Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill

Supplementary Report No. 1 to the Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

Research and Development – Small Taxpayers and Materiality

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Prepared by the Policy Advice Division of the Inland Revenue Department and the Treasury

Clause 39

BACKGROUND

The main focus of the oral research and development (R&D) submissions to the Finance and Expenditure Committee was on the issue of materiality. Very broadly, for accounting purposes, an amount is material if its disclosure in the financial reports is likely to influence the decisions or assessments of the users of that report.

As the proposal is currently drafted, taxpayers may take advantage of the new R&D rules if they apply the asset-recognition criteria in financial reporting standard 13 (FRS 13) to all items of R&D expenditure – whether the expenditure is material or immaterial. For financial reporting purposes, paragraph 2.3 of FRS 13 states that a taxpayer is not required to apply the standard to immaterial items of expenditure. Under the proposed tax rules, therefore, if taxpayers have not applied FRS 13 to immaterial items for financial reporting purposes, they will be required to adjust their financial reports for tax purposes.

Several oral submissions suggested that this requirement to make an adjustment would give rise to significant additional compliance for taxpayers and favoured an approach that would allow taxpayers to treat immaterial expenditure for tax purposes in the same way as it is treated for accounting purposes. This would have the effect of allowing an immediate deduction for all immaterial R&D expenditure.

The Committee did not appear to accept this suggestion. It was concerned that a rule that did not require adjustments to take into account immaterial expenditure would unfairly favour large firms over small firms. This is because, under such a rule, a large firm could automatically deduct large amounts of R&D on the grounds that the expenditure is immaterial to that firm. Small firms with similar levels of R&D would, however, be required to apply the asset-recognition criteria because, in relation to the firm, such expenditure would be material.

The Committee was, however, concerned that, where possible, the FRS 13 proposal should minimise compliance costs for small firms with less sophisticated accounting systems and less access to professional accounting advice. The Committee therefore instructed officials to undertake some further consultation with the New Zealand Chambers of Commerce (the Chambers), who had suggested two methods that could relieve compliance costs for small taxpayers.

FURTHER CONSULTATION

Chambers' main proposal

As instructed, officials have undertaken further consultation with the Chambers. Consistent with its written submission, Chambers' main suggestion is that "small taxpayers" should be permitted to deduct all R&D expenditure, whether the expenditure is material or immaterial, without the requirement of applying FRS 13. The Chambers propose that "small taxpayer" should be defined as a taxpayer with turnover of less than $3 million (the same as the definition in the trading stock tax rules). Without this exception, it is argued, businesses that do not prepare financial statements would either not be able to access the new R&D rules or would need to seek expert, and expensive, accounting advice.

The Chambers consider that there is good precedent for such an approach. The trading stock tax rules provide a simplified method for valuing closing stock for "small taxpayers". This approach recognises that certain small taxpayers do not prepare financial statements in accordance with financial reporting standards and relaxes the rules accordingly.

Comment

Consistent with officials' main report to the Committee on submissions, we are still of the view that to allow a blanket exemption for "small taxpayers" from the R&D rule, thereby allowing an immediate deduction for all R&D, is not good policy. It amounts to a tax concession for all small businesses meeting the definition and would provide a taxpayer with a tax incentive to structure itself to fall within the definition of "small taxpayer".

In addition, we consider that the exemption from the trading stock rules is different to that being proposed for the R&D rules. The trading stock exemption does not exempt small taxpayers from the trading stock regime itself. Instead it removes some of the information requirements for small taxpayers by providing a simplified valuation option. The "small taxpayer" exemption proposed by the Chambers would, if enacted, go further than this and exempt all small taxpayers from the core R&D rule.

Chambers' secondary proposal

The Chambers has suggested, as an alternative, that small taxpayers should be able to immediately deduct R&D that is immaterial to them without being required to apply FRS 13.

Comment

Even though the Chambers gave no detail of a proposal, we assume they are thinking in terms of a rule with at least two conditions:

- the firm's total R&D expenditure for a year must be below a low de-minimis threshold; and
- the firm must have treated its total R&D expenditure for a year as immaterial for financial reporting purposes.

Such a rule would mean that qualifying taxpayers could effectively deduct immediately their R&D even though a portion of that R&D may be capital. This provides a limited tax concession for such taxpayers because, under general tax principles, capital expenditure should be amortised over the economic life of the asset to which it relates. At the margin, this rule may induce qualifying taxpayers to recharacterise other capital expenditure as R&D (up to the threshold).

However, the extent of any recharacterisation is likely to be minimal, as any de-minimis threshold would be set at a very low level.

Compliance costs

The problem raised by the Chambers relates to small businesses that do not apply accounting standards. A small taxpayer with an unsophisticated accounting system may find it difficult to apply FRS 13 to such expenditure. The information may not be readily accessible, and it is likely that professional advice would need to be obtained. This can be both time-consuming and costly. Any such rule would, therefore, be set at a low level.

Taxpayers would of course not have to apply the FRS 13 proposal, which has been designed to assist them. If they consider that its complexity outweighs its benefits, they are entitled to apply existing law.

Equity

It could be argued that effectively confining this rule to small taxpayers is inequitable. However, the proposal is designed to reduce compliance costs for those taxpayers who do not apply the accounting standards. As noted above, small taxpayers would incur proportionately greater compliance costs when making materiality adjustments. In addition, the type of rule we are thinking of would strictly be open to taxpayers of all sizes.

Revenue implications

Given that the de-minimis threshold would be set at a very low level and the majority of qualifying expenditure is likely to be being deducted anyway, the revenue implications of this proposal would be negligible.

Setting a de-minimis threshold

Officials have looked at the potential number of taxpayers that could be assisted by such a rule, depending on where the threshold is set. We have used information gleaned from the IR 10 tax return to provide the data. On the IR 10 there is a non-compulsory box where taxpayers can fill out how much they have expended on R&D in the year. Because this is not compulsory and because anecdotal evidence suggests that much R&D is not characterised as such for tax purposes, we assume that these figures have understated the position, possibly by a large margin.

It was found that in excess of 6,000 companies, partnerships, trusts and individuals indicated that they spent between $1 and $10,000 on R&D in a year. It is estimated that such expenditure would be immaterial for about 4,000 of those taxpayers. In other words, the indication is that at least 4,000 taxpayers could benefit if the maximum threshold was set at $10,000.

We also found that if the maximum thresholds were set at $20,000 or, even $30,000, there would only be a very small (300 and 400 respectively) increase in the number of taxpayers benefiting. The appropriate threshold for such a rule could, therefore, be $10,000.

Fixed assets

Expenditure on fixed assets used in the R&D process should not qualify under any such exception. Such assets represent the capital of the firm and should be written off over their economic life under the depreciation rules.

There do not appear to be any compliance cost reasons for including fixed assets within a de-minimis rule. Small taxpayers would generally already be depreciating other fixed assets. The Chambers agree that any exception to the FRS 13 proposal should not include fixed assets.

Immaterial for accounting purposes

Any exception should also contain a requirement that the taxpayer has treated the total R&D expenditure as immaterial for accounting purposes. Generally Accepted Accounting Practice may allow taxpayers to capitalise immaterial amounts if there is a probable future economic benefit and the costs or benefits can be reliably measured. There is no apparent policy reason for allowing taxpayers to expense immaterial amounts that they have capitalised for accounting.

Complexity

While officials consider that the rule could be drafted relatively simply, it is acknowledged that any addition to the legislation inevitably leads to greater complexity. Whether this additional complexity is warranted depends to a large degree on how many taxpayers would benefit, and the ability of those taxpayers to cope with the complexity. Taxpayers are less concerned with complexity where it leads to a tax benefit.

Pressure for future changes to a de-minimis rule

The Committee should be aware that there is a risk that the enactment of an exemption, however limited, provides the opportunity for interested groups to lobby in the future for both the threshold to be raised and to allow larger taxpayers to benefit. This could result in the original rationale for the exemption (reducing compliance costs for taxpayers that do not apply accounting standards) being undermined. Further, there is a precedent risk in that it could lead to lobbying for exemptions from other tax rules for taxpayers within the relevant threshold.

RECOMMENDATION

Officials recommend that, on balance, the bill should be amended to introduce a limited low compliance rule. Such a rule would remove the requirement for a taxpayer to apply FRS 13 to their R&D expenditure provided that their total R&D expenditure for the year does not exceed $10,000 and they have treated that expenditure as immaterial for accounting purposes.

This exception would provide compliance cost savings for, potentially, quite a large number of taxpayers. Although there are risks associated with recharacterisation of expenses, and the rule would introduce more complexity into the R&D tax rules, officials do not consider these to be significant. The risk associated with future pressure in the threshold, thereby undermining the only real rationale for the rule, could be more significant.