Tax Working Group
Te Awheawhe Tāke

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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Coversheet: **Intangible assets under an ETCI**

Position Paper for Session 20 of the Tax Working Group
October 2018

Purpose of discussion

This paper covers:

- What was said by the TWG on this issue in their interim report.
- What should the final report say on what is to be included as intangible assets for ETCI purposes.
- How do emissions trading units and other intangible assets with their own tax rules fit into the proposals, and how are they currently treated.
- Will R&D tax credits in effect be clawed back through ETCI?

Key points for discussion

Whether all intangibles are to be included, subject to specific exclusions, or should only specifically listed intangibles be included? The Secretariat favours the former approach as a list would be difficult to future proof.

Recommended actions

We recommend that you:

a. **indicate** whether the Group wants:

   i. all intangibles to be included, subject to specific exclusions, or
   ii. only specifically listed intangibles to be included.

b. **agree** to appendix A being used as the basis for draft text for the Final Report.

c. **note** that the Secretariat is organising a series of consultation hui for Māori stakeholders in mid-October. Those hui may raise further issues relating to intangible assets and the Māori economy, especially in relation to fishing and water rights.

Intangible assets under an ETCI

Position Paper for Session 20
of the Tax Working Group

October 2018

Prepared by Inland Revenue and the Treasury

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1. Introduction

Context – What did the interim report recommend?

1. In the interim report the Group identified a list of asset classes that are not already subject to tax and proposed that capital gains from these assets should be included in the tax base of any extension to the taxation of capital income (ETCI). The assets are:
    - interests in land (other than the family home); this includes all other residential land, commercial, agricultural, industrial and leasehold interests not currently taxed;
    - intangible property, including goodwill; the Group is still considering how widely this should be defined;
    - all other assets held by a business or for income producing purposes that are not already taxed on sale (for example, depreciable assets);
    - shares in companies and other equity interests; and
    - certain choses in action (for example trade tie agreements).
2. Including more assets in the tax base is in effect an extension of the definition of 'revenue account property' – that is, property where the proceeds of sale are subject to income tax. The cost of that property is deducted at the time of sale, with the result that the net gain is taxable.
3. The focus of this paper is on the intangible property category given the Group is still considering how widely it should be defined.
4. The Group's interim report notes that using a defined list of included assets is intended to avoid any difficulties that might arise if the extension applied simply to capital gains not otherwise taxed. The latter approach has been adopted in some other countries and has caused difficulties when unintended gains or losses have been brought into the tax base. The Group notes that capital gains or losses arising otherwise than from the sale of included assets can be brought into the base separately and intentionally if desirable.
5. Overall, however, the Group's approach is intended to be comprehensive in its coverage of the gains from capital. The list is not deliberately intended to exclude any assets, other than the family home and some personal assets.

2. What should the final report recommend?

6. Before answering this question it would be useful to provide a sense of what qualifies as an intangible asset.

What is an 'intangible asset'?

7. The generally accepted definition of an intangible asset is an asset that has no physical being or substance, other than perhaps being represented by a document. This, along with their uniqueness, means that their value can be hard to evaluate. Intangible assets can be valuable for a firm and be critical to its long-term success or failure. Goodwill, a promissory note evidencing a debt, and intellectual property, such as patents, trademarks and copyrights, are all intangible assets. The general interpretation also includes software and other intangible computer based assets. Research and development (R&D) can also create intangible assets.

8. Definitions generally exclude monetary assets. This is necessary in order to preclude the classification of items such as accounts receivable, derivatives and cash in the bank as intangible assets.

9. In legal terms, in many cases, intangible assets are a type of chose in action. A chose in action is a right that can only be obtained or enforced through legal action. However, a chose in action may go further in that it encompasses, for example, the right of an heir to interest in the estate of his or her decedent, and the right to sue for damages for an injury. These can be more of a private nature than business related.

10. The Group in its interim report distinguishes between certain choses in action and intangible assets. This is a difficult line to sustain, and essentially we see them as all potentially being intangible assets.

11. Our presumption is that the Group would want to include only gains on business related intangible assets/choses in action. Some examples are provided below.

Specific examples of intangible assets in a business context

Business-related intangible assets

Trademarks, tradenames, service marks, collective marks, certification marks, registered designs.
Copyrights.
Trade dress (unique colour, shape, or package design).
Newspaper mastheads.
Internet domain names.
Non-competition agreements.

Goodwill-related intangible assets

Customer lists.
Order or production backlog.
Customer contracts and related customer relationships.

Non-contractual customer relationships.

Artistic and cultural-related intangible assets
Plays, operas, ballets.
Cultural images/assets (including Māori cultural assets) able to be copyrighted or otherwise legally enforced.
Books, magazines, newspapers, other literary works.
Musical works such as compositions, song lyrics, advertising jingles.
Pictures, photographs.
Video and audiovisual material, including motion pictures, music videos, television programs.

Contract-based intangible assets
Licensing, royalty, standstill agreements.
Advertising, construction, management, service or supply contracts.
Lease agreements.
Construction permits.
Franchise agreements.
Operating and broadcast rights, including radio spectrum rights.
Use rights such as drilling, water, air, mineral, timber cutting (profit a prendre).
Servicing contracts such as mortgage servicing contracts.
Employment contracts.

Technology-based intangible assets
Patented technology.
Computer software and mask works.
Unpatented technology.
Databases, including title plants.
Trade secrets, such as secret formulas, processes, recipes.

Regulation-related intangible assets
Emissions units.
Resource management consents.
Fishing quota.

12. The above list is by no means exhaustive. A key issue for the Group to consider is, therefore, whether all intangibles are to be included, subject to specific exclusions, or should only specifically listed intangibles be included?

13. The Secretariat favours the former approach as a comprehensive list could be very long, open to definitional issues, and difficult to future proof given developments over time. A prime example of the latter is cryptocurrencies which five years ago would not have been considered relevant for inclusion. We note that the definition of services in the Goods and Services Tax Act 1985 has taken, from the Act's inception, a very wide approach, being defined as "anything which is not goods and money". This wide definition has withstood the test of time.

14. We note the Group's concern about having a too broad definition of capital gains, particularly because this approach may have caused difficulties overseas when unintended gains or losses have been brought into the tax base, and that further assets can be added to a list over time. However, in the context of intangible assets, trying to limit coverage to certain listed intangibles may be difficult to sustain and it would be better to have a wider approach, with specific exclusions. Even then trying to specially exclude some items may be problematic given the difficulty of determining a coherent basis on which to make a distinction.

15. However, practicably, intangible assets/choses in action that are not held for business purposes and are purely private in nature would need to be excluded. These assets are held by individuals in a personal capacity that is removed from any profit-making motive. Moreover, in many cases they are not expected to appreciate in value. Some examples are a gym membership, a parking licence, a winning lottery ticket, the right to humiliation payments, and a right to property under an estate.

16. While the wider approach may initially create some additional uncertainty, in the longer term it should provide greater certainty as it should mean fewer periodic updates.[1] It will also likely lead to a relatively quicker discovery of areas that should be excluded.

[1] The Income Tax Act contains a list of depreciable intangible property but this is intentionally narrow so as to reduce revenue risks. In contrast, the ETCI is intended to have broad coverage.

3. What implications does an ETCI have for intangible assets already covered under the tax rules?

Revenue account property items

17. Some intangible property is already covered by separate rules in the tax legislation, many of which are variations on treating the underlying asset as revenue account property. Many of these areas, therefore, do not need to be included in an ETCI.[2] Alternatively, it could be an opportunity to consider whether some of the areas could be rationalised and incorporated into an ETCI, but that would be a matter for possible future consideration. Below, we outline the various areas, how they are currently taxed and some preliminary comments on a number of those areas.

Emissions units

18. New Zealand's emissions trading scheme (ETS) involves the pricing of emissions from industry, transport and other sectors. A business must hold sufficient emissions units to cover its carbon-related emissions. Units are surrendered annually to the Government to cover the emissions. Businesses with excess units can sell them. Income from the sale of emissions units is taxable under its own tax rules. This is a prime example of an approach that in effect treats the units as if they were revenue account property.

19. There is an exception for pre-1990 forest land emissions units. The ETS places mandatory deforestation obligations on exotic forests that were first established before 1990. This means if pre-1990 landowners choose to deforest, for example when converting forest land to a different use, they face 'deforestation liabilities' under the ETS and have to report on emissions and surrender an equivalent amount of New Zealand emission units to the Government. When the ETS was introduced, owners of pre-1990 forests were able to apply for a one-off free allocation of New Zealand emissions units. This allocation was intended to recognise the possible impact on land values due to the cost the ETS places on deforesting, and the resulting reduction in land-use flexibility.

20. The proceeds from the sale of pre-1990 forestry emissions units by their original holders are generally non-taxable to reflect the nature of the units.[3] Any subsequent sales of these emissions units are, however, taxable.

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[2] There are a number of ways in which this could be achieved in practice, such as specifically carving out those areas from an ETCI or ensuring the existing specific treatment overrides the ETCI provisions.

[3] A wide variety of owners applied for the pre-1990 forestry allocation of free units, including farmers with small forest holdings, regional councils, owners of large commercial forests, and Maori entities who received forest land as part of treaty settlements. In total, nearly 48 million New Zealand units were allocated in relation to pre-1990 forests, some of which have since been either sold or surrendered. Although there is a register of unit holders, those records do not allow information on current holders to be publically identified. However, our expectation is that the current holders will largely be those who take a longer-term view to holding the underlying land, which is consistent with, but not exclusively, the view taken by those who focus on intergenerational sustainability and kaitiakitanga (guardianship).

21. Our preliminary view is that with the exception of pre-1990 forestry emissions units, any extension of the taxation of income from capital to intangibles should exclude disposals of emissions units. The units should continue to be dealt with under their own tax rules. Pre-1990 forestry emissions units should be subject to an ETCI when they are held as a capital asset. It would mean that the original holders of the units would be subject to tax on gains in the value of the units made from 1 April 2021. This treatment is consistent with that proposed for the underlying forestry land.

Patents rights and patent applications

22. The income from disposing of patents is also taxable under its own tax rules. There is a spreading rule for the income derived from the sale of patent applications and patent rights. The income can be spread evenly over the income year of sale and the following two income years. This spreading is intended to alleviate cash-flow difficulties for vendors who sell patent rights for non-cash consideration.

Forest cutting rights

23. A sale of forestry cutting rights (profit a prendre) is taxable under the forestry rules. The income can be spread back over the past five years.

Mineral rights

24. Consideration received from the sales of exploring, mining or prospecting rights or permits are currently income. Likewise, the income of a petroleum miner includes consideration received from the disposal of a petroleum permit. We consider these specific rules remain appropriate and so in practice would be unaffected by an ETCI.

Financial arrangements

25. Many financial arrangements are intangible assets. They should continue to be covered by the financial arrangement rules rather than an ETCI. Generally, those rules already treat the arrangements as if they were revenue account property.

Lease inducement payments

26. Lease inducement payments are assessable and deductible, except where residential premises are involved. There are specific rules for spreading the income and deductions over the life of the lease. These rules are relatively recent and their rationale remains appropriate.

Related matters

Share options

27. The exercising of share options should be excluded from an ETCI, as these are either subject to their own rules where held by employees, or the exercise price will be reflected in the cost base of the share, with any gain (or loss) being recognised if the share is subsequently sold. We anticipate that the sale of unexercised options would be taxable under an ETCI.

Disposals of liabilities

28. Conceivably, the disposal of a liability can also result in a gain on sale. Such liabilities are often covered by the financial arrangement rules, but those rules preserve the capital/revenue distinction in relation to bad debts and debt remission. Ideally, we consider that boundary should be removed under an ETCI but this is an issue that requires further consideration as part of the generic tax policy process.

Fishing quota

29. Fishing quota is currently generally treated as a capital asset so that gains or losses on the sale of fishing quota are exempt from income tax, and non-deductible to the purchaser. Gains are only taxable if the seller is in the business of dealing in quota or acquired the quota with the intention of selling it. At a first principles level, we expect that the sale of quota would be taxable under an ETCI, but note that this is likely to be an area of particular interest to Māori stakeholders so will include any feedback received as part of the report-back on the hui consultation process.

Intangible depreciable property

30. Certain intangible property with fixed lives is able to be depreciated over their respective estimated useful lives. In many cases, the current tax rules limit income on disposal to the amount of depreciation claimed. As with other depreciable assets, we anticipate that, under an ETCI, income would not be limited in this way.

4. Will R&D tax credits be clawed back by an ETCI?

31. A question has been raised as to whether an ETCI will result in a clawback of the proposed research and development (R&D) tax credit.

32. There appears to be no conflict between the R&D tax incentive and expanding the capital income tax base. The R&D tax incentive and the extension of taxation on capital income are largely independent policies, each of which should be considered on its own merits. The various factors that we have taken into account in coming to this conclusion are set out below.

- Taxing disposals of R&D will not clawback tax credits. Tax credits will be allowed when there is qualifying R&D expenditure. The credit will in effect be like a non-taxable cash grant, and will therefore neither be shown as income nor lower the business' expenditure for tax purposes.
- R&D tax credits boost the value of the business to the extent that the cash is not spent on further expenditure. The business value is likely to also reflect any expected future tax credits. To the extent that occurs, it will mean that shareholders could receive a higher price when they come to sell their shareholding. An ETCI may clawback some of these additional shareholder gains. However, this outcome is not inconsistent with either policy.[4]
- The current model for start-ups is to incur losses in early years, and then to make good by selling at a capital gain once the business is established. As a result, there have been numerous examples of New Zealand businesses that have developed intellectual property and sold out to overseas buyers without much tax having been paid. Similar gains in future may in effect be supplemented by tax credits. Taxing some of those shareholder gains with an ETCI seems appropriate from a policy perspective.
- Currently there can be incentives for intellectual property to be sold offshore and leased back, especially if New Zealand intellectual property is in foreign-owned firms. Extending the taxation of capital income could make New Zealand less vulnerable to this behaviour.
- Some commentators have noted the absence of a capital gains tax as a positive factor within the current New Zealand environment with respect to firms' willingness to innovate and grow. However, we note that the Angel Association (which represents start-up investors), in its submission to the Tax Working Group, concluded that it supported a well-designed capital gains tax, as this would:

[4] The R&D tax credit has a goal of growing business R&D. It recognises that there are spill-overs from R&D and that firms may not be able to capture the full benefits of the R&D they perform. It rewards firms for expenditure undertaken on R&D. The extension of taxation on capital income aims to tax investments more neutrally, by applying tax equally to investments which generate current income and investments which generate gains in asset values. This wider coverage could be expected to increase the productivity of capital, as tax will be playing less of a role in directing people's investment choices. The R&D tax credits will not be capital income, so the extension of taxation on capital income will not "tax" the value of the tax incentive received by a firm.

"see resources channelled more efficiently and purposefully to support the success of these high risk, but high impact ventures. A capital gains tax, and a corresponding offset for capital losses, would allow early stage investors some respite from the inevitable failure of early stage investment."

- When considering the extension of taxation on capital income, it is important not to focus only on the direct impact of extending the tax base but also to focus on the benefits that the extra revenue from the additional tax would provide. For example, the Tax Working Group interim report is also raising questions about tax-revenue negative items such as recognising black-hole expenses or enabling loss continuity so that taxes do not get in the way of rapidly expanding firms acquiring new capital. There is an argument that some relaxation in these areas could encourage innovation and R&D.

5. Summary

33. The Secretariat favours including all intangibles, with a specific exclusion for assets that are not held for business purposes and are purely private in nature. The alternative of a comprehensive list could be very long, open to definitional issues, and difficult to future proof given developments over time.

34. Some intangible property, including emissions units, is already covered by separate rules in the tax legislation. Many of these rules are variations on treating the underlying asset as revenue account property, in which case the asset would not need to be brought within an ETCI. Pre-1990 forestry emissions units, however, should be included.

35. However, introducing a broad ETCI does offer the opportunity to rationalise rules that would result in inconsistent treatment between revenue account property and similar assets that would be subject to the 'general' ETCI rules. In the event that a broad ETCI is recommended, such a review could take place and be subject to the generic tax policy process.

36. Taxing disposals of R&D will not clawback tax credits. More generally, we do not consider there is a conflict between the R&D tax incentive and expanding the capital income tax base. The R&D tax incentive and the extension of taxation on capital income are largely independent policies, each of which should be considered on its own merits.

37. The Secretariat is organising a series of consultation hui for Māori stakeholders in mid-October. Those hui may raise further issues relating to intangible assets and the Māori economy, especially in relation to fishing and water rights.

Appendix A: Suggested text for the final report

Background

1. In the interim report the Group identified a list of asset classes that are not already subject to tax and proposed that capital gains from those assets should be included in the tax base of any ETCI. The assets are:
   - interests in land (other than the family home); this includes all other residential land, commercial, agricultural, industrial and leasehold interests not currently taxed;
   - intangible property, including goodwill;
   - all other assets held by a business or for income producing purposes that are not already taxed on sale (for example, depreciable assets);
   - shares in companies and other equity interests; and
   - certain choses in action (for example trade tie agreements).

2. Including more assets in the tax base is in effect an extension of the definition of 'revenue account property' – that is, property where the proceeds of sale are subject to income tax. The cost of that property is deducted at the time of sale, with the result that the net gain is taxable.

3. This approach is intended to be comprehensive in its coverage of the gains from capital. The list is not deliberately intended to exclude any assets, other than the family home and some personal assets.

4. Below we discuss what we propose in relation to the coverage of intangible assets. This also includes the certain choses in action that are mentioned above.

Intangibles assets

What is an 'intangible asset'?

5. The generally accepted definition of an intangible asset is an asset that has no physical being or substance, other than perhaps being represented by a document. Intangible assets can be valuable for a firm and be critical to its long-term success or failure. Goodwill, a promissory note evidencing a debt, and intellectual property, such as patents, trademarks and copyrights, are all intangible assets. The general interpretation also includes software and other intangible computer based assets. Research and development (R&D) can also create intangible assets.

6. Definitions generally exclude monetary assets. This is necessary to preclude the classification of items such as accounts receivable, derivatives and cash in the bank as intangible assets.

7. In legal terms, in many cases, intangible assets are a type of chose in action. A chose in action is a right that can only be obtained or enforced through legal action. However, a chose in action may go further in that it encompasses, for example, the right of an heir to interest in the estate of his or her decedent, and the right to sue for damages for an injury. These can be more of a private nature than business related.

8. Given the breadth of "intangibles", the Group has considered whether all intangibles are to be included in an ETCI, subject to specific exclusions, or alternatively, to include only specifically listed intangibles. The Group's preference is to include all intangibles, with some specific exclusions. The alternative of a comprehensive list could be very long, open to definitional issues, and difficult to future proof given developments over time. A good example of the latter is cryptocurrencies which five years ago would not have been considered relevant for inclusion. We note that the definition of services in the Goods and Services Tax Act 1985 has taken, from the Act's inception, a very wide approach, being defined as "anything which is not goods and money". This wide definition has withstood the test of time.

9. In terms of exclusions, the Group recommends that intangible assets/choses in action that are not held as part of a business and are purely private in nature should not be included. A winning lottery ticket and the right to a humiliation payment would fall into this category.

10. While a wider approach may initially create some additional uncertainty, in the longer term it should provide greater certainty as it should mean fewer periodic updates. It will also likely lead to a relatively quicker discovery of areas that should be excluded.

What implications does this have for intangible assets already covered under the tax rules?

11. Some intangible property is already covered by separate rules in the tax legislation. In many cases those rules are variations on treating the underlying asset as revenue account property, in which case the relevant intangible property does not need to be included in an extended ETCI as any gains in value are already taxable. Examples include disposals of financial arrangements, emissions units under New Zealand's emissions trading scheme (with the exception of pre-1990 forest land emissions units held on capital account)[5], forest cutting rights, and petroleum permits. We recommend that officials give consideration to how these separate regimes should best be dealt with in the detailed design of an ETCI, including whether a broad ETCI offers the opportunity to rationalise rules that

[5] Under the emissions trading scheme, if a landowner of an exotic forest first established before 1990 chooses to convert forest land to a different use they have to surrender an equivalent amount of New Zealand emission units to the Government. Owners of pre-1990 forests were able to apply for a one-off free allocation of New Zealand emissions units when the emissions trading scheme was introduced. This allocation was intended to recognise the possible impact on land values due to the reduction in land-use flexibility. Currently, the proceeds from the sale of pre-1990 forestry emissions units by their original holders are generally non-taxable.

result in inconsistent treatment between revenue account property and similar assets that would be subject to the ‘general’ ETCI rules.

Glossary

Capital account. New Zealand tax shorthand for a gain or loss that is not taxable or deductible because it is considered a capital gain or loss for tax purposes. Also used to describe an asset that when sold would result in a non-taxable, non-deductible capital gain or loss.

Depreciation (tax). The decline in the value of an asset for taxation purposes, which is generally intended to approximate the decline in the market value of the asset over its economic life.

Derivative. An arrangement or product (such as a future, option, or warrant) whose value derives from and is dependent on the value of an underlying asset, such as a commodity, currency, or security.

Goodwill. Goodwill is an intangible asset that arises when one entity purchases another for a premium value. The value of a company's brand name, solid customer base, good customer relations, good employee relations, and any patents or proprietary technology represent goodwill.

Mask work. The legal protection of the layout on a computer chip of semiconductor devices such as transistors and passive electronic components such as resistors and interconnections.

Promissory note. A signed document containing a written promise to pay a stated sum to a specified person or the bearer at a specified date or on demand.

Revenue account. New Zealand tax shorthand for a gain or loss that is taxable or deductible because it is not considered a capital gain or loss under general (legal) principles, or is explicitly taxable or deductible under the Income Tax Act. Also used to describe an asset that when sold would result in a taxable gain or deductible loss.

Service mark. A legally registered name or designation used in the manner of a trademark to distinguish an organization's services from those of its competitors.

Trade dress. A legal term of art that generally refers to characteristics of the visual appearance of a product or its packaging (or even the design of a building) that signify the source of the product to consumers.