apply in the case of pure service agreements – see [169].

[40] *Russel v Ministry of Commerce for Northern Ireland* [1945] NI 184 (NIHC) at 188.

> The word licence has a well recognised signification in English law. According to our law a licence properly so called is merely a permission granted to a person to do some act which but for such permission it would be unlawful for them to do so.

Additionally, in *Heap v Hartley*,[41] Cotton LJ stated:

> [W]here there is only a license which does not entitle the licensee to take anything away, or to acquire any property, then the license simply remains a license, this is, an authority from the person who grants it to the person who receives it, enabling him to do lawfully that which without the license he could not do; …

224. Given this, an issue arises about the potential application of the finance lease rules to some SaaS arrangements with a term.[42] This is because since 2004, the finance lease rules have extended the definition of "lease" to include "licence(s) to use intangible property".[43] This express inclusion means that such a licence need not conform with the usual characteristics of a lease.

225. If a SaaS arrangement is a "lease", it can potentially be a "finance lease" under subs (b) of the definition of that term in s YA 1:

> **finance lease** means a lease of a personal property lease asset entered into by a person on or after 20 May 1999 that—
> …
>
> (b) when the person enters the lease or from a later time, involves a term of the lease that is more than 75% of the asset's estimated useful life as defined in section EE 63 (Meaning of estimated useful life):

226. If a SaaS arrangement is subject to the finance lease rules, the effect would be to deem the underlying software the SaaS provider owns as having been sold to the taxpayer. This is because the finance lease rules look through to the underlying asset (here the software, not the rights to the software)[44] and recharacterise the transaction.

227. On first glance, this outcome seems highly unusual given that no underlying sale occurs in economic terms and, as a result of applying the rules, the taxpayer is treated as the outright "owner" of the software (including the copyright in it) when they simply have non-exclusive rights to use it. This outcome prompts consideration of the background to the introduction of the extension to the finance lease rules.

[41] (1889) 42 Ch D 461 (EWCA) at 468.

[42] These are arrangements with a term of over 75% of the estimated useful life of software.

[43] Definition of a "lease" under s YA 1(d)(iii).

[44] Sale and Leaseback of Intangibles, *Tax Information Bulletin* Vol 17, No 1 (February 2005) at 49.

Background to introduction of licences to use intangible property to the finance lease rules

228. In 2004, s 261(13)(b) of the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 inserted subpara (iii) of the definition of "lease" into the Act. It amended the definition of "lease" under s OB 1 (d)(iib) of the Income Tax Act 2004. The Commentary on the Bill explains:[45]

> **SALE AND LEASEBACK OF INTANGIBLES**
>
> *(Clauses 19 and 65)*
>
> …
>
> *Background*
>
> The government announced in May 2003 that it was concerned about a scheme involving the sale and leaseback of intangibles under which tax deductions are claimed for what are, in substance, repayments of principal under a loan. The government said that it would propose remedial legislation to ensure that such deductions could not be taken.
>
> …
>
> Described below are the simplified features of a transaction that may allow deductions for what are, in substance, loan principal repayments.
>
> A Co, B Co and C Co are associated. A Co sells its trademarks or brand names to a non-resident bank for, say, $20 million (which is non-taxable as any profit is a capital gain). The bank immediately grants to B Co an exclusive licence to use the trademarks for a fixed term in return for annual royalty payments totalling, say, $12 million that are deductible to B Co. B Co grants a sublicence to A Co on the same terms. The bank grants to C Co an option to purchase the trade marks, subject to the bank retaining the right to receive the licence payments from B Co. The exercise price under the option is, say, $11 million, the reduction in value of the trademarks from $20 million reflecting the bank's right to continue to receive the royalty income from B Co during the licence period. The option is exercised on the date that the bank buys the trademarks and the licence begins, so that the bank pays A Co $20 million for the trademarks and immediately sells them to C Co for $11 million. The bank's net outgoing is $9 million, which it pays in return for future payments of $12 million.
>
> In substance, the transaction is a loan of $9 million from the bank to the group and the bank treats the transaction for tax, regulatory and accounting purposes accordingly. By structuring the loan as a licence, a deduction may be available to B Co for what are, in substance, repayments of the $9 million principal, instead of only the $3 million interest

[45] *Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill Commentary on the Bill* (Policy Advice Division, Inland Revenue, March 2004) at 11–13.

> that would be allowed if the transaction were in the form of a loan. This outcome is contrary to the policy intent underlying the tax treatment of debt transactions (and it may be that the tax avoidance provisions in the Income Tax Act 1994 apply to it).

229. When the Bill was reported back at the Select Committee stage, the following comments were made[46]:

> The bill amends the finance lease rules in the Income Tax Act 1994 in response to certain situations in response to a person selling an intangible asset, such as a trademark, and then leasing back the same asset. In such cases, lease payments may, in substance, be partly repayments of loan principal, and it is necessary to amend the law on finance leases to ensure people in such arrangements are not able to claim a deduction for these repayments.

230. It is clear that the focus of these amendments was on arrangements very different from the SaaS arrangements that this guideline is considering. Under the Bill, the payments made by the SaaS customer are not "in substance" repayments of loan principal. In the Commissioner's view, imposing the finance lease rules on a SaaS arrangement does not mean the tax treatment that results then accords with the economic substance of the transaction, in the way that it does with the targeted sale and leaseback arrangements. Instead, it imposes an economic reality that is different to the legal and economic reality of SaaS arrangements that are the focus of this guidance.

231. This raises an interpretive question as to whether to depart, in this instance, from the ordinary meaning of "licence" for the purposes of the lease definition that applies to the finance leases rules? The meaning of legislation is "ascertained from its text and in light of its purpose and its context".[47] The meaning of a provision is the most natural and ordinary meaning of the words in their context and taking into account the purpose of the provision.[48] However, in *Frucor Beverages Ltd v Rio Beverages Ltd*,[49] the Court of Appeal departed from the ordinary meaning of the words in s 34 of the Evidence Amendment Act (No 2) 1980, a provision that conferred legal privilege on patent attorneys and their clients. It did so on the basis that the ordinary meaning would give rise to a practical absurdity, and that it was not in accordance with the intention of those that framed the legislation.

232. The court stated:

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[46] *Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill Commentary as reported from the Finance and Expenditure Committee* (Policy Advice Division, Inland Revenue, September 2004) at 14

[47] Legislation Act 2019, s 10(1).

[48] JF Burrow and RI Carter, *Statute Law in New* Zealand (6th ed, LexisNexis, Wellington, 2021) at 288.

[49] *Frucor Beverages Ltd v Rio Beverages Ltd* [2001] 2 NZLR 604 (CA).

> [28] Once satisfied that Parliament intended to confer privilege on both patent attorneys and their clients in respect of the defined protected communications, the Court should strive to arrive at a meaning which gives effect to that intention. The principles of interpretation which assist the Courts in that exercise are well established. They reflect commonsense propositions and should, therefore, be applied sensibly. Thus, it would be less than sensible to presume that Parliament intended to legislate in a manner which is absurd. Indeed, it would be uncharitable, if not presumptuous, for the Courts to approach the task of interpreting Parliament's legislation on any other basis. Thus, the Courts have come to give the concept of "absurdity" a wide meaning, using it to include virtually any result which is unworkable or impracticable, inconvenient, anomalous or illogical, futile or pointless, artificial, or productive of a disproportionate counter-mischief. See Bennion, *Statutory Interpretation* 3rd ed at p 751; see also Laws NZ, Statutes para 181, at p 177.
>
> [29] The literal interpretation of s 34 fits many of these descriptions. … In such circumstances, and where the main legislative purpose of the statute is clear, the provision should not be reduced to a nullity by a literal adherence to the language, unless the language is "intractable". This principle recognises the reality that the defect may be due to the "want of skill or knowledge" on the part of the draftsperson (Laws NZ, Statutes para 182, at p 178). The Court will strive for an interpretation which will make the Act work in the manner that the Court presumes Parliament must have intended. See *Commerce Commission v Telecom Corporation of New Zealand Ltd* [1994] 2 NZLR 421, per Cooke P at pp 424 – 425; *Capital Coast Health Ltd v New Zealand Medical Laboratory Workers Union Inc* [1996] 1 NZLR 7, per Hardie Boys J at p 18; and *McDonald v Australian Guarantee Corporation* (NZ) Ltd [1990] 1 NZLR 227 at p 237.
>
> [30] Allied to this tenet is the principle that the Courts will endeavour to avoid an interpretation of a section where that interpretation would lead to unworkable or inconvenient consequences. This case illustrates the undesirable consequences which would follow from a literal interpretation. … Although in the best of all worlds the problem might be managed, the scope for confusion is limitless. Parliament cannot readily be thought to have intended these impractical consequences.

233. As the response above shows, the Court of Appeal considered that it was possible to depart from the ordinary meaning of a provision if it avoided any result that is unworkable or impracticable, inconvenient, anomalous or illogical, futile or pointless, or artificial or if it produces a disproportionate counter-mischief.

234. In this case, as noted from [224], the context and purpose of the reforms that led to the inclusion of the phrase "licence to use intangible property" in the "lease" definition strongly suggest the phrase is limited to exclusive licences where the economic substance of the arrangements in question are those of a sale and leaseback (the

intended mischief). Support for this interpretative approach comes from the added consideration that unworkable outcomes follow from treating a SaaS arrangement as a finance lease. In particular, such unworkable outcomes relate to the spreading rules and the base price adjustment (BPA) aspects of the financial arrangements rules that follow from treating a SaaS arrangement as a finance lease.

235. Given all of the above, the Commissioner considers that were a court to consider the application of the finance lease rules to a SaaS arrangement, it would conclude that the rules do not apply. On this basis, the Commissioner is satisfied that the rules have no application to the SaaS arrangements that this guideline has considered.

Diagrams | Hoahoa

Figure | Hoahoa 1 Deductibility of SaaS C&C costs

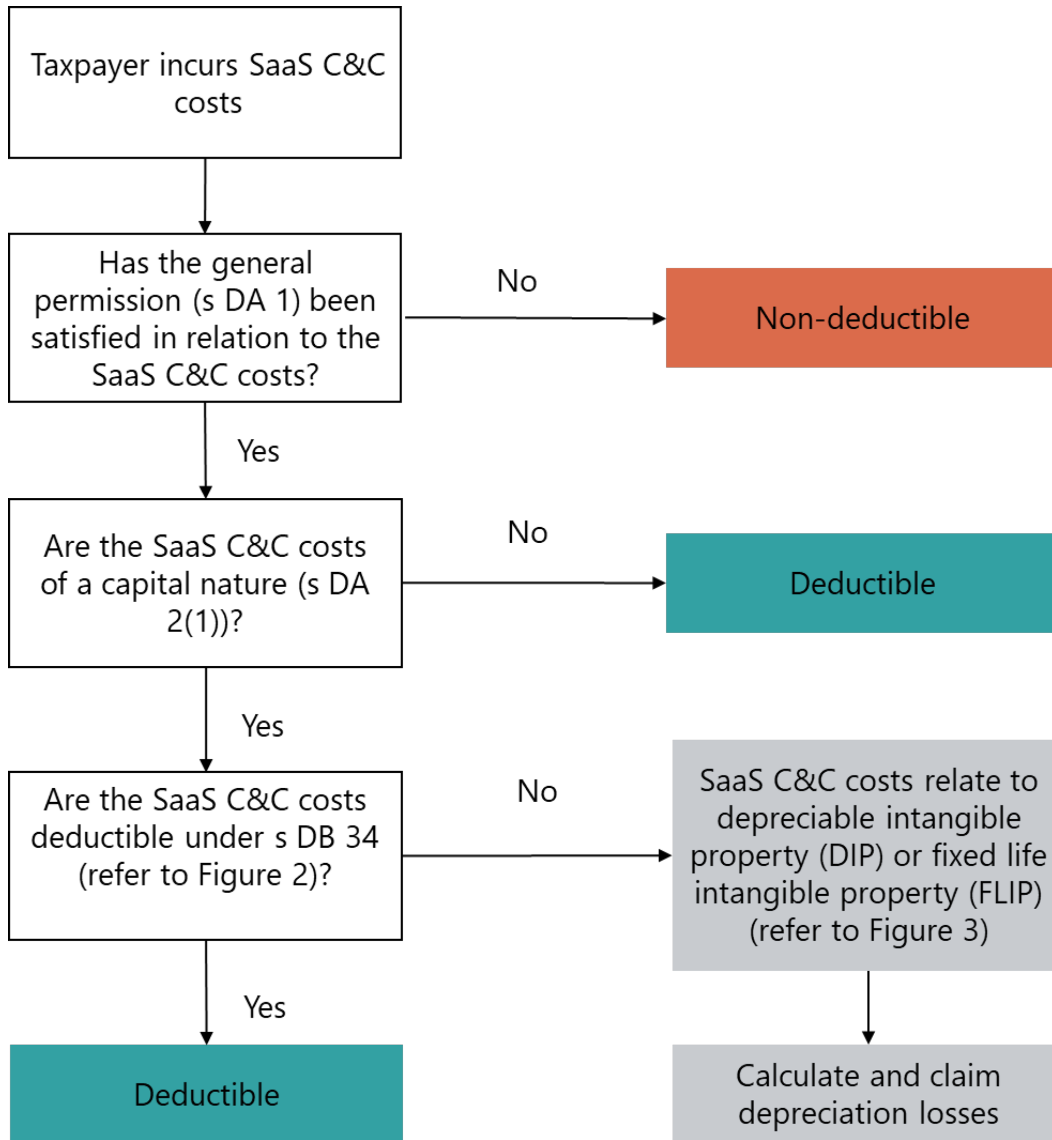
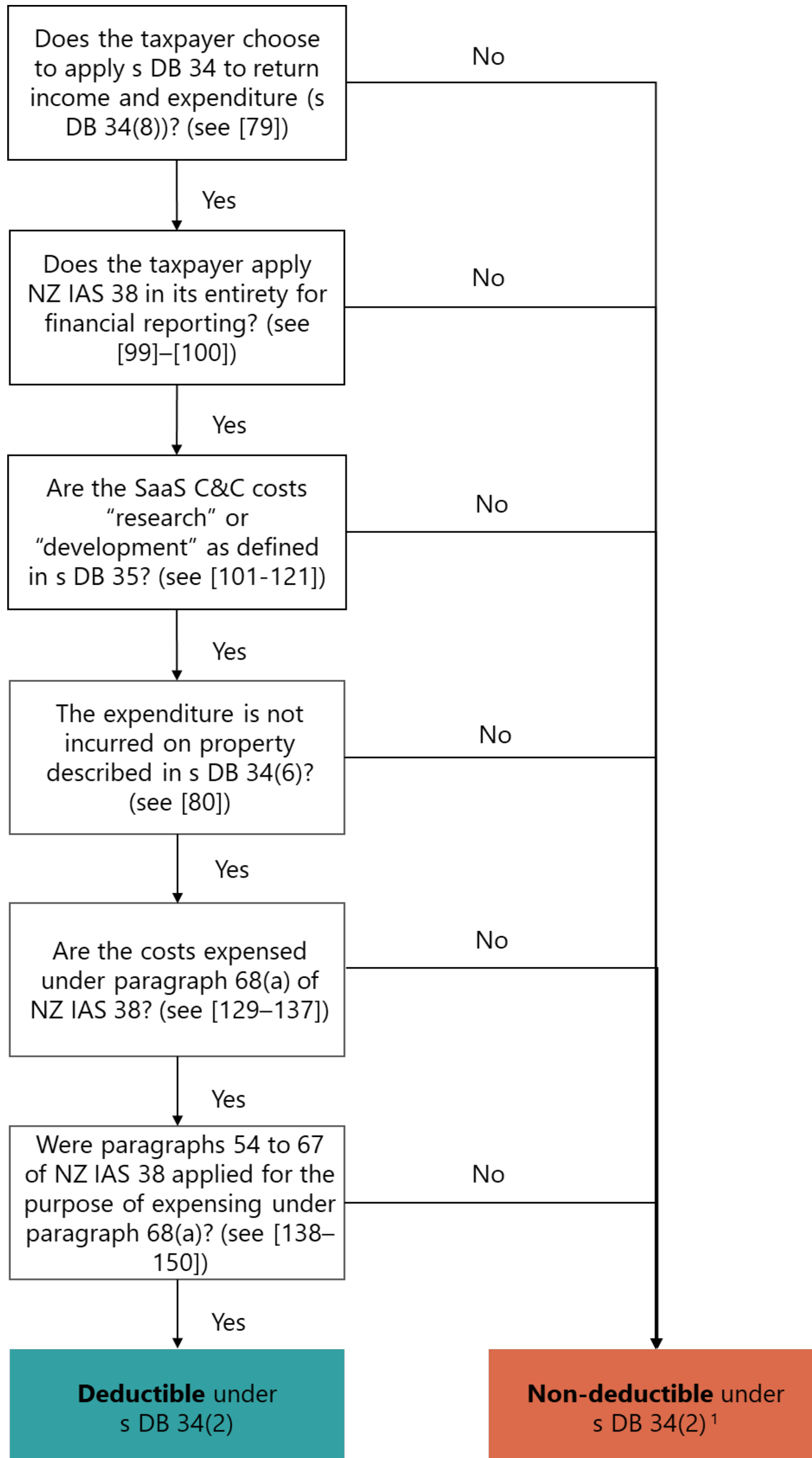
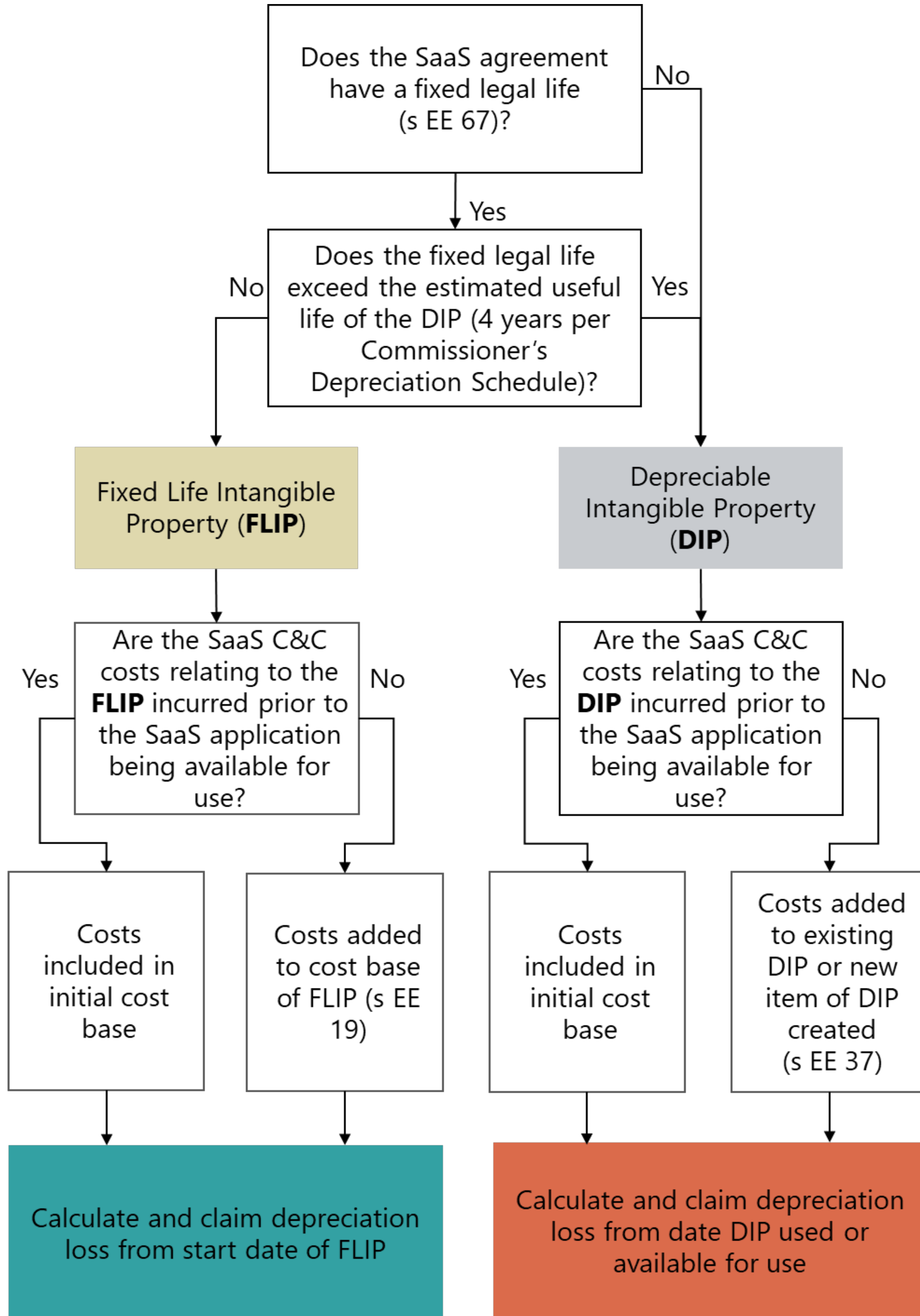


Figure | Hoahoa 2 Research and development expenditure (s DB 34(2))



[1] refer to Figure 1 and Figure 3 to determine the tax treatment

Figure | Hoahoa 3 Depreciable Intangible Property



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