Hon Grant Robertson, Minister of Finance

Hon Stuart Nash, Minister of Revenue

Information Release

Tax initiatives to support the Government's Economic Plan

December 2019

Availability

This information release is available on Inland Revenue's Tax Policy website at http://taxpolicy.ird.govt.nz/2019-ir-cab-dev-19-sub-0255/overview.

Documents in this information release

1. IR2019/490 T2019/2768 – Tax policy report: Tax measures to support the Government's economic strategy (6 September 2019)
2. DEV-19-SUB-0255 – Cabinet paper: Tax initiatives to support the Government's Economic Plan (18 September 2019)
3. DEV-19-SUB-0255 – Regulatory impact assessment: Feasibility and other non-deductible expenditure for incomplete assets (13 September 2019)
4. DEV-19-MIN-0255 – Minute: Tax initiatives to support the Government's Economic Plan (18 September 2019)

Additional information

The Cabinet paper was considered by the Cabinet Economic Development Committee on 18 September 2019 and confirmed by Cabinet on 23 September 2019.

Information withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply are identified. Where information is withheld, no public interest was identified that would outweigh the reasons for withholding it.

Sections of the Act under which information was withheld:

9(2)(a)	to protect the privacy of natural persons, including deceased people
9(2)(f)(iv)	to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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POLICY AND STRATEGY

Tax policy report: **Tax measures to support the Government's Economic Strategy**

Date:	6 September 2019	**Priority:**	High
Security level:	Sensitive - Budget	**Report number:**	IR2019/490 T2019/2768

Action sought

	Action sought	**Deadline**
Minister of Finance	**Note** the contents of this report **Agree** to recommendations	9 September 2019
Minister of Revenue	**Note** the contents of this report **Agree** to recommendations	9 September 2019

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Chris Gillion	Policy Lead – Business Policy and Strategy Inland Revenue	s 9(2)(a)
Mark Vink	Manager Tax Strategy The Treasury	

6 September 2019

Minister of Finance
Minister of Revenue

Tax measures to support the Government's Economic Strategy

Executive summary

1. This report seeks your approval to:

   - clarify the tax treatment of feasibility and other non-deductible expenditure to encourage innovation and investment. This measure would be advanced for inclusion in the first taxation bill scheduled for introduction in 2020 and have application from the start of the 2020-21 income year;

   - prepare a Government discussion document investigating options for relaxing the tax loss continuity rules and reviewing the research and development tax loss cash out scheme. This discussion document could be released in early 2020 with application of any change in the 2021-22 income year.

2. These measures support the Government's economic strategy to build a productive, sustainable and inclusive economy, to improve the living standards and wellbeing of all New Zealanders.

Feasibility and other non-deductible expenditure

3. The tax treatment of feasibility and other non-deductible expenditure may be having a detrimental effect on businesses wanting to take risks associated with developing new assets.

4. The Tax Working Group recommended that:

   - feasibility and other non-deductible expenditure should be able to be deducted and spread over a 5-year period (which is the spreading period for an equivalent rule in Australia); and

   - a de minimis safe harbour be included to reduce compliance costs of smaller taxpayers who have total annual expenditure of this type below $10,000; in this case the expenditure would be immediately deductible in the year incurred.

5. Officials recommend that a longer (7 year) period for spreading be adopted in New Zealand. This is primarily due to the absence of a capital gains tax in New Zealand that taxes any increases in value of these types of investments in the event they are successful (as compared to Australia, where there is a capital gains tax). However, there are compelling arguments for either a 5 or 7 year spreading period.

6. Officials recommend that changes to feasibility and other non-deductible expenditure apply from the start of the 2020-21 income year and be introduced in the first tax bill of 2020.

7. We understand Ministers have discussed the possibility of these rules applying from the current 2019-20 income year, with a Supplementary Order Paper being tabled to the *Taxation (Kiwisaver, Student Loans, and Remedial Matters) Bill* that is currently being considered by the Finance and Expenditure Committee. This would

occur at the Committee of the Whole House stage meaning there would be no opportunity for consultation.

8. Officials do not recommend this option. This is because to apply the new rules to the current income year will not result in any increase in innovation spend over and above that which would have already taken place, as investment decisions have already been made for this income year. Accordingly, the legislative option of the first tax Bill of 2020 would seem more appropriate and allow sufficient time to draft the legislation.

Relaxation of the loss continuity rules

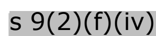
9. The restrictive nature of the current loss continuity rules may also be hindering the ability of innovative businesses to expand and grow.

10. The Tax Working Group recommended these be reviewed specifically in relation to start-up firms. In respect of larger firms, they indicated that care was needed to ensure that the ability to trade in tax losses was minimised.

11. To some extent, the current research and development tax loss cash out scheme potentially lessens the negative impact of the loss continuity rules; however, it is narrowly targeted and there are a range of innovative firms which would benefit from a more general relaxation of the loss continuity rules. Given this, officials consider this scheme should be reviewed along with any relaxation of the loss continuity rules.

12. Officials recommend that the Government release a discussion document early in 2020 which will canvas options for the relaxation of the loss continuity rules along with the review of the research and development tax loss cash out scheme.

13. We understand that Ministers may prefer a faster timeline for this discussion document. However, given the integrity concerns around relaxation of these rules officials recommend that a release in early 2020 is preferable to a less developed issues paper or summary document that is released earlier.



s 9(2)(f)(iv)

Consultation

16. Substantial consultation has been undertaken with the private sector in respect of allowing deductions for feasibility and other non-deductible expenditure, including the release of a discussion document and a second round of consultation.

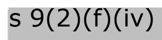
17. No specific consultation has been undertaken in respect of the relaxation of the tax loss continuity rules, however, this issue was considered as part of the Tax Working Group process and the business sector has consistently raised the need to address this issue with officials.

Recommended action

18. We recommend that you:

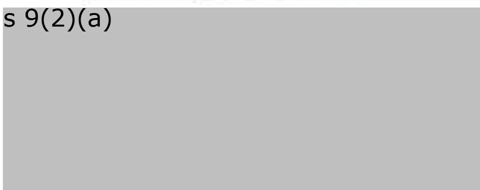
Recommendations		Minister of Finance	Minister of Revenue
Feasibility and non-deductible expenditure			
(a)	**Agree** to allow deductions for feasibility and certain other non-deductible expenditure to encourage innovation and growth.	Agreed Not agreed	Agreed Not agreed
(b)	**Agree** to spread deductibility of feasibility and certain other non-deductible expenditure that is not currently deductible over a period of 5 years in accordance with the Tax Working Group recommendation. **OR**	Agreed Not agreed	Agreed Not agreed
(c)	**Agree** to spread deductibility of feasibility and certain other non-deductible expenditure that is not currently deductible over a period of 7 years (*officials' recommended option*).	Agreed Not agreed	Agreed Not agreed
(d)	**Agree** to a de minimis rule to allow those businesses that have, in total, $10,000 or less of feasibility and other non-deductible expenditure in a tax year to deduct that expenditure in the year incurred.	Agreed Not agreed	Agreed Not agreed
(e)	**Agree** that the changes to the deductibility of feasibility and other non-deductible expenditure will be included in the first tax Bill of 2020 (*officials' recommended option*). **OR**	Agreed Not agreed	Agreed Not agreed
(f)	**Agree** that the changes to the deductibility of feasibility and other non-deductible expenditure will be included as a Supplementary Order Paper to the *Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill* which is currently before Parliament's Finance and Expenditure Committee.	Agreed Not agreed	Agreed Not agreed
(g)	**Agree** that the amendments referred to in recommendations (a) to (d) apply from the start of the 2020-21 income year (*officials' recommended option*). **OR**	Agreed Not agreed	Agreed Not agreed
(h)	**Agree** that the amendments referred to in recommendations (a) to (d) apply from the start of the 2019-20 income year.	Agreed Not agreed	Agreed Not agreed

s 9(2)(f)(iv)


s 9(2)(f)(iv)

Relaxing the loss continuity rules			
(p)	**Direct** officials to prepare an issues paper canvasing the options for relaxing the loss continuity rules for taxpayers and reviewing the current research and development tax loss cash out scheme.	Directed	Directed
(q)	**Agree** to a limited discussion document being released in late 2019 with any changes being applicable from the start of 2021-22 income year. **OR**	Agreed Not agreed	Agreed Not agreed
(r)	**Agree** to a full Government discussion document being released in early 2020 with any changes being applicable from the start of the 2021-22 income year (*officials' recommended option*).	Agreed Not agreed	Agreed Not agreed

s 9(2)(a)



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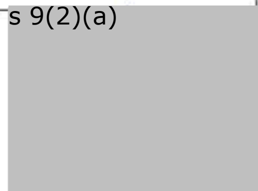


Mark Vink
Manager – Tax Strategy
The Treasury

Chris Gillion
Policy Lead – Business
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Background

19. You have asked for officials' advice on tax measures to support the Government's Economic Strategy with a view to encouraging New Zealand business to be innovative and assist those business to grow by removing any barriers to growth that exist within the tax system.

20. This report seeks your approval to:

    - encourage innovation and investment by clarifying the tax treatment of feasibility and other non-deductible expenditure. This measure could be advanced for inclusion in the first taxation Bill scheduled for introduction in 2020 and have application from the start of the 2020-21 income year; and
    - prepare a Government discussion document on growing New Zealand's productive businesses through investigating options for relaxing the tax loss continuity rules and reviewing the research and development tax loss cash out scheme. This discussion document could be released in early 2020 with any resulting changes applying from the start of the 2021-22 income year.

21. Together officials consider these measures support the Government's economic strategy to build a productive, sustainable and inclusive economy, to improve the living standards and wellbeing of all New Zealanders.

22. These measures will ensure that businesses have certainty over the treatment of feasibility and other non-deductible expenditure, and any relaxation of the current loss continuity rules will remove an impediment to the growth of innovative businesses allowing them better access to capital.

Problem definition

23. The Government's economic vision for New Zealand is to build a productive, sustainable and inclusive economy, to improve the living standards and well-being of all New Zealanders.

24. Two key economic shifts that are needed to achieve that vision are:

    - assisting New Zealand businesses to become more productive, which includes initiatives to encourage innovation such as the recently introduced research and development tax credit; and
    - ensuring that New Zealand businesses have timely access to capital to enable them to innovate and grow.

25. There are currently two tax impediments to these economic shifts:

    - the current tax treatment of feasibility and other non-deductible expenditure is uncertain following the Supreme Court decision in *Trustpower Limited v Commissioner of Inland Revenue*[1] (*Trustpower*) which may deter those businesses who want to undertake feasibility studies with a view to innovating and expanding their businesses; and
    - the current policy settings for allowing firms to continue to use tax losses after a change in ownership (including the introduction of new investors) could be an impediment to businesses obtaining capital to further innovate and grow.

[1] SC 74/2015 [2016] NZSC 91

26. Addressing these impediments is likely to have a positive effect on businesses and provide them more certainty to undertake innovative projects and expand to encourage new and larger investment.

Feasibility and other non-deductible expenditure

27. As a general principle, expenditure on business operating costs or assets whose economic value is expected to decline should either be immediately deductible, or, when it provides an on-going benefit over multiple years, deductible over time (under the depreciation rules). Some expenditure will never be deductible, because it is not expected to result in an economic loss.

28. When the tax system does not provide for the appropriate treatment of these different types of expenditure, an economic distortion is created.

29. Under current law, certain classes of expenditure that should be either deductible or depreciable are not. Prime examples are expenditure incurred to investigate whether to invest in a new asset, process or business model (feasibility expenditure) and expenditure that is incurred to create a business asset that is subsequently abandoned.

30. This is particularly problematic for businesses in the infrastructure/utilities sector following the *Trustpower* decision which materially limited the deductibility of such expenditure.

31. The non-deductibility of this expenditure effectively raises the cost of risky investments in new assets, processes or business models (where a viable outcome is uncertain), and therefore reduces the incentives for businesses to undertake them. These are the very types of investments that are vital to innovation and driving productivity improvements.

Example

Company A, an electricity generator, is exploring the practicality of establishing a new windfarm. It incurs expenditure over a five-year period associated with measuring wind frequency and speeds (anemology) relevant to the local geography at six different sites.

At the end of year 5, the studies indicate that three sites are suitable for windfarms. Those three projects go ahead, but the remaining three are not suitable and so are abandoned.

Tax impact

The anemology expenditure does not give rise to an immediate deduction under the Income Tax Act. As three of the assets (windfarms) are not completed, there are no tax assets for the purposes of the tax depreciation rules in the Income Tax Act.

Result

Company A incurs feasibility expenditure and receives no tax deductions for the three abandoned sites. The non-deductibility of the feasibility expenditure effectively raises the cost of the risky investment in new windfarm assets and therefore reduces the incentives for businesses like Company A to undertake them. These are the very types of investments that are vital to innovation and driving productivity improvements and moving to a sustainable economy.

32. Providing appropriate economic deductions and addressing the complexity of the current state of the law, would improve economic efficiency, minimise distortions and reduce compliance and administration costs.

Consultation on the problem

33. The proposed changes to the deductibility of feasibility and other non-deductible expenditure have been subject to two rounds of public consultation and consideration by the Government's Tax Working Group.

- In May 2017, a discussion document was released by the previous Government in response to the *Trustpower* decision which narrowed the scope of deductibility of feasibility expenditure. Twenty-three submissions were received that largely supported the policy direction of the discussion document but had concerns regarding the complexity of the proposal and its practical application.
- In October 2017, a second-round of consultation was held on a revised proposal with key stakeholders. Of the ten responses we received, feedback was generally supportive of the revised approach but were concerned (again) with the degree of complexity of the proposal (as it was a blend of financial and tax accounting concepts). Submitters were also concerned that the revised proposal created gaps which could still give rise to non-deductible treatment of feasibility expenditure.
- Subsequent to these rounds of consultation, officials proposed that to address submitters concerns that businesses be allowed to deduct expenditure related to the impairment of unsuccessful or abandoned assets over a period of 7 years. The proposal would not apply to expenditure on land or assets that do not decline in value. The 7-year period was decided on in the absence of a capital gains tax. The absence of a capital gains tax is relevant because for any risky investment a deduction for losses when unsuccessful (the proposal), can create a tax bias to invest if there is not symmetric treatment (by taxing the capital gain) on the upside if the successful asset is sold. Choosing a longer period of spreading can lessen this to some degree, although there is no precise science in choosing either 5 or 7 years.
- As part of their review, the Tax Working Group also considered the issue of feasibility and other non-deductible expenditure and recommended to the Government that expenditure that is not already deductible be deducted over 5 years. In addition, they recommended a safe-harbour de-minimis rule be added for businesses who have less than $10,000 in total of feasibility expenditure annually.

34. From the consultation undertaken it is highly likely this proposal will be favourably received by the business sector.

Proposal

35. Officials recommend amending the Income Tax Act 2007 to allow a deduction (spread over either five or seven years) for expenditure incurred to investigate whether to invest in a new asset, process or business model (feasibility expenditure) and create a business asset that is subsequently abandoned, in cases where the expenditure is otherwise not deductible.

36. A similar approach is applied in Australia and allows such expenditure to be spread over a 5-year period. Officials consider a longer period (such as 7 years) could be appropriate for New Zealand in recognition that capital gains on these types of

investments are not comprehensively captured by New Zealand's income tax system.

37. However, Ministers may consider that a period of 5 years is more suitable as this is consistent with the Tax Working Group's recommendation and mirrors the rules that apply in Australia.

38. To reduce complexity and compliance costs, we also propose to include a threshold whereby this type of expenditure incurred and not otherwise deductible under the Income Tax Act, would be immediately deductible if that expenditure, in total, amounted to $10,000 or less annually. This threshold is similar to other compliance cost savings measures in the Income Tax Act that allow taxpayers to immediately deduct low levels of expenditure, such as legal fees.

39. The proposal would also have appropriate integrity safeguards. Apart from expenditure deducted under the $10,000 threshold, deductions claimed for abandoned or impaired assets that are subsequent reinstated would be reversed in the year of reinstatement.

40. We consider this proposal strikes a suitable balance between business sector expectations that any policy change is simple and easy to apply (a criticism directed at earlier proposals), and ensuring the policy response is fiscally sustainable. As a result, we expect the proposal to be favourably received by the business sector.

Application date and delivery

41. Officials recommend that to support the Government's economic vision to encourage innovation, the change apply from start of the 2020-21 income year (for most firms this is 1 April 2020) to new expenditure incurred on and after that date. Expenditure incurred in that year would be eligible to be spread and deducted.

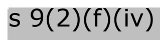
42. Officials recommend this application date, as investment decisions by firms have already been made for the current 2019-20 income year and introducing clarifying rules will not change or increase investment. If the rules were changed for the current income year it is possible that the objective of the initiative – to change innovation decision-making behaviours – would be lost and rather result in a windfall gain to taxpayers who have already incurred the expenditure.

43. Officials also recommend these changes be included in the first available tax Bill in 2020. It is important that the legislation is robust and is correctly targeted and allowing more time to develop that legislation will reduce the risk that the rules can be manipulated. It will also give officials the opportunity to test the legislation with interested parties.

44. Officials also consider it is important that legislation that makes a substantial change should have full consideration in the select committee process.

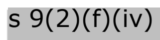
45. Another option would be to deliver the legislation as a Supplementary Order Paper to the current *Taxation (Kiwisaver, Student Loans, and Remedial Matters) Bill* which is currently before the Finance and Expenditure Committee. We do not recommend this as:

- this could result in rushed legislation with little consultation than a full legislative process;
- substantial law changes such as this would benefit from the select committee process; and



- if Ministers agree with officials on the application date for the amended rules there would be no benefit in rushing the legislation.

s 9(2)(f)(iv)



s 9(2)(f)(iv)

Relaxing the loss continuity rules and the tax loss cash out scheme

57. The second proposal would review the asymmetrical treatment of losses and income under New Zealand's company tax system. Currently, companies pay tax when their income is positive, but the Government does not provide a refund when income is negative. Instead, losses can be carried forward to offset any future income of a company.

58. The loss continuity rules determine whether losses from a previous year can be used in a future year. Generally, losses may be used to offset future income, unless more than 51% of the company's shares have changed hands since the losses were incurred.

59. The loss continuity rules require a balance between efficiency and integrity objectives. Strict rules can reduce efficiency by discouraging risk taking but loose rules may allow companies to reduce their taxable income by trading in losses.

60. For many companies the existing loss continuity rules are appropriate, but they do not work well for start-up firms. These firms require equity capital to grow. The capital is often raised over time, through multiple rounds, from differing types of investors. Yet these firms are often inherently loss-making as they grow from an idea to a viable business. The existing loss continuity rules may be constraining their ability to grow through additional equity capital – because such capital injections will generally breach the 51% threshold.

61. New Zealand's lost continuity rules are more stringent than many other OECD countries, including our closest trading partner, Australia.

62. The Tax Working Group considered that the existing loss continuity rules are appropriate for most companies but may not be working well for start-up firms as these firms require equity capital to grow and the current settings may be constraining their ability to grow. To address this the Tax Working Group recommended some relaxation of the rules to support the growth of innovative start-up firms.

63. It was noted by the Tax Working Group that any relaxation of the rules would need to be carefully calibrated to ensure that the change does not facilitate trading in losses among larger firms.

64. Some of the business arrangements that can be impeded by strict loss continuity rules include:

- the sale of a company by a controlling shareholder, such as a founder cashing out of a start-up;
- the acquisition of a company, with the intention of using that company's business assets in a continuing business;
- the merger of two companies with commercial synergies;
- the initial public offering of a start-up company; and
- major capital raising to fund business expansion.

65. To an extent, the research and development tax loss cash out scheme provides some relief to those companies who do incur losses in their initial years. That scheme allows research and development intensive firms to receive cash refunds

for their tax losses to the extent these match their research and development expenditure. It is a separate scheme from the research and development tax incentive that this Government has introduced.

66. However, the research and development tax loss cash out is narrowly targeted. There are a range of innovative firms who would benefit from a more general relaxation of the loss continuity rules, who do not currently benefit from the research and development tax loss cash out scheme.

67. Though adjusting the loss continuity rules would not necessarily provide the same benefits to current recipients of the research and development tax loss cash out, there are links between these policies – the research and development tax loss cash out scheme was developed to mitigate the effects of the stringent loss continuity rules for a specific set of firms. For that reason, we propose to review the loss cash out scheme in conjunction with reviewing the loss continuity rules.

68. It is important to balance any relaxation of the loss continuity rules to support the growth of start-up entities with the need to ensure that the integrity of the tax system is protected, and large taxpayers are not permitted to trade in tax losses. Such trading of tax losses could have a detrimental effect on New Zealand's tax base. The current stock of tax losses is approximated at $44 billion. This is why it is important to consult carefully on different options to relax the rules, while minimising the potential fiscal risk.

Proposal

69. We recommend the Government direct officials to prepare a discussion document canvassing options for relaxing the loss continuity rules and reviewing the research and development tax loss cash out scheme.

70. Given the frequency that this issue is raised by the business sector we expect this proposal to be favourably received.

Application date and delivery

71. Officials recommend any changes to the loss continuity rules and the research and development tax loss cash out scheme apply from the start of the 2020-21 income year. We consider that development of these rules will involve substantial consultation with the business sector and due to the integrity issues around relaxing the loss continuity rules the development of legislation will be important and should be progressed over time.

72. Officials consider there are substantial fiscal and integrity risks with a faster implementation timeframe.

73. The timeframe for delivery of the discussion document is dependent on its content. Although the research and development tax loss cash out scheme component could be done prior to the end of 2019, in terms of the work on relaxing the loss continuity rules there are three possible timing options:

- a high-level officials' issues paper – Officials could release an issues paper that would seek feedback from stakeholders in respect of the problems with the current loss continuity rules and potential solutions. The risk to this approach is that submitters will have an expectation that one of the suggestions made will be accepted by Government – and some suggestions may involve large amounts of forgone revenue. However, such a document could be developed on a faster timeframe potentially before the end of 2019;

- an officials' issues paper containing international comparisons – Officials could release an issues paper that summarises the rules of other countries in respect of loss continuity and ask for submissions on the regime New Zealand should adopt. Again, a document of this type could be issued before the end of 2019; or

- a full Government discussion document – a discussion document that provides several options developed through consultation with the private sector and worked through the policy development process. This document would not be meet a timeframe of the end of 2019 but could be released in early 2020.

74. Officials' recommend the third option – a Government discussion document for release in early 2020. This has the benefit of providing options that the Government is willing to implement and will allow pre-consultation with interested parties to form the basis for the options provided. Although there is a longer timeframe to release, officials consider that the work required to implement changes resulting from the consultation is likely to be reduced.

Financial implications

75. There are no expected financial implications for the release of the discussion document in relation to the relaxation of loss continuity rules and review of the research and development tax loss cash out scheme.

76. Any changes to relaxing the loss continuity rules or to the research and development tax loss cash out scheme will have a fiscal impact. The size of the impact will depend on which options are selected and how they are designed. Advice on financial implications will be provided when approval of the finalised proposals is sought.

Compliance and administration implications

77. For the proposal on feasibility and other non-deductible expenditure, the proposals are expected to reduce compliance costs and have no direct implications on Inland Revenue's technology platform or systems. Officials consider the proposed changes to feasibility and other non-deductible expenditure incurred in investigating and/or developing assets will reduce compliance costs as it resolves an uncertainty in the tax rules that has existed since the *Trustpower* decision.

78. The preparation and release of a discussion document on the loss continuity rules and the review of the tax loss cash out scheme have no compliance or administrative impacts, although any change in the rules will result in some impacts which will be determined when the discussion document is prepared.

Consultation

79. Given the time available, other than previous public consultation on the tax treatment of feasibility expenditure and feedback during the Tax Working Group process, officials have not consulted stakeholders on the proposals discussed in this report.

Next steps

80. We have provided you a companion report (IR2019/491; T2019/2793 refers) with an attached draft Cabinet paper for your review and comment that seeks the Cabinet Economic Development Committees' agreement to announce these proposals as part of the release of the Government's Economic Strategy on 23 September 2019.

Sensitive - Budget

Office of the Minister of Finance

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

TAX INITIATIVES TO SUPPORT THE GOVERNMENT'S ECONOMIC PLAN

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to the announcement of a law change to allow greater deductibility of feasibility and other expenditure, which is designed to support the Government's objective of building a productive, sustainable and inclusive economy. This paper also seeks the Cabinet Economic Development Committee's approval to announce the Government will consult on further tax changes to support small and innovative businesses. We propose to announce these initiatives in support of the launch of the Government's Economic Plan on 23 September 2019. These two initiatives were considered and recommended by the Tax Working Group, and are included on the recently released Government Tax Policy Work Programme.

Executive Summary

2. We seek the Cabinet Economic Development Committee's agreement to announce a law change to provide greater deductibility of feasibility and other currently non-deductible expenditure to encourage business innovation and investment. This initiative is well developed and would be included in the first taxation bill scheduled for introduction in 2020, with effect from the 2020-21 income year.

3. We also seek the Cabinet Economic Development Committee's agreement to announce the Government's commitment to consult on options to relax the tax loss continuity rules and review the research and development tax loss cash out scheme introduced in 2016. This initiative is the next in a pipeline of proposed measures in the Government's tax policy work programme that aim to support the growth of New Zealand's productive businesses. We recommend the Cabinet Economic Development Committee's direct officials to start the consultation process on proposals in late 2019.

4. Together these measures support the Government's Economic Plan to ensure that New Zealand's economy is productive, sustainable and inclusive. The measures will contribute to two of the key economic shifts we need to achieve this economic vision – moving the New Zealand economy from volume to value with Kiwi businesses, including SMEs, becoming more productive and deeper pools of capital are available to invest in infrastructure and grow New Zealand's productive assets (highlighted below). It will do this by assisting firms that invest in exploring new and better ways of doing business, and small and medium businesses, especially start-up firms.

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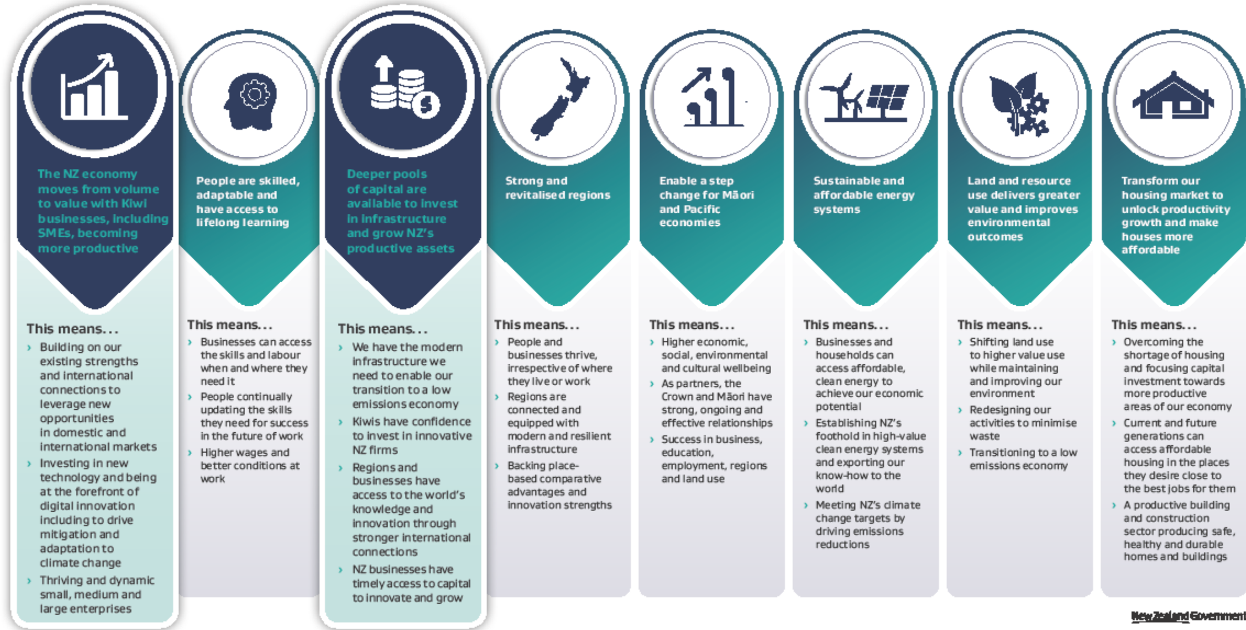

Source: Ministry of Business, Innovation and Employment.

5. Both of these tax initiatives have had long-standing support within the business community s 9(2)(f)(iv) These measures have been developed with a view to supporting business growth and innovation, while also maintaining the integrity of the tax system.

6. We propose to announce these initiatives as part of the release of the Government's Economic Plan on 23 September 2019.

7. We also seek, in respect of the initiative described in paragraph 2, the Cabinet Economic Development Committee's agreement to delegate authority to the Minister of Finance and the Minister of Revenue to make decisions about the final details of the proposal.

Feasibility and other non-deductible expenditure

8. This initiative, which we recommend including in the first taxation bill for 2020, with application from the start of the 2020-21 income year, will remove tax barriers for businesses to invest in innovation, new assets and business expansion by allowing greater tax deductions for feasibility and other non-deductible expenditure.

9. Under current law expenditure incurred to investigate whether to invest in a new asset, process or business model (feasibility expenditure, sometimes called

"blackhole expenditure") and expenditure that is incurred to create a business asset that is subsequently abandoned, is generally not deductible.

10. This is particularly problematic for businesses in the infrastructure/utilities sector following the 2016 decision by the Supreme Court in *Trustpower Limited v Commissioner of Inland Revenue*[1] (*Trustpower*) which materially limited the deductibility of such expenditure. Examples of possible expenditure affected by the decision are set out in the attached annex.

11. The non-deductibility of this expenditure effectively raises the cost of risky investments in new assets, processes or business models (where a viable outcome is uncertain), and therefore reduces the incentives for businesses to undertake them. These are the very types of investments that are vital to innovation and driving productivity improvements.

12. Business sector interest in this issue is long-standing and high and potential solutions to the problem have been subject to two rounds of public consultation in 2017. The Tax Working Group also considered the issue and made recommendations for policy change in this area.

13. Our proposal responds to stakeholder comments and the Tax Working Group recommendations and complements the work the Government has already done to support innovation which includes the introduction of the research and development tax incentive. The proposal means that businesses undertaking the full range of innovative investment, whether it is formal research and development or other types of innovative activities, these activities will be supported by the tax system.

14. This will support the key shift of driving the New Zealand economy from volume to value, by encouraging businesses to invest in new technologies and ways of working as the after tax cost of undertaking these investments will be reduced.

15. This is because the cost of feasibility expenditure should be allowed as a tax deduction, but currently is not. Because of this, a company undertaking this kind of investment has less money to invest, or may choose not to make the investment. There have been numerous case studies and feedback from leading practitioners that this measure will increase productive investment, and have positive flow on impacts to innovation and the economy.

Proposal

16. We recommend amending the Income Tax Act 2007 to allow a deduction (spread over five years) for expenditure incurred to investigate whether to invest in a new asset, process or business model (feasibility expenditure) and create a business asset that is subsequently abandoned, in cases where the expenditure is otherwise not deductible.

17. We recommend a spreading period of 5 years as this is consistent with the Tax Working Group's recommendation and mirrors a similar set of tax rules that apply in Australia.

1 [2016] NZSC 91. Under New Zealand's income tax laws expenditure connected with developing an asset is not immediately deductible. If the partially developed asset is subsequently impaired and abandoned so that it is not completed, a depreciable asset is not created for tax purposes and the taxpayer cannot deduct depreciation. As such, the expenditure incurred by the business in developing the asset is not tax deductible at all.

18. The change would apply from the start of the 2020-21 income year (for most firms this is 1 April 2020) to new expenditure incurred on and after that date. This is the first income year the proposal could take effect and have an impact on business investment decisions. Expenditure incurred in that year would be eligible to be spread and deducted.

19. To reduce complexity and compliance costs, we also propose to include a threshold whereby this type of expenditure incurred and not otherwise deductible under the Income Tax Act, would be immediately deductible in a year if that expenditure, in total, amounted to $10,000 or less. This threshold is similar to other compliance cost savings measures in the Income Tax Act that allow taxpayers to immediately deduct low levels of expenditure, such as legal fees.

20. The proposal would also have appropriate integrity safeguards. Apart from expenditure deducted under the $10,000 threshold, deductions claimed for abandoned or impaired assets that are subsequently reinstated would be reversed in the year of reinstatement, with the reinstated asset able to be subsequently depreciated.

21. We consider this proposal strikes a suitable balance between business sector expectations that any policy change is simple and easy to apply (a criticism directed at earlier proposals), and ensuring the policy response is fiscally sustainable. The proposal also has significant (but unquantifiable) benefits for the business community as it provides greater certainty for business decision-making which has been sought following the *Trustpower* decision (which reduced the scope of the deduction available as compared to business expectations). Our proposal ensures that tax is not a barrier for businesses seeking to invest in new projects or assets.

22. Details of the proposal, such as the implications for reinstated assets, will need to be finalised, as well as legislative design. We recommend delegating final design decisions, including the detail of the proposed amendment, to the Minister of Finance and the Minister of Revenue.

Relaxing the loss continuity rules and reviewing the tax loss cash scheme rules

23. The next tax initiative we recommend progressing, is a review of the asymmetrical treatment of losses and income under New Zealand's company tax system. Currently, companies pay tax when their income is positive, but the Government does not provide a refund when income is negative. Instead, losses can be carried forward to offset against the future income of a company.

24. The loss continuity rules determine whether losses from a previous year can be used in a future year. Generally, losses may be used to offset future income, unless more than 51 percent of the company's shares have changed hands since the losses were incurred.

25. The loss continuity rules require a balance between efficiency and integrity objectives. Strict rules can reduce efficiency by discouraging risk taking but loose rules may allow companies to reduce their taxable income by trading in losses.

26. For many companies the existing loss continuity rules are appropriate, but they do not work well for start-up firms. These firms require equity capital to grow. The capital

is often raised over time, through multiple rounds, from differing types of investors. Yet these firms are often inherently loss making as they grow from an idea to a viable business. The existing loss-continuity rules may be constraining their ability to grow through additional equity capital – because such capital injections will generally breach the 51 percent threshold.

27. New Zealand's loss continuity rules are more stringent than many other OECD countries, including our closest trading partner, Australia.

28. The Tax Working Group recommended that these loss continuity rules be changed to support the growth of innovative start-up firms.

29. Some of the business arrangements that can be impeded by strict loss continuity rules include:

    29.1 the sale of a company by a controlling shareholder, such as a founder cashing out of a start-up;

    29.2 the acquisition of a company, with the intention of using that company's business assets in a continuing business;

    29.3 the merger of two companies with commercial synergies;

    29.4 the initial public offering of a start-up company; and

    29.5 major capital raising to fund business expansion.

30. To an extent, the research and development tax loss cash out scheme provides some relief to those companies who do incur losses in their initial years. That scheme allows research and development intensive firms to receive cash refunds for their tax losses to the extent these match their research and development expenditure. It is a separate scheme from the research and development tax incentive that this Government has introduced.

31. However, the research and development tax loss cash out is narrowly targeted. There are a range of innovative firms who would benefit from a more general relaxation of the loss continuity rules, who do not currently benefit from the research and development tax loss cash out scheme.

32. Though adjusting the loss continuity rules would not necessarily provide the same benefits to current recipients of the research and development tax loss cash out, there are links between these policies – the research and development tax loss cash out scheme was developed to mitigate the effects of the stringent loss continuity rules for a specific set of firms. For that reason we propose to review the loss cash out scheme in conjunction with reviewing the loss continuity rules.

33. It is important to balance any relaxation of the loss continuity rules to support the growth of start-up entities with the need to ensure that the integrity of the tax system is protected and large taxpayers are not permitted to trade in tax losses. Such trading of tax losses could have a detrimental effect on New Zealand's tax base. The current stock of tax losses is approximated at $44 billion. This is why it is important

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to consult carefully on different options to relax the rules, while minimising the potential fiscal risk.

Proposal

34. We recommend that the Government announces a commitment to consult on relaxing the loss continuity rules, and officials prepare a discussion document canvassing options for relaxing the loss continuity rules and reviewing the research and development tax loss cash out scheme.

35. We propose that discussions with stakeholders begin in late 2019, with a final discussion document to be released in early 2020.

36. Addressing loss continuity issues will assist our small, innovative businesses to grow through capital injections, and support the key economic shift from volume to value, by encouraging a thriving and dynamic business sector.

Financial Implications

Feasibility and other non-deductible expenditure

37. The financial implications of allowing firms tax deductions for unsuccessful or abandoned assets, including deductions falling under the minimum threshold ($10,000) for small-to-medium enterprises, is illustrated in the table below.

38. The revenue estimates are based on business sector asset formulation statistics and assume a 3 percent growth in spending per annum. When fully phased in, in the 2024-25 income year, the proposal is estimated to cost approximately $42 million (growing by 3 percent per annum thereafter).

39.

	$million – increase/(decrease)				
Vote Revenue Minister of Revenue	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24 & outyears**
Crown Revenue and Receipts: Tax Revenue	-	(7.000)	(16.000)	(24.000)	(33.000)
Total Operating	**-**	**7.000**	**16.000**	**24.000**	**33.000**

40. s 9(2)(f)(iv)

Relaxing the loss continuity rules

41. There are no financial implications of the release of the discussion document canvassing options to relax the loss continuity rules. Any changes to relaxing the

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SENSITIVE

loss continuity rules or to the research and development tax loss cash out scheme will have a fiscal impact. The size of the impact will depend on which options are selected and how they are designed. Advice on financial implications will be provided when approval of the finalised proposals is sought.

Consultation

42. The proposed changes to the deductibility of feasibility and other non-deductible expenditure have been previously subject to two rounds of public consultation and consideration by the Government's Tax Working Group.

43. In May 2017, the previous government released a discussion document in response to the *Trustpower* decision. Twenty-three submissions were received that largely supported the policy direction of the discussion document, but had concerns regarding the complexity of the proposal and its practical application.

44. In October 2017, a second-round of consultation was held on a revised proposal with key stakeholders. Of the ten responses received, feedback was generally supportive of the revised approach but were concerned (again) with the degree of complexity of the proposal (as it was a blend of financial and tax accounting concepts). Submitters were also concerned that the revised proposal created gaps which could still give rise to non-deductible treatment of feasibility expenditure.

45. The proposal we are recommending in this paper is broadly similar to the proposals consulted on, but responds to submitters' concerns by significantly simplifying the rule and providing an immediate deduction for those with qualifying expenditure that is $10,000 or less (in total) in an income year. Stakeholders have informed officials that the most important issue is that such expenditure is deductible; not the timing of that deduction.

46. While there has been some limited public consultation on the loss continuity rules as part of the Tax Working Group process, this paper seeks approval for specific consultation through a Government discussion document.

Legislative Implications

47. Implementing these proposals requires changes to the Income Tax Act 2007.

48. If approved, we propose including the legislative changes on feasibility expenditure and other non-deductible expenditure in the first omnibus taxation bill scheduled for introduction early 2020, with application from the start of the 2020-21 income year.

49. The publication of the discussion document on the relaxation of loss continuity rules does not have any legislative implications. However legislative change will be necessary if Cabinet subsequently decides to implement the policy recommendations developed as a result of public consultation on the discussion document.

Impact Analysis

Feasibility and other non-deductible expenditure

50. The Quality Assurance reviewer at Inland Revenue has reviewed the *Feasibility and other non-deductible expenditure for incomplete assets* regulatory impact

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SENSITIVE

assessment (RIA) prepared by Inland Revenue and considers that the information and analysis summarised in the RIA partially meets the quality assurance criteria.

51. As outlined in section 5 of the RIA, consultation has been carried out with stakeholders in relation to the identified problem and potential solutions over the last few years. However, as noted in the Key Limitations and Constraints on Analysis section of the RIA, the detailed policy design of officials' preferred option is still to be developed and consulted on with stakeholders and this has limited officials' ability to undertake a complete analysis. A key unexplored issue with the preferred option is the point in time in the development of an asset at which the spreading over 5 years of deductions for expenditure incurred will commence. Consequently, there is still uncertainty as to the impacts of the preferred option (for example, on taxpayers' compliance costs). The RIA notes that consultation on the final design of the preferred option will occur over the coming months if Cabinet decides to proceed with it.

Loss continuity and research and development tax loss cash out scheme

52. Elements of the regulatory impact analysis will be included in the discussion document at a level that is appropriate given the stage of policy development. A full regulatory impact analysis will be carried out later in the policy process, once officials have finalised their policy recommendations.

Human Rights

53. The recommendations in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Publicity

54. Once Cabinet Economic Development Committee has made a decision on the proposals in this paper, we will make an announcement on 23 September 2019 as part of the launch of the Government's Economic Plan.

Proactive Release

55. We propose to release this Cabinet paper and accompanying Regulatory Impact Statement on the date the proposal is announced.

Recommendations

The Minister of Finance and the Minister of Revenue recommend that the Cabinet Economic Development Committee:

1. **Note** that the Minister of Finance and the Minister for Economic Development propose to announce the Government's Economic Plan on 23 September 2019, including measures to reform the tax deductibility of feasibility and innovation expenditure and a commitment to consult on the rules for carrying forward tax losses.

2. **Note** there is strong business sector support for these two tax measures.

Tax treatment of feasibility and innovation expenditure

3. **Agree** to amend the Income Tax Act 2007 to:

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SENSITIVE

3.1 allow firms to deduct, over a five-year period, expenditure incurred in developing an asset where that asset is abandoned and, if it had been completed, it would have been depreciable; and

3.2 allow an immediate deduction for expenditure referred to in recommendation 3.1 where the total eligible expenditure is less than $10,000 for the tax year.

4. **Agree** that recommendation 3 apply to new expenditure incurred from the start of 2020-21 income year.

5. **Delegate** to the Minister of Finance and Minister of Revenue authority to finalise the detailed design of the proposed measure in recommendations 3 and 4.

6. **Note** the following changes as a result of the decisions in recommendations 3 and 4 above, with a corresponding impact on the operating balance:

7.

	$million – increase/(decrease)				
Vote Revenue Minister of Revenue	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24 & outyears**
Crown Revenue and Receipts: Tax Revenue	-	(7.000)	(16.000)	(24.000)	(33.000)
Total Operating	**-**	**7.000**	**16.000**	**24.000**	**33.000**

8. s 9(2)(f)(iv)

9. **Note** that when fully phased in, in the 2024-25 income year, the proposal is expected to cost approximately $42 million per year, growing by 3% thereafter.

10. s 9(2)(f)(iv)

11. **Agree** that legislation implementing the measures in recommendations 3 and 4 be included in the next taxation bill, scheduled for introduction in early 2020.

12. **Invite** the Minister of Revenue to instruct Inland Revenue to draft the necessary amendments to give effect to recommendations 3 and 4.

Relaxation of the loss continuity rules

13. **Direct** officials to draft a discussion document canvassing the options for relaxing the loss continuity rules for taxpayers and reviewing the current research and development tax loss cash out scheme.

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SENSITIVE

14. **Note** that officials will begin consultation with stakeholders in late 2019, with a final discussion document to be released in early 2020.

15. **Delegate** authority to the Minister of Finance and the Minister of Revenue to decide when the discussion document will be released.

16. **Note** that we will report back to Cabinet with a draft of the discussion document prior to its release.

17. **Note** that this Cabinet paper, the associated Cabinet minute and other policy reports relating to the Cabinet paper will be proactively released on Inland Revenue's website.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance

Hon Stuart Nash

Minister of Revenue

Annex: Examples of feasibility expenditure

Company A, an electricity generator, is exploring the practicality of establishing a new windfarm. It incurs expenditure over a five-year period associated with measuring wind frequency and speeds (**anemology)** relevant to the local geography at six different sites.

At the end of year 5, the studies indicate that three sites are suitable for windfarms. Those three projects go ahead, but the remaining three are not suitable and so are abandoned.

Tax impact

The anemology expenditure does not give rise to an immediate deduction under the Income Tax Act. As three of the assets (windfarms) are not completed, there are no tax assets for the purposes of the tax depreciation rules in the Income Tax Act.

Result: Company A incurs feasibility expenditure and receives no tax deductions for the three abandoned sites.

The non-deductibility of the feasibility expenditure effectively raises the cost of the risky investment in new windfarm assets and therefore reduces the incentives for businesses like Company A to undertake them. Yet, these are the very types of investments that are vital to innovation and driving productivity improvements and moving to a sustainable economy.

Company B, a water management company is working on ways to meet demand in times of low-aquifer inflows and drought without have to resort to water restrictions. It is exploring the viability of desalination. The company carries out a number of studies on the practicality of building and operating a desalination plant and secondly, how water from the plant could be connected to the wider network. Work on the project is shelved after an assessment determines it is uneconomic, in terms of energy needs and water output, for the plant to meet forecast demand – given current technology. The project is shelved pending further work on desalination nanotechnology. However, the investigation work carried out as part of the studies yielded useful information about how such desalination plants could be built and brought to market in future once the technology advances. It also identified other useful areas for future research and several other potential projects that could be commercialised in the next 3 years.

Tax impact

The costing and initial scoping work does not give rise to an immediate deduction under the Income Tax Act. As the expenditure does not relate to an existing tax asset or create a new tax asset, there is no tax deduction for the purpose of the deprecation rules in the Income Tax Act.

Result: Company B incurs feasibility expenditure and receives no tax deductions.

As in the example above, the tax rules raise the cost of undertaking the risky investment, and some companies may not be prepared to undertake it. This would mean that the advances in the understanding of desalination technology would not have taken place. It is possible that the other resulting projects will be highly profitable, and these would not have been possible without the investigatory work carried out on the shelved desalination plant.

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Impact Summary: Feasibility and other non-deductible expenditure for incomplete assets

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis
There is no direct evidence on hand to give an estimate about the extent to which non-deductible expenditure affects efficiency in the tax system. This makes it difficult to quantify the scale of the problem or the potential benefits from introducing the preferred option. Officials were informed during consultation of anecdotal examples where current tax policy settings were acting as a barrier for businesses in respect of developing assets where uncertainty existed in respect of their completion or potential impairment and abandonment. Estimates on the impacts of the proposed option have been based on New Zealand 2018 gross fixed capital formation ($m) provisional statistics. The assessed impacts in the table in section 4.1 contain assumptions regarding taxpayer compliance and the composition of private sector asset creation in the 2018 statistics. Officials have a moderate level of confidence in the assumptions we have used but note the 2018 statistics are subject to volatility as a result of asset revaluations. Although the proposals in this RIA have been developed over several years the recent development of final proposal has been completed in a short timeframe which has limited officials' ability to undertake a complete analysis of the final proposals including its final design. The time available has also prevented officials from fully testing the design of the preferred option with stakeholders.
Responsible Manager (signature and date):
   Chris Gillion Policy Lead Policy and Strategy Inland Revenue 13 September 2019

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Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This RIA considers two questions:

- Do the current tax policy settings hinder businesses from committing resource to developing new assets in situations where the completion of that asset is uncertain, and
- If the answer to the first question is yes, what is the best option for solving the problem.

The first question is considered in this section, section 2, the second question is considered in section 3.

Do current tax policy settings hinder businesses from committing resource to developing new assets in situations where the completion of that asset is uncertain?

Business decision-making on the potential or practicality of developing new assets, business models or processes is vital to innovation and driving productivity improvements.

The Government is concerned that current tax settings are acting as a barrier to business decision-making on these types of investment, specifically investments that decline in value. Under current law, expenditure (that is more than preliminary in nature) incurred to invest in a new asset, process, or business model (feasibility expenditure), and expenditure that is incurred to create a business asset that is subsequently abandoned, is generally not deductible.

As a general principle, the economic value of business expenditure that does not provide an enduring benefit should either be immediately deductible, or, when it provides an enduring benefit, deductible over time if that benefit declines over time and has a finite lifetime. When the tax system does not provide for that treatment, an economic distortion is created.

Overlaying this principle, New Zealand's income tax framework draws a distinction between the treatment of economic income from capital and non-capital sources. The distinction is best described using the following metaphor of a fruit-bearing tree. New Zealand's income tax is designed to tax the fruit from the tree. It does not necessarily tax the tree itself. The corollary of the example is that expenditure is deductible when it has a connection or relationship with producing taxable income (fruit) and is non-deductible when it relates to capital assets (the tree). Consistent with the general principle above, the system also allows depreciation deductions recognising the use of capital assets in producing taxable income.

The income tax system's distinction between income from capital and revenue can result in expenditure not being deductible. For example, feasibility expenditure or other expenditure that results in an economic cost to a taxpayer, but for which neither immediate deductions nor depreciation deductions are available (commonly referred to as "black hole" expenditure). Such examples can skew investment decisions.

Feasibility expenditure is expenditure that is undertaken to determine the practicality of a new proposal. In some cases, the Income Tax Act 2007 will deny taxpayers an immediate deduction for such expenditure when it has a connection with an asset that has the potential to yield future economic benefits beyond the taxpayer's immediate income year. In addition, because of the early-stage nature of feasibility expenditure uncertainty exists over the outcome and this can make it difficult for taxpayers to assess whether an asset indeed exists.

Inland Revenue's original interpretation statement[1] on feasibility expenditure allowed a

SENSITIVE

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relatively wide scope for preliminary expenditure to be immediately deductible if there was no definitive commitment to proceeding with a project.

Concerns that the Income Tax Act was skewing business decisions came to a head in 2016 as a result of obiter comments by the Supreme Court in *Trustpower Ltd v Commissioner of Inland Revenue*[2] (the *Trustpower* decision). The case itself was about resource costs, which the Commissioner of Inland Revenue maintained were not immediately deductible. The Supreme Court agreed with the Commissioner's view but noted that the statutory test for deducting certain types of expenditure was narrower than Inland Revenue's interpretation and taxpayer expectations at the time.

Officials have been informed that an effect of the *Trustpower* decision is that less expenditure is immediately deductible for tax purposes than previously thought[3] which increases the likelihood that businesses will incur non-deductible expenditure when creating income producing depreciable assets. In 2017 Inland Revenue released an updated interpretation statement that applies the analysis from the *Trustpower* decision.[4]

Inland Revenue has been anecdotally informed by stakeholders that the current state following the *Trustpower* decision is discouraging businesses from undertaking spending on new assets or processes that they otherwise would have undertaken in the absence of tax.

Additionally, if a project or investment is unsuccessful or abandoned, the capitalised expenditure may not generate depreciation deductions over time. As such, businesses may be incentivised to complete projects that, but for the tax effect, would be abandoned. This behaviour affects economic efficiency. Figure 1 illustrates a simple project timeline and the tax treatment of the expenditure incurred in developing that project following the *Trustpower* decision and Inland Revenue's 2017 interpretation statement:

Figure 1: Tax treatment of feasibility expenditure

[1] Interpretation Statement IS 08/02: Deductibility of feasibility expenditure, Tax Information Bulletin Vol 20, No 6 (July 2008) available at https://www.classic.ird.govt.nz/resources/e/e/ee3c54c3-4675-45d3-8fa4-2cea747ff52b/tib-vol20-no6.pdf

[2] *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91.

[3] This outcome is appropriate, however, for assets that are not expected to decline in value.

[4] Interpretation Statement IS 17/01: Deductibility of feasibility expenditure, Tax Information Bulletin Vol 29, No 3 (April 2017) available at https://www.classic.ird.govt.nz/resources/3/e/3e0303d0-0b02-4f86-844a-547a6179b661/tib-vol29-no3.pdf

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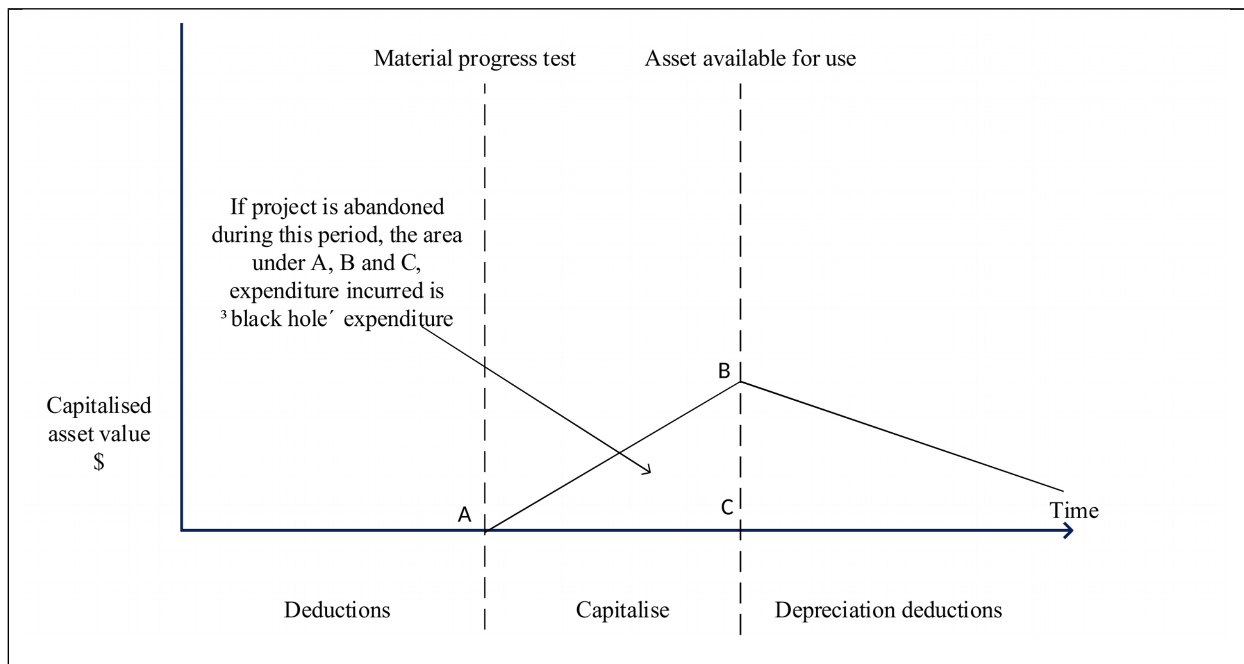

2.2 Who is affected and how?

The proposal in this RIA is directed at businesses, specifically in the following circumstances:

- Businesses delaying or not undertaking feasibility studies that would otherwise occur if there is uncertainty over whether the expenditure would be deductible and the higher after-tax cost of an unsuccessful investment.
- Businesses continuing with feasibility studies that would be uneconomic on a pre-tax basis to ensure they can claim deductions for expenditure already incurred.

The Government is concerned that current tax settings are not providing the correct outcome for businesses in respect of expenditure on new assets and processes (that would, if completed, decline in value). The Government wants to remove these tax barriers to promote economically efficient business decisions.

It is not intended that the reform would have effect on spending related to assets that are not expected to decline in value over time, such as land or shares, or other assets where the Income Tax Act 2007 provides for a specified treatment.

Inland Revenue does not hold information to inform who is directly impacted by the current treatment of expenditure directed at creating new assets. We are, however, aware from tax practitioner comment following the *Trustpower* decision and the views of submitters about the initial problem definition and initial solutions, that there is an impact on small-to-medium sized firms and the large corporate sector. Not for profits, public sector entities and individuals are not considered be within the scope of those affected.

Reform in this area of tax law has had long-standing support from the business community. The magnitude of the impact is also difficult to estimate as Inland Revenue does not directly capture data relating to the costs incurred by business when making investment decisions or when decisions are made that result in physical assets being abandoned. In assessing the revenue impact of the preferred option discussed in this RIA, Inland Revenue has used asset formulation statistics to get an understanding about how asset formulation changes from year to year.

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2.3 Are there any constraints on the scope for decision making?
To date, the government has taken an incremental approach to other instances of non-deductible expenditure under New Zealand's tax system in relation to: • Research and development; • Company administration costs; • Resource consents; • Software projects; • Patents; and • Plant variety rights. The options discussed in this impact statement are not intended to replace or otherwise alter the rules that are specific to the type of expenditure on the activities or transactions listed above. As such, it is not within the scope of this project to review or consolidate these previous responses. It is expected that any policy change would be directed at expenditure that is not the subject of these other rules in the Income Tax Act; as such, it is likely to act as a rule of last resort. The options in this RIA therefore consider expenditure that is not dealt with elsewhere in the Income Tax Act. The options are also not intended to alter the current non-deductibility for assets that are expected to appreciate in value such, as land or shares, as such assets are not expected to result in an economic loss. The Tax Working Group's consideration of the treatment of expenditure on feasibility and expenditure on abandoned assets, as set out in its final report in February 2019 have also had a strong influence on the selection of the preferred option.[5]

[5] Future of Tax: Final Report Volume I – Recommendations, Thursday, 21 February 2019 https://taxworkinggroup.govt.nz/resources/future-tax-final-report-vol-i-html#section-3, recommendation 33 refers.

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Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options considered:

- *Neutrality*: the tax rules should not influence taxpayer decisions about incurring feasibility expenditure
- *Compliance and administration costs*: the impacts on taxpayers complying with the tax rules and Inland Revenue's administration of those rules, should be minimised as far as possible.
- *Integrity*: Tax deductions should not be available for expenditure that when incurred is unlikely to give rise to taxable income now or in the future or for expenditure on assets that are not expected to decline in value over time.

Option One: Status quo

This would leave the deductibility of feasibility expenditure to be considered on a case-by-case basis with guidance from Inland Revenue's 2017 interpretation statement following the *Trustpower* decision.

Option Two: Spread the timing and recognition of feasibility expenditure over 5 years

This option would allow taxpayers to deduct expenditure on developing new assets and incomplete assets over a defined period of 5 years.

Alternative spreading periods have been considered such as 7 years. Officials initially considered 7 years was most appropriate for New Zealand, noting the absence of a comprehensive tax on the income from capital. A 5-year spread was chosen following detailed consideration of the treatment of feasibility and other non-deductible expenditure on incomplete assets by the Tax Working Group headed by Sir Michael Cullen. It is also noted that Australia has a comparable 5 year spreading rule to deal with expenditure incurred for similar purposes when developing new assets.[6] A period shorter than 5 years was considered to introduce a distortion to abandon incomplete assets earlier than would otherwise occur (in the absence of tax).[7]

Officials plan to carry out an additional round of consultation with key stakeholders on the final design of this option including any resulting draft amendments. An outstanding matter for stakeholder comment is the test(s) that would need to be met to establish the point in time in which expenditure can be recognised for tax deductibility.

Option Three: Generally accepted accounting practice (application of Financial Reporting Standards)

This option would allow generally accepted accounting practice (with certain constraints) to determine the recognition and timing of deductions.

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[6] Inland Revenue notes that any comparison of this proposal with tax deductibility rules that apply in Australia should be considered in the context of differences between New Zealand's and Australia's treatment of income from capital.

[7] Noting that a tension can exist for taxpayers who are required to comply with financial reporting standards. Assets expensed for tax purposes have a direct reflex in the taxpayer's balance sheet and profit and loss statement.

SENSITIVE

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This would allow for:

- a defined class of expenditure, known as “feasibility expenditure”, to be immediately tax deductible until an asset is recognised under generally accepted accounting practice; and
- an immediate deduction if the project or proposal is abandoned and written off under generally accepted accounting practice.

This option would also require support by new rules to deal with abandoned partially completed assets. The additional rule would be needed to remove distortions that would otherwise be created as depreciation deductions are available for completed assets only.

Modifications to options 2 and 3 for compliance and tax base integrity reasons

Options 2 and 3 have modifications that are not separate options in themselves but alter their application and effect to ensure the reform option is appropriately targeted and contains appropriate safeguards.

Reinstatement of expenditure if abandoned or completed asset is subsequently recognised

Under options 2 and 3, safeguards would be added to provide that deductions claimed for abandoned or impaired assets that are subsequently reinstated would be reversed in the year of reinstatement. Reinstatement would involve bringing back earlier tax deductions as an increase in revenue in the year of reinstatement and capitalizing those values in the cost of the asset (which would then be subject to tax depreciation).

Safe harbour for low threshold expenditure

Submitters on option 3 argued that a safe harbour was necessary to reduce compliance costs on small-to-medium sized taxpayers. This was largely due to the fact that such taxpayers were unlikely to be required to comply with New Zealand financial reporting standards. Similar compliance cost savings arguments apply to option 2 as there are costs attached with identifying and spreading expenditure under the option. It therefore makes sense for low levels of spending on investigating and/or developing a new asset, model or process to be immediately deductible. It has yet to be explored with stakeholders if expenditure covered by the safe harbour would have to be reinstated if it related to a completed asset that is expected to decline in value.[8]

A threshold of $10,000 was suggested by stakeholders, and officials considered that it was an appropriate amount that targeted asset creation expenditure by small-to-medium sized businesses. The $10,000 threshold is similar to other compliance cost savings measures in the Income Tax Act that allow taxpayers to deduct low levels of expenditure, such as legal fees.

[8] Ibid footnote 8. Officials note that taxpayers who are not required to comply with financial reporting standards do not always face a tension between accounting for tax and financial reporting when making decisions about whether to abandon an asset prior to completion.

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3.2 Which of these options is the proposed approach?

The Government considers the status quo is inefficient. Current tax policy settings, based on comments from stakeholders and the conclusions reached by the Tax Working Group, act as a barrier to businesses committing to expenditure on developing assets when uncertainty exists as to whether that asset would be completed. In the absence of regulatory change, the current state requires taxpayers and Inland Revenue to take decisions regarding the deductibility of expenses and the recognition of assets through to disputes and the Courts. Regulatory intervention therefore seeks to remove, or substantially reduce, these interpretative transaction costs.

The next question is, which option for reform is preferable. Option 3 was initially developed in response to stakeholder concerns following the *Trustpower* decision and was the subject of the government discussion document *Black hole and feasibility expenditure*. Option 3 proposed that financial reporting should be used by businesses to determine the deductibility of expenditure or if it should be capitalised. Responses to option 3 suggested that it would not be a complete solution and could be expensive for taxpayers, who are not required to use financial reporting standards, to apply. Stakeholders also noted that the tax treatment of abandoned incomplete assets was unsatisfactorily unanswered if financial reporting standards were applied. Further consideration of option 3 by officials identified a concern that immediate tax deductibility could incentivise decisions to abandon incomplete assets earlier than otherwise occur (in the absence of tax).

Option 2 is a response to the concerns stakeholders voiced regarding the application and effect of option 3. Option 2 is preferred as it better meets the assessment criteria in section 3.1. Allowing deductions for expenditure incurred in developing assets, including abandoned incomplete assets, improves neutrality as businesses no longer face tax barriers depending on whether the results of that expenditure are successful or not.

Relative to the other options, option 2 should have a lower compliance and administration impacts. This comment is subject to final decisions about the legislative design of the proposal. Further consultation will be carried out on the practical application of Option 2, if Cabinet decides to proceed.

The details of when reinstatement of previously deducted expenditure is required has yet to be tested with stakeholders. It is, however, necessary to ensure the integrity of the proposal and the wider tax system.

There are no areas of incompatibility with the Government's 'Expectations for the design of regulatory systems'.

A summary of our analysis of the options is set out in the table on page 10. The analysis is by reference to the status quo.

SENSITIVE

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Table: summary analysis

Option	Option 1: Status quo	Option 2: Spread the timing and recognition of feasibility expenditure over 5 years	Option 3: Generally accepted accounting practice
Neutrality	0	+ (tax barriers are removed)	+ (tax barriers are removed)
Compliance and administration costs	0	+ (++ if the safe harbour threshold is included	0 – recognising that financial reporting standards imposes its own asset recognition principles. (+ if the safe harbour threshold is included)
Integrity	0	+	+

Key:

++ much better than doing nothing/the status quo

+ better than doing nothing/the status quo

0 about the same as doing nothing/the status quo

- worse than doing nothing/the status quo

- - much worse than doing nothing/the status quo

SENSITIVE

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Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*

Additional costs of proposed approach, compared to taking no action		
Regulated parties	Tax records will need to be kept and maintained to support any tax deductions under the proposal. This requirement is expected to align with good record keeping practice. The requirement to spread the expenditure may impose an additional marginal cost on taxpayers.	Low
Regulators	None	Not applicable
Wider government	Reduction in tax revenue	$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual cost is expected to be $42 million, increasing by 3% per annum thereafter.
Other parties	None	Not applicable
Total Monetised Cost		$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual cost is expected to be $42 million, increasing by 3% per annum thereafter.
Non-monetised costs		*Low*

Expected benefits of proposed approach, compared to taking no action		
Regulated parties	Reduced tax payments for businesses that incur expenditure to develop new assets, business processes or abandon incomplete investments that, if completed, would decline in value. Feasibility expenditure will be more likely to be incurred where it is economic to do so on a pre-tax basis.	$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual cost is expected to be $42 million, increasing by 3% per annum thereafter. High but unquantified

SENSITIVE

2r4hxlcklw 2019-10-04 09:50:28

	Reduction in uncertainty over whether feasibility expenditure will be deductible.	Medium but unquantified
Regulators	None	Not applicable
Wider government	Tax barriers removed on business decision-making on the potential or practicality of developing new assets, business models or processes is vital to innovation and driving productivity improvements.	Low
Other parties	None	Not applicable
Total Monetised Benefit		$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual benefit is expected to be $42 million, increasing by 3% per annum thereafter
Non-monetised benefits		*Medium*

4.2 What other impacts is this approach likely to have?

The intent of the preferred option is to remove barriers to firms carrying out expenditure on developing new assets, business processes and other investments where the result of that expenditure is uncertain and could result in abandonment or impairment of the investment. This type of investment is important to innovation and driving productivity improvements. As such, the preferred option is expected to produce wider benefits to the business community.

The final design of the preferred option has not been the subject of full consultation with stakeholders. This consultation is expected to occur in the next few months following the outcome of Cabinet's decision. To ensure the integrity of the proposal, the consequences of any reinstatement of expenditure have not been fully explored and this may involve trade-offs regarding how simple option 2 operates in practice.

Officials have made certain assumptions regarding taxpayer behaviour in response to the proposal, those assumptions have inherent uncertainties, including:

- Whether the proposal may incentivise taxpayers to commit to completing uneconomic assets to reduce tax payments (raising tax-base integrity risks); and
- Whether this proposal, in conjunction with earlier policy responses outlined in section 2.3, causes introduces more complexity in taxpayer decision-making and associated tax compliance costs.

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Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Following the *Trustpower* decision, the private sector, being corporate taxpayers and their advisors, approached the government seeking a revision of the tax policy settings for expenditure on projects that was more in line with business norms and prevailing practices.

Officials undertook preliminary targeted consultation to define the parameters of the problem and consider initial solutions. The outcome from this consultation was the development of a proposal that was released in May 2017 for wider public comment in the government discussion document *Black hole and feasibility expenditure*. 23 submissions were received that largely supported the policy direction but had concerns regarding the complexity of the proposal and its practical application.

In October 2017, a second round of consultation was held on a revised proposal with key stakeholders. Of the ten responses received, feedback was generally supportive of the revised approach but concerns were again expressed over the complexity of the proposal. Submitters were also concerned that the revised proposal created gaps which could still give rise to non-deductibility of feasibility expenditure.

The preferred option in this RIA simplifies the rule and introduces a trade-off that deductions are spread over five years rather than immediately unless the qualifying expenditure is $10,000 or less in a tax year. Stakeholders have informed officials that the most important issue is the expenditure being deductible; not necessarily the timing of that deduction.

Consultation with stakeholders initially focused on a framework (option 3) that would allow businesses upfront tax deductions for expenditure incurred in developing assets, that if completed would decline in value, at the point when a decision was made to completely abandon progress on that incomplete asset. Immediate tax deductions would also be allowed for feasibility expenditure by reference to accounting principles, with an overlay of tax principles for tax base integrity purposes.

Submissions on the practicality of option 3 noted that the proposed deductibility test for feasibility expenditure was too complex. Submissions also noted that partial write down of assets needed to be recognised for tax purposes. Submitters noted that accounting standards imposed tight requirements on when assets should be written off and specific tax rules were recommended to provide for such impairments. Submitters also recommended a safe-harbour threshold that would allow small- to-medium sized businesses immediate tax deductions for low-levels of exploratory expenditure on new assets. Submitters noted that for businesses considering developing new assets, the requirement to use financial reporting standards could be an impediment if the business was not required to use New Zealand International Financial Reporting Standards, which also have a compliance cost attached to their use and application.

Officials revised the parameters of option 3 in response to submissions and undertook a second round of consultation with key stakeholders. The revised proposal relaxed the basis on which tax deductions could be claimed on partially impaired assets and suggested the tests for deductibility would be based on Inland Revenue's revised interpretation statement. Submitters were supportive of the revision but again noted the degree of complexity with the proposal (as it was a blend of accounting and tax concepts). Concerns were also expressed that the integrity measures that supported option 3 would lead to gaps with its application.

Option 3, without appropriate safeguards could, by allowing immediate tax deductions raise

SENSITIVE
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integrity risks around activities being claimed to be ceased while they were still intended to be progressed in order to access the tax deduction. This option is an improvement over the status quo, but less than option two. There is a risk that if the proposal is not well targeted the change may incentivise taxpayers deferring the recognition of asset (so as to continue incurring feasibility expenses) or encourage the early abandonment of projects and proposals.

In response to the concerns identified by submitters on option 3, officials considered that option 2 could provide a more complete response to submitter concerns. However, there is a trade-off. While option 2 is intended to deal with the gaps and problems identified in option 3, the deduction allowed under the option is spread over a specified period. As the requirement to track and record expenditure can create compliance costs, a safe harbour threshold is still required to ensure option 2 does not unreasonably disincentivise small-to-medium sized businesses. Consultation on the final design of option 2 has not occurred and is subject to Cabinet decision-making. Subject to Cabinet decisions, Inland Revenue will discuss the practical application of option 2 with stakeholders. Another round of consultation will also available as part of Parliament's consideration of any legislative amendment through the Parliamentary select committee process.

SENSITIVE
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Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The preferred option would require changes to the Income Tax Act 2007 which could be introduced in the next available tax omnibus bill planned for early 2020.

Legislation implementing the preferred option is expected to have effect for new expenditure incurred from the start of the 2020-21 income year (for most firms this is 1 April 2020) even if the feasibility project itself had started in previous years. It is not intended that these rules would apply to expenditure incurred before that date as these periods have already occurred so the change in tax treatment would not be able to impact on business investment decisions.

These proposals would be favourable to affected taxpayers and would be enacted before taxpayers would typically file tax returns for the relevant periods.

When the bill is introduced into Parliament, a Commentary on the bill will be concurrently released explaining the amendments. Further explanation about their effect will be contained in Inland Revenue's *Tax Information Bulletin* series, which would be released shortly after the bill receives Royal assent.

Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual. Inland Revenue has assessed the magnitude of the administrative impacts and considers that the proposed approach can be implemented and made effective for qualifying expenditure incurred anytime from the start of the 2020-21 income year.

No changes to Inland Revenue systems are expected as a result of implementing the proposals. Taxpayers would be expected to use existing schedules and internal record-keeping processes to capture information to support tax positions that involve tax deductions relating to developing new assets, or when decisions are made to impair and abandon incomplete assets (that would otherwise decline in value if completed).

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

There are no plans to specifically collect data on the proposal as, of itself, expenditure on developing new assets is a general business activity that would be incorporated and aggregated within existing business tax disclosures and tax returns. The existing record-keeping rules in the Tax Administration Act 1994 would apply to deductions allowed under the proposal.

Monitoring of the proposed approach will be done through existing relationships Inland Revenue has with relevant stakeholders and their advisors. Following enactment of the proposal, any issues with the new law identified by tax practitioners and taxpayers would be considered for inclusion for remedial change as part of the stewardship programme on the Government's tax policy work programme. Comments from stakeholders and their advisors will inform officials if the proposal is not working as intended or creating unintended outcomes.

Inland Revenue's enforcement of the relevant rules (referred to in section 6.1) would also

SENSITIVE
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inform officials if the risks noted in section 4.2 are material, or raise concerns regarding the integrity of the tax system.

Inland Revenue would monitor the outcomes as per the objectives of the Generic Tax Policy Process (GTPP) to confirm that the proposed approach meets its objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

7.2 When and how will the new arrangements be reviewed?

If the Government adopts option 2, officials propose to engage with key stakeholders 18 months after the proposal's enactment and receive feedback regarding the effectiveness of the proposal (if feedback is not received earlier) for the period 2020-21.

The Government's tax policy work programme makes provision for work required to deal with remedial matters where tax legislation is not achieving its policy intent. Remedial work is informed from a variety of sources external and internal to Inland Revenue.

Any concerns identified by stakeholders about the proposed approach discussed in this RIA would be considered for priority as part of the remedial items component of the tax policy work programme. If the concerns with the proposal are more substantive, consideration would be given to prioritising the matter on the tax policy work programme.

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Cabinet Economic Development Committee

Minute of Decision

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Tax Initiatives to Support the Government's Economic Plan

Portfolios **Finance / Revenue**

On 18 September 2019, the Cabinet Economic Development Committee (DEV), having been authorised by Cabinet to have Power to Act [CAB-19-MIN-0486]:

Background

1 **noted** that the Minister of Finance and the Minister for Economic Development propose to announce the government's Economic Plan on 23 September 2019 [DEV-19-MIN-0244], and to include in that announcement:

1.1 measures to reform the tax deductibility of feasibility and innovation expenditure;

1.2 a commitment to consult on the rules for carrying forward tax losses;

2 **noted** that there is strong business sector support for these two tax measures;

Tax treatment of feasibility and innovation expenditure

3 **agreed** to amend the Income Tax Act 2007 to:

3.1 allow firms to deduct, over a five-year period, expenditure incurred in developing an asset where that asset is abandoned and, if it had been completed, it would have been depreciable;

3.2 allow an immediate deduction for expenditure referred to in paragraph 3.1 above where the total eligible expenditure is less than $10,000 for the tax year;

4 **agreed** that the above proposal apply to new expenditure incurred from the start of 2020-21 income year;

5 **authorised** the Minister of Finance and the Minister of Revenue to finalise the detailed design of the proposed measure outlined in paragraphs 3 and 4 above;

6 **noted** the following changes as a result of the decisions in paragraphs 3 and 4 above, with a corresponding impact on the operating balance:

	$million – increase/(decrease)				
Vote Revenue Minister of Revenue	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24 & outyears**
Crown Revenue and Receipts: Tax Revenue	-	(7.000)	(16.000)	(24.000)	(33.000)
Total Operating	-	7.000	16.000	24.000	33.000

7 s 9(2)(f)(iv)

8 **noted** that when fully phased in, in the 2024-25 income year, the proposal is expected to cost approximately $42 million per annum, growing by 3 percent per annum thereafter;

9 s 9(2)(f)(iv)

10 **agreed** that legislation to implement the above measures be included in the next taxation bill, scheduled for introduction in early 2020;

11 **invited** the Minister of Revenue to issue drafting instructions to Inland Revenue to draft the necessary amendments to give effect to paragraphs 3 and 4 above;

Relaxation of the loss continuity rules

12 **directed** officials to draft a discussion document canvassing the options for relaxing the loss continuity rules for taxpayers and reviewing the current research and development tax loss cash out scheme;

13 **noted** that officials will begin consultation with stakeholders in late 2019, with a final discussion document to be released in early 2020;

14 **authorised** the Minister of Finance and the Minister of Revenue to decide when the discussion document will be released;

15 **invited** the Minister of Finance and the Minister of Revenue to report back to DEV a draft of the discussion document prior to its release.

Janine Harvey
Committee Secretary

Hard-copy distribution: (see over)

Present:
Hon Kelvin Davis
Hon Grant Robertson (Chair)
Hon Phil Twyford
Hon Dr Megan Woods
Hon Carmel Sepuloni
Hon Iain Lees-Galloway
Hon Damien O'Connor
Hon Shane Jones
Hon James Shaw
Hon Eugenie Sage

Officials present from:
Office of the Prime Minister
Officials Committee for DEV

Hard-copy distribution:
Minister of Finance
Minister of Revenue

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