

This is a reissue of the interpretation statement “Income tax treatment of New Zealand patents” published in *Tax Information Bulletin* Vol 17, No 10 (December 2005). This new interpretation statement replaces that interpretation statement. There were some errors in the examples included in the previous interpretation statement. These examples have been corrected and some further text added to this interpretation statement to clarify certain matters raised in the examples.

INCOME TAX TREATMENT OF NEW ZEALAND PATENTS

1. SUMMARY

- 1.1 This Interpretation Statement covers the income tax treatment for New Zealand patent applications, New Zealand patents and New Zealand patent rights, particularly:
- patent applications, patents, patent rights and their depreciation;
 - costs incurred in legal proceedings;
 - proceeds and allowable deductions on the sale of patent applications and patent rights; and
 - patent-related expenses and proceeds under old legislative rules, which still apply in some circumstances.
- 1.2 All legislative references in this statement are to the Income Tax Act 2004 (“the Act”) unless otherwise indicated. The Act states that, except for the identified policy changes specified in Schedule 22A, its provisions are those of the Income Tax Act 1994 in rewritten form and they are intended to have the same effect as the corresponding provisions in the Income Tax Act 1994. Section YA 3(3) states:
- Intention of new law*
- (3) Except when subsection (5) applies, the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994.
- 1.3 None of the provisions referred to in this statement are specified in Schedule 22A and it is considered that the position as to the law, set out in this statement, would equally apply to the income tax treatment of New Zealand patents under the provisions of the Income Tax Act 1994.
- 1.4 The Act refers generally to “patent rights” rather than “patents”. Section OB 1 of the Act defines “patent rights” as meaning “the right to do or authorise the doing of anything that would but for the right, be an infringement of a patent”. “Patent” is not defined in the Act, but is defined in the Patents Act 1953 as meaning “letters patent for an invention”. It is considered that “patent rights” include the rights granted to the patent holder and also rights subsequently

assigned to other parties. In discussing the legislative provisions, this statement uses the term “patent” in those places which refer to a “patent”. Where the provisions refer to “patent rights”, sometimes for clarity, the discussion uses the terms “patent” and “patent rights”.

1.5 In summary, the conclusions of this Interpretation Statement are:

- References in the legislation to a “patent” refer to the legal rights that the owner of the patent obtains as a result of the grant of that patent. In the case of New Zealand patents, this will be the legal rights obtained as the result of a patent granted under the Patents Act 1953.
- Other intellectual property rights are not patent rights.
- The treatment of expenditure on research and development for tax purposes, including that on the construction of prototypes, will be in accordance with:
 - section DB 25 for scientific research;
 - sections DB 26 and DB 27 for other research and development if the taxpayer both complies with the relevant requirements of FRS-13, and chooses to apply these sections; or
 - sections BD 2, DA 1 to DA 4 and DY 2.
- The current statutory provisions relating to “patents” only affect income and expenditure incurred in the patenting process, i.e. typically the administrative and legal costs incurred in the application for the patent, not income and expenditure incurred in devising the invention to which the patent relates.
- Legal expenses incurred in either defending or attacking a patent are generally revenue in nature.
- For a person who devised an invention for which a patent has been granted and who uses the patent for deriving income, the person is allowed a deduction for expenditure incurred before 1 April 1993: section DB 29(2).
- If the person who devised the invention sells the patent rights relating to the invention, a deduction is allowed for the expenditure incurred in deriving the invention to the extent that a deduction has not already been allowed under section DB 29(2): section DB 29(3).
- When patent rights acquired on or after 1 April 1993 are sold, a deduction is allowed of the total cost to the person of those patent rights less total amounts of depreciation loss: section DB 31.
- The disposal of patent rights is the disposal of a capital item unless it is the rare situation where the taxpayer is in the business of buying and

selling patent rights, in which case, patent rights are trading stock and their disposal is a revenue item. Patent rights, which are trading stock, are not depreciable.

- An amount that a person derives from the sale of patent rights is income of the person, section CB 26.

1.6 The position in respect of patents applied for after section DJ 9A of the Income Tax Act 1994 (replaced by sections DB 26 and DB 27 of the Act) came into force is considered first. (Section DJ 9A came into force on 24 October 2001, with application to the 2001-02 and subsequent income years.) Discussion of the statutory provisions relating to patents and patent rights applied for prior to the application of sections DB 26 and DB 27 is in the latter part of the statement.

2. BACKGROUND

Patents, patent rights and income tax

- 2.1 Under the current legislation, patent applications, patents and the rights to use a patent are generally depreciable intangible assets which, when sold, give rise to assessable income.
- 2.2 A “patent” refers to the legal rights, granted to an applicant, to exclude others from using a particular mode of manufacture. The patent does not include the invention to which the patent relates. The depreciable value of a patent or a right to use a patent relates only to costs incurred in obtaining the patent. These costs are typically legal and administrative costs. As a result, research and development costs incurred in devising an invention, for which a patent is sought, are not included in the depreciable value of that patent or the right to use that patent.

Former tax treatments of patents and patent rights

- 2.3 The tax treatment of patents and patent rights has changed several times. Before 1945, there was no specific tax treatment applicable to patents. Patents were capital assets under ordinary principles, unless the taxpayer was in the business of selling patents.
- 2.4 Under the Land and Income Tax Amendment Act 1945, provisions were enacted that dealt with the costs of devising the invention and purchasing patents. These provisions also dealt with the costs of granting, maintaining and extending patents, and the receipts from the sale of patents. Generally, proceeds from the sale of patents were assessable, the costs deductible and the income and deductions could be spread. A provision was also introduced relating to scientific research expenditure.
- 2.5 Further provisions relating to the depreciation of patents were enacted in the Income Tax Amendment Act 1993 and the Taxation (Core Provisions) Act 1996, and, under the Taxation (Remedial Provisions) Act 1997, the ability to

spread income derived on the sale of a patent provided for under section DJ 6(1) of the Income Tax Act 1994 (now section DJ 28 of the Act) was removed.

- 2.6 Under the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005, a patent application with a complete specification lodged on or after 1 April 2005 is included as depreciable intangible property under Schedule 17. The Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 also inserted sections EE 27B to EE 27D in the Income Tax Act 2004, which provide formulae for the respective annual rates to be used for the depreciation calculations of patent applications and patents.

Patents generally

The Patents Act 1953

- 2.7 In New Zealand, the Patents Act 1953 governs the granting of patents for inventions. The Intellectual Property Office of New Zealand, formerly known as the New Zealand Patent Office, administers the Act. Under the Patents Act, a person can apply for a patent for “any manner of new manufacture”. This may include a saleable article or commodity, an apparatus or a process. By preventing others from using that patented specification for a term of 20 years, the grant of a patent provides the applicant, now the “patentee”, with the sole right to exploit the patent for that period.

The patent application

- 2.8 A patent applicant usually engages a patent attorney to file the patent application. Amongst other things, the work of the patent attorney will include the search of published patent specifications at the Intellectual Property Office before the application is filed.
- 2.9 The patent application may be filed with either a provisional or a complete specification of an invention. A provisional specification is a general description of the invention. A complete specification is a detailed description of the invention. In all cases, a complete specification must be filed within 12 months of the application.
- 2.10 After examining the application, the Office may accept and publish the specification. If no one opposes the application, the Office may then grant a patent for which a fee is payable by the applicant.

The patent date

- 2.11 The date of the patent is the date that the complete specification is filed. Although the patent is not necessarily granted on this date, the 20-year term of the patent runs from this date. As a result, the patent expires at some time less than 20 years after the patent is granted. This is in accordance with section 30 of the Patents Act 1953, which states:

- (1) Every patent shall be dated with the date of filing the complete specification:

Provided that no proceeding shall be taken in respect of an infringement committed before the date of the publication of the complete specification.

...

- (3) The term of every patent shall be 20 years from the date of the patent.

The effect of a patent

- 2.12 Following the grant of a patent, a patentee, as the patent holder, has a number of options. The patentee may license the patent rights to a third person, permitting that person to manufacture the patented article, or use the patented process, in return for a royalty. Alternatively, the patentee may exploit the patent by using the patented process themselves or by merely retaining the patent rights. Another option would be for the patentee to sell or assign the patent rights to a third person to similarly exploit. In each case, the holder of the patent rights can exclude others from the use of the particular patented specification. The patent holder is able to prevent others from making, using or selling the patented invention in New Zealand or importing the patented invention into New Zealand.

When a patent or patent application is bought

- 2.13 When a person buys a patent or the right to use a patent, what is purchased is the right to use the complete specification for an invention. Provided the person is not purchasing an item, such as a prototype of a patented invention, and is only purchasing the patent, the purchase is of the patent rights and the complete specification. In this situation, there is no necessity for any splitting of the cost. The purchaser's asset is the patent inclusive of the complete specification.

Patents outside New Zealand

- 2.14 The Patents Act 1953 governs patents registered and applicable for use in New Zealand. Patents can also be registered in other countries and the relevant local legislation in any particular country may give the patentee rights to make, use, sell, or import the invention in that country. This statement only applies to the income tax treatment of patents and patent applications applied for or granted under the New Zealand Patents Act 1953.

“Patent or the right to use a patent” does not include similar intellectual property rights

- 2.15 Although it may be suggested that other similar intellectual property rights are within the ambit of “patent”, for the purposes of the Act, the Commissioner's view is that the word “patent”, in the Income Tax Act, refers to the rights registered, granted and protected as a patent. For New Zealand patents, these are the rights registered, granted and protected under the Patents Act 1953. This view is in accord, firstly, with the ordinary meaning of “patent” and, secondly, with the text of the legislation, which refers to different types of intellectual property in specific terms. An example is Schedule 17 of the Act.

Schedule 17 distinguishes, in some detail, between types of depreciable intangible property and lists both “a patent or the right to use a patent” and “a patent application with a complete specification lodged on or after 1 April 2005” separately from other depreciable property.

3. LEGISLATION

Patents Act 1953

3.1 Section 2, defines a “patent” and an “invention” as follows:

“**Patent**” means letters patent for an invention:

“**Invention**” means **any manner of new manufacture** the subject of letters patent and grant of privilege within section 6 of the Statute of Monopolies and any new method or process of testing applicable to the improvement or control of manufacture; and includes an alleged invention:

[emphasis added]

Income Tax Act 2004

3.2 The Income Tax Act 2004 has a number of specific provisions dealing with patents and patent rights. For ease of reference, these will typically be set out where appropriate in the body of the Interpretation Statement. However, the following provisions are key to the tax treatment of expenditure incurred by the taxpayer in devising an invention that may be patented, both before and after the enactment of the specific research and development provision of section DJ 9A of the Income Tax Act 1994 (replaced by sections DB 26 and DB 27 of the Act). Section DJ 9A came into force on 24 October 2001, with application to the 2001-02 and subsequent income years.

3.3 The general provision, section BD 2, states in respect of allowable deductions:

BD 2 Deductions—

An amount is a **deduction** of a person if they are allowed a deduction for the amount under Part D (Deductions).

3.4 Section DA 1 sets out the general permission. The section states:

Nexus with income

- (1) A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—
 - (a) incurred by them in deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income; or
 - (b) incurred by them in the course of carrying on a business for the purpose of deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income.

General permission

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

3.5 Section DA 2 sets out general limitations in respect of deductions. The section states:

Capital limitation

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

...

Relationship of general limitations to general permission

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

3.6 Section DA 3 provides for the effect of specific rules on general rules. The section states:

Supplements to general permission

- (1) A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.

Express reference needed to supplement

- (2) A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.

Relationship of general limitations to supplements to general permission

- (3) Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.

Relationship between other specific provisions and general permission or general limitations

- (4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.

Express reference needed to override

- (5) A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—
(a) that it overrides the general permission or the relevant limitation; or
(b) that the general permission or the relevant limitation does not apply.

Part E

- (6) No provision in Part E (Timing and quantifying rules) supplements the general permission or overrides the general permission or a general limitation.

3.7 Section DA 4 provides for the treatment of an amount of depreciation loss. The section states:

The capital limitation does not apply to an amount of depreciation loss merely because the item of property is itself of a capital nature.

3.8 Section DB 25 provides for a deduction for expenditure incurred in connection with scientific research. The section states:

DB 25 Scientific research—

Deduction: scientific research

- (1) A person is allowed a deduction for expenditure they incur in connection with scientific research that they carry on for the purpose of deriving their assessable income.

Exclusion

- (2) Subsection (1) does not apply to expenditure that the person incurs on an asset that—
 - (a) is not created from the scientific research; and
 - (b) is an asset for which they have an amount of depreciation loss for which—
 - (i) they are allowed a deduction; or
 - (ii) they would have been allowed a deduction but for the Commissioner's considering that incomplete and unsatisfactory accounts were kept by or for them.

Link with subpart DA

- (3) This section supplements the general permission and overrides the capital limitation. The other general limitations still apply.

3.9 Section DB 26 provides that expenditure on research and development may, in some circumstances, be expensed by a taxpayer in the year in which the expenditure is incurred. This can apply to expenses incurred by taxpayers in research or development that may be intended to lead to a patent application. This section and section DB 27(1), which provides some definitions applicable to section DB 26, state:

DB 26 Research or development—

Deduction

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

Person recognising expenditure as expense

- (2) Subsection (1) applies to a person who recognises the expenditure as an expense for financial reporting purposes under paragraph 5.1 or 5.2 of the reporting standard.

Person not recognising expenditure as asset

- (3) Subsection (1) also applies to a person who does not recognise the expenditure as an asset for financial reporting purposes because of paragraph 5.4 of the reporting standard.

Person recognising expenditure otherwise

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

- (a) recognises the expenditure as an expense for financial reporting purposes because of paragraph 2.3 of the reporting standard; and
- (b) would be required to recognise the expenditure as an expense for financial reporting purposes under paragraph 5.1 or 5.2, or because of paragraph 5.4, of the standard if—
 - (i) any 1 of those paragraphs were applied to the expenditure; and
 - (ii) the expenditure were material.

Person with minor expenditure

- (5) Subsection (1) also applies to a person who—
 - (a) incurs expenditure of \$10,000 or less, in total, on research and development for a tax year; and
 - (b) has not treated the expenditure as material, as described in paragraph 2.3 of the reporting standard; and
 - (c) has recognised the expenditure as an expense for financial reporting purposes.

Exclusion

- (6) Subsection (1) does not apply to expenditure that the person incurs on property to which all the following apply:
 - (a) the property is used in carrying out research or development; and
 - (b) it is not created from the research or development; and
 - (c) it is 1 of the following kinds:
 - (i) property for which the person is allowed a deduction for an amount of depreciation loss; or
 - (ii) property the cost of which is allowed as a deduction by way of amortisation under a provision of this Act outside subpart EE (Depreciation); or
 - (iii) land; or
 - (iv) intangible property, other than depreciable intangible property; or
 - (v) property that its owner chooses, under section EE 8 (Election that property not be depreciable) to treat as not depreciable.

Section need not be applied

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

Relationship with section EA 2

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

Link with subpart DA

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

DB 27 Some definitions—

Definitions

- (1) In this section, and in section DB 26,—

development is defined in paragraphs 4.1 and 4.2 of the reporting standard as interpreted by paragraphs 4.3 to 4.7

Financial Reporting Standard No 13 1995 (Accounting for Research and Development Activities) means the standard approved under the Financial Reporting Act 1993, or an equivalent standard issued in its place, that applies in the tax year in which the expenditure is incurred

reporting standard means Financial Reporting Standard No 13 1995 (Accounting for Research and Development Activities)

research is defined in paragraphs 4.1 and 4.2 of the reporting standard, as interpreted by paragraphs 4.3 to 4.7.

- 3.10 In short, under section DB 26, the taxpayer is treated as having incurred expenses of a revenue nature, rather than expenditure of a capital nature, if the expenditure would be recognised as a revenue expense under the Financial Reporting Standards (No 13) 1995. Some of the relevant parts of Financial Reporting Standard No 13 (“FRS-13”), to which section DB 26 refers, are:

4 Definitions

STANDARD

The following terms are used in this Standard with these meanings:

- 4.1 “Development” is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.
- 4.2 “Research” is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

- 3.11 Paragraph 5 of FRS-13 provides for the treatment of research and development costs:

5 Financial Reporting

Recognition of Research Costs

STANDARD

- 5.1 Research costs shall be recognised as an expense in the period in which they are incurred.

Recognition of Development Costs

STANDARD

- 5.2 The development costs of a project shall be recognised as an expense in the period in which they are incurred unless the criteria for asset recognition identified in paragraph 5.3 are met.
- 5.3 The development costs of a project shall be recognised as an asset when all of the following criteria are met:
- (a) the product or process is clearly defined and the costs attributable to the product or process can be identified separately and measured reliably;
 - (b) the technical feasibility of the product or process can be demonstrated;
 - (c) the entity intends to produce and market, or use, the product or process;

- (d) the existence of a market for the product or process or its usefulness to the entity, if it is to be used internally, can be demonstrated; and
- (e) adequate resources exist, or their availability can be demonstrated, to complete the project and market or use the product or process.

5.4 The development costs of a project recognised as an asset shall not exceed the amount that is probable of recovery from related future economic benefits, after deducting further development costs, related production costs, and selling and administrative costs directly incurred in marketing the project.

3.12 Sections DB 28 provides for a deduction from a taxpayer’s annual gross income, for expenditure incurred in the patent process, if the taxpayer acquired the patent before 23 September 1997. Effective 1 October 2005 and with application for the 2005-06 and subsequent income years, section DB 28B provides for a deduction from a taxpayer’s assessable income in respect of expenditure they incurred in the patent process in relation to a patent application that is refused or withdrawn if the person “is not allowed a deduction under another provision”. These sections state:

DB 28 Patent expenses—

Deduction

- (1) A person is allowed a deduction for expenditure that they incur in connection with the grant, maintenance, or extension of a patent if they—
 - (a) acquired the patent before 23 September 1997; and
 - (b) use the patent in deriving income in the tax year in which they incur the expenditure.

Link with subpart DA

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

DB 28B Expenses of failed or withdrawn patent application

Deduction

- (1) A person who applies for the grant of a patent and is refused the grant or withdraws the application is allowed a deduction for expenditure -
 - (a) that the person incurs in relation to the application; and
 - (b) that would have been part of the cost of fixed life intangible property if the application had been granted; and
 - (c) for which the person is not allowed a deduction under another provision.

Timing of deduction

- (2) The deduction is allocated to the income year in which the grant is refused or the application is withdrawn.

...

3.13 Section DB 28B only applies if the person is not allowed a deduction under another provision. However, for patent applications with complete specifications lodged on or after 1 April 2005 which constitute depreciable intangible property, section EE 41 allows an amount of depreciation loss on the cessation of the rights in the intangible property where the patent is refused

or the patent application is withdrawn. Section DB 28B does not apply in this situation.

- 3.14 Sections DB 29(1) and DB 29(2) provide for a deduction from a person's annual gross income for expenditure incurred in devising an invention for which a patent has been granted, if the expenditure is incurred before 1 April 1993. Section DB 29 states:

When this section applies

- (1) This section applies when a person incurs expenditure in devising an invention for which a patent has been granted. The section applies whether the person devised the invention alone or in conjunction with another person.

Deduction: expenditure before 1 April 1993

- (2) When the person uses the patent in deriving income in a tax year, they are allowed a deduction for expenditure incurred before 1 April 1993, but not if a deduction has been allowed for the expenditure under any other provision of this Act or an earlier Act.

...

- 3.15 Section DY 2 provides for amounts that are not deductions under Parts F to I.

DY 2 Amounts that are not deductions under Parts to be rewritten—

No deduction

- (1) An amount of expenditure or loss is denied as a deduction if it is denied as a deduction under a provision in any of Parts F to I.

General permission

- (2) A provision in any of Parts F to I may, without expressly stating so, override the general permission or any provision that supplements the general permission.

4. PATENT APPLICATIONS, PATENTS AND PATENT RIGHTS: THEIR COSTS AND THEIR DEPRECIATION

Summary

- 4.1 The Commissioner considers that a “patent” refers to the legal rights to exclude others from using a particular mode of manufacture. The patent does not include the invention to which the patent relates.
- 4.2 References to a patent application in the discussion below generally refer to “a patent application with a complete specification lodged on or after 1 April 2005”, which is depreciable intangible property under Schedule 17.
- 4.3 The original patentee or the purchaser of the patent application, patent or patent rights may depreciate the cost of the patent application, patent or patent rights, using the straight line method of depreciation. Under this method, the cost of the patent application, patent, or patent rights is spread over the legal life of the patent rights.

- 4.4 Sections EE 27B, EE 27C and EE 27D, which came into force on 1 October 2005 and apply to the 2005-06 and later tax years, provide formulae for depreciation deduction annual rates for patents and patent applications. An amendment to section CB 26 also came into force on 1 October 2005 and this provides that an amount derived by a person from the sale of a patent application with a complete specification lodged after 21 June 2005 or from the sale of patent rights is income of the person.

What is a patent?

- 4.5 Although the Act does not define “patent”, “patent rights” is defined in section OB 1:

patent rights means the right to do or authorise the doing of anything that would, but for the right, be an infringement of a patent

- 4.6 Section 2 of the Patents Act 1953 distinguishes between “patent”, being the rights granted, and “invention”, being the subject of those rights:

“Patent” means letters patent for an invention:

“Invention” means any manner of new manufacture the subject of letters patent and grant of privilege within section 6 of the Statute of Monopolies and any new method or process of testing applicable to the improvement or control of manufacture; and includes an alleged invention:

- 4.7 *The Concise Oxford Dictionary* (10th ed, 2001) defines “patent” as particular legal rights:

Patent *n.* a government licence to an individual or body conferring a right or title for a set period, especially the sole rights to make, use or sell an invention.

- 4.8 Accordingly, the ordinary meaning of “patent” is the legal rights obtained by the grant of a patent and does not include the invention or any prototype of the invention that is the subject of the patent.

The courts’ interpretation of “patent”

- 4.9 The Court of Appeal has considered what is meant by a “patent”. In *Re Merrell Dow Pharmaceuticals Inc* [1994] 2 NZLR 706, the Court held that the grant of a patent guarantees the patentee the right to exploit a specific invention without competition and in *Pharmaceutical Management Agency Ltd v Commissioner of Patents* [2000] 2 NZLR 529, Gault J stated:

[8] The patent system rests on the policy that a limited-term monopoly will be granted as an incentive to innovation but subject to the invention and the best method of carrying it out being disclosed and made available to public use at the end of the term of protection.

- 4.10 Similar views have been expressed in decisions in Australia, England and the United States. This is illustrated by the cases referred to in the following discussion.

- 4.11 The High Court of Australia in *The Grain Pool of WA v The Commonwealth of Australia* (2000) 202 CLR 479 held that patent law was concerned with a monopoly right to exclude others from employing either a particular mode of manufacture or invention. The High Court referred to and quoted from the House of Lords' decision in *Steers v Rogers* [1893] AC 232:

What the letters patent confer is the right to exclude others from manufacturing in a particular way, and using a particular invention. (per Lord Hershell LC, p 235)

- 4.12 In the English case of *Re Wardwell's Patent* (1913) 30 RPC 408, a similar view was expressed. In this case, it was held that the patent is not based on a physical entity called an invention, but on a specification upon which the patent is granted and from which, subsequently, a patented article may be manufactured.

- 4.13 In *Butterworth (Inspector of Taxes) v Page* [1935] All ER Rep 943, Romer LJ agreed that a patent is a right of monopoly. He stated:

A patentee has, of course a monopoly, and that monopoly, which is a right of preventing other people utilising his invention, is a capital asset in his hands. (p 955)

- 4.14 In the Supreme Court of United States' decision in *United States v American Bell Telephone Co* (1897) 167 US 224, Brewer J came to a similar decision. He stated:

The only effect of [the patent] was to restrain others from manufacturing and using that which [the patentee] invented. (p 239)

- 4.15 There is, therefore, a common view across a number of jurisdictions that "patent" refers to a legal right to prevent others from using a particular invention.

A distinction between a patent and an invention in the legislation

Provisions for the tax treatment of patents acquired before 23 September 1997 and inventing expenditure incurred before 1 April 1993

- 4.16 Section DB 29 distinguishes between a patent and an invention. Section DB 28 applies to expenditure incurred by the taxpayer, in connection with the grant, maintenance or extension of a patent, for a patent acquired before 23 September 1997. This is expenditure incurred by the taxpayer solely for the patent process. In contrast, section DB 29(2), although only applicable to expenditure incurred before 1 April 1993, provides that where a patent has been granted for any invention, a deduction is allowed for expenditure incurred by the taxpayer in connection with the devising of the invention.
- 4.17 Section DB 29(1) sets out when section DB 29(2) applies. Section DB 29(1) refers to two processes; the grant of the patent and the devising of the invention. By providing for separate tax treatments for each process, section DB 29 indicates recognition that a patent and an invention, although related concepts, are not synonymous for the purposes of income tax treatment.

The arguments supporting the view that “patent” includes inventing costs

- 4.18 It can be argued that “patent” in the Act means the patent rights and the invention.
- 4.19 The strongest of the arguments in support of the view that the cost of a “patent” includes associated inventing costs for depreciation purposes, is that when the legislation was enacted to make patents depreciable, section DJ 6(2) of the Income Tax Act 1994 (now replaced by section DJ 29(1) and (2) of the Act), which gave immediate deductions for inventing expenditure, was terminated. Therefore, although it might be suggested that those inventing expenses were intended to be depreciated with the cost of the patent to which they relate, this argument, in the Commissioner’s opinion, is inconclusive.
- 4.20 Although following the termination of section DJ 6(2), some expenditure incurred in devising an invention remained deductible, the deduction was limited. Before the introduction of section DJ 9A of the Income Tax Act 1994, which provided for deductions for expenditure incurred on research and development (now replaced by sections DB 26 and DB 27 of the Act), the deduction was available only when the patent rights, to which the inventing expenditure related, were sold. This deduction, which is now provided under section DB 29 of the Act, is discussed in paragraphs 6.2 and 6.3. It is considered that the intention of the legislation was not to depreciate the expenditure on the inventing process, but to limit the deductibility of such expenditure by linking it to the time at which income is derived from a patent or patent rights that result from that expenditure.

The current provisions for the tax treatment of patents and patent rights

- 4.21 The current rules in the depreciation provisions refer to the cost of a “patent” only. Although there is no reference to the tax treatment of inventions, there is no evidence that the meaning of “patent” was intended to be changed to mean “the patent and the invention” under the current depreciation legislation. Had this been the intention, it would be expected that such change would have been explicitly made. As this is not the case, it is the Commissioner’s view that, in the depreciation rules, the patent costs means the costs of acquiring the patent and not expenditure incurred in devising an invention.
- 4.22 Further, the reference in section DB 26(8) to “... devising an invention that is patented” indicates an understanding that a patent and an invention, although intrinsically linked, are not synonymous. The invention may be the subject of the patent, but “patent” refers to the legal rights only.

A patent is an intangible asset with a limited life

- 4.23 This interpretation of “patent” is consistent with the policy behind bringing certain intangible assets into the depreciation regime; a policy proposed by the Valabh Committee, in its *Tax Accounting Issues* paper published in February 1991.

- 4.24 The Committee's recommendation was confined to intangible assets with a limited life. In this respect, inventions do not necessarily have a limited life. In contrast, a patent's life is restricted by statute. Accordingly, it may be argued that an invention is not within the types of intangible assets that the Valabh Committee considered and recommended should be depreciated.

Conclusion on the meaning of "patent"

- 4.25 Taking into consideration the ordinary meaning of "patent", the view of the Court of Appeal, the referral to "patent and patent rights" in the Act and the enactment of section DJ 9A of the Income Tax Act 1994, (now sections DB 26 and DB 27, which provide for expenditure on research and development to be expensed in the year in which it is incurred), it is the Commissioner's opinion that for tax purposes, "patent" refers to the legal rights granted to an applicant to exclude others from using a particular mode of manufacture. A "patent" does not include the invention that is the subject of the patent. Accordingly, the patent costs able to be depreciated are those costs incurred by the taxpayer that are directly attributable to the patent.
- 4.26 It is noted that this view, that a patent does not include the invention, is consistent with the way in which "patent rights" are defined in section OB 1. The definition of "patent rights", set out above, refers to a right to do "anything which would, but for that right, be an infringement of a patent". In addition, this reference to "an infringement of a patent" appears to endorse the view that, when the Act refers to a "patent", it is only referring to the legal rights that are a "patent" and not also to the invention. The infringement is not of the invention. The infringement is of the right to use that invention.

A patent application is made but a patent is not granted

- 4.27 Section DB 28B, which is effective 1 October 2005, provides that in some situations, where the application for the grant of a patent made by a taxpayer is refused or withdrawn in the 2005-06 and subsequent income years, the taxpayer is allowed a deduction for expenditure that they have incurred in relation to the application. Such deduction is allowed if the expenditure incurred would have been part of the cost of fixed life intangible property if the application had been granted and provided the taxpayer is not allowed a deduction under another provision for such expenditure. Such expenditure will include patent application fees and legal fees incurred in making the application. However, section DB 28B only applies if the taxpayer is not allowed a deduction under another provision.

Depreciating a patent application, a patent or the right to use a patent

- 4.28 Under the Act, "a patent or the right to use a patent" and "a patent application with a complete specification lodged on or after 1 April 2005" are "depreciable intangible property" as defined in section OB 1 and listed in Schedule 17. Section OB 1 states:

depreciable intangible property is defined in section EE 53 (Meaning of depreciable intangible property)

4.29 Section EE 53 states:

EE 53 Meaning of depreciable intangible property—

Meaning

- (1) Depreciable intangible property means the property listed in schedule 17 (Depreciable intangible property).

Criteria for listing in schedule 17

- (2) For property to be listed in schedule 17 (Depreciable intangible property), the criteria are as follows:
- (a) it must be intangible; and
 - (b) it must have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its acquisition.

Schedule 17 prevails

- (3) Property that is listed in schedule 17 (Depreciable intangible property) is depreciable intangible property even if the criteria are not met.

4.30 Schedule 17 lists intangible property, which is depreciable. Items 3 and 3b on the list are:

- 3 a patent or the right to use a patent
- 3b a patent application with a complete specification lodged on or after 1 April 2005

4.31 Therefore, a patent application with a complete specification lodged on or after 1 April 2005, a patent or the right to use a patent is depreciable, providing the other requirements for depreciation are met. However, depreciation of a patent or patent rights can only be claimed when the patent rights are used or available for use in deriving income. If an asset has not been used or is not available for use in deriving income or in a business, section FB 7, which is set out in paragraph 4.43, provides for an adjustment in the depreciation calculation to reflect this.

Depreciation method effective prior to 1 October 2005

4.32 The following discussion relates to the depreciation method for patents generally. However, effective 1 October 2005, the calculations of annual rates to be used for the depreciation of patent applications and patents will be in accordance with sections EE 27B, EE 27C and EE 27D. These are discussed in paragraph 4.46.

4.33 Sections EE 12(1) and EE 12(2) provide that the straight-line method of depreciation must be used to calculate depreciation for “fixed life intangible property”. The section states:

EE 12 Depreciation methods—

Meaning of depreciation method

- (1) **Depreciation method** means a method that a person may use to calculate an amount of depreciation loss.

Methods described

- (2) The depreciation methods are—
...
(b) the straight-line method, which—
(i) may be used for any item of depreciable property; and
(ii) **must be used for an item of fixed life intangible property:**
...
[emphasis added]

- 4.34 The straight-line method, as defined in section OB 1, requires that each year, a constant percentage of the cost of the property to the taxpayer is deducted from the property's adjusted tax value.

straight-line method, for depreciation, is defined in section EE 58 (Other definitions)

- 4.35 Section EE 58 states that in the Act:

straight-line method means the method of calculating an amount of depreciation loss for an item of depreciable property by subtracting, in each income year, a constant percentage of the item's cost, to its owner, from the item's adjusted tax value

- 4.36 Because a patent or the right to use a patent is depreciable property with a legal life which, on acquisition, can reasonably be expected to be the same as the property's remaining useful life, a patent or the right to use a patent is also "fixed life intangible property" as defined in section OB 1.

fixed life intangible property is defined in section EE 58 (Other definitions)

- 4.37 Section EE 58 states that in the Act:

fixed life intangible property means property that—
(a) is depreciable intangible property; and
(b) has a legal life that could reasonably be expected, on the date of the property's acquisition, to be the same length as the property's remaining estimated useful life

- 4.38 "Legal life" is defined in section OB 1:

legal life is defined in section EE 58 (Other definitions)

- 4.39 Section EE 58 states that in the Act:

legal life means the number of years, months, and days for which an owner's interest in an item of intangible property exists under the contract or statute that creates the owner's interest, assuming that the owner exercises any rights of renewal or extension that are either essentially unconditional or conditional on the payment of predetermined fees

- 4.40 Accordingly, the legal life of the patent or the right to use a patent is required to be calculated assuming rights of renewal are exercised. (For patents registered in New Zealand, renewal fees are payable in years 4, 7, 10 and 13

and the legal life of a patent is 20 years. If the holder of a patent does not exercise the rights of renewal, the patent expires and the Act treats this situation as a disposal of the patent and, as a result, the cost of the patent, not already depreciated, is deductible.)

- 4.41 Section EE 27(3), however, modifies the definition of “legal life”. If section EE 19 applies, the legal life of the intangible property is from the start of the income year in which it was acquired by the taxpayer who incurs additional costs. Section EE 27 effective prior to 1 October 2005 states:

EE 27 Annual rate for fixed life intangible property—

What this section is about

- (1) This section is about the annual rate that applies to an item of fixed life intangible property (not including an item of excluded depreciable property, for which a rate is set in section EZ 14 (Annual rate for excluded depreciable property: 1992-93 tax year)).

Rate

- (2) The rate is the rate calculated using the formula—

$$\frac{1}{\text{legal life}}$$

Definition of item in formula

- (3) **In the formula, “legal life” is,—**
- (a) **if section EE 19 applies, the item's remaining legal life from the start of the income year in which a person incurs the additional costs referred to in that section:**
- (b) if section EE 19 does not apply, the item's remaining legal life from the time at which a person acquires it.

How rate expressed

- (4) The rate given by the formula is expressed as a decimal and rounded to 2 decimal places, with numbers at the midpoint or greater being rounded up and other numbers being rounded down.

[emphasis added]

- 4.42 Section EE 19 states:

EE 19 Cost: fixed life intangible property—

When this section applies

- (1) This section applies when—
- (a) a person owns an item of fixed life intangible property; and
- (b) the person incurs additional costs in an income year for the item; and
- (c) the person is denied a deduction for the additional costs other than a deduction for an amount of depreciation loss.

Additional costs for fixed life intangible property

- (2) For the purposes of the formula in section EE 16, the item's cost at the start of the income year is treated as being the total of—
- (a) the item's adjusted tax value at the start of the income year; and
- (b) the additional costs the person incurs.

4.43 If, for part of an income year, the patent or patent rights are not used or available for use in deriving assessable income or in a business carried on for the purpose of deriving assessable income, section FB 7 provides a formula by which the depreciation deduction is reduced to reflect the period during which the patent or patent rights were used or available to derive income. This section states:

FB 7 Depreciation: partial income-producing use—

- (1) Subsection (2) applies when—
- (a) a person has an amount of depreciation loss for an item of depreciable property for an income year, other than an amount arising under section EE 41(2); and
 - (b) at a time during the income year, the item is partly used, or is partly available for use, by the person—
 - (i) in deriving assessable income or carrying on a business for the purpose of deriving assessable income; or
 - (ii) in a way that is subject to fringe benefit tax; and
 - (c) at the same time, the item is partly used, or is partly available for use, by the person for a use that falls outside both paragraph (b)(i) and (ii); and
 - (d) the item is not a motor vehicle to which subpart DE applies.

- (2) The deduction the person is allowed for the amount of depreciation loss must not be more than the amount calculated using the formula—

$$\text{depreciation loss} \times \frac{\text{qualifying use days}}{\text{all days}}$$

- (3) In the formula,—

- (a) **depreciation loss** means the amount of depreciation loss for the income year;
 - (b) **qualifying use days** means the number of days in the income year on which the person owns the item and uses it, or has it available for use, for a use that falls within subsection (1)(b)(i) or (ii);
 - (c) **all days** means the number of days in the income year on which the person owns the item and uses it or has it available for use.
- (4) A unit of measurement other than days, whether relating to time, distance, or anything else, is to be used in the formula if it achieves a more appropriate apportionment.

- (5) Subsection (6) applies when—

- (a) a person has an amount of depreciation loss for an item of depreciable property arising under section EE 41(2); and
- (b) the item was, at any time during the period the person owned it, dealt with in—
 - (i) subsection (2); or
 - (ii) any applicable paragraph in section EZ 10; and
- (c) the item is not a motor vehicle to which subpart DE applies.

- (6) The deduction the person has for the amount of depreciation loss is calculated using the formula—

$$\text{disposal depreciation loss} \times \frac{\text{all deductions}}{\text{(base value – adjusted tax value)}}$$

- (7) In the formula,—

- (a) **disposal depreciation loss** is the amount resulting from a calculation made for the item under section EE 41(2);
- (b) **all deductions** is all amounts of depreciation loss relating to the item for which the person has been allowed a deduction in each of the income years in which the person has owned the item;

- (c) **base value** has the applicable one of the meanings in sections EE 48 to EE 50:
- (d) **adjusted tax value** is the item's adjusted tax value on the date on which the disposal or event occurs.

4.44 The depreciation rate is then multiplied by both the cost of the property and the fraction of the year that the property is owned by the taxpayer. This formula is set out in section EE 16, which states:

EE 16 Amount resulting from standard calculation—

Amount

- (1) For the purposes of the comparison of amounts required by section EE 14(1), the amount dealt with in this section is calculated using the formula—

$$\text{annual rate} \times \text{value or cost} \times \frac{\text{months}}{12}$$

Definition of items in formula

- (2) The items in the formula are defined in subsections (3) to (5).

Annual rate

- (3) **Annual rate** is the annual rate that, in the income year, applies to the item of depreciable property under the depreciation method that the person uses for the item. It is expressed as a decimal.

Value or cost

- (4) **Value or cost** is,—
 - (a) when the person uses the diminishing value method, the item's adjusted tax value at the end of the income year before the deduction of an amount of depreciation loss for the item for the income year; and
 - (b) when the person uses the straight-line method, the item's cost to the person, excluding expenditure for which the person is allowed a deduction under a provision of this Act outside this subpart. (Variations to cost are in sections EE 18 and EE 19.)

Months: income year of normal length or shorter

- (5) **Months**, for a person whose income year contains 365 days or fewer (or 366 days or fewer in a leap year), is the lesser of the following:
 - (a) 12; and
 - (b) the number of whole or part calendar months in the income year in which—
 - (i) the person owns the item; and
 - (ii) the person uses the item or has it available for use for any purpose.

Months: income year of longer than normal length

- (6) **Months**, for a person whose income year contains more than 365 days (or more than 366 days in a leap year) is the number of whole or part months in the income year in which—
 - (a) the person owns the item; and
 - (b) the person uses the item or has it available for use for any purpose.

- 4.45 Therefore, prior to 1 October 2005, the depreciation of a patent or patent rights is by a straight-line method (section EE 12), with the annual rate calculated in accordance with section EE 27. The standard calculation to determine the amount of depreciation loss is then provided in section EE 16. For the purposes of that calculation, section EE 19 provides that the cost at the start of the income year is treated as being the total of the adjusted tax value of the patent or patent rights and the additional costs the person incurs for the item in an income year for which a deduction is denied other than for an amount of depreciation loss.

Depreciation rates for patents and patent applications effective on or after 1 October 2005

- 4.46 Effective 1 October 2005, section EE 27(1) is amended so that the formula for the annual rate calculation of 1/legal life set out in section EE 27(2), for application in section EE 16, does not apply to a patent or patent application, for which a rate is set in sections EE 27B, EE 27C and EE 27D. Section EE 27(1), effective 1 October 2005, states:

EE 27 Annual rate for fixed life intangible property—

What this section is about

- (1) This section is about the annual rate that applies to an item of fixed life intangible property, not including -
- (a) an item of excluded depreciable property for which a rate is set in section EZ 14 (Annual rate for excluded depreciable property: 1992-93 tax year):
 - (b) **a patent or patent application for which a rate is set in sections EE 27B or EE 27D:**
 - (c) plant variety rights for which a rate is set in section EE 27E.

...

- 4.47 Sections EE 27B to EE 27D provide the formulae for the calculation of the annual rate for patent applications and patents. Sections EE 27B, EE 27C and EE 27D provide for three different circumstances depending on when the patent application, complete with full specification, is lodged.
- 4.48 Section EE 27B provides for the annual rate for patents where the application for the patent is lodged with complete specification before 1 April 2005. This provision provides that the depreciation rate for the first income year of depreciation of the patent will also include depreciation from the time of the patent application with the full specification to the time of the grant of the patent. Section EE 27B states:

EE 27B Annual rate for patents: applications lodged with complete specifications before 1 April 2005

When this section applies

- (1) This section applies if —
- (a) an application for a patent with a complete specification is lodged with the Intellectual Property Office of New Zealand or a similar office in another jurisdiction; and
 - (b) the application is lodged with the complete specification before 1 April 2005; and

- (c) the patent is granted to a person in an income year of the person that corresponds to the 2005 - 06 or a later tax year.

Income years for which usual rate applies

- (2) The rate given by subsection (3) applies for the patent for an income year that begins —
- (a) after the date on which the patent is granted; and
- (b) before the date that is 240 months after the patent application date.

Usual rate

- (3) The rate is calculated using the formula -

$$\frac{\text{months}}{\text{depreciation months}}$$

Rate for first income year of use

- (4) For the patent and the income year that includes the date on which the patent is granted, the rate is found by adding together the following rates:
- (a) the rate calculated using the formula –
- $$\frac{\text{months before grant}}{\text{depreciation months}}$$
- (b) the rate calculated for the income year under subsection (3).

Effect of change in ownership of patent application

- (5) If the patent is granted to a person who does not lodge the application for the patent with the complete specification, the rates calculated under subsections (3) and (4) for the person depend on the period between the date on which the person acquires the application and the date on which the patent is granted.

Definition of items in formulas in subsections (3) and (4)

- (6) The items in the formulas in subsections (3) and (4) are defined in subsections (7) to (9).

Months

- (7) **Months** is the number in the income year of months, beginning on or a whole number of months after the beginning of the income year, —
- (a) in which the patent is used or is available for use; and
- (b) that include or begin after the date on which the patent is granted; and
- (c) that end before the date that is 240 months after the patent application date.

Depreciation months

- (8) **Depreciation months** is, —
- (a) if subsection (5) does not apply, 240;
- (b) if subsection (5) applies, 240 reduced by the number of months, beginning on or a whole number of months after the beginning of an income year of the person, that –
- (i) include or begin after the patent application date; and
- (ii) end before the date on which the person acquires the application.

Months before grant

- (9) **Months before grant** is the number of months, beginning on or a whole number of months after the beginning of an income year of the person, that,
- - (a) if subsection (5) does not apply, -
 - (i) include or begin after the patent application date; and
 - (ii) end before the date on which the patent is granted:
 - (b) if subsection (5) applies –
 - (i) include or begin after the date on which the person acquires the application; and
 - (ii) end before the date on which the patent is granted.

4.49 Section EE 27C provides for the annual rate for patent applications lodged with complete specification on or after 1 April 2005. This provision provides for the depreciation rate for the period from when the patent application is lodged with complete specification until the application is granted, refused or withdrawn. Section EE 27C states:

EE 27C Annual rate for patent applications lodged with complete specifications on or after 1 April 2005

When this section applies

- (1) This section applies if –
- (a) an application for a patent with a complete specification is lodged with the Intellectual Property Office of New Zealand or a similar office in another jurisdiction; and
 - (b) the application is lodged with the complete specification on or after 1 April 2005.

Income years for which rate applies

- (2) The rate given by subsection (3) applies for a patent application for an income year that -
- (a) includes or begins after the patent application date; and
 - (b) begins before the date on which –
 - (i) the patent is granted; or
 - (ii) the patent application is refused or withdrawn.

Rate

- (3) The rate is calculated using the formula -

$$\frac{\text{months}}{\text{depreciation months}}$$

Months

- (4) **Months** is the number in the income year of months, beginning on or a whole number of months after the beginning of the income year, that -
- (a) include or begin after the patent application date; and
 - (b) end before the date on which -
 - (i) the patent is granted; or
 - (ii) the patent application is refused or withdrawn.

Depreciation months

- (5) **Depreciation months** is, -
- (a) if subsection (6) does not apply, 240:
 - (b) if subsection (6) applies, 240 reduced by the number of months, beginning on or a whole number of months after the beginning of an income year of the person, that -
 - (i) include or begin after the patent application date; and

- (ii) end before the date on which the person acquires the application.

Effect of change in ownership of patent application

- (6) If the person who owns the patent application when the patent is granted, or when the patent application is refused or withdrawn, is not the person who lodges the application for the patent with the complete specification, the rate calculated under subsection (3) for the person depends on the period between the patent application date and the date on which the person acquires the application.

4.50 Section EE 27D provides for the annual rate for patents, the application for which was lodged with complete specification on or after 1 April 2005. This provision is applicable only to patents. It is noted that for patents applied for on or after 1 April 2005, in the year in which a patent is granted, section EE 27C will be applicable until the grant and section EE 27D will be applicable from the date of the grant to the end of the income year. The formula in section EE 27D is applicable for the remaining legal life of the patent. Section EE 27D states:

EE 27D Annual rate for patents: applications lodged with complete specifications on or after 1 April 2005

When this section applies

- (1) This section applies if -
 - (a) an application for a patent with a complete specification is lodged with the Intellectual Property Office of New Zealand or a similar office in another jurisdiction; and
 - (b) the application is lodged with the complete specification on or after 1 April 2005; and
 - (c) the patent is granted to a person in an income year of the person that corresponds to the 2005 - 06 or a later tax year.

Income years for which rate applies

- (2) The rate given by subsection (3) applies for a patent for an income year that -
 - (a) includes or begins after the date on which the patent is granted; and
 - (b) begins before the date that is 240 months after the patent application date.

Rate

- (3) The rate is calculated using the formula -

$$\frac{\text{months}}{\text{depreciation months}}$$

Months

- (4) **Months** is the number in the income year of months, beginning on or a whole number of months after the beginning of the income year, that -
 - (a) include or begin after the date on which the patent is granted; and
 - (b) end before the date that is 240 months after the patent application date.

Depreciation months

- (5) **Depreciation months** is, -

- (a) if subsection (6) does not apply, 240:
- (b) if subsection (6) applies, 240 reduced by the number of months, beginning on or a whole number of months after the beginning of an income year of the person, that –
 - (i) include or begin after the patent application date; and
 - (ii) end before the date on which the person acquires the application.

Effect of change in ownership of patent application

- (6) If the patent is granted to a person who does not lodge the application for the patent with the complete specification, the rate calculated under subsection (3) for the person depends on the period between the patent application date and the date on which the person acquires the application.

4.51 Effective 1 October 2005, the appropriate rates calculated in accordance with sections EE 27B, EE 27C and EE 27D are the “annual rate” for application in section EE 16 (refer paragraph 4.44) for determining the amount of depreciation for an income year for patents and patent applications.

4.52 The Commissioner is aware that the amount of depreciation of a patent or patent application under the current legislation is reduced twice by a factor relating to the length of time the patent or patent application is owned. For patents granted on or after 1 April 2005, the annual rate derived from the application of sections EE 27B to EE 27D is proportional to the time that the patent or patent application is held (i.e. the fraction of months/depreciation months). However, when that rate is inserted in the formula in section EE 16 to derive the amount of depreciation, that rate is multiplied again by the fraction, months/12. This issue is addressed by amendments included in The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill 2006.

When the legal life starts for tax purposes

4.53 Although, under the Patents Act, the patent date is the date of the filing of the complete specification irrespective of the date that the patent is granted, for tax purposes, prior to 1 October 2005, the Commissioner considers that the legal life of a New Zealand patent starts from the date the Intellectual Property Office of New Zealand grants the patent. This is the date that the patent is available for use.

4.54 In the Commissioner’s view, for patents granted before 1 April 2005, the time at which the intangible property is acquired by the taxpayer is the start of the legal life of the patent (section EE 27(3)(b)). This is because section FB 7 provides that, if property is not wholly used or available for use by the taxpayer for the derivation of assessable income at any time during the income year, the depreciation deduction is apportioned and depreciation can only be claimed for the period for which the asset was available for use. Accordingly, the legal life/remaining legal life for tax purposes of patents granted before 1 April 2005 is less than the 20-year patent term.

4.55 However, effective 1 October 2005, the Act does not require “legal life” to be determined in respect of patents for the calculation of depreciation. Effective

1 October 2005, sections EE 27B, EE 27C and EE 27D refer to “depreciation months”. This term is defined in these sections as 240 or 240 reduced by the number of whole months from the patent application date to the date on which the person acquires either the patent application or the patent. This figure is then used as part of the formulae also set out in these sections to determine the depreciation rate of the patent or patent application.

What is included in the cost of a “patent application”, “patent” or “patent rights”?

- 4.56 Depreciation is calculated on the cost of a patent application, patent or patent rights. If a taxpayer has purchased the patent application, patent or patent rights, the cost of purchasing them is depreciable. If the taxpayer developed the invention that is patented, the Commissioner considers that the cost of a “patent application”, “patent” or “patent rights” does not include the cost of research or development work that may have led to the application for a patent. Although this research and development work may include, for example, the construction of a prototype of the invention, the specification of which is ultimately the subject of a patent application, for tax purposes, these costs are not considered part of the cost of a patent application or patent and are not part of the depreciable cost of the patent application, patent or patent rights. A patent refers solely to the legal right to exclude others from the use of that patented specification.
- 4.57 This view accords with the ordinary usage of the word “patent” (being the sole rights to make, use or sell an invention, which are conferred by statute) and the definition of “patent rights” in section OB 1:

patent rights means the right to do or authorise the doing of anything that would, but for the right, be an infringement of a patent

Depreciable patent costs

- 4.58 If the taxpayer has lodged a patent application with full specification or had a patent for an invention granted, the costs of the patent include fees charged by the Intellectual Property Office of New Zealand, fees charged by other patent authorities and patent attorney fees. In short, it is the administrative and legal fees incurred in the patent process that are the depreciable patent costs.
- 4.59 On the granting of a patent, those patent application costs form part of the adjusted tax value of the patent and the amounts continue to be depreciated over the same term of 240 months. The Commissioner is of the view that there is no disposal of the patent application in terms of section EE 37.
- 4.60 If the taxpayer has purchased the patent application, patent or patent rights, the cost of the patent application, patent or patent rights is depreciable. In this case, the taxpayer has either purchased the application for or the right to use a particular specification, which is protected by a patent, and to exclude others from such use. It is the cost incurred in buying that right or application for that right that is depreciable. As above, there is no disposal of the patent application when the patent is granted. If the taxpayer also bought an item

such as a prototype of the patented invention, the cost of the prototype is not part of the cost of the patent application, patent or the right to use the patent.

Treatment of invention expenditure

- 4.61 As set out above, it is the Commissioner's view that allowable deductions for the costs incurred in the "patent" process do not include expenditure incurred in the investigative process that may culminate in an invention. This means that invention expenditure, which is capital in nature, cannot be depreciated as part of the cost of a patent application, patent or the right to use a patent.
- 4.62 Although, under the present legislation, some invention expenditure may be deductible under other provisions, there may, in some circumstances, be expenditure incurred on an invention that is neither deductible nor depreciable. The following discussion considers the tax treatment of various invention expenditure. It must be reiterated that this does not apply to a person who simply purchases a patent application, patent or right to use a patent.

Research and development expenditure

- 4.63 Expenditure on research and development that may lead to an invention may be deductible:
- if a taxpayer chooses to utilise the provisions of section DB 26, expenditure incurred on research or development, up to the point of "asset recognition" (defined in FRS-13, paragraph 5.3), can be expensed in the year in which it is incurred (the five criteria in FRS-13 required to be complied with to satisfy "asset recognition", include the demonstration of both the technical feasibility of a product and the existence of a market for the product, and, therefore, expenditure beyond the point of "asset recognition" which is required to be capitalised, can be made by the taxpayer with that knowledge); or
 - if the taxpayer's annual research and development expenditure does not exceed \$10,000 (section DB 26(5) provides for the entire quantum of such research and development costs to be expensed in the year in which it is incurred provided that the expenditure has not been treated as material for financial reporting purposes and the expenditure has been recognised as an expense for financial reporting purposes); or
 - if the expenditure is revenue in nature, i.e. if the expenditure is incurred in deriving assessable income or in carrying on a business for the purpose of deriving assessable income and it is not capital in nature (an example might be expenditure on materials consumed in research related to a taxpayer's business: the expenditure would be deductible without the benefit of section DB 26 but, research expenditure contributing to the cost of an asset, or related to establishing a new line of business, is likely to be capital in nature and non-deductible); or
 - if the expenditure is on scientific research, section DB 25 provides for deductions; or

- if a person who devised an invention for which a patent is granted and uses the patent in deriving income in an income year, under section DB 29(2), they are allowed a deduction for expenditure incurred before 1 April 1993 provided a deduction is not otherwise allowed; or
- if a person who devised and patented an invention, sells all of the patent rights relating to the invention, under section DB 29(3), they are allowed a deduction from their annual gross income for expenditure incurred in connection with devising the invention, whenever it is incurred, to the extent that it not already allowed under section DB 29(2) or some other provision such as section DB 26; or
- similarly, if only some of the patent rights are sold, a proportional deduction of the expenditure incurred is allowed, section DB 29(4).

Deductions allowable for expenditure incurred in devising an invention only to extent of total expenditure

4.64 Under section DB 29, a taxpayer, who devises an invention to which the patent relates and who then sells the patent rights, is allowed a deduction of the amount of the expenditure incurred in connection with devising the invention that has not already been allowed under section DB 29(2). To the extent that a taxpayer, who devised the invention, has already claimed the invention costs in full, under sections DB 25 or DB 26, section BD 4(5) ensures that the allowable deductions for the expenditure are only available once.

4.65 Section BD 4(5) provides:

Allocation

- (5) If an expenditure or loss gives rise to more than 1 deduction, the deductions are allocated to income years to the extent that their total is no more than the amount of the expenditure or loss.

Depreciation of assets used for or developed in the inventing process

4.66 In some circumstances, invention expenditure that forms part of the cost of an asset may be deducted by way of depreciation, if the asset is depreciable property that is used or available for use in deriving assessable income or in carrying on a business for the purpose of deriving assessable income. Intangible assets are depreciable only if they are listed in Schedule 17 to the Act.

4.67 However, section DB 26, by the application of the FRS-13 criteria, provides for the cost of assets used on a project, in the inventing process up to the point of “asset recognition”, to be treated as revenue expenditure in the year in which the cost is incurred. After the point of asset recognition, such costs are required to be capitalised and unless those costs are for an asset that is otherwise depreciable property, no depreciation allowance is available. (Where section DB 26(5) applies, i.e. where the person incurs expenditure of \$10,000 or less, in total, on research and development for a tax year and the

expenditure is not treated as material and is recognised as an expense for financial reporting purposes, the person is allowed a deduction for that expenditure.)

4.68 Section EE 6 defines “depreciable property”:

EE 6 What is depreciable property?—

Description

- (1) **“Depreciable property”** is property that, in normal circumstances, might reasonably be expected to decline in value while it is used or available for use—
- (a) in deriving assessable income; or
 - (b) in carrying on a business for the purpose of deriving assessable income.

...

Prototypes and other tangible assets used in the inventing process

4.69 Expenditure on the construction of prototypes or other assets used to develop or trial an invention may be of a capital nature under general case law principles. In *Case N55* (1991) 13 NZTC 3,434, Judge Barber held that expenditure on the development of a prototype farm vehicle was capital in nature. Judge Barber found that the prototype was part of the establishment or expansion of a profit making structure and, as such, was made prior to the commencement of ordinary business operations in relation to the manufacture of that vehicle.

4.70 However, if the taxpayer utilises section DB 26, FRS-13 lists “pre-production prototypes” as an example of a typical activity that would be included in “development”. The expenditure incurred in the manufacture of such prototype or other tangible assets used in the inventing process can be expensed, in the year in which the cost is incurred, provided the project has not yet met the five criteria for “asset recognition”. After the point of “asset recognition” has been reached, development expenditure on the project, including the expenditure on a prototype, is required to be capitalised.

Additional costs that are depreciable

4.71 Although section EE 19 provides for “additional costs” to be added to the depreciation cost base of an intangible asset, “additional costs” are not defined. Section EE 19 states:

EE 19 Cost: fixed life intangible property—

When this section applies

- (1) This section applies when—
- (a) a person owns an item of fixed life intangible property; and
 - (b) the person incurs additional costs in an income year for the item; and
 - (c) the person is denied a deduction for the additional costs other than a deduction for an amount of depreciation loss.

Additional costs for fixed life intangible property

- (2) For the purposes of the formula in section EE 16, the item's cost at the start of the income year is treated as being the total of—
- (a) the item's adjusted tax value at the start of the income year; and
 - (b) the additional costs the person incurs.

4.72 Accordingly, additional costs are costs that the taxpayer incurs in relation to fixed life intangible property that the taxpayer owns, and for which a person is denied a deduction other than a deduction for depreciation loss. If additional costs are added, the adjusted cost base is then depreciated over the remaining legal life of the patent.

Patent renewal fees

4.73 Patent renewal fees are payable to the Intellectual Property Office at intervals to keep patent rights in existence. These fees are payable before the end of the fourth, seventh, tenth and thirteenth years from the date of the filing of the complete specification of the patent. If the patent renewal fees are not paid, the patent expires (refer to paragraph 4.76, “What happens if a patent is not renewed?”).

4.74 In the Commissioner’s opinion, patent renewal fees relate to the ownership of the patent, are capital in nature and are “additional costs” within section EE 19. Patent renewal fees are not paid to maintain a patent, in the sense of keeping it up to date, and they are not simply an administrative fee. The Commissioner considers that Parliament intended to include this type of expenditure as “additional costs” subject to section EE 19. Therefore, the nature of the fee will determine whether or not it is an “additional cost” and whether or not it is depreciable under section EE 19.

4.75 However, if the patent was acquired before 23 September 1997, patent renewal fees remain deductible under section DB 28. Section DB 28 provides for a taxpayer to claim a deduction for expenditure incurred in connection with the grant, maintenance, or extension of a patent used by the taxpayer in the production of the taxpayer’s income for that year. This provision is discussed further in paragraphs 7.1- 7.5.

What happens if a patent is not renewed?

4.76 If the patent renewal fees are not paid, the patent rights end. The owner of the patent is no longer able to exercise those patent rights and section EE 40(9) provides that sections EE 41 to EE 44 apply. In this situation, section EE 41(2) provides for an amount of depreciation loss. This is the amount “by which the consideration is less than the item’s adjusted tax value ...”. This can be seen from the following legislation.

4.77 Section EE 37 states:

EE 37 Application of sections EE 41 to EE 44—

When sections apply

- (1) Sections EE 41 to EE 44 apply when a person derives consideration from the disposal of an item or from an event involving an item, if—
 - (a) the consideration is consideration of a kind described in section EE 38; and
 - (b) either—
 - (i) the item is an item of a kind described in section EE 39; or
 - (ii) the event is an event of a kind described in section EE 40.

Exclusion

- (2) Sections EE 41 to EE 44 do not apply when a person disposes of an item of intangible property as part of an arrangement to replace it with an item of the same kind.

4.78 Section EE 40 lists those events to which sections EE 41 to EE 44 apply. It includes section EE 40(9), which states:

Cessation of rights in intangible property

- (9) The eighth event is an occurrence that has the effect that the owner of an item of intangible property is no longer able, and will never be able, to exercise the rights that constitute or are part of the item.

...

4.79 Section EE 41(2) provides:

Amount of depreciation loss

- (2) For the purposes of section EE 37, if the consideration is less than the item's adjusted tax value on the date on which the disposal or the event occurs, the person has an amount of depreciation loss, for the income year in which the disposal or the event occurs, that is the amount by which the consideration is less than the item's adjusted tax value on that date. This subsection does not apply if the item is a building.

4.80 Therefore, when patent rights are voided or disposed of, being the eighth event as described in section EE 40(9), any cost of the patent or patent rights, which has not already been depreciated, can be deducted under section EE 41.

4.81 Section EE 37 refers to consideration derived from the disposal of an item. In the case of a patent which is allowed to lapse, the Commissioner considers that in light of the other provisions in Part E, relating to losses on disposals, (including express references to a number of transactions where no actual consideration would be received) a nil amount of consideration is derived. This has now been clarified by an amendment to the legislation. Section EE 38(1B) now provides specifically that, for the purposes of section EE 37, an amount that a person derives as consideration may be nil or a negative amount. This amendment applies for income years corresponding to the 2005-2006 and subsequent tax years.

4.82 However, section EE 37(2) provides that sections EE 41 to EE 44 do not apply when a person disposes of an item of intangible property, if the disposal of that property is part of an arrangement to replace it with property of the same type (refer paragraph 4.77).

- 4.83 In summary, subject to the exception discussed above, the non-renewal of a patent is an event, for the purposes of sections EE 41 to EE 44, and any costs, not already depreciated, can be deducted.

Should worthless patent applications, patents or the rights to use a patent be recognised as assets and depreciated?

- 4.84 Sometimes a patent might be applied for or registered “just in case” the protection that a patent offers, for a particular invention, may one day prove to be valuable. The same situation could also occur with the acquisition of patent rights. It could be argued that these patents or patent rights should not be treated as assets, until the feasibility of the invention is known.
- 4.85 The Act does not make this distinction. In sections EE 14, EE 16, EE 19, EE 27, EE 27B, EE 27C and EE 27D, the Act provides rules for the depreciation of the cost of patents and patent rights, if these were used or available for use in deriving assessable income or in a business carried on for the purpose of deriving assessable income. The cost includes all of the costs incurred in acquiring the patent or the right to use a patent. It has been held that the test of whether something is used in deriving income or in a business is satisfied not only if the asset directly produces income, but also if the asset is used in the course of deriving income or in a business (*C of IR v Banks* (1978) 3 NZTC 61,236). Sections EE 14 states:

EE 14 Diminishing value or straight-line method: calculating amount of depreciation loss—

Most depreciable property

- (1) The amount of depreciation loss that the person has for an income year for an item of depreciable property is the lesser of the amounts dealt with in sections EE 15 and EE 16.

Exclusion: petroleum-related depreciable property

- (2) The amount of depreciation loss that the person has for an income year for an item of petroleum-related depreciable property is the lesser of the amounts dealt with in sections EE 15 and EE 17.

- 4.86 For section EE 16, refer paragraph 4.44. For section EE 19, refer paragraph 4.71.

5. LEGAL FEES INCURRED IN DEFENDING OR ATTACKING A PATENT

- 5.1 The legal fees may relate to an opposition action or a revocation action. An opposition action is taken when a patent has not yet been granted and the action is taken against another person’s application for a patent, to prevent that patent being granted. A revocation action is taken against someone who has had a patent granted, to revoke that patent.
- 5.2 The Commissioner’s opinion is that the same principles apply to both opposition and revocation actions. In both cases, the action relates to an asset

of the person who is bringing the action, whether it is a patent or a patent application. The terms “defending” and “attacking” respectively are used to mean defending, and taking, a revocation action (including an opposition action).

General principles

5.3 Legal expenses incurred in either attacking or defending a patent are generally incurred in the maintenance or preservation of a capital asset which, in the case of a patent, is a right.

5.4 The Privy Council in *BP Australia v FC of T* [1965] 3 All ER 209 has provided a number of factors to consider in the determination of whether expenditure is capital or revenue in nature. The factors for consideration have since been summarised by the Court of Appeal in *CIR v McKenzies New Zealand Limited* (1988) 10 NZTC 5233 in the judgment of the court given by Richardson J under the heading “The capital-income distinction”:

Amongst the factors weighed by the Judicial Committee in *BP Australia* were: (a) the need or occasion which called for the expenditure; (b) whether the payments were made from fixed or circulating capital; (c) whether the payments were of a once and for all nature producing assets or advantages which were an enduring benefit; (d) how the payment would be treated on ordinary principles of commercial accounting; and (e) whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned. (pp 5,235, 5236)

5.5 The approach of the Privy Council in *BP Australia* has subsequently been adopted in a number of other New Zealand cases. These include *CIR v L D Nathan & Co Limited* [1972] NZLR 209, *Buckley & Young v CIR* (1978) 3 NZTC 61,271, *Christchurch Press Company Limited v CIR* (1993) 15 NZTC 10,206, *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 and *Birkdale Service Station v CIR* (2000) 19 NZTC 15,981. The most recent New Zealand Privy Council case in this area, *CIR v Wattie* (1998) 18 NZTC 13,991, also adopted the *BP Australia* approach.

5.6 Fundamental to the capital/revenue determination is the “enduring benefit” test of the House of Lords in *British Insulated and Helsby Cables v Atherton* [1928] AC 205, which has become the commonly accepted test in the English Courts:

... when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital ... (p 629)

5.7 The “enduring benefit” test that has been approved and affirmed by both the House of Lords (in *Lawson (Inspector of Taxes) v Johnson Matthey plc* [1992] 2 All ER 647), and the Privy Council (in *BP Australia*) since the *Atherton* test was interpreted and applied in *Southern v Borax Consolidated Ltd* [1940] 4 All ER 412.

- 5.8 The *BP Australia* approach to the determination of expenditure as capital or revenue was applied by Moller J in the Supreme Court decision of *CIR v Murray Equipment Limited* [1966] NZLR 360, and the expenditure incurred on legal costs in attacking patent applications of others was held to be revenue in nature.

In this instance it might well be that the identical situation might not have to be faced by the company again, but the very fact that this one arose is a clear indication that there might well occur, in the future, similar threats to the money-earning process. (p 369)

- 5.9 It was considered that the payment would be made from circulating capital, and although an identical situation might not have to be faced by a business again, Moller J considered that the fact that this one arose, indicates that a similar threat might well occur in the future. It was also considered that under ordinary principles of commercial accounting the expenditure would be treated as being of a revenue nature.
- 5.10 Moller J's comment in *Murray* could equally apply in either a situation of attacking another's patent or the defence of a patent. An identical situation may not arise for the company again, but the fact that the situation arose indicates that a similar threat, requiring either defence or attack, may arise in the future. Therefore, the expenditure was not incurred in the production of assets or advantages of an enduring benefit.
- 5.11 It is noted that the approach taken following *BP Australia*, is not consistent with the decision of the Supreme Court in *Commissioner of Taxes v Ballinger and Co Ltd* (1903) 23 NZLR 188. In that case, it was held that expenses, incurred in unsuccessfully defending the taxpayer's patent against an action by the prior patent holder who claimed that the taxpayer's patent had infringed the prior patent, were capital in nature:

...the moneys expended have been lost in an unsuccessful endeavour to retain the means for earning additional profit for the company. Such expenditure has not resulted in a profitable investment, but it is none the less an investment of capital. (pp 193, 194).

- 5.12 This decision has been the subject of considerable criticism, particularly in the later patent case of *Murray Equipment*. With respect, it is considered that the approach in the later case of *Murray Equipment* following *BP Australia* is to be preferred. This is consistent with the doctrine of *stare decisis* or judicial precedent. Under this doctrine, a court is required to follow previous decisions unless they are inconsistent with a higher court's decision. At the time of both *BP Australia* and *Murray Equipment*, the Privy Council was New Zealand's highest Court and, as such, its decisions were required to be followed by New Zealand courts if the relevant New Zealand law was common with that of the jurisdiction that originated the appeal to the Privy Council.

Conclusion

- 5.13 It is the Commissioner's opinion that the application of *BP Australia* is the correct authority by which to determine whether expenditure is capital or revenue in nature. Accordingly, it is the Commissioner's opinion that expenditure incurred on legal costs in actions either defending or attacking a patent, including infringement proceedings, is revenue in nature. A similar analysis would also apply in the case of the right to use a patent.

6. PROCEEDS AND ALLOWABLE DEDUCTIONS ON THE SALE OF PATENT RIGHTS OR A PATENT APPLICATION

Sum received income

- 6.1 An amount derived by a taxpayer, in respect of a sale of any patent rights or a patent application with a complete specification, whether a capital asset or trading stock, is income of that taxpayer under section CB 26. For patent applications, this is applicable only to those lodged for the first time after 21 June 2005. The section states:

CB 26 Sale of patent applications or patent rights—

If a person derives an amount from the sale of a patent application with a complete specification or from the sale of patent rights, the amount is income of the person.

Sections EE 37 to EE 44 can also apply to the disposal of depreciable property such as patents and patent applications other than by way of sale.

Amount of deduction

- 6.2 The amount of allowable deductions on the sale of a patent application or patent rights depends on the circumstances of the taxpayer. Such deductions may, in some circumstances, be allowable for a taxpayer in the business of buying and selling patent applications, patents or patent rights. For example, if a taxpayer is in the business of buying and selling patent applications, patents or patent rights, but they buy and retain a patent and derive income from it by licensing the patent rights to a third party to exploit, when those patent rights are sold, allowable deductions are in accordance with sections DB 30 and DB 31. These deductions are allowable despite the fact that other patents or patent rights of that taxpayer may be trading stock and, therefore, required to be treated in accordance with the trading stock rules in Subpart EB – Valuation of trading stock (including dealer's livestock).
- 6.3 Similarly, if a taxpayer in the business of buying and selling patent applications, patents or patent rights, also devises the invention to which a patent application or patent relates, but is not in the business of inventing, allowable deductions in respect of the sale of the patent application or those patent rights will be in accordance with section DB 29.
- 6.4 Sections DB 29, 30 and 31 provide:

DB 29 Patent rights: devising patented inventions—

When this section applies

- (1) This section applies when a person incurs expenditure in devising an invention for which a patent has been granted. The section applies whether the person devised the invention alone or in conjunction with another person.

Deduction: expenditure before 1 April 1993

- (2) When the person uses the patent in deriving income in a tax year, they are allowed a deduction for expenditure incurred before 1 April 1993, but not if a deduction has been allowed for the expenditure under any other provision of this Act or an earlier Act.

Deduction: devising invention

- (3) If the person sells all the patent rights relating to the invention, they are allowed a deduction for the expenditure that they have incurred (whenever it is incurred) in connection with devising the invention to the extent to which a deduction has not already been allowed under subsection (2).

Deduction: devising invention: proportion of expenditure

- (4) If the person sells some of the patent rights relating to the invention, they are allowed a deduction for part of the expenditure described in subsection (3). The part is calculated by dividing the amount derived from the sale by the market value of the whole of the patent rights on the date of the sale.

Link with subpart DA

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

DB 30 Patent rights acquired before 1 April 1993—

When this section applies

- (1) This section applies when a person sells patent rights that they acquired before 1 April 1993.

Deduction

- (2) The person is allowed a deduction on the sale of the patent rights.

Amount of deduction

- (3) The amount is calculated using the formula—
- $$\frac{\text{unexpired term of the patent rights at the date of sale}}{\text{unexpired term of the patent rights at the date of acquisition}} \times \text{cost}$$

Link with subpart DA

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

DB 31 Patent applications or patent rights acquired on or after 1 April 1993—

When this section applies

- (1) This section applies when a person sells a patent application with a complete specification or patent rights that they acquired on or after 1 April 1993.

Deduction

- (2) The person is allowed a deduction on the sale of the patent application with a complete specification or patent rights.

Amount of deduction

- (3) The amount is calculated using the formula—
total cost – total amounts of depreciation loss

Definition of items in formula

- (4) In the formula,—
(a) **total cost** is the total cost to the person of the patent application with a complete specification or patent rights;
(b) **total amounts of depreciation loss** is the total of the amounts of depreciation loss for the patent application with a complete specification or patent rights for which the person is allowed a deduction.

Link with subpart DA

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

- 6.5 If a taxpayer sells a patent application with a complete specification or patent rights that they acquired on or after 1 April 1993, section DB 31 will apply to the sale. Sections EE 37 to EE 44 can also apply to the disposal of depreciable property, such as patents or patent applications, other than by way of sale.

Timing of allowable deductions on the sale of a patent application, a patent or patent rights, purchased for the purpose of resale

- 6.6 If a taxpayer, not in the business of buying and selling patent applications, patents or patent rights, buys a patent application, a patent or patent rights for the purpose of reselling them, the cost is deductible, but only when the taxpayer on-sells that patent application, that patent or those patent rights. Section EA 2 requires deductions for “revenue account property”, which is not trading stock, to be deferred until those patent or patent rights are disposed of or cease to exist. Section EA 2 states:

EA 2 Other revenue account property—

When this section applies

- (1) This section applies to revenue account property that is not—
(a) trading stock valued under subpart EB (Valuation of trading stock (including dealer's livestock)); or
...

Timing of deduction

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

- (a) the **income year** in which the person **disposes of the property**;
and
- (b) the **income year** in which the property ceases to exist.

[emphasis added]

Timing of allowable deductions on the sale of a patent application, a patent or the right to use a patent, being trading stock of a business

- 6.7 If the proceeds of sale of property are income, then the property is “revenue account property”. In the rare case of a business dealing in patent applications, patents or patent rights, those patent applications, patents or patent rights will also constitute trading stock and, accordingly, their cost, and any additional expenditure relating to them, is deductible and not depreciable. The deductions will be subject to the trading stock rules in Subpart EB.
- 6.8 Similarly, if a person is in the business of buying and selling patent applications, patents or patent rights and also in the business of inventing, income and expenditure relating to research carried out for the business of inventing would be on revenue account and anything produced for sale would be subject to the trading stock rules.

7. THE TREATMENT OF PATENT-RELATED EXPENSES AND PROCEEDS UNDER PREVIOUS RULES

Summary

- 7.1 Before patents and the right to use a patent became depreciable property in 1993, there were specific provisions in the Act applicable to patents. The costs of applying for, maintaining or extending a patent, were deductible. Expenses incurred in devising an invention and the cost of buying a patent were also deductible, although spread. Proceeds from the sale of a patent were income, but these too could be spread.
- 7.2 Some of these old provisions remain relevant because the Commissioner required these expenses to be spread over the 20-year term of a patent and some of these terms have not yet expired. In addition, fees for maintaining or extending a patent remain deductible if the patent was acquired by the taxpayer before 23 September 1997.

Expenditure incurred for the grant, maintenance, or extension of a patent (section DB 28)

- 7.3 Section DB 28 (refer paragraph 3.12) is briefly mentioned earlier in relation to the distinction between patents and inventions in the legislation. Under section DB 28, if a patent was acquired before 23 September 1997, a taxpayer may claim a deduction for expenditure incurred in connection with the grant, maintenance, or extension of a patent used by the taxpayer in the production of the taxpayer’s income for that year. Because a patent can have a life of 20 years, section DB 28 will continue to apply to the costs for maintaining and extending patents acquired before this date, until the year 2017.

- 7.4 The types of expenditure covered under section DB 28 are renewal fees and extension costs charged either by the Intellectual Property Office of New Zealand or an overseas patent authority, plus associated legal fees. Prior to 1 January 1995, a patentee could apply under the Patents Act 1953 to have the term of their patent extended. The facility to extend the term of patents is no longer available under New Zealand legislation, although there may be a few extensions still operative. Extensions may continue to be available from overseas patent authorities and, therefore, provided the patent was acquired before 23 September 1997, the fees for these extensions will remain deductible, under section DB 28.
- 7.5 The Commissioner considers that section DB 28 includes the cost of amending a patent. An amendment ensures the validity of a patent by narrowing the claims or correcting an obvious mistake. An amendment, therefore, can be viewed as maintenance, or as a continuation of the pre-grant proceedings.

Expenditure incurred in devising an invention before 1 April 1993 (section DB 29)

- 7.6 If a patentee both devised an invention and derived income from the use of its patent, section DB 29(2) provides for a deduction for expenditure incurred before 1 April 1993 in connection with the devising of the invention.
- 7.7 However, under section DJ 6(2) of the Income Tax Act 1994 (now replaced by section DB 29(2)), allowance of the deduction was originally available as the Commissioner thought fit. The expenditure was required to be spread over the life of the patent. (The allowance of a deduction is no longer discretionary.) In addition, although the allocation usually commenced from the date of grant, if the use of the invention began in a subsequent income year, the Commissioner considered that the spread should commence from that later year.
- 7.8 It is also noted that those taxpayers who commenced the spreading exercise while the patent term was 16 years, and, under the Patents Amendment Act 1994, have since obtained the automatic extension to 20 years effective from 1 January 1995, should re-spread their allocated deductions over the remaining life of the patent. This approach is consistent with the depreciation legislation and generally accepted accounting principles. Inland Revenue will not disturb allocations that have already resulted in the full cost being deducted.

Patent rights bought before 1 April 1993 and used in the production of income (sections DZ 8 and EZ 5)

- 7.9 Section DZ 8 provides that if a taxpayer bought patent rights before 1 April 1993 and has used those patent rights in deriving income, a deduction is allowed of the amount quantified in section EZ 5. The amount of the deduction is the expenditure that the person incurred in buying the patent rights and this deduction is allocated over the unexpired term of the patent rights at the date of their purchase. The amount allocated to an income year is deductible in that income year. Sections DZ 8 and EZ 5 state:

DZ 8 Buying patent rights before 1 April 1993—

When this section applies

- (1) This section applies when a person buys patent rights before 1 April 1993 and uses them in deriving their income. In this section, if the person dies after incurring expenditure on buying the rights, references to the person include their personal representative, a trustee of their estate, and a beneficiary of their estate.

Deduction

- (2) The person is allowed a deduction of the amount quantified in section EZ 5(2) (Buying patent rights before 1 April 1993).

Link with subpart DA

- (3) This section supplements the general permission. The general limitations still apply.

EZ 5 Buying patent rights before 1 April 1993—

When this section applies

- (1) This section applies when section DZ 8 (Buying patent rights before 1 April 1993) applies.

Amount of deduction

- (2) The amount of the deduction is the expenditure that the person has incurred in buying the patent rights.

Amount when patent rights expired or disposed of

- (3) If, before the expiry of the patent rights, the rights have come to an end or have been disposed of, the person is allowed a deduction of an amount that bears to the total sum of the expenditure on the purchase of the rights the same proportion as the unexpired term of the rights when they came to an end or were disposed of bears to their unexpired term at the date of their purchase. An amount that the person has otherwise been allowed as a deduction is not included.

Timing of deduction: subsection (2)

- (4) The deduction referred to in subsection (2) is allocated to the income years in relation to which the term of the patent rights that is unexpired at the date of purchase applies.

Timing of deduction: subsection (3)

- (5) The deduction referred to in subsection (3) is allocated to the income year in which the rights have come to an end or been disposed of.

7.10 In accordance with sections DZ 8 and EZ 5(3), when patent rights bought before 1 April 1993 come to an end, or the taxpayer sells the patent rights before they expire, the taxpayer is allowed a deduction for the remaining portion of the allocation, in the income year that the patent rights either come to an end or are sold. The amount of the deduction is calculated using the following formula.

$$\text{Deduction} = \frac{\text{Total sum expended by the taxpayer to purchase the patent rights}}{\text{Unexpired term of the patent rights, at the date they come to an end or are sold}} \times \frac{\text{Unexpired term of the patent rights, at the date the taxpayer purchased them}}{\text{Unexpired term of the patent rights, at the date they come to an end or are sold}}$$

EXAMPLES

Example 1 – how depreciation is calculated (sections EE 12, EE 14, EE 16, EE 27C and EE 27D) and what happens when a patent is not renewed

A company devises an invention for a new light bulb. The company has a 31 March balance date. The company files the patent application with the complete specification for the new light bulb on 20 October 2005. The company spends \$320 on filing fees and \$4,480 on patent attorney fees. The Intellectual Property Office grants a patent for the invention on 3 December 2006. The company begins making the light bulbs in June 2007.

The patent will expire on 20 October 2025. The term of the patent rights under the Patents Act 1953 is 20 years (240 months), and runs from the date the complete specification is filed. The patent life is, therefore, from 20 October 2005 to 20 October 2025.

Although, the patent rights have not been used in deriving income in the year ended 31 March 2007 (or any previous year), the patent rights are available for use by the company in the 2006-07 income year to derive income or to carry on the business.

Therefore, the depreciation calculations for the income years of:

- 2005-06 (the year in which the patent application is filed with complete specification);
- 2006-07 (the year in which the patent is granted); and
- 2007-08 (a typical year following the grant of the patent),

are as follows:

*2005-06 income year (1 April 2005 – 31 March 2006)
(the year the patent application is filed with complete specification)*

Depreciation of the **patent application**.

$$\begin{aligned} \text{Annual rate (section EE 27C)} &= \text{months / depreciation months} \\ &= 6 / 240 \quad [\text{October 05 – March 06}] \\ &= 0.025 \\ &= 0.03 \text{ (to two decimal places).} \end{aligned}$$

For the income year ended 31 March 2006, section EE 27C(4) provides for the depreciation rate of the patent application to be calculated on the basis of six calendar months, i.e. the number of whole months the patent application has been owned, but inclusive of the month of the application date.

$$\begin{aligned}
\text{Depreciation deduction} &= \text{annual rate} \times \text{value or cost} \times \frac{\text{months}}{12} \\
\text{(section EE 16)} & \\
&= 0.03 \times \$4,800 \times 6 / 12 \\
&= \$72
\end{aligned}$$

2006-07 income year (1 April 2006 – 31 March 2007)
(the year the patent is granted)

Depreciation of the patent application.

$$\begin{aligned}
\text{Annual rate (section EE 27C)} &= \text{months / depreciation months} \\
&= 8 / 240 \quad [\text{April 06 – November 06}] \\
&= 0.0333 \\
&= 0.03 \text{ (to two decimal places).}
\end{aligned}$$

For the income year ended 31 March 2007, the patent application has been owned for eight calendar months.

$$\begin{aligned}
\text{Depreciation deduction} &= \text{annual rate} \times \text{value or cost} \times \frac{\text{months}}{12} \\
\text{(section EE 16)} & \\
&= 0.03 \times \$4,800 \times 8 / 12 \\
&= \$96
\end{aligned}$$

Depreciation of the patent or patent rights.

$$\begin{aligned}
\text{Annual rate (section EE 27D)} &= \text{months / depreciation months} \\
&= 4 / 240 \quad [\text{December 06 – March 07}] \\
&= 0.01667 \\
&= 0.02 \text{ (to two decimal places).}
\end{aligned}$$

For the income year ended 31 March 2007, section EE 27D provides that the depreciation rate for the patent or patent rights is calculated on the basis of four calendar months i.e. inclusive of the month in which the patent is granted.

$$\begin{aligned}
\text{Depreciation deduction} &= \text{annual rate} \times \text{value or cost} \times \frac{\text{months}}{12} \\
\text{(section EE 16)} & \\
&= 0.02 \times \$4,800 \times 4 / 12 \\
&= \$32
\end{aligned}$$

Therefore, for the 2006-07 income year, the taxpayer has a depreciation loss of \$96 for the patent application **and** \$32 for the ensuing patent or patent rights, i.e. \$128.

2007-08 income year (1 April 2007 – 31 March 2008)
(a typical year in which the patent or patent rights are owned)

Depreciation of the patent or patent rights.

$$\begin{aligned}
\text{Annual rate (section EE 27D)} &= \text{months / depreciation months} \\
&= 12 / 240 \\
&= 0.05 \text{ (to two decimal places).}
\end{aligned}$$

For the income year ended 31 March 2008, the patent application has been owned for a full twelve calendar months.

$$\begin{aligned}
 \text{Depreciation deduction} &= \text{annual} \times \text{value or cost} \times \frac{\text{months}}{12} \\
 \text{(section EE 16)} &= 0.05 \times \$4,800 \times 12 / 12 \\
 &= \$240
 \end{aligned}$$

For the 2008-09 income year, the depreciation for the patent or patent rights is again for a full 12 months and the depreciation deduction is as for the 2007-08 years, i.e. \$240.

Before the expiry of the fourth year after the complete specification of the patent application is filed (2009-10), the company decides not to renew the patent, and so the patent expires on 20 October 2009. Under sections EE 37 and EE 40(9), this is an event to which section EE 41 applies. The taxpayer can deduct the cost of the patent not already depreciated. Section EE 11(1) provides that depreciation for the last year is not claimed twice, i.e. once as the year's depreciation, and once under section EE 41(2) for a loss on disposal. Section EE 11(1) provides that a person does not have a depreciation loss for the year in which they dispose of the depreciable property. Section EE 41 applies so that the taxpayer can deduct the remaining cost of the patent that has not already been depreciated.

Depreciation already claimed for year ended:

31 March 2006	72
31 March 2007 (96 + 32)	128
31 March 2008	240
31 March 2009	<u>240</u>
Total depreciation claimed	\$680

Therefore, for the 2009-10 income year, the taxpayer can deduct the following amount from assessable income for loss on disposal of the patent:

Cost of the patent	4,800
Less depreciation claimed	<u>680</u>
Deduction for loss on disposal	\$4,120

Example 2 – how depreciation is calculated if a patent application with complete specification is lodged before 1 April 2005 (sections EE 12, EE 14, EE 16 and EE 27B)

The facts and dates are the same as for Example 1, except that the patent application for the light bulb was lodged with complete specification on **20 December 2004**, i.e. before 1 April 2005 and, therefore, section EE 27C, which provides for the depreciation of a patent application, is not applicable. As stated in Example 1, the patent is granted 3 December 2006.

Pursuant to section EE 27B, in this situation, the first year in which a depreciation loss is allowed is the year in which the patent is granted, i.e. the 2006-07 income year. There is no depreciation loss allowed for either the

patent or the patent application, before the year in which the patent is granted. However, section EE 27B provides for a rate in this first year that provides a one-off “catch up” depreciation loss allowance for the period from the date the patent application with complete specification was lodged.

*2006-07 income year (1 April 2006 – 31 March 2007)
(the year the patent was granted)*

Depreciation of the patent.

First income year rate
(section EE 27B(4)) = months before grant / depreciation months
= 4 mths (in the 2005 year [Dec 04 – Mar 05])
+ 12 mths (in the 2006 year [Apr 05 – Mar 06])
+ 8 mths (in the 2007 year [Apr 06 – Nov 06]) / 240
= 24 / 240
= 0.10 (to two decimal places).

and

Usual rate
(section EE 27B(3)) = months / depreciation months
= 4 / 240 [Dec 06 – Mar 07]
= 0.0167
= 0.02 (to two decimal places)

Therefore, the rate for the 2006-07 year is:

$$0.10 + 0.02 = 0.12$$

For the income year ended 31 March 2007, the patent or patent rights have been owned for four calendar months, inclusive of the month in which the patent is granted.

Depreciation deduction (section EE 16)	=	annual rate	×	value or cost	×	<u>months</u> 12
	=	0.12	×	\$4,800	×	4 / 12
	=	\$192				

For the 2007-08 and subsequent typical years that rate is the same as for the calculation for the typical year (2007-08) in Example 1.

Example 3 – how depreciation is calculated if a patent application with complete specification is lodged after 1 April 2005, but the application is later either withdrawn or refused (sections EE 12, EE 14, EE 16 and EE 27C)

The facts are the same as for Example 1, except that the patent application for the light bulb was not granted but was refused or withdrawn on 3 December 2006.

*2005-06 income year (1 April 2005 – 31 March 2006)
(the year the patent application is filed with complete specification)*

The calculation for the depreciation for the patent application is as for Example 1.

*2006-07 income year (1 April 2006 – 31 March 2007)
(the year the patent is refused or withdrawn)*

Section EE 11(1) provides that a person does not have a depreciation loss for the year in which they dispose of the depreciable property.

Under sections EE 37 and EE 40(9), the refusal or withdrawal of the patent application on 3 December 2006 is an event to which section EE 41 applies. The taxpayer can deduct the cost of the patent application not already depreciated as in Example 1.

Depreciation already claimed for year ended 31 March 2006, being the total depreciation claimed:

31 March 2006	72
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Therefore, the amount that the taxpayer can deduct from assessable income for loss on disposal of the patent application is:

Cost of the patent		4,800
Less depreciation claimed	<u>72</u>	
Deduction for loss on disposal		\$4,728

Example 4 – how depreciation is calculated when the patent or patent rights are purchased from another person (sections EE 16 and EE 27)

On 1 May 2006, a taxpayer purchased the patent rights to manufacture and sell a therapeutic bed. The taxpayer paid \$240,000 for the patent rights which expire on 31 October 2010. The taxpayer begins making and selling the beds. The taxpayer's balance date is 31 March. Because the patent was granted prior to the income year ended 31 March 2006, section EE 27 determines the annual rate.

The remaining legal life of the patent right is 4 years and 6 months (counting full and part calendar months), i.e. 4.5 years.

Annual rate (section EE 27) =	1 / legal life
=	1 / 4.5
=	0.22 (to two decimal places).

The annual depreciation deduction on the patent rights in the 2006-07 income year is:

Depreciation deduction	=	0.22	×	\$240,000	×	11/12
	=	\$48,400				

and in the 2007-08 income year:

Depreciation deduction	=	0.22	×	\$240,000	×	12/12
	=	\$52,800				

Example 5 – depreciation and deductions for additional costs for a patent acquired before 23 September 1997 (section DB 28)

A taxpayer manufacturing computers devises an invention for a computer that listens and talks. The taxpayer instructs a patent attorney to take out a patent in New Zealand. The taxpayer has a 31 March balance date.

- The patent attorney files the patent application with the provisional specification on 14 November 1995, and on 22 November 1995 charges the taxpayer the following fees:

Patent search	500
Preparing the working drawings for the provisional specification	1,300
Intellectual Property Office provisional application filing fee	<u>80</u>
Total amount due	\$1,880

- On 22 September 1996 the attorney files the complete specification and charges the following fees on 30 September 1996:

Preparing complete specification	\$2,400
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- The attorney resolves two objections raised, and on 1 February 1997 charges the following additional fees:

Reporting and responding to examiner's report	800
Intellectual Property Office sealing (registration) fee	<u>100</u>
Total amount due	\$900

The Intellectual Property Office grants the patent on 15 February 1997 and the taxpayer immediately begins manufacturing the listening and talking computers.

The taxpayer pays the renewal fees of \$170 in September 2000, \$340 in September 2003, \$540 in September 2006, and \$1,000 in September 2009.

Section DB 28 provides that if a patent is acquired before 23 September 1997, costs incurred in connection with granting, maintaining and extending a patent are deductible. As the taxpayer's patent was acquired on 15 February 1997, section DB 28 applies.

Therefore:

The taxpayer can deduct \$3,300 (being \$2,400 + \$900) in the income year ended 31 March 1997, as expenditure incurred in connection with the grant of the patent and incurred during the tax year in which the patent was used in deriving income. The amount of \$1,880 is not deductible under section DB 28 as the patent was not used in deriving income in the tax year in which the expenditure was incurred.

The renewal fees are incurred in connection with the maintenance of a patent and are also deductible under section DB 28, but only because the patent was acquired by the taxpayer, who incurred the costs, before 23 September 1997

and the taxpayer was using the patent in deriving income in the tax year in which they incurred the expenditure.

Therefore:

The taxpayer may deduct the renewal fees of \$170, \$340, \$540, and \$1,000 in the income years in which they are incurred. If the renewal fees are paid in advance, a deduction is allowed for the \$2,050 (the total of the renewal fees) in the year in which they are paid but this is subject to section EA 3 which provides that the unexpired portion of the patent is income of the taxpayer .

Example 6 – additional costs for a patent acquired on or after 23 September 1997 (section EE 19)

A taxpayer manufacturing locks devises an invention for a lock that will only respond to a personal voice signal. The taxpayer lodges a patent application with a complete specification for a patent in New Zealand, on 30 October 2005. The taxpayer incurs costs in relation to the patent application, including patent attorney fees. These form part of the cost of the patent application. The taxpayer has a 31 March balance date.

- Some further costs are incurred. The taxpayer’s patent attorney resolves two objections raised, and on 1 March 2006 charges the following additional fees:

Reporting and responding to examiner’s report	900
Intellectual Property Office sealing (registration) fee	150
Total amount due	\$1,050

The Intellectual Property Office grants the patent on 15 April 2006 and the taxpayer immediately begins manufacturing the new locks.

The taxpayer pays the renewal fees of \$170 in October 2009, \$340 in October 2012, \$540 in October 2015, and \$1,000 in October 2018.

As the patent was not acquired before 23 September 1997, section DB 28 does not apply.

However, section EE 19 provides that where a person owns an item of fixed life intangible property, incurs additional costs in an income year for the item and is denied a deduction for the additional costs (other than a deduction for an amount of depreciation loss), such costs are added to the item’s adjusted tax value at the start of the income year. In this case, once the taxpayer lodged a patent application with complete specification after 1 April 2005, he or she owned an item of fixed life intangible property.

Therefore:

Although the taxpayer’s patent attorney fees were only incurred at the end of the income year ended 31 March 2006, the additional fees of \$1,050 can be added to the patent application’s adjusted tax value at the start of the 2005-06 income year, for the purposes of section EE 16. This is because

they are an additional cost incurred in the income year in which the taxpayer owned the patent application.

The renewal fees for the patent are incurred also as additional costs for an item of fixed life intangible property owned by the taxpayer, in this case the patent. As such, under section EE 19, these additional costs will be added to the patent's adjusted tax value at the start of the income year in which the additional costs are incurred.

Example 7 – income and deductions on sale of patent rights (sections CB 26 and DB 29)

The light bulb company in Example 1 spends \$45,000 in the 2005 income year devising the light bulb. The company filed for a patent with a complete specification on 20 October 2005. The company received the patent on 3 December 2006, and began production on 20 June 2007. Instead of letting the patent expire on 20 October 2009, the company sells the patent on 20 October 2009 for \$750,000.

The company cannot claim depreciation for the income year ending 31 March 2010, because section EE 11(1) says that depreciation cannot be claimed in the year a depreciable asset is sold.

The proceeds of \$750,000 from the sale is income, under section CB 26. The company can claim the cost of the patent, less depreciation already deducted, as a deduction, under section DB 31. The cost of the patent to the company was \$4,800. Depreciation already deducted up to and including the year ended 31 March 2009 is \$680.

Therefore, the deduction on sale is:

Cost of the patent	4,800
Depreciation already claimed	680
Deduction	\$4,120

The expenses of \$45,000 incurred in devising the invention can also be deducted under section DB 29. This is on the basis that a deduction has not already been allowed under another provision such as section DB 26.

Example 8 – legal expenses incurred in defending and attacking a patent (section BD 2 and subpart EE)

A pharmaceutical company, Company A, was granted a patent on 1 April 2006 for a cold medication. The syrup was a combination of known substances – analgesics and decongestants, and a new substance. Company B, another pharmaceutical company manufacturing cold medications, applied for the revocation of the patent in the High Court on the ground of obviousness. The Court held that the patent was valid.

Company A spent \$300,000 in defending the attack on its patent, while Company B spent \$225,000 in attacking the patent.

The amounts spent by Company A and Company B are deductible under section BD 2.

Example 9 – research and development expenses incurred in devising an invention (sections DB 26, EE 16, EE 27C and EE 27D)

In the 2005-06 income year, a tyre manufacturing company spends \$10,000 on research and development into coloured snow tyres, for which the company hopes eventually to obtain a patent. The \$10,000 is the total amount of expenditure the company has incurred in that year on research and development. The company has a 31 March balance date.

For income tax purposes, the treatment of the company's research and development costs for the 2005-06 income year is:

Under section DB 26, provided the company does not treat the expenditure as material, as described in paragraph 2.3 of the financial reporting standard, and recognises the expenditure as an expense for financial reporting purposes, section DB 26(5) provides that that company can expense all development expenditure in the year in which it is incurred.

In the 2006-07 income year, the same company spends \$50,000 on equipment to assist the research (equipment that is not otherwise depreciable) and various sums on prototype tyres. The project has not yet satisfied the five criteria for asset recognition set out in FRS-13.

For income tax purposes, the treatment of the company's research and development costs for the 2006-07 income year is:

As for the 2005-06 income year, under section DB 26(1)–(4) and DB 26(9), the company can expense all research and development expenditure on the project, including the sums on the equipment and prototypes.

In June 2007, the project satisfies the five criteria for “asset recognition”, but additional development is required prior to the company's application for a patent for the coloured snow tyres. On 1 October 2007, after additional development expenditure of \$100,000, which included expenditure on further prototypes, the company files for a patent, incurring \$15,000 in costs. The patent is granted 1 December 2007.

For income tax purposes, the treatment of the company's research and development costs for the 2007-08 income year is:

As for the 2005-06 and 2006-07 income years, under sections DB 26(1)–(4) and DB 26(9), the taxpayer company can expense all research and development expenditure incurred prior to asset recognition in June 2007.

The \$100,000 of development expenditure, incurred subsequent to the point of “asset recognition”, **cannot** be deducted.

Effective 1 October 2005, a patent application with complete specification is an item of Schedule 17 depreciable intangible property and section EE 27C

provides the calculation for the rate at which the \$15,000 costs incurred in making the patent application can be depreciated.

*2007-08 income year (1 April 2007 – 31 March 2008)
(the year the patent is granted)*

Depreciation of the patent application for the period 1 October 2007 to 1 December 2007, i.e. 2 months.

$$\begin{aligned}
 \text{Annual rate (section EE 27C)} &= \text{months / depreciation months} \\
 &= 2 / 240 \\
 &= 0.0083 \\
 &= 0.01 \text{ (to two decimal places).}
 \end{aligned}$$

For the income year ended 31 March 2008, the patent application has been owned for 2 whole calendar months.

$$\begin{aligned}
 \text{Depreciation deduction} &= \text{annual rate} \times \text{value or cost} \times \frac{\text{months}}{12} \\
 \text{(section EE 16)} &= 0.01 \times \$15,000 \times 2 / 12 \\
 &= \$25
 \end{aligned}$$

Depreciation of the patent or patent rights for the period 1 December 2007 to 31 March 2008, i.e. 4 whole calendar months.

$$\begin{aligned}
 \text{Annual rate (section EE 27D)} &= \text{months / depreciation months} \\
 &= 4 / 240 \\
 &= 0.0166 \\
 &= 0.02 \text{ (to two decimal places).}
 \end{aligned}$$

For the income year ended 31 March 2008, the patent or patent rights have been available for use for 4 whole calendar months.

$$\begin{aligned}
 \text{Depreciation deduction} &= \text{annual rate} \times \text{value or cost} \times \frac{\text{months}}{12} \\
 \text{(section EE 16)} &= 0.02 \times \$15,000 \times 4 / 12 \\
 &= \$100
 \end{aligned}$$

Therefore, for the 2007-08 income year, the taxpayer has a depreciation loss of \$25 for the patent application **and** \$100 for the ensuing patent or patent rights.

Example 10 – treatment of research and development costs where a patent application has been made, but has been refused or withdrawn (sections DB 28B, EE 16, EE 27C, EE 41, EE 47, and EE 48)

The tyre manufacturing company in Example 9, instead of having its patent granted, has had its patent application refused on 1 December 2007. As noted in Example 9, the company has had development expenditure of \$100,000. The company employed a patent attorney to make their patent application. As a result of the patent attorney fees and ancillary charges associated with the patent application, the company incurred an extra \$15,000 making the patent application.

For income tax purposes, the treatment of the company's development costs for the 2007-08 income year is:

As for the 2005-06 and 2006-07 income years, under sections DB 26(1)-(4) and DB 26(9), the taxpayer company can expense all research and development expenditure but only that incurred prior to "asset recognition" in June 2007.

Although the taxpayer company had the patent application for 2 months before the patent grant was refused on 1 December 2007, section EE 11(1) provides that a person does not have an amount of depreciation loss for an item of depreciable property for the year in which they dispose of it.

Section DB 28B provides that the company is allowed a deduction, in the year in which the grant is refused or the application is withdrawn, for expenditure incurred in relation to the application that would have been part of the cost of the patent if the application had been granted and for which the company is not allowed a deduction under another provision.

However, for patent applications with complete specifications lodged on or after 1 April 2005 section EE 41 allows an amount of depreciation loss. The consideration received is nil, so will be less than the patent application's adjusted tax value. The adjusted tax value is provided by the formula in section EE 47(1) which is:

base value – total deductions

There have been no "total deductions" in this case. The base value is found by applying section EE 48 which provides that the base value is the cost of the item to the person. Therefore, the company is allowed a deduction of the \$15,000 incurred in making the patent application.