TAX INFORMATION BULLETIN

Vol 17, No 10
December 2005

CONTENTS

Get your TIB sooner on the internet	3
This month's opportunity for you to comment	4
Binding rulings	
Public ruling – BR Pub 05/14	5
Interpretation statements	
Income tax treatment of New Zealand patents	9
Standard practice statements	
SPS 05/11 – Instalment arrangements for payment of tax debt	41
Withdrawal of the standard practice statement INV-140 Fast tracking small simple disputes	49
Legislation and determinations	
Determination DET 05/02 Amortisation rates for landfill cell construction expenditure	50
Determination DET 05/03 Standard-cost household service for boarding service providers	54
Correction – General depreciation determination DEP53	65
Legal decisions – case notes	
Commissioner obtains Mareva Injunction Chesterfield Preschools Ltd & Ors v The Commissioner of Inland Revenue	66
Commissioner loses appeal Commissioner of Inland Revenue v Wellington Regional Stadium Trust	67
Solicitor breaches undertaking The Commissioner of Inland Revenue v Manu Chotubhai Bhanabhai & Ors	69
Commissioner's decision reviewed Claire Avon Rae Hollis v The Commissioner of Inland Revenue	70
Regular features	
Due dates reminder	72
Your chance to comment on draft taxation items before they are finalised	73

Inland Revenue
Te Tari Taake

ISSN 0114–7161

GET YOUR TIB SOONER ON THE INTERNET

This *Tax Information Bulletin* is also available on the internet in PDF. Our website is at **www.ird.govt.nz**

It has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you prefer to get the TIB from our website and no longer need a paper copy, please let us know so we can take you off our mailing list. You can do this by completing the form at the back of this TIB, or by emailing us at **tibdatabase@ird.govt.nz** with your name and details, and the number recorded at the bottom of the mailing label.

PLEASE NOTE:

Details submitted on the renewal of subscription form, mailed to subscribers with the November 2005 *Tax Information Bulletin*, will take effect as from February 2006.

THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

Inland Revenue produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents.

Because we are keen to produce items that accurately and fairly reflect taxation legislation, and are useful in practical situations, your input into the process—as perhaps a "user" of that legislation—is highly valued.

The following draft items are available for review/comment this month, having a deadline of 19 January 2006.

Ref.	Draft type	Description
ED 0081	Standard practice statement	Writing off tax debt
ED 0084	Operational statement	GST treatment of supplies of telecommunications services

Please see page 73 for details on how to obtain a copy.

The following draft item is available for review/comment this month, having a deadline of 31 January 2006.

Ref.	Draft type	Description
ED 0085	Question we've been asked	Records for controlled foreign companies or foreign investment funds to be available in English

Please see page 73 for details on how to obtain a copy.

BINDING RULINGS

This section of the TIB contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings, a guide to binding rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin* Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at **www.ird.govt.nz**

"ANYTHING OCCURRING ON LIQUIDATION" WHEN A COMPANY REQUESTS REMOVAL FROM THE REGISTER OF COMPANIES

PUBLIC RULING – BR PUB 05/14

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2004 unless otherwise stated.

This Ruling applies in respect of paragraph (b)(i) of the definition of "liquidation" in section OB 1.

The Arrangement to which this Ruling applies

The Arrangement is the liquidation of a company where a request is made under section 318(1)(d) of the Companies Act 1993 that the company be removed from the New Zealand register of companies.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

The first step legally necessary to achieve liquidation where a request is made to the Registrar of Companies to remove a company from the New Zealand register under section 318(1)(d) of the Companies Act 1993 is a resolution by the shareholders or board of directors or, where applicable, another overt decision-making act provided for in a company's constitution, to adopt a course of action that will culminate in removal from the register. That step starts the period specified in paragraph (b)(i) of the definition of "liquidation" in section OB 1, and anything done after that step for the purpose of enabling liquidation occurs "on liquidation" for the purposes of the Income Tax Act.

The period for which this Ruling applies

This Ruling will apply from 8th November 2005 to 31 December 2008.

This Ruling is signed by me on the 8th day of November 2005.

Martin Smith
Chief Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 05/14

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 05/14 ("the Ruling").

Background

This Ruling concerns the meaning of "anything occurring on liquidation" in paragraph (b) of the definition of "liquidation" in section OB 1 of the Income Tax Act 2004.

"Liquidation" includes removal from the register of companies which can either follow the full liquidation process, or can be an alternative means of ending the life of a company in itself. Under section 318(1)(d) of the Companies Act 1993 a request for removal from the register can be made by an authorised shareholder, or by the board of directors or any other person required or permitted to do so by the constitution of the company, after the company has paid its debts and distributed any surplus to its members. Removal from the register under this section is sometimes referred to as "short form liquidation" and is a cheaper and simpler option than a full liquidation.

Paragraph (b) of the definition of liquidation prescribes the period during which anything can occur on liquidation, saying that it starts with "a step that is legally necessary to achieve liquidation". Establishing the beginning of that period – by the first legally necessary step – is critical in determining what things may occur on liquidation.

Paragraph (b)(i) gives two examples of steps, one of which is a request under section 318(1)(d), and this has given rise to some uncertainty as to whether the request is the first step legally necessary when that process is followed.

One important practical result of this relates to the ability of companies to make tax-free distributions "on liquidation" under section CD 18(2) of the Income Tax Act. If the request is the first step of that section 318(1)(d) removal process, as some commentators have suggested, distributions cannot be made "on liquidation" as all surplus assets must have been distributed before the request is made. So while amounts could be distributed tax-free under section CD 18(2) of the Income Tax Act on a full liquidation, they could not be exempt on a "short form liquidation".

Legislation

Section OB 1 provides:

OB 1 For the purposes of this Act, unless the context otherwise requires,-

liquidation, for a company, -
(a) includes -
(i) removal of the company from the register of companies under the Companies Act 1993; and
(ii) dissolution of the company under the Companies Act 1955; and
(iii) termination of the company's existence under any other procedure of New Zealand or foreign law; and
(b) includes, in references in this Act to anything occurring on liquidation, anything occurring -
(i) during the period that starts with a step that is legally necessary to achieve liquidation, including the appointment of a liquidator or a request of the kind referred to in section 318(1)(d) of the Companies Act 1993; and
(ii) for the purpose of enabling liquidation

A request to remove a company from the New Zealand register of companies can be made under section 318 of the Companies Act 1993, paragraph (d) of which provides:

318(1) Subject to this section, the Registrar must remove a company from the New Zealand register if—
(d) There is sent or delivered to the Registrar a request in the prescribed form made by—
(i) A shareholder authorised to make the request by a special resolution of shareholders entitled to vote and voting on the question; or
(ii) The board of directors or any other person, if the constitution of the company so requires or permits—
that the company be removed from the New Zealand register on either of the grounds specified in subsection (2) of this section; …

Section 318(2) provides the grounds for making such a request:

318(2) A request that a company be removed from the New Zealand register under subsection (1)(d) of this section may be made on the grounds—

(a) That the company has ceased to carry on business, has discharged in full its liabilities to all its known creditors, and has distributed its surplus assets in accordance with its constitution and this Act; or

(b) That the company has no surplus assets after paying its debts in full or in part, and no creditor has applied to the Court under section 241 of this Act for an order putting the company into liquidation.

Application of the Legislation

A request to remove a company from the register of companies under section 318(1)(d) of the Companies Act 1993 can be made by a shareholder authorised by shareholders' special resolution, or by the board of directors or any other person where the constitution requires or permits them to do so.

It is clear from the two alternative grounds for requesting removal under this section (set out in section 318(2)) that at the time the request for removal is made any surplus assets must have already been distributed.

The function of paragraph (b) of the definition of "liquidation" in the Income Tax Act is to set out when anything may occur on liquidation. Subparagraph (i) defines the period. The beginning of the period is most important and starts with "a step that is legally necessary to achieve liquidation". This puts the focus on the first of such steps. Subparagraph (ii) limits the "anything occurring on liquidation" to things occurring within that period that are for the purpose of enabling liquidation. Things that occur for another purpose will not occur "on liquidation".

What is meant by "a step that is legally necessary to achieve liquidation"?

The phrase "a step that is legally necessary to achieve liquidation" distinguishes between steps that are legally necessary and any other steps, and between steps that are to achieve liquidation and those taken for any other purpose.

The ordinary meaning of the word "step" implies an "action" so the focus is on overt acts rather than, for example, the existence of circumstances or beliefs. Some steps necessary to achieve liquidation in practice may not be legally necessary. For example, a step that is necessary in practice for a liquidation by special resolution of shareholders is to decide who the liquidator will be. That decision is not a legally required step even though it must have occurred. The closest legally necessary step would be appointing the liquidator or obtaining the liquidator's written consent to appointment.

The words "to achieve liquidation" further narrow the range of steps that are legally necessary that can commence the period. Some steps legally necessary to achieve liquidation may be taken for some other purpose than to achieve liquidation. For example, paying all creditors is necessary before making a section 318(1)(d) request, but may be done in the ordinary course of business rather than for the purpose of enabling liquidation.

Other steps may not reach the required threshold to be "to achieve liquidation". For each liquidation procedure, the series of steps involved will largely be settled by the governing legislation – usually the Companies Act 1993. However, in relation to each procedure there will be some preliminary activities, which will culminate in the decision to act being made, followed by a series of acts in implementation. Potential early "steps" include the formulation of a belief, the existence of certain circumstances, giving of notices, holding of meetings, making decisions, and passing resolutions.

The word "achieve" requires that an end or goal is established and committed to. In paragraph (b) this means that the steps are taken with liquidation as the established end. Until that goal is established and the path to it committed to, steps cannot be taken "to achieve liquidation". Essentially this requires that the decision has been made to liquidate.

This emphasis on the established goal of liquidation means that steps that are preparatory to the liquidation process proper (for example, the exercise by the liquidator of his or her functions) are capable of being the first step to achieve liquidation. However, a decision must have been made. Preliminary activities such as investigating circumstances, exploring and evaluating options and the mere formulation of an idea will not suffice.

The silent making of a decision is not an overt act so will not be a "step" as required by paragraph (b). Further, while a decision has to be made in practice, the step required by law in relation to a company's decision is usually the passing of a resolution. It is an overt act - a "step" - and in most cases is the first step legally necessary to achieve liquidation, and for the purpose of enabling liquidation.

The first step that is legally necessary to achieve liquidation where a request is made to remove a company from the register under section 318(1)(d)

One of the two grounds in section 318(2) must be satisfied before making a request for removal from the register under section 318(1)(d). Only ground (a) applies where the company will have surplus assets to distribute, and so only this ground is considered here. It requires that the company has ceased business, paid its creditors and distributed any surplus assets in accordance with its constitution and the Companies Act.

Therefore the first step that is legally necessary to achieve liquidation when a request is made to remove the company from the register under this ground will relate to ceasing business, paying all creditors and distributing surplus assets, but there is no set order that these must occur in.

To be the first step legally necessary in terms of the definition of "liquidation" in section OB 1, the relevant step under section 318(1)(d) must be an overt act on or following the decision to carry out the necessary actions to satisfy the grounds in section 318(2)(a) with the aim of achieving liquidation. It will usually be a resolution to cease business, pay all creditors, distribute surplus assets and to then request removal. The Commissioner will be satisfied that a resolution in these terms is the first step that is legally necessary to achieve liquidation. A company's constitution may provide another means of making that decision which, where it is an overt act, can also be the first step that is legally necessary to achieve liquidation.

Other steps may be taken that are the first step that is legally necessary to achieve liquidation, for example, the company may act less formally than by passing a resolution to carry out the grounds in section 318(2). If the step is overt and carried out with the aim of achieving removal from the register it could be the first step that is legally necessary to achieve liquidation.

The significance of the parenthetical examples in paragraph (b)(i)

After the phrase "a step that is legally necessary to achieve liquidation", paragraph (b)(i) sets out two parenthetical examples: "including the appointment of a liquidator or a request of the kind referred to in section 318(1)(d) of the Companies Act 1993;".

The examples can be read as being first steps of relevant processes put in the section by Parliament specifically as illustrations of first steps that commence the period. However, in the Commissioner's view, the wording of paragraph (b) is ambiguous. The examples could be either of:

a) *a* step that is legally necessary to achieve liquidation: or

b) *the first* step that is legally necessary to achieve liquidation;

in respect of relevant liquidation processes.

Probably the more obvious meaning is that the examples are of first steps – it is suggested by the immediate context, and the emphasis in the section. The focus of paragraph (b)(i) is on determining "the period" and its commencement which suggests that the examples are of first steps rather than any steps of the processes which they are relevant to. However, this is not conclusive. Whether the examples should be taken to be the first steps or just any steps in the processes they are relevant to becomes clear when the examples are examined.

In the processes of "liquidation" in which a liquidator is appointed, the appointment of a liquidator is *not* the first step legally necessary to achieve liquidation. For example, where the shareholders resolve to appoint a liquidator, obviously the resolution is a legally necessary step that precedes the appointment.

Regarding the second example, where removal from the register is requested under section 318(1)(d), the request is also *not* the first step legally necessary. Passing a resolution to cease business, pay all creditors, distribute surplus assets and to then request removal will usually be the first step that is legally necessary to achieve liquidation, and for the purpose of enabling liquidation.

Notwithstanding any implication to the contrary, it is clear that the steps given as examples in paragraph (b)(i) are not the first steps legally necessary to achieve liquidation in the liquidation processes that they relate to, but are examples of a step (in fact fundamental steps) in the processes.

Exemption of distributions upon liquidation where a request is made to remove a company from the register under section 318(1)(d)

One situation where this is important is in relation to the exemption of dividends "on the liquidation" of a company under section CD 18(1). Under section CD 2 of the Income Tax Act 2004, the term "dividends" includes a wide range of payments, distributions, or transactions where essentially value is transferred to shareholders. Section CD 18(2) excludes any amount distributed that is essentially of subscribed capital ("available subscribed capital per share") and capital gains ("excess return amount") where the distributions are made "on the liquidation of the company".

To be excluded from being dividends by section CD 18(2), amounts distributed in relation to a request to remove a company from the register under section 318(1)(d) of the Companies Act 1993 must be made during the period which starts with a step that is legally necessary to achieve removal from the register. Accordingly, there may be an extended period between the initial step legally necessary to achieve liquidation and the removal. In some situations, as the period may span different tax years, a distribution may be made in a period preceding removal from the register. The Commissioner will assume that such distributions are made pursuant to a bona fide intention to liquidate. However, it should be noted that, if the liquidation is not completed then such a distribution will not have occurred "on liquidation" and the exclusion under section CD 18 (and the ruling) will not apply.

As discussed above, the Commissioner's view is that the first step is not the making of the request under section 318(1)(d), but is ordinarily the passing of the resolution to cease business, pay all creditors, distribute surplus assets and to then request removal. It is noted that a company's constitution may provide another means of making that decision which, where it is an overt act, can be the first step legally necessary to achieve liquidation.

Amounts distributed in respect of shares in the company following that step will be distributed "on liquidation" and be eligible for exclusion from being dividends under section CD 18(2). The other criteria of section CD 18(2) would also have to be met.

A company taking some other overt action with the aim of achieving removal from the register under section 318(1)(d) may be able to show that this is the first step legally necessary to achieve liquidation. However, a company taking such a course of action may be required to produce evidence establishing the taking of the step was carried out with the aim of achieving liquidation.

Taxpayers making distributions should ensure that they keep adequate records of relevant resolutions or other decision-making acts so that they can demonstrate that the essential genuineness of the resolution or other act preceded distribution of the company's assets, and that the distributions were for the purpose of enabling liquidation.

INTERPRETATION STATEMENTS

This section of the *Tax Information Bulletin* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

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 Section DB 28 provides for a deduction from a taxpayer's annual gross income, for expenditure incurred in the patent process, by the taxpayer 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. 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 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.
>
> …

3.14 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 *Grain Pool of WA v 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.

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 sections state:

> **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 fee

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 is voided 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—

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

(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 on 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 currently under review and may be the subject of a future legislative change.

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 Similarly, 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. 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

4.60 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.

4.61 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

4.62 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
- 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

4.63 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.

4.64 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

4.65 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.

4.66 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.)

4.67 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

4.68 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.

4.69 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 satisfied, development expenditure on the project, including the expenditure on a prototype, is required to be capitalised.

Additional costs that are depreciable

4.70 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.

4.71 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

4.72 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 is voided (refer to paragraph 4.75, "What happens if a patent is not renewed?").

4.73 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.

4.74 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 7.1-7.6.

What happens if a patent is not renewed?

4.75 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. (It is noted that, in most cases, no consideration would be received where the patent renewal fees are not paid.)

4.76 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.

4.77 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.
>
> …

4.78 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.

4.79 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.

4.80 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 4.76).

4.81 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?

4.82 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.

4.83 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.

4.84 For section EE 16, refer paragraph 4.44. For section EE 19, refer paragraph 4.70.

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.

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.

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

6.5 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

6.6 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.

6.7 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.

7.6 The Commissioner considers that legal costs incurred in defending a revocation of or an opposition to a patent are of the same nature as renewal fees: costs incurred to keep the patent alive. If they are not paid, the patent lapses. These costs are of a capital nature. However, under section DB 28, legal expenses, incurred "in connection with the grant, maintenance, or extension" of the patent, are deductible if the patent is acquired before 23 September 1997.

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

7.7 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.

7.8 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.

7.9 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)

7.10 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.

7.11 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.

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

Examples over the page

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

Annual rate (section EE 27C)	=	months/depreciation months	
	=	6 / 240	[October 05 – March 06]
	=	0.025	
	=	0.03 (to two decimal places).	

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.

Depreciation deduction (section EE 16)	**=**	**annual rate**	×	**value or cost**	×	**months / 12**
	=	0.03	×	$4,800	×	6 / 12
	=	$72				

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

Depreciation of the patent application

Annual rate (section EE 27C)	=	months / depreciation months	
	=	8 / 240	[April 06 – November 06]
	=	0.0333	
	=	0.03 (to two decimal places).	

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

Depreciation deduction (section EE 16)	**=**	**annual rate**	×	**value or cost**	×	**months / 12**
	=	0.03	×	$4,800	×	8 / 12
	=	$96				

Depreciation of the patent or patent rights

Annual rate (section EE 27D)	=	months / depreciation months	
	=	4 / 240	[December 06 – March 07]
	=	0.01667	
	=	0.02 (to two decimal places).	

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.

Depreciation deduction (section EE 16)	=	**annual rate**	×	**value or cost**	×	**months** / **12**
	=	0.02	×	$4,800	×	4 / 12
	=	$32				

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**

Annual rate (section EE 27D)	=	months / depreciation months
	=	2 / 240
	=	0.05 (to two decimal places).

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

Depreciation deduction (section EE 16)	=	**annual rate**	×	**value or cost**	×	**months** / **12**
	=	0.05	×	$4,800	×	12 / 12
	=	$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	240
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	680
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 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, does not apply.

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
= 6 mths (in the 2006 year [October 05 – March 06]) + 12 mths (in the 2007 year) + 8 mths (in the 2008 year [April 06 – November 06]) / 240
= 26 / 240
= 0.1083
= 0.11 (to two decimal places).

and

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

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

0.11 + 0.02 = 0.13

For the income year ended 31 March 2007, the patent or patent rights have been owned for four calendar months.

Depreciation deduction	=	**annual rate**	×	**value or cost**	×	**months / 12**
	=	0.13	×	$4,800	×	4 / 12
	=	$208				

For the 2007-08 and subsequent typical years, the rate is the same as for the calculations for those years 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 2007.

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)

Depreciation of the patent application

Annual rate (section EE 27C)	=	months / depreciation months
	=	8 / 240 [April 06 – November 06]
	=	0.0333
	=	0.03 (to two decimal places).

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

Depreciation deduction (section EE 16)	**=**	**annual rate**	×	**value or cost**	×	**months / 12**
	=	0.03	×	$4,800	×	8 / 12
	=	$96				

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 years ended:	
31 March 2006	72
31 March 2007	96
Total depreciation claimed	$168

Therefore, the amount that the taxpayer can deduct from assessable income for loss on disposal of the patent is:

Cost of the patent	4,800
Less depreciation claimed	168
Deduction for loss on disposal	$4,632

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.

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 / 4.5
	=	0.22 (rounded 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 (sections 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	80
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

- 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	100
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 immediately deductible. As the taxpayer's patent was acquired on 15 February 1997, section DB 28 applies.

Therefore:

The taxpayer can deduct $5,180 (being $1,880 + $2,400 + $900) in the income year ended 31 March 1997, as expenditure incurred in connection with the grant of the patent.

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.

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, the Commissioner may allow the taxpayer to deduct up to $2,050 (the total of the renewal fees) in the year in which they are paid.

Example 6 – additional costs for a patent acquired 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.

- 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, they owned an item of fixed life intangible property.

Therefore:

> Although the taxpayer's patent attorney fees were only incurred at the end of in 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.

Therefore:

> The taxpayer may deduct the renewal fees of $170, $340, $540, and $1,000 in the income years in which they are incurred, i.e. $170 in the 2009-19 income year, $340 in the 2012-13 income year, $540 in the 2015-16 income year and $1,000 in the 2018-19 income year.

If the renewal fees are paid in advance, the Commissioner may allow the taxpayer to deduct up to $2,050 (the total of the renewal fees) in the year in which they are paid.

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 devising the light bulb. The company received the patent on 3 December 2006, and began production on 20 June 2007. Instead of letting the patent expire on 3 December 2010, the company sells the patent on 3 December 2010 for $750,000.

The company cannot claim depreciation for the income year ending 31 March 2011, because section EE 11(1) says that depreciation cannot be claimed in the year a depreciable asset is sold.

The proceeds from the sale are 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 2010 is $680.

Therefore, the deduction on sale is:

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

The amount of $750,000 received by the company for the sale is income of the company, under section CB 26. Expenses incurred in devising the invention can be deducted from that income, under section DB 29.

Therefore, the amount of net income arising from the sale is:

Amount received on sale	750,000
Cost of the invention	45,000
Net income	$705,000

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 (section DB 26)

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.

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. In November 2007, after additional development expenditure of $100,000, which included expenditure on further prototypes, the company files for and is granted a patent.

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

Annual rate (section EE 27C)	=	months / depreciation months
	=	2 / 240
	=	0.0083
	=	0.01 (to two decimal places).

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

Depreciation deduction (section EE 16)	=	**annual rate**	×	**value or cost**	×	**months / 12**
	=	0.01	×	$15,000	×	2 / 12
	=	$25				

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

Annual rate (section EE 27D)	=	months / depreciation months
	=	4 / 240
	=	0.0166
	=	0.02 (to two decimal places).

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

Depreciation deduction (section EE 16)	=	**annual rate**	×	**value or cost**	×	**months / 12**
	=	0.02	×	$15,000	×	4 / 12
	=	$100				

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 (section DB 28B, EE 16 and EE 27C)

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.

The company can depreciate the patent application for the period from the time the patent application was made with complete specification, i.e. 1 October 2007, until the time the patent grant is refused on 1 December 2007, i.e. 2 months. The calculation of the depreciation for this period is as set out in Example 9, i.e. for 2 months and the depreciation loss is $25.

However, 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. Therefore, the company is allowed a deduction for the $15,000 incurred in making the patent application, less the $25 depreciation loss otherwise allowed, pursuant to section EE 16 and EE 27C, i.e. $14,975.

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

SPS 05/11 – INSTALMENT ARRANGEMENTS FOR PAYMENT OF TAX DEBT

Introduction

1. This Standard Practice Statement (SPS) sets out Inland Revenue's practice on providing relief by way of an instalment arrangement when taxpayers are in debt.

2. Please refer to the relevant SPS on writing off tax debt for further details on Inland Revenue's practice on providing relief under section 177C of the Tax Administration Act 1994.

Application

3. This SPS applies to applications for relief by way of instalment arrangement made on or after 15 November 2005. It replaces SPS *RDC 610 – Instalment arrangements for payment of tax debt* originally published in *Tax Information Bulletin* Vol 14, No 11 (November 2002).

4. This SPS also applies to instalment arrangements for student loan repayment debt and late payment penalties incurred on that debt. Interest is not charged on instalment arrangements for student loan repayment debt although it will be charged on student loan balances.

5. This SPS does not apply to instalment arrangements for payment of child support arrears by non-custodial or custodial parents.

6. Unless specified otherwise, all legislative references in this SPS refer to the Tax Administration Act 1994.

Summary

7. Pursuant to section 176, the Commissioner must not recover tax debt from a taxpayer, being a natural person if recovery would place that person in serious hardship.

8. Section 177 allows a taxpayer to apply for financial relief by requesting to enter into an instalment arrangement.

9. The Commissioner will negotiate with the taxpayer to determine what method of payment best suits the taxpayer's financial situation and will maximise recovery of the tax debt from the taxpayer.

10. Applications for relief by way of an instalment arrangement may be made by telephone or in writing.

11. The Commissioner may require relevant information to be provided in support of the application. This may include financial information and the filing of outstanding returns. This information must be provided within 20 working days or a longer period allowed by the Commissioner.

12. Upon receipt of a taxpayer's application for an instalment arrangement the Commissioner may accept the request, seek further information from the taxpayer, make a counter offer or decline the request.

13. The Commissioner's authority to enter into instalment arrangements for the payment of tax debt under the Tax Administration Act 1994 ("the TAA") is further qualified by the requirement:

   - to maximise the recovery of tax debt from a taxpayer, but not if:
     - recovery would represent an inefficient use of the Commissioner's resources, or
     - a taxpayer, being a natural person, would be placed in serious hardship by enforcement of the debt.
   - that, if the Commissioner can recover more through an instalment arrangement than from bankruptcy or liquidation action, the Commissioner is required to enter into an instalment arrangement.

   In *Raynel v CIR* (2004) 21 NZTC 18,583 Randerson J noted that the obligation to maximise recovery of outstanding debt from a taxpayer is not an absolute obligation. Rather the Commissioner's duty is to be approached on "a pragmatic basis with proper regard to the likely benefits and the costs of achieving them." Randerson J also considered that this obligation does not relieve Inland Revenue officers from their duty under section 6(1) to use their best endeavours to protect the integrity of the tax system. Further, Randerson J noted that the Commissioner is required under section 6A(3)(b) to have regard to the importance of promoting voluntary compliance by all taxpayers with the Inland Revenue Acts. Thus taxpayers are entitled to expect that appropriate and firm action is taken against non-complying taxpayers and that this may override any proposed instalment arrangement.

14. Use-of-money interest will continue to accrue during the term of an instalment arrangement.

15. Under section 139B, the initial late payment penalty is divided into two steps with a staggered application.

16. In addition, monthly incremental penalties will not be charged while a debt is under an instalment arrangement, provided that the taxpayer complies with the instalment arrangement. This applies from the date on which the taxpayer contacts Inland Revenue seeking financial relief.

17. When the Commissioner accepts an instalment arrangement, he will issue to the taxpayer a letter of confirmation setting out both the taxpayer's and the Commissioner's obligations.

18. The taxpayer may renegotiate an instalment arrangement at any time. However, the Commissioner may only do so after two years have elapsed from the date the instalment arrangement was entered into.

19. The Commissioner may cancel an instalment arrangement because the taxpayer has provided misleading information or is not meeting their obligations under the arrangement. In these circumstances monthly incremental penalties will be imposed retrospectively as if the instalment arrangement had not been entered into.

Legislation

20. The relevant legislative provisions are sections 14B, 139B, 139BA, 176, 177, 177A, 177B and 177CA.

Discussion

21. Pursuant to section 176, the Commissioner must not recover tax debt from a taxpayer, being a natural person if recovery would place that person in serious hardship.

22. The taxpayer may apply for financial relief under the TAA. The relief may be in the form of an instalment arrangement and/or a write-off of all or part of the tax debt. (Refer to the relevant SPS for details on Inland Revenue's practice on writing off tax debt.)

23. Taxpayers may apply for an instalment arrangement by telephone or in writing. In some cases, however, Inland Revenue may require a taxpayer to apply in writing.

24. Pursuant to section 14B, where a taxpayer is required to apply for financial relief by giving notice in writing to the Commissioner, the taxpayer may do so by:

    - delivering the notice in person to an Inland Revenue office, or
    - issuing the notice by fax to an Inland Revenue office, or
    - sending an email on Inland Revenue's Online Correspondence Service, or
    - sending the notice to an Inland Revenue office by post.

25. In all cases the taxpayers must provide supporting financial information. This information can be supplied either orally or in writing. Despite this, Inland Revenue officers may obtain written financial information from the taxpayers to verify or further support their applications for financial relief. However, in some cases, Inland Revenue may already hold adequate financial information about the taxpayers and thus further financial information may not be required.

26. Upon receipt of an application for an instalment arrangement, Inland Revenue may:

    (a) Accept the taxpayer's request

    Once the request is accepted written confirmation will be sent to the taxpayer. This will include:

    - the commencement date of the instalment arrangement, and
    - any terms and conditions in addition to the agreed repayments under the instalment arrangement negotiated between Inland Revenue and the taxpayer.

    If the taxpayer disagrees with any of the terms and conditions they should contact the Inland Revenue officer who issued the confirmation immediately.

    (b) Seek further information from the taxpayer

    If the Commissioner requires additional information it must be received by a date agreed to between the Commissioner and the taxpayer.

    (c) Make a counter offer

    The Commissioner may make a counter offer to the taxpayer where:

    - the Commissioner considers that the taxpayer's financial circumstances disclose that the taxpayer can make instalments at a higher amount than was proposed by the taxpayer in the application, or
    - the Commissioner considers that to accept instalments based on the amount the taxpayer offers to pay would place the taxpayer in serious hardship. In this case the Commissioner may make a counter offer to accept instalments of a lesser amount.

(d) **Decline the request**

The Commissioner must not enter into an instalment arrangement:

- if recovery would represent an inefficient use of the Commissioner's resources, or
- to the extent that it would place a taxpayer, being a natural person, in serious hardship. However an exception arises where the taxpayer is liable to pay, in relation to a tax debt, a shortfall penalty for either an abusive tax position under section 140D(2) or evasion under section 141E(1) or a similar act. In these circumstances recovery action to collect both the shortfall penalty and the underlying tax will continue even if recovery would place a taxpayer in serious hardship.

If the Commissioner declines a request for an instalment arrangement the taxpayer will be notified of the reasons for the decision. The taxpayer may request the Commissioner to explain the decision in writing.

In addition, the Commissioner may decline to enter into an instalment arrangement:

- if it is considered that the taxpayer is able to pay the debt in full. For example, a taxpayer has term deposits or other investments or the ability to borrow sufficient funds to pay the tax debt, or
- if the Commissioner considers that more can be recovered by commencing bankruptcy or liquidation proceedings.

Timeframe for responding

27. If the Commissioner is unable to make a decision on granting relief immediately and requires further information, or makes a counter offer, the taxpayer will be advised in writing.

28. The letter will contain the following details:

- the date the application was received
- the name and contact number of the Inland Revenue officer handling the request
- the additional information the taxpayer is required to supply (if applicable)
- the timeframe for the supply of that information
- the consequences of failing to provide that information by the required date.

29. Generally, the taxpayer must provide the information requested or respond to Inland Revenue's counter offer within 20 working days. However, the Commissioner may allow a longer period to respond if the taxpayer is having difficulties in obtaining the required information or responding to the counter offer within the time frame. In this situation, the taxpayer may contact Inland Revenue to request an extension of the response period. Inland Revenue will consider such a request on its own merits, taking into account the reason for the taxpayer's difficulty in providing the information or responding to the counter offer and whether it is reasonable for the request to be granted.

30. Incremental late payment penalties and in some cases, part of the initial late payment penalties will not be imposed during the response period. However, use-of-money interest will continue to accrue on a daily basis.

31. If the information or response to the Commissioner's counter offer is not provided within the negotiated timeframe, late payment penalties will be imposed as though no application had been made.

32. If the information is forwarded at a later date, the Commissioner will treat this as a new request for financial relief unless there is good reason why the taxpayer was unable to provide the information or respond to the Commissioner's counter offer within the timeframe. Possible reasons could include illness, or involvement in an accident which prevented the taxpayer from contacting Inland Revenue to request an extension.

33. If the Commissioner, upon receipt of the information requested, declines to enter into an instalment arrangement, any late payment penalties not imposed during the response period will be imposed as though no application for financial relief had been made.

34. The Commissioner will not commence recovery action during a negotiation period. However, if recovery action has already commenced, the Commissioner will discuss with the taxpayer whether this recovery action will continue during the negotiation period.

35. For example, a taxpayer may already be paying an outstanding amount by way of an instalment arrangement and may contact the Commissioner to discuss a reduction in the instalment amounts. In this instance, the Commissioner will discuss with the taxpayer whether the current instalment arrangement is to continue until such time as a new instalment arrangement is successfully negotiated.

36. If the taxpayer incurs further debt during the response period, this amount may be added to the total amount under negotiation.

Considering the request

37. When considering a request for an instalment arrangement, declining such a request, deciding whether to seek further information, or making a counter offer, Inland Revenue will take into account the following factors:

    (a) Whether the proposal will place the taxpayer, being a natural person, in serious hardship.

    (i) This requires the Commissioner to take into account the circumstances of the taxpayer, specifically:

    - whether the taxpayer will be unable to meet minimum living expenses according to normal community standards, or
    - the cost of medical treatment for an illness or injury of the taxpayer or the taxpayer's dependant(s), or
    - a serious illness suffered by the taxpayer or the taxpayer's dependant(s) which directly caused financial difficulty in complying with their statutory obligations to file returns and make tax payments (including penalties and/or interest), or
    - the cost of education for the taxpayer's dependant(s).

    (ii) The Commissioner may take into account whether the recovery of tax debt would place a shareholder who owns, or two shareholders who jointly own, 50% or more of the shares in a company or a shareholder-employee of a close company in serious hardship.

    (iii) A "close company" for these purposes means a company which has five or fewer natural persons whose voting interests or market value interests in the company exceed 50% and are not a special corporate entity.

    (iv) Serious hardship does not include financial difficulties that arise because:

    - the taxpayer is obligated to pay tax, or
    - the taxpayer may become bankrupt, or
    - the taxpayer's, or the taxpayer's dependant's social activities and entertainment may be limited, or
    - the taxpayer is unable to afford goods or services that are expensive or of a high quality or standard according to normal community standards.

    (v) Whether a person is a taxpayer's "dependant" will be determined on a case by case basis. In determining dependency issues, the Commissioner will consider:

    - whether the person is dependent on the taxpayer for financial support, and
    - what degree of financial support is provided by the taxpayer, and
    - to what extent providing financial support impacts on the taxpayer's ability to meet minimum living expenses according to normal community standards.

    For further discussion on consideration of serious hardship, refer to the separate SPS on *Writing off tax debt*.

    (b) Whether the instalment arrangement would maximise the recovery of tax debt from the taxpayer.

    (i) Inland Revenue has a duty to maximise the recovery of tax debt from a taxpayer. The Commissioner is therefore obliged to compare the value of the likely recovery from entering into an instalment arrangement with any other viable options for recovery. In some cases, it is clear which option will maximise recovery. In other cases there may be options that could yield similar returns. Accordingly it is necessary to determine which option will maximise recovery.

    (ii) Whilst not necessary in most circumstances, one method of distinguishing between alternative repayment options is to apply a net present value calculation.

    A net present value calculation recognises the time value of money, as well as the probability of payment (risk). The proposed payments are discounted for the time value of money and for the likelihood of receiving the money. Inland Revenue needs to determine the amount, date, and probability of each payment and apply an appropriate discount rate. The discount rate is calculated from published Government stock rates. Inland Revenue uses a calculation

that multiplies the amount of payment by the probability of payment (for risk), divided by the discount factor appropriate to the term (for interest).

The methodologies for determining the discount rate, probability of payment and net present value are outlined in the appendix to *Tax Information Bulletin* Vol 6, No. 14 (June 1995).

(iii) The legislation imposes no time limit in which an instalment arrangement must be completed. However, Inland Revenue considers it desirable, in order to maximise the recovery of tax debt, that instalment arrangements are over a shorter period of time, rather than a longer period of time. This is because the longer the period, the greater the risk of non-payment and the greater the loss of the time value of money.

The Commissioner will also consider whether the proposed instalment arrangement would lead to a monetary return to Inland Revenue greater than any amount likely to be received if legal proceedings were initiated.

(c) Whether the taxpayer is in a position to pay all of the tax debt immediately.

An opinion will be formed based on the financial information provided by the taxpayer and the result of any further enquiries the Commissioner considers necessary.

(d) Whether the taxpayer has met their obligations under a previous instalment arrangement.

Where a taxpayer has previously entered into an instalment arrangement with Inland Revenue and has not met their obligations under that instalment arrangement, the Commissioner may decline to enter into a further instalment arrangement.

In reaching this decision, Inland Revenue will also take into account:

- the length of time since the previous instalment arrangement
- whether the previous instalment arrangement was realistic
- any changes in the taxpayer's position over that time
- whether there are any other factors likely to indicate that the taxpayer will meet their obligations if an instalment arrangement is agreed to this time.

(e) Whether the taxpayer is being frivolous or vexatious.

This includes situations where:

- Inland Revenue considers the taxpayer is not seriously contemplating entering into, and/or complying with an instalment arrangement, or
- previous requests for instalment arrangements have been declined and the taxpayer provides the same information when requesting a further instalment arrangement.

In these circumstances Inland Revenue may decline to enter into an instalment arrangement.

(f) Whether the taxpayer's proposal is realistic.

(i) An opinion will be made based upon the financial information provided by the taxpayer and any further information the Commissioner considers necessary. The Commissioner will consider whether the taxpayer can reasonably afford to repay the outstanding amount at the rate detailed in the taxpayer's application.

(ii) The Commissioner must, under section 6(1), have regard to protecting the integrity of the tax system and will be conscious of taxpayers re-ordering their tax affairs by reducing personal assets or deliberately concealing assets overseas, or by some other method to prevent recovery of tax debt and to achieve a settlement with the Commissioner.

(g) Whether future compliance by the taxpayer is likely.

Inland Revenue will consider whether entering into an instalment arrangement would be likely to allow the taxpayer to meet future tax obligations by their due dates. For example, if a taxpayer is continuing in business, whether the instalment arrangement would allow the taxpayer to meet their ongoing provisional, residual income tax and GST obligations as they arise.

(h) Whether the taxpayer has filed all required returns.

Inland Revenue may, in certain circumstances, request outstanding returns to be filed in order to ascertain the taxpayer's full debt situation. This may occur if the outstanding amount relates to assessments made by the Commissioner in the absence of returns having been filed.

(i) Other relevant factors:

In *Clarke & Money v Commissioner of Inland Revenue* (2005) 22 NZTC 19,165 Priestley J considered the following factors relevant to the exercise of the discretion under section 177:

(i) the circumstances which led to the taxpayer's taxation debts

(ii) the nature and extent of the taxpayer's co-operation and negotiating stance

(iii) the speed with which the taxpayer has provided requested information, and the extent of that information

(iv) the taxpayer's degree of compliance in providing information.

In R*aynel v CIR* (2004) 21 NZTC 18,583, Randerson J noted that where there has been a flagrant and on-going failure to comply with the taxpayer's obligations and where recovery is dubious or is likely to result only in a relatively minor proportion of the overall debt being recovered, the Commissioner may be justified in initiating or continuing enforcement proceedings to secure the wider interests identified by the legislation.

In *Rogerson v CIR* (2005) 22 NZTC 19,260, Potter J also considered the taxpayer's compliance history was a factor relevant to the Commissioner's exercise of the discretion to grant financial relief.

Cancellation of an instalment arrangement

38. Under section 177B(6), the Commissioner may cancel an instalment arrangement in the following circumstances:

- if the instalment arrangement was entered into on the basis of false or misleading information provided by the taxpayer.

  For example, where a taxpayer has overstated outgoings or understated income, it may not have been appropriate for the Commissioner to have entered into an instalment arrangement; or where a taxpayer has a vested right to income or assets of a trust, and this was not disclosed to the Commissioner.

- if the repayment obligations under the instalment arrangement are not being met.

39. If an instalment arrangement is cancelled because misleading information was provided, any late payment penalties not imposed under the instalment arrangement from the date the taxpayer contacted Inland Revenue seeking financial relief will be reinstated in full.

40. When an instalment arrangement is cancelled due to the repayment obligations not being met, incremental late payment penalties will be imposed on a monthly basis from the date the taxpayer stops meeting the repayment obligations. Any late payment penalties not charged under the instalment arrangement from the date the taxpayer contacted Inland Revenue seeking financial relief to the date Inland Revenue cancels the instalment arrangement are not reinstated.

Payments

41. Inland Revenue will negotiate with the taxpayer to achieve the frequency and method of payment that matches the taxpayer's financial circumstances and which maximises recovery of the tax debt from the taxpayer.

42. Inland Revenue will only apply credits that arise in a taxpayer's account to the outstanding arrears that are under an instalment arrangement when requested by the taxpayer.

43. A taxpayer may start making voluntary payments at any time, without contacting the Commissioner to request an instalment arrangement. However, in these situations the taxpayer will not be eligible for any late payment penalty reduction or non-imposition. If the taxpayer does subsequently contact Inland Revenue to request an instalment arrangement, after commencing the voluntary payments, and that request is granted, the non-imposition of penalties will apply from the date the taxpayer contacted Inland Revenue requesting financial relief.

Reviewing instalment arrangements

44. A taxpayer may renegotiate an instalment arrangement at any time.

45. The Commissioner may only initiate renegotiation of an instalment arrangement after the end of two years from the date on which the instalment arrangement was entered into. Such a review will consider whether the instalment arrangement is still appropriate to the taxpayer's financial circumstances and may therefore require updated financial information from the taxpayer.

46. The date the instalment arrangement is entered into is the date the instalment arrangement is accepted by the Commissioner. The taxpayer will be notified of the Commissioner's acceptance of the instalment arrangement in writing.

Imposition of late payment penalty

47. Late payment penalties imposed under section 139B comprise an initial late payment penalty and incremental late payment penalties.

48. The initial late payment penalty is a two-step penalty being:
    - an initial late payment penalty of 1% imposed on the day after due date, and
    - a second initial late payment penalty of 4% imposed at the end of the 6th day after the date on which the 1% initial late payment penalty is imposed if the tax owing remains outstanding. In practice, if the tax owing remains outstanding, this means the 4% second initial late payment penalty is imposed at the end of the 7th day after the due date.

49. An incremental late payment penalty of 1% is imposed on the balance of tax debt outstanding at the end of every month after the date the initial 1% late payment penalty was imposed.

50. The Commissioner will review monthly all instalment arrangements entered into to determine whether the expected instalment amount has been received for the previous month. Where the instalment has been received, the incremental late payment penalty will not be imposed for that month.

51. The agreed instalment arrangement amount is the minimum amount that is due each month. Extra payments in one month are not used as credits towards future monthly obligations. Instead they are applied to reduce the term of the instalment arrangement and the amount of interest payable.

Instalment arrangements entered into before the due date – commonly known as "Pre-emptive instalment arrangements"

52. Where the taxpayer contacts the Commissioner seeking financial relief by way of an instalment arrangement before the due date, the 1% initial late payment penalty under section 139B(2A)(a) will be imposed. However, the 4% initial late payment penalty under section 139B(2A)(b) will not be imposed. This type of arrangement is commonly known as a "pre-emptive" instalment arrangement.

53. In addition, where monthly repayment obligations under the instalment arrangement have been met, the monthly incremental late payment penalty of 1% will not be imposed for that month. Failing to meet any monthly repayment obligations will result in the incremental late payment penalty being imposed for that month based on the balance outstanding under that instalment arrangement.

54. If financial relief is not granted, the late payment penalties mentioned earlier will be imposed as if the taxpayer had not requested financial relief.

55. When a taxpayer seeks to enter into a pre-emptive instalment arrangement for provisional tax payments they must provide cashflow forecasts and budgets to substantiate the proposed instalment arrangement when required. The Commissioner may consider the taxpayer's trend of making tax payments, taxable income and the industry in which they are working. The Commissioner may also refer to other taxpayers in the same industry to establish whether the taxpayer will have residual income tax to pay.

56. When a taxpayer seeks to enter into a pre-emptive instalment arrangement for the payment of provisional tax instalments based on the standard method but there is evidence, such as a cashflow forecast or budget, to establish that the taxpayer will have no tax to pay in the tax year, the Commissioner may decline to enter into an instalment arrangement with the taxpayer.

Instalment arrangements entered into on or after due date

57. Where the taxpayer contacts the Commissioner seeking financial relief on or after the due date, both the 1% and 4% initial late payment penalties will be imposed. In addition, any incremental late payment penalties imposed up to the date the taxpayer requests financial relief are also payable.

58. The monthly incremental late payment penalty of 1% will not be charged in those months where the monthly repayment obligations are met. Failing to meet monthly repayment obligations will result in an incremental penalty being imposed for that month based on the balance outstanding under that instalment arrangement.

59. If all obligations under the instalment arrangement are fulfilled, these instalment arrangements will, in effect, be charged only the 1% and 4% initial late payment penalties plus any monthly incremental penalties imposed prior to the taxpayer requesting financial relief.

STANDARD PRACTICE

60. Upon receipt of a taxpayer's application for an instalment arrangement, Inland Revenue has four options:
    (a) accept the taxpayer's request, or
    (b) seek further information from the taxpayer, or
    (c) make a counter offer, or
    (d) decline the request.

61. Inland Revenue will take into account the following factors when considering a taxpayer's application for an instalment arrangement:
    (a) Whether the proposal will place the taxpayer, being a natural person, in serious hardship.
    (b) Whether the instalment arrangement would maximise the recovery of outstanding tax from the taxpayer.
    (c) Whether the taxpayer is in a position to pay all of the tax debt immediately.
    (d) Whether the taxpayer has met their obligations under a previous instalment arrangement.
    (e) Whether the taxpayer is being frivolous or vexatious.
    (f) Whether the taxpayer's proposal is realistic.
    (g) Whether future compliance by the taxpayer is likely.
    (h) Whether the taxpayer has filed all required returns.
    (i) Whether other relevant factors exist.

62. When considering a taxpayer's application, the Commissioner may require the taxpayer to provide additional information within 20 working days or a longer period allowed by the Commissioner.

63. The taxpayer must provide the required information within the timeframe. Failure to do so will be treated as if the application for an instalment arrangement had not been made. This means that the initial late payment penalty, the monthly incremental late payment penalty and use-of-money interest will be imposed on the unpaid tax.

64. When the Commissioner accepts an instalment arrangement, a letter of confirmation setting out both the taxpayer's and the Commissioner's obligations will be issued to the taxpayer.

65. Where the taxpayer applies for an instalment arrangement before the due date and the Commissioner accepts the application, the initial late payment penalty of 1% on the unpaid tax will be imposed. Use-of-money interest will also be accrued daily on the unpaid tax.

66. Where the taxpayer applies for an instalment arrangement after the due date and the Commissioner accepts the application, the initial late payment penalty of 1% and 4% on the unpaid tax will be imposed. In addition, any incremental late payment penalties imposed up to the date the taxpayer requests financial relief are also payable. Use-of-money interest will also be accrued daily on the unpaid tax.

67. The taxpayer may renegotiate an instalment arrangement at any time. The Commissioner may do so only after the end of two years from the date on which the instalment arrangement was entered into. During the renegotiation process, the Commissioner may require the taxpayer to provide further information (including financial information).

68. The Commissioner may cancel an instalment arrangement because the taxpayer has provided misleading information. In this case, the monthly incremental penalty of 1% will be imposed on the unpaid tax from the date on which the taxpayer contacted Inland Revenue seeking financial relief.

69. However, when an instalment arrangement is cancelled because the taxpayer does not meet their repayment obligations, a monthly incremental penalty of 1% will be imposed on the unpaid tax from the date on which the taxpayer fails to meet their repayment obligations under the instalment arrangement.

This Standard Practice Statement is signed on 15 November 2005.

Graham Tubb
National Manager
Technical Standards

WITHDRAWAL OF THE STANDARD PRACTICE STATEMENT *INV-140 FAST TRACKING SMALL SIMPLE DISPUTES*

Inland Revenue has decided to withdraw the Standard Practice Statement *INV-140 Fast tracking small simple disputes* from 1 November 2005. The withdrawal is due to recent changes in the disputes resolution process. Part of the withdrawn Standard Practice Statement (SPS) has already been incorporated into the two SPSs on the new disputes resolution process, namely *SPS 05/03 Disputes resolution process commenced by the Commissioner* and *SPS 05/04 Disputes resolution process commenced by a taxpayer*.

Graham Tubb
National Manager,
Technical Standards

LEGISLATION AND DETERMINATIONS

This section of the TIB covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

DETERMINATION DET 05/02

AMORTISATION RATES FOR LANDFILL CELL CONSTRUCTION EXPENDITURE

This Determination may be cited as "Determination DET 05/02 Amortisation rates for landfill cell construction expenditure".

1. Explanation (which does not form part of the Determination)

This Determination sets out the amortisation rates for landfill cell construction expenditure as determined by the Commissioner of Inland Revenue.

2. Reference

This Determination is made pursuant to section 91AAN of the Tax Administration Act 1994.

3. Scope of Determination

This Determination applies to taxpayers who meet the criteria under section DB 37 of the Income Tax Act 2004 and have incurred landfill cell construction expenditure in an income year starting on or after 10 June 2005. Its application may be supplemented or amended by supplementary Determinations pursuant to section 91AAN(6) of the Tax Administration Act 1994.

4. Interpretation

In this Determination, unless the context otherwise requires, expressions used have the same meanings as those in sections CB 6B, DB 37, OB 1, schedules 6B and 11 of the Income Tax Act 2004 and section 91AAN of the Tax Administration Act 1994 in respect of an income year starting on or after 10 June 2005 and subsequent income years.

5. Determination

Pursuant to section 91AAN of the Tax Administration 1994, for the purposes of section 91AAN(2), the rate set out in schedule 11 of the Income Tax Act 2004 that is to be used to amortise the types of landfill cell construction expenditure, described in the schedule to this Determination and incurred in an income year starting on or after 10 June 2005, shall be, at the election of the taxpayer, either:

(a) 63.5% (straight-line equivalent), or

(b) 63.5% (diminishing value depreciation rate).

This Determination is made by me, acting under delegated authority from the Commissioner of Inland Revenue under section 7 of the Tax Administration Act 1994.

This Determination is signed on the 15th day of November 2005.

Graham Tubb
National Manager
Technical Standards

SCHEDULE TO DETERMINATION DET 05/02

AMORTISATION RATES FOR LANDFILL CELL CONSTRUCTION EXPENDITURE

Types of landfill cell construction expenditure to which this Determination applies

Cell construction costs

Excavation means costs relating to:

- earthworks design
- preparatory works (such as clearing the cell site)
- earthworks, including excavation, borrowing and filling
- erosion control measures and remediation of borrowed areas associated with cell construction
- contractors overheads related to cell construction
- cell-specific resource consents other than those which qualify as fixed life intangible property.

Cell lining means costs relating to the design, construction and quality assurance of cell liners (clay, geosynthetic, flexible membrane, concrete or bitumen) and protection and separation layers, including reworking and sub-excavation to support subsequent compaction or to provide slope stability.

Leachate drainage means the provision of drainage material to assist in drainage of leachate from the base and sidewalls of a landfill cell.

This excludes drainage pipes and systems designed for the passage and extraction of leachate from the landfill.

Note: The above landfill cell construction expenditure does not include expenditure that relates to the site development of the landfill and expenditure that is deductible under any legislative provision in the Income Tax Act 2004 other than section DB 37.

COMMENTARY ON DETERMINATION DET 05/02

AMORTISATION RATES FOR LANDFILL CELL CONSTRUCTION EXPENDITURE

Introduction

This commentary does not form part of the Determination. It is intended to provide assistance in the understanding and application of the Determination.

This Determination sets out the amortisation rates (depreciation-like deductions) that the Commissioner has determined for each of the types of landfill cell construction expenditure that is listed in the schedule to this Determination (referred to in this commentary as “listed landfill cell construction expenditure”).

Taxpayers who meet the criteria under section DB 37 of the Income Tax Act 2004 and have incurred the listed landfill cell construction expenditure in an income year starting on or after 10 June 2005, are required to elect to apply either the amortisation rate of 63.5% (diminishing value depreciation rate) or 63.5% (straight-line equivalent).

This Determination does not apply to types of expenditure that are not listed in the schedule to this Determination.

Criteria under section DB 37 of the Income Tax Act 2004

A taxpayer meets the criteria under section DB 37 of the Income Tax Act 2004 if:

- the taxpayer carries on a business in New Zealand; and
- the taxpayer incurs, in the business, expenditure:
  - that is of a type listed in schedule 6B of the Income Tax Act 2004, other than expenditure listed in part C of the schedule,
  - that is not incurred in relation to revenue account property (other than land that is subject to section CB 6B of the Income Tax Act 2004), and
  - that is not deductible under any other legislative provision in the Income Tax Act 2004 but for section DB 37.

Estimated useful life

The amortisation rate for listed landfill cell construction expenditure is based on:

- the average planned filling time for commercial landfill cells in New Zealand, and
- the average estimated economic life of commercial landfill cells in New Zealand.

Commercial landfill cells refer to landfill cells that are constructed by taxpayers in the waste management industry who meet the above criteria under section DB 37 of the Income Tax Act 2004.

For the listed landfill cell construction expenditure, the estimated useful life begins once construction of the commercial landfill cell to which the expenditure relates has been completed and continues until the relevant landfill cell is filled and capped.

The average planned filling time of commercial landfill cells in New Zealand is approximately one year. However, there are operational factors, such as intermediate filling, which mean a commercial landfill cell can be open for more than one year.

The practice of intermediate filling affects the estimated economic life of commercial landfill cells. Intermediate filling refers to situations where a commercial landfill cell can only be filled to a certain level of the cell's capacity in the first year of operation. Intermediate filling may occur due to the size and/or depth of the landfill cell, topographical or other operational factors. Where intermediate filling is involved, the commercial landfill cell will have an estimated economic life longer than the planned filling time of one year.

Inland Revenue has taken into account the fact that even if intermediate filling is involved, most revenues will be derived from a commercial landfill cell in its first year of operation. Using a weighted-average, Inland Revenue has generally applied more weight to the first year of a commercial landfill cell's operation as opposed to the later year(s) before the cell is fully filled and capped.

During the process of making this Determination, Inland Revenue has also taken into account the following matters, but decided that these matters do not significantly impact on the estimated useful life of a commercial landfill cell in New Zealand:

- future development in waste management technologies and initiatives
- landfill gas revenues derived from commercial landfill cells
- the likelihood of reopening commercial landfill cells after they have been capped
- non-commercial landfills, and
- commercial landfills in overseas jurisdictions.

The estimated useful life of commercial landfill cells in this Determination has been established by Inland Revenue following extensive consultation with taxpayers in the waste management industry and industry experts.

Amortisation rates

The process adopted in arriving at the amortisation rates for listed landfill cell construction expenditure began with the establishment of an estimated useful life for the commercial landfill cells. This data was then translated into an established straight-line equivalent rate as set out in column 2 of schedule 11 of the Income Tax Act 2004. The straight-line equivalent rate in column 2 is further translated into an appropriate diminishing value depreciation rate as set out in column 1 of schedule 11.

Although the estimated useful life of commercial landfill cells may vary in New Zealand, the amortisation rates for the listed landfill cell construction expenditure in this Determination are average rates for the waste management industry.

Application of this Determination to expenditure incurred in an income year starting on or after 10 June 2005

This Determination applies to taxpayers who meet the criteria under section DB 37 of the Income Tax Act 2004 and incur the listed landfill cell construction expenditure in an income year starting on or after 10 June 2005.

For example, taxpayers with the standard balance date of 31 March may apply this Determination from 1 April

2006 onwards. They shall not apply this Determination to their 2005-2006 income year or prior income years.

Where taxpayers have an approved non-standard balance date, the Determination applies to the listed landfill cell construction expenditure incurred in income years beginning on or after 10 June 2005. For example, for a taxpayer with a 30 June balance date, the Determination would apply from 1 July 2005.

Tax deductions for landfill cell construction expenditure incurred in those income returns furnished in respect of income years starting before 10 June 2005 should be based on the previous rules that applied. These previous rules will continue to apply to this expenditure, notwithstanding the issue of this Determination.

Additions of new amortisation rates/ amendments to existing amortisation rates

Amendments to this Determination will be made by the Commissioner issuing supplementary Determinations pursuant to subsection 91AAN(6) of the Tax Administration Act 1994.

Amendments may include adding further expenditure to those already listed in column 1 of the schedule to this Determination or adjusting the estimated useful life of commercial landfill cells due to operational changes in the waste management industry in New Zealand. Such amendments will be effective for the current or future income years. They will not apply to previous income years.

Changes may also be made to the Determination from time to time by Inland Revenue on receipt of written applications from taxpayers in the waste management industry.

Applications for changes must include the following information:

- applicant's details - this includes full name, IRD number (if applicable), address, telephone number, fax number and contact person for enquiries,
- the nature of the amendment to the Determination being sought, and
- information to support the change requested.

Applications for changes to the Determination are to be sent to:

The National Manager
Technical Standards
National Office
Inland Revenue
PO Box 2198
WELLINGTON

In considering applications for amendments to this Determination, Inland Revenue will continue to consult with relevant taxpayers in the waste management industry and industry experts.

Inland Revenue will discuss any amendment to this Determination with the applicant before it is finalised.

DETERMINATION DET 05/03

STANDARD-COST HOUSEHOLD SERVICE FOR BOARDING SERVICE PROVIDERS

This Determination, made pursuant to section 91AA(2) of the Tax Administration Act 1994, may be cited as "Determination DET 05/03: *Standard-Cost Household Service for Boarding Service Providers*."

1. Explanation (which does not form part of the Determination)

(a) This Determination establishes allowable standard-costs for a household service that has been provided as private boarding services, by providers, who are natural persons, in their domestic accommodation. The standard-costs have been determined based on current tax law and are to be used for the calculation of a boarding service provider's income tax liability, if any. They cannot and should not be used for any other purpose.

(b) It also describes the components of expenditure recognised as generally incurred in providing boarding services.

(c) This Determination establishes a figure for a cost or costs for the purpose of the Tax Administration Act 1994 and the Income Tax Act 2004 that may be treated as being incurred by a boarding service provider in deriving:

(i) exempt income and

(ii) assessable income.

(d) This Determination also prescribes a method of calculating such a figure, as set out in paragraph (c).

2. Reference

This Determination is made pursuant to section 91AA of the Tax Administration Act 1994.

3. Scope of Determination

Except where its application is specifically excluded in another Determination or a fresh Determination, this Determination may be used by all natural persons who provide private boarding services in their domestic accommodation.

This Determination shall not apply to situations which are the subject of any other Determination made under section 91AA, such as where persons are accommodated in domestic accommodation as an extension of any specialised health care or institutional half-way house to facilitate rehabilitation. It also does not apply where the boarding service is provided as part of a GST taxable activity of a registered person or to cases where the boarding service provider has on average five or more boarders in residence during the income year.

Subject to any adjustment based on the annual movement of the Consumers Price Index as at the end of March each year, this Determination, unless specifically withdrawn, shall apply from the 2007 income year.

4. Interpretation

In this Determination, unless the context otherwise requires:

- expressions used have the same meanings as those in sections CW 49 and OB 1 of the Income Tax Act 2004 and section 91AA of the Tax Administration Act 1994
- "boarding service provider" means a natural person (which term shall include one or more natural persons living together in the same residence) who carries on an activity of providing a private boarding service in their domestic accommodation
- "private boarding service" means all activities in respect of accommodation and associated care including meals, laundry and utilities typically provided by a boarding service provider to other persons (boarders) in the boarding service provider's domestic accommodation, in return for payment
- "Consumers Price Index" means the application of the annual movement of the All Groups Consumers Price Index to the weekly standard-cost per boarder
- "domestic accommodation" means the dwelling which is the principal residence of any boarding service provider
- "standard-cost" in relation to any private boarding service, means the standard-cost that has been determined by the Commissioner of Inland Revenue for the purpose of this Determination, as referred to in section 91AA of the Tax Administration Act 1994.

5. Standard-cost for boarding service providers: general notes

A boarding service provider who derives income from such services in an income year, may:

- elect to use the standard-cost as set out in this Determination, and
- to that extent payments received from private boarding services will be exempt income.

Boarding service providers may elect to use the standard-cost method by not including the amount of income derived from providing boarding services, up to but not exceeding the determined standard-costs in aggregate in any tax return otherwise required to be furnished.

A boarding service provider who makes such an election will not be eligible to claim any net tax loss. Losses may only be claimed where the taxpayer furnishes a full return of income (showing all payments received) and claims actual expenditure, with sufficient records available to support their tax position.

That is, where a boarding service provider elects to use the determined standard-costs, they may not deduct any additional cost of providing the boarding services, if the additional cost relates to an item of standard-cost expenditure represented in this Determination.

6. Determination

A private boarding service shall be a standard-cost household service for the purposes of section 91AA where:

- the private boarding service involves the use of the boarding service provider's domestic accommodation, and
- the private boarding service involves activities and benefits that usually or commonly occur in or are derived from a domestic ("family") household.

The standard-cost which the taxpayer may treat as incurred in deriving exempt income for the purposes of section CW 49 of the Income Tax Act 2004 consists of two elements – the weekly standard-cost per boarder and the annual capital standard-cost. It is expected however that many boarding service providers will be able to determine their tax position by referring to the weekly standard-cost, and will not need to additionally calculate the annual capital standard-cost.

(a) Weekly standard-cost per boarder

The weekly standard-cost per boarder represents the direct cost of providing private boarding services to each boarder on a weekly basis.

Weekly standard-cost for one to two boarders	$200 each
Weekly standard-cost for third and subsequent boarders	$162 each

This component covers expenditure on items and services typically provided to boarders, such as food, laundry, cleaning, heating, power, transport, telephone rental, use of bedroom chattels, general household furniture, linen and incidentals.

Where a taxpayer elects to use this method and the weekly payments for the relevant number of boarders in any week do not exceed the standard-cost amount, the income is exempt.

(b) Annual capital standard-cost

The annual capital standard-cost element represents the cost for the use of the domestic accommodation in providing the private boarding service and includes financing and depreciation costs. This is an annual calculation for the use of the domestic accommodation, based on:

- The actual cost to the boarding service provider of acquiring and making capital improvements to the domestic accommodation or renting the domestic accommodation in which the boarding services are provided
- the proportion of boarders who reside in the accommodation in relation to the overall average number of occupants, and
- the proportion of the actual period during which private boarding services are provided in an income year.

The calculation depends on whether a boarding service provider owns or rents their domestic accommodation. Additionally, the annual capital cost calculated must be reduced by the amount of any accommodation supplement received by a boarding service provider.

(i) Boarding service provider who owns their domestic accommodation

Where a boarding service provider owns their domestic accommodation, the annual capital standard-cost for any income year must be determined in accordance with the following formula:

$$[(a \times 5\%) - b] \times c \times d$$

where–

a is the purchase price of the domestic accommodation plus the cost of all capital additions, and

b is the annualised amount of accommodation supplement received by the boarding service provider (weekly amount received multiplied by 52 weeks), and

5% represents the typical expenditure incurred in owning a domestic property, including depreciation of the building and outgoings such as rates, insurance, mortgage interest cost, repairs and maintenance, and

c is the average percentage of boarders in relation to the overall average number of occupants living in the domestic accommodation during the income year, and

d is the number of full weeks during which private boarding services were provided in an income year, divided by 52.

(ii) Boarding service provider who rents their domestic accommodation

Where the boarding service provider rents their domestic accommodation, the annual capital standard-cost for any income year must be determined in accordance with the following formula:

$$(a - b) \times c \times d$$

where–

a is the annualised rental payment (weekly rent paid x 52 weeks), and

b is the annualised amount of accommodation supplement received by the boarding service provider (weekly amount received x 52 weeks), and

c is the average percentage of boarders in relation to the overall average number of occupants living in the domestic accommodation during the income year, and

d is the number of full weeks during which private boarding services were provided in an income year, divided by 52.

The standard-cost for boarding service providers is calculated inclusive of GST, if any.

This Determination is made by me, acting under delegated authority from the Commissioner of Inland Revenue.

This Determination is signed on the 14th day of November 2005.

Graham Tubb
National Manager
Technical Standards

COMMENTARY ON DETERMINATION DET 05/03

This commentary and its appendices do not form part of the Determination. They are intended to provide assistance in the understanding and application of the Determination.

This Determination and this commentary also appear in Tax Information Bulletin Vol 17 No 10 (December 2005).

Standard-cost basis and actual-cost basis

(a) In accordance with section 91AA(3) of the Tax Administration Act 1994, a boarding service provider may use the standard-cost basis to calculate their income tax liability for the elected income year.

(b) A boarding service provider elects to use the standard-cost basis by treating income from private boarding services as exempt income, either in a tax return or by electing not to file a tax return, up to but not exceeding the sum of standard-cost set in this Determination, for the relevant income year.

(c) The boarding service provider in any one income year, must adopt either the standard-cost basis or the actual-cost basis.

(d) In electing to use the actual-cost basis, a boarding service provider must keep sufficient records to support their tax position.

Income tax implications and filing of tax returns

The following income tax implications apply to a boarding service provider who provides a private boarding service and elects to use the standard-cost basis set out in the Determination.

(a) Section DA 2(3) of the Income Tax Act 2004 prohibits any actual tax losses above the level of the standard-cost from being utilised against other income for any income year or carried forward to future income years.

(b) In accordance with section CW 49 of the Income Tax Act 2004, a boarding service provider would not be required to file a tax return for that income year if:

   (i) after applying the amount of standard-cost under the Determination, and treating boarding income up to that level as exempt, the boarding service provider has zero income tax liability, and

   (ii) the boarding service provider does not have any other income where tax has not been deducted at source.

Standard-cost election

Form of election
A boarding service provider may elect to use the standard-cost basis in calculating their income for an income year. An election is merely a decision to use either the standard-cost basis or actual-cost basis for calculating assessable income, if any, for an income year. An election does not require notice to be given to Inland Revenue of which method is used to calculate a boarding service provider's income for an income year.

Timing of election
It is envisaged that many boarding service providers will make their election to use either the standard-cost or actual-cost basis at the beginning of an income year, as those who decide to use the actual-cost basis should prepare themselves to keep adequate records to support expenditure claimed at the end of the income year when filing a return. An election can be made at any time prior to filing a return. Should boarding service providers not provide a return of income by the due date for filing, it will be assumed they have elected to use the standard-cost option.

Consumers Price Index

To assist boarding service providers, Inland Revenue will publish the effect of the annual movement of the All Groups Consumers Price Index, as at the end of March each year, on the weekly standard-cost per boarder. The revised standard-cost component will be published in the *New Zealand Gazette* and in Inland Revenue's *Tax Information Bulletin*. This Determination uses information current as at March 2005.

The changes in the annual movement of the All Groups Consumers Price Index will not be applied to the annual capital standard-cost. This is because the basis for this component is either historical (where a boarding service provider owns their domestic accommodation) or market-related (where a boarding service provider rents their domestic accommodation).

An annual adjustment will be made as at March 2006 to the weekly standard-cost per boarder applicable for the 2007 income year.

Goods and services tax (GST)

As private boarding services are an exempt activity for GST purposes, boarding service providers will not be eligible to register for GST for this activity or claim back GST charged on goods and services consumed. Accordingly, the standard-cost components determined by the Commissioner have been prepared on a GST-inclusive basis.

Purchase price of domestic accommodation

The purchase price of a domestic accommodation will include any subsequent cost of capital improvement such as building an extension, but does not include the cost of general repairs and maintenance. Boarding service providers will be required to provide verification of capital improvements. The cost of improvements should be supported by receipts but may also be evidenced by local authority building consent applications detailing related costs, if applicable.

Current tax law allows deductions for expenditure to the extent such expenditure is incurred. Accordingly, boarding service providers are only permitted to use the purchase price and cost of capital improvements to a property; you cannot use current market or local body rateable values for the annual capital-cost calculation.

Family trusts

Where a domestic property is in a family trust occupied by the beneficiaries who provide boarding services, they may only calculate the standard-cost for the annual capital component based on any rent paid. Any rent claimed will be proportional to the period of boarding services provided and further limited to the proportion of boarders compared to the average number of household occupants. The rent claim will be calculated as follows:

$$\text{Rent claimable} = \frac{\text{annual rent paid}}{1} \times \frac{\text{service period}}{\text{52 weeks}} \times \frac{\text{number of boarders}}{\text{average household number}}$$

International students and the code of practice

Inland Revenue has used the code of practice for the Pastoral Care of International Students as the standard to ensure a sizable group of service providers are not denied the compliance cost reduction opportunities available under the standard-cost option.

Where five or more international students are accommodated as boarders, the domestic accommodation is a boarding establishment for the purposes and relevant standards of Code of Practice. The domestic accommodation may be viewed by Inland Revenue as a commercial dwelling. For example, a building required to be registered with local authorities under sec 636 of the Local Government Act 1974 as a residential institution will be considered a commercial dwelling by Inland Revenue.

Receipt of accommodation supplement by a boarding service provider

A boarding service provider may be entitled to an accommodation supplement. The Ministry of Social Development assesses each applicant's entitlement based on a set of guidelines. The assessment of entitlement takes into account such factors as accommodation costs, income, assets, family status, employment status and residential location. Where a boarding service provider is entitled to an accommodation supplement, the annual capital standard-cost will be reduced by the annual amount of the accommodation supplement received. The examples in Appendix C illustrate how the receipt of an accommodation supplement affects the calculation of the annual capital standard-cost for the use of domestic accommodation.

Number of occupants and number of boarders

Boarding service providers will need to record the period(s) during the year when they provide boarding services and the number of occupants in their household during those periods. This will allow them to correctly apply the rules relating to the annual capital standard-cost component. The calculation will involve a degree of rounding of the number of weeks for which boarding services were provided and (where family members come and go during the year) a fair estimate of the average number of occupants during that time.

Where a child (under 18 years) accompanies a parent or guardian in a private boarding service arrangement and there is no separate charge for keep of the child, they should not be counted as an occupant for the purpose of the annual capital standard-cost calculation.

Where a boarding service provider has a shared custody arrangement for a child over five years of age, the child should not be counted as an occupant for the purpose of the annual capital standard-cost calculation if they reside with the boarding service provider for less than half of the year. The same will apply where a dependent child is absent from the household while attending boarding school or living elsewhere for more than half of the year.

Children under five years of age should not to be counted as occupants (for the purpose of the annual capital standard-cost calculation) or as boarders (for the purpose of the weekly standard-cost calculations), where they are accompanying a parent or guardian boarding in a private boarding service arrangement. Similarly, any child under five years of age of the boarding service provider should not be counted.

Family visitors and guests accommodated without charge on a short-term stay are not counted as occupants for the purpose of the standard-cost calculation or as boarders for the weekly standard-cost calculations.

Reimbursements

Reimbursements for specific additional costs are not viewed as income nor are these costs viewed as an expense incurred by the boarding service provider, eg, payment received from the boarder for telephone toll calls.

Impact on previously accepted practice

Prior to the issue of Determination DET 05/03, boarding service providers may have applied the practice as published in *Tax Information Bulletin* Vol 5 No 9 (February 1994).

Determination DET 05/03 supersedes any previously accepted practice, which is now withdrawn. Boarding service providers, in calculating their income tax liability, must now elect to use either the standard-cost basis (as detailed in DET 05/03) or the actual-cost basis. In adopting the actual-cost basis, boarding service providers must also ensure sufficient records are kept to support their claimed tax position.

Returning income

The standard-cost components will assist the majority of boarding service providers to readily identify if they are required to return assessable income. The flowchart on the next page outlines the use of the standard-cost basis. The flowchart also shows the key stages when boarding service providers should give consideration to an election on whether to use the standard-cost or actual-cost basis.

When total payments received exceed the aggregate annualised value of weekly and capital standard-cost for the income year, boarding service providers are required to return the excess as assessable income.

Inland Revenue will accept, where there is more than one host providing boarding services, the returning of assessable income by the boarding service provider who is most directly involved on a day-to-day basis. This is to minimise compliance costs by only requiring one householder to file the return.

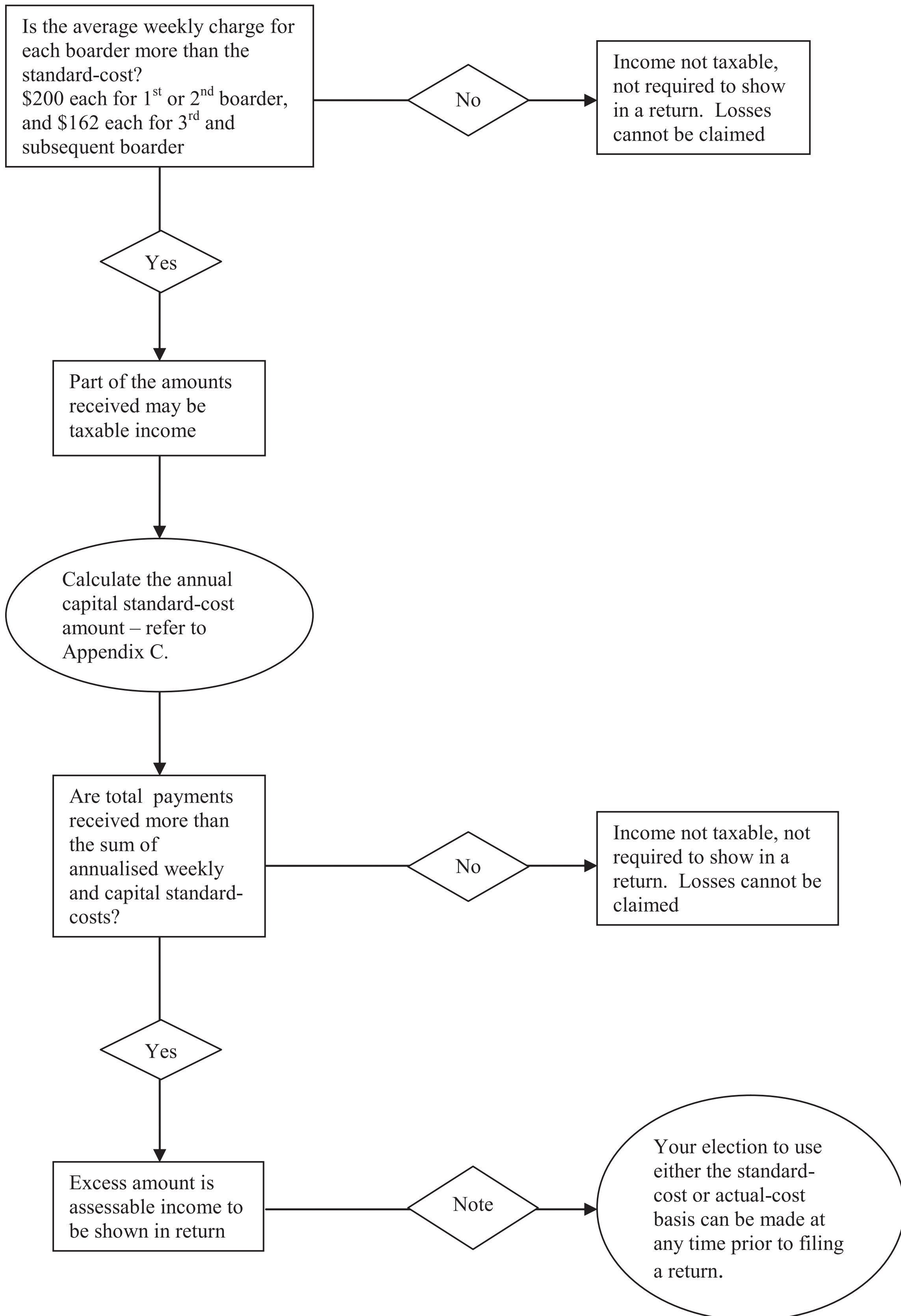
Where boarding service providers elect to claim expenditure on the actual-cost basis, they will be required to show all payments received as income and claim actual expenditure incurred in a return of income. In addition, they are required to keep sufficient records to support their tax position.

Standard-costs as determined

Determination DET 05/03 sets out the components of standard-costs that are likely to be incurred by boarding service providers. The standard-costs are determined based on special tax rules as provided for under current tax law. They are to be used for tax purposes only and cannot be used for any other purpose. The determined weekly standard-costs are not intended as any guide to the amounts which taxpayers can or should charge on a weekly basis, but rather reflect the maximum expenditure recognised by Inland Revenue as likely incurred by boarding service providers. Uniform weekly standard-cost rates are applied nationally to maintain simplicity and minimise tax compliance costs but it is accepted that there may be significant variations in the circumstances and amounts charged.

Should boarding service providers consider that the standard-cost components do not reflect the higher costs incurred in their situation, they may elect to use the actual-cost basis. They must keep sufficient records to support their tax position.

The variance in weekly standard-cost rates for smaller households with one to two boarders versus households with three or more boarders, acknowledge that larger households are more economical to operate when looking at costs incurred on average for each person. The weekly standard-cost rates are based on average costs, which are set on the higher end in favour of boarding service providers.


Do I have to return income?
Is the average weekly charge for each boarder more than the standard-cost? $200 each for 1st or 2nd boarder, and $162 each for 3rd and subsequent boarder
No
Income not taxable, not required to show in a return. Losses cannot be claimed
Yes
Part of the amounts received may be taxable income
Calculate the annual capital standard-cost amount – refer to Appendix C.
Are total payments received more than the sum of annualised weekly and capital standard-costs?
No
Income not taxable, not required to show in a return. Losses cannot be claimed
Yes
Excess amount is assessable income to be shown in return
Note
Your election to use either the standard-cost or actual-cost basis can be made at any time prior to filing a return.

APPENDIX A

Part I WEEKLY STANDARD-COST PER BOARDER

Average weekly standard-cost specific to a boarder in a domestic household		
Type of expenditure	Standard-cost for **each** boarder	
	1st and 2nd boarder	3rd and subsequent boarder
Food	80.00	80.00
General household items	3.45	2.04
Heating and power	20.00	20.00
Transport costs	45.85	21.46
Bedroom chattels & linen	12.20	12.20
General household chattels	12.50	6.25
Telephone rental	5.00	Nil
Incidentals	15.00	15.00
Total standard-cost per boarder per week – March 2004	$194.00	156.95
Adjusted in accordance with the annual movement of the All Groups Consumers Price Index for the twelve months to March 2005, which showed an increase of 2.8%.	$200.00 ($199.43 rounded up)	$162.00 ($161.34 rounded up)

Explanation of the weekly standard-cost expenditure items

With the exception of bedroom and general household chattels, the weekly standard-cost items have been calculated based on statistical data from Statistics New Zealand. The level of costs arrived at takes into account the operation of economies of scale in relation to the size of a household.

Food – This covers the cost of food and includes such items as fruit, vegetables, meat, poultry, fish, farm products, fats, oils, cereals, sweet products, spreads, beverages, meals away from home, ready-to-eat meals and other foodstuffs.

General household items – These cover household supplies for general cleaning and laundry products, toilet paper and other similar items.

Heating and power – These cover the use of all appliances including the cost of heating, lighting, cooking and hot water. It includes other heating fuels such as gas, wood and coal.

Transport costs – These cover the costs of providing transportation to boarders using public transport and road vehicles, and include vehicle ownership expenses.

Telephone rental – This covers a 50% claim for a primary telephone rental, consistent with business use of a home phone, as published in *Tax Information Bulletin* Vol 5 No 12 (May 1994).

Bedroom chattels and linen – These cover the straight line depreciation of a bed, student desk and chair, carpet, drapes, portable heater, electric blanket, bed linen, bathroom linen provided for a boarder’s personal use. Further details are provided in Part II of this appendix.

General household chattels – These cover the straight-line depreciation of a lounge suite, television, dining suite, dishwasher, washing machine, stove, microwave, crockery and cutlery items in general living areas used by boarders. This is further explained in Part II of this appendix.

Incidentals – These cover miscellaneous expenditure such as gifts, leisure and entertainment activities provided by service providers to boarders.

Part II STANDARD-COST FOR THE USE OF CHATTELS

Provision for wear and tear of bedroom and general household chattels is included as part of the weekly standard-cost per boarder, as detailed in Part I of this appendix.

Chattels listed are those likely to be subject to greater wear and tear due to additional use by boarders. The values of the chattels reflect product ranges likely to be found in the average home, based on their current market purchase prices.

Standard-cost for the use of chattels – *Bedroom chattels and linen*

Category/item	Standard value	Straight-line depreciation rate	Approximate annual cost	Standard-cost calculation
Bed (single)	500	12.5%	62.50	$634.75 ÷ 52 weeks = $12.20 pw each boarder.
Dresser/drawer unit	400	12.5%	50.00	
Student desk and chair	250	12.5%	31.25	
Drapes	200	15.5%	31.00	
Carpet	500	24%	120.00	
Heater (portable)	100	40%	40.00	
Electric blanket	150	40%	60.00	
Bathroom linen	100	40%	40.00	
Bed linen, blankets, covers	500	40%	200.00	
			$634.75	

The weekly standard-cost for the use of general household chattels has been apportioned to 50% ($12.50 weekly for each boarder, up to two boarders) for situations where only one or two boarders are hosted, whereas the apportionment for the third and subsequent number of boarders is reduced to 25% ($6.25 weekly for the third and subsequent number of boarders). The apportioned weekly amounts are relative to the average household of three persons (2001 census).

Standard-cost for the use of chattels – *General household chattels*

Category/item	Standard value	Straight-line depreciation rate	Approximate annual cost	Standard-cost calculation
Dining suite	1,500	12.5%	187.50	Rounded up to $1,300 = $12.50 pw each for the first two boarders and reduced to $6.25 pw for the third and subsequent number of boarders.
Lounge suite	3,000	12.5%	375.00	
Stove	1,200	15.5%	186.00	
Microwave oven	300	18%	54.00	
Washing machine	1,000	18%	180.00	
Television	700	24%	168.00	
Crockery	200	40%	80.00	
Cutlery	100	40%	40.00	
			$1,270.50	

APPENDIX B

EXAMPLES OF THE APPLICATION OF WEEKLY STANDARD-COST FOR BOARDING SERVICE PROVIDER

Example B1

A boarding service provider owns a domestic property, which costs $200,000. The boarding service provider receives an accommodation supplement of $10 per week based on the location of the domestic property and their individual circumstances. One boarder pays $180 per week for accommodation over a full year. There are no other private boarders.

The boarding service provider elected to use the standard-cost basis in accordance with this Determination. As the weekly service payment received is less than the determined weekly standard-cost per boarder of $200, they are not required to return the income.

Example B2

A boarding service provider rents a domestic property for $300 per week. The boarding service provider receives an accommodation supplement of $20 per week based on the location of the domestic accommodation and their individual circumstances. One boarder pays $180 per week for accommodation over a full year. There are no other private boarders.

The boarding service provider elected to use the standard-cost basis in accordance with this Determination. As the weekly service payment received is less than the determined weekly standard-cost per boarder of $200, they are not required to return the income.

Example B3

Sharon lives at home and pays her parents $120 per week for board. There are no other private boarders. As the payment for board is less than the weekly standard-cost per boarder of $200, it will be exempt income and no tax liability arises for her mother for boarding service provided.

APPENDIX C

EXAMPLES OF THE APPLICATION OF THE WEEKLY STANDARD-COST AND ANNUAL CAPITAL STANDARD-COST FOR BOARDING SERVICE PROVIDERS

(Note: All the calculations are rounded to the nearest dollar)

Example C1

A boarding service provider owns a domestic property. The purchase price of the domestic property is $200,000. The boarding service provider receives an accommodation supplement of $10 per week based on the location of the domestic property and their individual circumstances. One boarder is accommodated for $250 per week for a full year, in a household of four occupants (including the boarder). As the weekly rental exceeds the standard-cost, it is necessary to also calculate the annual capital cost component. The annual capital standard-cost per annum is:

[($200,000 x 5%) – ($10 x 52)] x 25% x 52/52 = $2,370

Example C2

A boarding service provider rents a domestic property. The rent is $200 per week. The boarding service provider receives an accommodation supplement of $20 per week based on the location of the domestic accommodation and their individual circumstances. One boarder is accommodated for a full year for $250 per week, in a household of four occupants (including the boarder). The annual capital standard-cost per annum is:

[($200 x 52) – ($20 x 52)] x 25% x 52/52 = $2,340

Example C3

A boarding service provider owns a domestic property that was purchased 20 years ago for $120,000. They do not receive an accommodation supplement. Two boarders are accommodated for the same period of six months (26 weeks) during the year, in a household of four occupants (including the two boarders). Both boarders each pay $250 weekly for the services provided.

The boarding service provider elected to use the standard-cost basis. As the weekly service payments received are greater than the weekly standard-cost figure of $200 for each boarder, it is necessary to calculate the annual capital standard-cost component to establish if assessable income should be returned.

The boarding service provider’s income tax liability is calculated as follows:

Income ($250 x 26 x 2)	$13,000
Less: Weekly standard-cost ($200 x 26 x 2)	$10,400
	$2,600
Less: Annual capital standard-cost [($120,000 x 5%) – $0] x 50% x 26/52	$1,500
Income to be returned	$1,100

Example C4

A boarding service provider owns a domestic property, which cost $275,000. They do not receive an accommodation supplement. Three boarders live in the household at different periods of the year. One permanent boarder pays $200 per week over 12 months and two boarders each pay $250 per week for six months (26 weeks) in the second half of the year. The overall household of three occupants (including the permanent boarder) increases to five occupants in the latter half of the year.

The boarding service provider's income tax liability is calculated as follows:

Income ($250 x 26 x 2) = $13,000 ($200 x 52 x 1) = 10,400		$23,400.00
Less: Weekly standard-cost		
($200 x 52) permanent boarder	$10,400	
($200 x 26) second boarder	5,200	
($162 x 26) for third boarder	4,212	
		$19,812.00
		$3,588.00
Less: Annual capital standard-cost		
[($275,000 x 5%) – 0] x 33% x 26/52 = $2,268.75		
[($275,000 x 5%) – 0] x 60% x 26/52 = $4,125.00		$6,393.75
		($2,805.75)
Income to be returned		Nil

Note that the apparent tax loss based on this calculation is not deductible against other income of the taxpayer or carried forward to future years.

Example C5

John provides boarding services to Joan and her four-year old son. John's partner and their two children each under five years old also occupy the household. As the three children are under five years, they are not counted as occupants for the purpose of the standard-cost calculation. John and his partner purchased their home for $150,000 ten years ago. No accommodation supplement is received.

In this situation, one boarder pays $240 per week for accommodation over a full year, in an overall household treated as consisting of three occupants (including the boarder). As the weekly service payment received is greater than the determined weekly standard-cost figure of $200, John will need to calculate the annual capital standard-cost component to establish if he or his partner is required to return income.

The boarding service provider's income tax liability is calculated as follows:

Income ($240 x 52)	$12,480
Less: Weekly standard-cost ($200 x 52)	$10,400
	$2,080
Less: Annual capital standard-cost	
[($150,000 x 5%) – 0] x 33% x 52/52	$2,475
	($395)
Income to be returned	Nil

Note that the apparent tax loss based on this calculation is not deductible against other income of the taxpayer or carried forward to future years.

Example C6

Rosanne purchased a home for $400,000 and had two groups of four students boarding with her between January to June (23 weeks), and July to December (23 weeks). Each boarder was charged $280 weekly during their stay.

The boarding service provider's income tax liability is calculated as follows:

Income ($280 x 23 x 4 x 2)	$51,520
Less: Weekly standard-cost ($200 x 23 x 2 x 2) = $18,400 ($162 x 23 x 2 x 2) = $14,904	$33,304
	$18,216
Less: Annual capital standard-cost [($400,000 x 5%) – 0] x 80% x 46/52	$14,154
Income to be returned	$4,062

Note: If Rosanne's tax to pay is $2,500 or more, she will also have to pay provisional tax for the following year.

Example C7

A not-for-profit organisation purchases a motel and employs a manager to provide care for forty students, occupying the motel units as boarders. The manager lives on site and arranges for meals to be delivered to the students in his care. The use of the motel to provide boarding services for the students has been approved by the local council as a residential institution. The manager enquires whether the Determination can be applied to the above situation.

The Determination is not available to the boarding service provider, for the reasons below:

- The not-for-profit organisation is not a natural person
- The residential establishment does not fit within the scope of a domestic dwelling.

The activity run by the not-for-profit organisation will likely be viewed by Inland Revenue as a commercial boarding house. All payments should be returned as income and allowable expenditure claimed, with sufficient records to support the tax position. If total payments received for the boarding services exceed $40,000 for any twelve month period, the service provider will also be required to register for GST purposes.

Correction

DAIRY FARM MILKING SHED BUILDING, PLANT AND MACHINERY – GENERAL DEPRECIATION DETERMINATION

In the item published under the section "Legislation and determinations" in *Tax Information Bulletin* Vol 17, No 8 (October 2005), p 5, under "2. Determination", the deleted general asset class for milking machinery, its estimated useful life, and diminishing value and straight-line depreciation rates (in the table in the first bullet point) was incorrectly duplicated in the table in the third bullet point.

The table in the third bullet point should read:

Dairy Plant	Estimated useful life (years)	DV banded dep'n rate (%)	SL equiv banded dep'n rate (%)
Milk storage vat/silo (on farm)	15.5	12	8
Compressor (refrigerant) (on farm)	12.5	15	10

LEGAL DECISIONS – CASE NOTES

This section of the TIB sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, Privy Council and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision. Where possible, we have indicated if an appeal will be forthcoming.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

COMMISSIONER OBTAINS MAREVA INJUNCTION

Case:	Chesterfield Preschools Ltd & Ors v The Commissioner of Inland Revenue
Decision date:	13 September 2005
Act:	High Court Rules
Keywords:	Mareva Injunction, solicitor's undertaking

Summary

The Commissioner obtained a Mareva Injunction against the plaintiffs in a judicial review, and against third parties. He also obtained a Court-directed solicitor's undertaking. The Court also critiqued the recent *Vinelight* decision in regards to the Commissioner's statutory powers and the Court process.

Facts

The Commissioner is endeavouring to recover a sum of $3 million from a number of different legal entities and persons including the plaintiffs in this proceeding. All of these persons are united by being members of the Hampton family, or being trusts or corporate entities formed by the Hampton family. The most important person within these proceedings is Mr David John Hampton.

The sum of $3 million has accumulated over a number of years, which has built up through various defaults, whether as to paying GST or other payments and accumulating penalties.

This application was to seek Mareva Injunctions against the plaintiffs, their directors and officers, employees, agents, family members or otherwise to restrain them from disposing or encumbering or otherwise dealing with in any way their money or other assets, whether in their own names or not and whether solely or jointly up to a value of $3 million. This includes orders against the following non-parties:

- the parents of DJ Hampton in respect to a property which was originally owned by their son and then transferred to his parents recently, and
- DJ Hampton's sister, Mrs Susan Stikkelman, who owns the business known as Chesterfield Preschools Ltd which, again, was owned by Mr Hampton but was transferred to Mrs Stikkelman.

Ancillary orders were sought for all parties and non-parties to disclose, by affidavit, the whereabouts of their assets.

There is a substantial history of the family members moving assets into different vehicles within the family, which raises the risk of the assets being disposed or dissipated. The sale of property by DJ Hampton to his parents and his sister (a transfer that is questionable, and the Court accepted could turn out to be a sham) are of particular interest.

The plaintiffs said that real property was held by DJ Hampton as trustee in the Anolbe Family Trust, then transferred to his parents partly due to his father's ill health and a wish for his parents to be settled in the property, which they had lived in prior to an attempt to sell the property on the open market, by auction, which did not proceed.

The Crown was seeking charging orders under r 567 HCR, over a number of real estate properties under the control of the plaintiffs. The plaintiffs argued that this was an abuse of the Court process as there is another statutory remedy available to the defendant under section 157 of the Tax Administration Act 1994.

Decision

Based on the lack of documentary evidence the Judge felt that there was a real issue around whether the represented advances that may have been made by Mr Hampton's parents to him for his family and may not, on strict analysis, be advances made for the benefit of the beneficiaries of the Anolbe Family Trust. It raised a question as to whether the real property was transferred to his parents to give them peace of mind, given the stressful situation they are in due to the grave illness of his father.

On this, the Judge said he was not satisfied that this was an ordinary inter-family transaction.

The Commissioner was successful in his application for a Mareva Injunction against Mr Hampton, his parents and sister based on the pattern of behaviour shown by Mr Hampton and his family and entities. The Judge felt that there was no real risk of the plaintiffs acting dishonestly in a personal sense but would be capable of entering into ingenious transactions, no doubt believing that they were within the law and therefore it being legitimate, but also have the consequence of making it difficult for the Commissioner to enforce tax liabilities and collect tax.

A Mareva Injunction was not ordered against Ms Sisson (Mr Hampton's former wife and a member of his trading partnerships) as she is a barrister and solicitor in practice and therefore an officer of the Court. In that case, Justice Fogarty sought a personal undertaking by her as to the aspect of the conduct of her practice which involved these parties.

It was argued that application for the Mareva Injunction appeared to rely on the defendant's notices or investigations under section 17 of the Tax Administration Act 1994 and this was an abuse of the use of section 17 and of the Court process. Section 17 is a mechanism of obtaining and producing for inspection:

> *..... any books or documents which the Commissioner of Inland Revenue considers necessary or relevant for any purpose relating to the administration and enforcement of any of the Inland Revenue Acts* (Emphasis added)

The plaintiffs submitted that use of the section 17 information in civil proceedings was an abuse of process regardless of whether it was for the Judicial Review or the Mareva order. In a recent decision, (*Vinelight Nominees Ltd v The Commissioner of Inland Revenue* (High Court) Auckland CIV-2005-404-2774, 14 July 2005) Justice Simon France held:

> [52] Section 17 is broad in its wording but its use after proceedings have been commenced must be consistent with s27(3) of the New Zealand Bill of Rights Act 1990.

Justice Fogarty considered *Vinelight* but came to a different conclusion to hold that, in this case, the Commissioner was correct in using section 17, or inferentially have section 17 as a backstop, in order to obtain the information it had gathered to support the application for a Mareva Injunction. A detailed discussion of the principles applied by Justice Fogarty is found at paragraph 26 to 46 of the judgment.

The Commissioner was unsuccessful in obtaining a charging order due to the evidence presented to the Court, had not, by fact, satisfied the test to issue a charging order. The language of r 567 is emphatic in saying that such an order shall be granted only on "*proof that the opposite party with intent to defeat is making away with property*."

The Judge was not satisfied that this was the only remedy available to the Commissioner to secure payments. The Commissioner was reserved leave to reapply if he could assemble a stronger case on the facts.

COMMISSIONER LOSES APPEAL

Case:	Commissioner of Inland Revenue v Wellington Regional Stadium Trust
Decision date:	6 September 2005
Act:	Income Tax Act 1994, Local Government Act 2002
Keywords:	Council Controlled Trading Organisation

Summary

The Wellington Regional Stadium Trust was held not to be a Council Controlled Trading Organisation.

Facts

In August 1993 the need for a new sports stadium in the Wellington region was identified and the Wellington Regional Council (WRC) arranged a meeting. Subsequently, various preliminary studies were undertaken. In September 1994, the Wellington Regional Stadium Trust (WRST) steering group was established on the initiative of the Wellington City Council (WCC). In November 1995, the Wellington Regional Stadium Development Trust (Trust) was established. The Trust obtained a commitment for funding from WCC. In August 1995, WRC also agreed to provide funding, subject to the passage of special legislation to allow WRC to provide the funding and to allow the appropriate management of the project and to the risks of the project being appropriately managed. Special legislation was promoted and a local Act, the Wellington Regional Council (Stadium Empowering) Act 1996 (the Empowering Act) was passed on 2 September 1996.

That Act:

- enabled WRC to lend up to $25million to the WRST, on such terms and conditions as WRC thinks fit, and
- provided that the trust was to be registered under the Charitable Trust Act 1957
- the trust deed had to contain provisions in sections 225F to 225J of the Local Government Act 1974 ("LGA 1974").

On 19 November 1997 the WRST was established pursuant to a trust deed in December 1997 and was registered under the Charitable Trusts Act 1957. Funding of $40 million, out of a total of $131 million total funding

required to build the stadium was provided by WCC ($15 million) and WRC ($25 million) by way of interest-free, subordinate, limited-recourse loans. A $33 million loan on commercial terms was also made by ANZ Bank to the Trust. Sales of corporate boxes, membership, naming rights, signage, sponsorships and grants from the Lottery Board and the Community Trust of Wellington provided the remaining funding.

In January 2002 the Commissioner informed the WRST that its charitable status had ceased on 31 March 1999 as a result of changes to LGA 1974 and to the Income Tax Act 1994. The WRST issued these proceedings to clarify its status.

Decision

The Empowering Act

The Court of Appeal considered that the regime of the WRST set up by the Empowering Act is modelled on the Community Trust regime in the LGA 1974 and the Empowering Act imports that regime to the extent it is not inconsistent with the Empowering Act itself. As the community trust regime is separately provided for in the LGA 1974 and the LGA 2002 with its own accountability regime, it is clear in the Court's view that the CCO and CCTO regime is not intended to apply to community trusts. As it is the community trust regime that was imported into the Empowering Act, the Court did not consider that the Empowering Act envisages the WRST being subject to the CCO and CCTO provisions either.

The Court accepted that provisions of the Empowering Act were a code.

In addition, the Court did not accept that it was possible to treat entities that are clearly outside the CCTO regime as nevertheless coming within the income tax provisions that were specifically designed for that CCTO regime.

The CCTO definition

The Court of Appeal held that the High Court was correct to hold that the WRST does not operate a trading operation for the purpose of making a profit.

The Court of Appeal considered that:

(a) *Plimmer* and *Walker* were not overruled by *National Distributors* or by *Holden and Hunter*. The distinction between "intention" and "purpose" is important in the income tax context, as well as in other contexts, including GST and competition law.

(b) The omission of the word "intention" from LGA 2002 clarifies the definition.

(c) The purpose of the WRST's promoters, as provided for in the legislation, the Trust Deed and the Funding Deed, cannot be sensibly be separated from the purpose of the Trust itself. The legislation and the Trust Deed form the foundation of the WRST and have an ongoing effect.

(d) Once the Stadium was built, the statutory purpose of the WRST was limited to the ownership, operation and maintenance of the Stadium as a multi-purpose sporting and cultural venue–see section 6(2)(a) of the Empowering Act. Any additional functions must be exercised for the benefit of the public of the Wellington region and are ancillary to the functions set out in section 6(2)(a) and section 6(2)(b) of the Empowering Act which means as held by the High Court that clause 3.1(c) of the Trust Deed is subordinated to clause 3.1(a) and (b).

(e) The Court of Appeal agreed with the High Court that the fact that the WRST had an operating surplus and that it operated in a businesslike manner are insufficient in themselves to mean that its purpose must be profit-making.

(f) The evidence and the nature of the funding arrangements themselves reinforced the view that the WRST's purpose is not profit-making. While there is no doubt that the WRST makes operating surpluses, this is only possible because of the totally non-commercial funding terms. The funding is interest free and limited recourse and the evidence was that the WCC and WRC regard the possibility even of a return of capital as distant.

Was the WRST a LATE?

Though the question "Whether or not the Trust was a local authority trading enterprise (LATE) under LGA 1974" was not before the Court it was decided that it should briefly be dealt with. The main aim of the introduction of the LATE regime was to put commercial enterprises undertaken by local authorities on a competitively neutral basis with the private sector and the taxation of LATEs was a vital part of that strategy.

The Court of Appeal agreed with the High Court that the WRST was within the class of organisation that the amended definition of LATE in LGA 1974 was meant to exclude.

The Court did not consider that the mere intention to make operating surpluses is sufficient for a trading undertaking to be operating with the intention or purpose of making a profit in terms of the LGA 1974. The WRST could never operate on proper commercial terms, it only makes operating surpluses because of funding on non-commercial terms, it cannot distribute its profits, it is charitable and not competing in any meaningful sense with any private sector organisation. The Court accepted that the WRST did not come within the definition of the LATE in the LGA 1974 as it was amended in 1999.

The Commissioner's appeal was dismissed.

SOLICITOR BREACHES UNDERTAKING

Case: The Commissioner of Inland Revenue v Manu Chotubhai Bhanabhai & Ors

Decision date: 5 October 2005

Keywords: Solicitor's Undertaking

Summary

Breach of Solicitor's Undertaking. Damages, costs and interest awarded to the Commissioner

Facts

The defendants were barristers and solicitors acting for two companies, Nautilus Developments Limited ("NDL") and Golden Gate Holdings Limited ("GGH"). Both companies were involved in a construction project of a block of residential apartments in Hobson Street, Auckland.

During the construction of the apartments GGH was entering into contracts for the sale and purchase of the apartments, with a deposit being required to be paid by the purchaser when entering the contract, and the balance being payable on completion of the unit and the title being available. There was an initial dispute between the companies and the Commissioner as to the time of supply and when the payment of GST was triggered. On 17 April 1997 the matter was finally resolved between the parties and it was agreed that GST would be payable on settlement in respect of the units with contracts entered into prior to July 1996. GST on agreements after July 1996 was to be accounted for on the basis of the normal time of supply rules, being the receipt of the deposit (July 1996 being the date on which the company had received a letter outlining an original proposal for agreement).

To ensure that GST payments in respect of the pre-July 1996 contracts was actually paid on settlement, an undertaking was required to be given by the defendants, and it was given, signed by Mr Bhanabhai. The undertaking given on 17 April 1997 was written in the following terms:

> "We are the solicitors for Golden Gate Holdings Ltd. We have been instructed to settle the sale of the units in the development and we undertake that on settlement of units 3F, 5A, B, C, D, E, F, 6A, B, C, D, E and F, we will forthwith pay to you the GST component of the sale consideration."

UDC was the principal lender to the development. On 10 June 1999 GGH went into liquidation, NDL had already been liquidated in September 1998.

The liquidator, Mr Montgomerie, issued proceedings against the Directors of NDL seeking to recover over $2 million on behalf of the unsecured creditors, including over $1 million claimed by the Commissioner. This proceeding was later settled for $500,000. The settlement monies were sufficient only to cover the liquidator's costs and no dividends were paid to the creditors.

The undertaking of 17 April 1997 was not met and the Commissioner sought an order that the defendants pay the GST which it undertook to pay or damages for the equivalent sum.

The defendants further filed a third party claim against their insurers, Vero Insurance New Zealand Limited ("Vero"), claiming indemnity, should any liability be found against them, pursuant to their professional liability insurance. Vero denied liability under the policy.

Decision

Laurenson J found for the Commissioner. He found that there was little doubt that the letter of 17 April was an undertaking. He found that the defendants were undertaking to pay monies to the Commissioner which they expected to receive on behalf of their client on the settlement of the units. Their liability arose from the receipt of the client's money, not from the client's pre-existing liability to pay GST. He held that the terms of the defendants' undertaking were clear and were given by the defendants deliberately as a personal undertaking to make payment of monies to be received when settlement took place. Mr Bhanabhai's evidence was rejected in relation to this matter.

Laurenson J further found that the defendants' undertaking was not absolved by the concession made by the Commissioner to allow further time for the settlements to take place. He found it was not credible that the undertaking was given on condition that payments to the Commissioner were subject to repayment to UDC first.

Laurenson J also found that the Commissioner's decision to await the outcome of the two liquidations and the proceedings of the claim by the liquidator did not entitle the defendants to consider that the undertaking had ceased to be effective.

There was a defence raised that the Commissioner was estopped from claiming under the undertaking because the debt sought to be recovered was part of the same debt in the liquidators earlier proceedings. This was rejected.

There was the further issue as to what form of relief to be given, following the findings in favour of the Commissioner. Laurenson J declined to order the defendants to perform the undertaking as he found that it would now be impossible to perform as the monies from the settlement of the units have long gone. They were mainly paid to UDC. However, he found that Mr Bhanabhai had acted inexcusably in his position as a solicitor. Mr Bhanabhai did not honour the undertaking as he was more concerned to protect his own position as an investor and guarantor in the companies. Accordingly, the Court was entitled to consider compensation and the amount of $300,000 was awarded. This reflected the

contribution already made by Mr Bhanabhai towards the liquidator's settlement. Costs and interest were also awarded to the Commissioner.

With regard to the claim against Vero, Laurenson J found that the policy did not apply as notwithstanding that the claim arose out of a trading loss, Mr Bhanabhai was fully involved in the management of the companies in his capacity as director, albeit in conjunction with the other directors. Accordingly, the exclusion clause applied, being that there is no indemnity under the policy for a claim "arising from a trading loss or trading liability incurred by a business managed by or carried on by the Insured".

Laurenson J went on to consider that a further exclusion clause applied, being that there is no indemnity for dishonest conduct. His Honour found that Mr Bhanabhai's failure to advise the Commissioner before the sales that he could not meet the undertaking was dishonest and deliberate.

COMMISSIONER'S DECISION REVIEWED

Case:	Claire Avon Rae Hollis v The Commissioner of Inland Revenue
Decision date:	6 October 2005
Act:	Tax Administration Act 1994
Keywords:	Judicial Review, Late Notice of Proposed Adjustment, Exceptional circumstances

Summary

No ground of judicial review existed in relation to the Commissioner's decision to not accept the plaintiffs NOPA which was filed outside the statutory response period.

Facts:

This was a Judicial Review of the decision of the Commissioner to refuse to accept the late filing of a Notice of Proposed Adjustment ("NOPA") under section 89K of the Tax Administration Act 1994 ("the TAA").

Prior to 2004 the plaintiff had been in dispute with the Accident Compensation Corporation ("ACC") over entitlement to compensation. During the 2004 income tax year the dispute was resolved and the plaintiff was granted employment-related compensation from ACC.

While the payment was made in two lump sums they effectively related to an earlier period of years. After discussions between the plaintiff and the Commissioner, the Commissioner agreed to allow the ACC payments to be allocated back into the years in which they effectively related, rather than in the year they were received.

Following this decision the plaintiff's Tax advisors, Coffey Davidson Limited, filed income tax returns reflecting this agreement for the income tax years ended 31 March 2000 through 2004 inclusive.

Following the filing of these income tax returns the Commissioner issued notices of assessment with respect to the income tax years ended 31 March 2000, 2001 and 2002 and income statements for the 2003 and 2004 income tax years.

These notices of assessment and income statements were issued by the Commissioner to the plaintiff's tax agents. The plaintiff's tax agents however, failed to pass these on to the plaintiff until around two months after they were originally issued by the Commissioner.

Having finally received the relevant information from her tax agents, the plaintiff prepared a NOPA for the 2000 through 2004 income tax years inclusive, which was then issued to the Commissioner along with a covering note requesting that the NOPA be accepted despite being issued outside the statutory response period required by the TAA.

For all save the 2004 income tax year, the NOPA was issued outside the two month statutory response period. Because of the operation of Part III of the TAA no assessment for the 2004 year has yet been made and as such the plaintiff will have two months to challenge that assessment by NOPA once such an assessment is made.

For the 2000 through 2003 income tax years a number of grounds were raised by the plaintiff in support for having her late NOPA accepted. These included:

a. The fact that the plaintiff was awaiting a Court of Appeal decision and other reviews and appeals relating to her entitlement to a benefit and ACC, which might affect her tax position and assist her.

b. Her tax agents, her accountants, did not pass on the relevant notice of assessment and income statements until the two month response period had expired or practically expired.

c. There was a dispute between herself and the Commissioner as to the correctness of the income tax returns.

d. The Commissioner should allow the underlying merits of the plaintiff's case to be heard and resolved.

e. Judge Barber (of the Taxation Review Authority) had previously made comments about the need for a liberal approach to be given to the interpretation of exceptional circumstances.

The Commissioner, through a duly delegated officer, concluded that none of these reasons constituted exceptional circumstances.

Decision

His Honour found for the Commissioner after working through the following submissions made by the plaintiff.

The plaintiff's first submission revolved around the difficulty of potentially different decisions on her tax liability for the 2004 income tax year, compared to her 2000 through 2003 income tax years. This arose as all parties agreed the plaintiff still had the right to NOPA the 2004 income tax year after the Commissioner makes a formal assessment for that year.

The plaintiff made the point that if she is successful in disputing her 2004 income tax assessment there will be conflicting tax liabilities for the 2000 through 2003 income tax years as all the years relate to exactly the same issues. Basically, the plaintiff submitted this was an exceptional circumstance.

His Honour noted that the plaintiff had never put this point to the Commissioner in support of her argument for exceptional circumstances. In any event His Honour noted that as counsel for the Commissioner had pointed out, if the plaintiff was successful in her dispute over her 2004 income tax year she would be able to apply to the Commissioner under section 113 of the TAA to have her earlier income tax years amended accordingly. Therefore, this was not a ground of review for the plaintiff.

His Honour then dealt with a number of submissions made by the plaintiff relating to the circumstances by which she was late in filing her NOPA.

His Honour concluded it was clear that the plaintiff did not formally know about the notices of assessment and income statements until her accountants had finally passed them on to her.

His Honour noted that once the plaintiff had received the notices, she called Inland Revenue and spoke to an employee who told her, that despite being out of time or almost out of time, there may have been grounds to justify exceptional circumstances.

His Honour again noted that the plaintiff had never put this point to the Commissioner in support of her argument for exceptional circumstances. Furthermore, the plaintiff did not claim to have been misled by this information nor did she claim that it had delayed her in issuing her NOPA.

His Honour concluded that although it is unwise for Inland Revenue employees to give such advice, on the facts of this case it did not provide a ground of review.

His Honour also concluded that although the plaintiff had not raised any substantive grounds of review she did nevertheless have an effective remedy in this case. That was to proceed through with the dispute in relation to the 2004 income tax year and if she was successful with this, she could apply to the Commissioner under section 113 of the TAA to have her 2000 through 2003 income tax years amended accordingly.

REGULAR FEATURES

DUE DATES REMINDER

January 2006

16 GST return and payment due

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

31 GST return and payment due

February 2006

7 End-of-year income tax

- **7 February 2006**

  2005 end-of-year income tax due for people and organisations with a March balance date and who do not have an agent

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

28 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendars 2004–2005* and *2005–2006*. These calendars reflect the due dates for small employers only—less than $100,0000 PAYE and SSCWT deductions per annum.

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

This page shows the draft binding rulings, interpretation statements, standard practice statements and other items that we now have available for your review. You can get a copy and give us your comments in these ways.

By post: Tick the drafts you want below, fill in your name and address, and return this page to the address below. We'll send you the drafts by return post. Please send any comments in writing, to the address below. We don't have facilities to deal with your comments by phone or at our other offices.

By internet: Visit **www.ird.govt.nz**
On the homepage, click on "Public consultation" in the right-hand navigation bar. Here you will find links to drafts presently available for comment. You can send in your comments by the internet.

Name ____________________

Address ____________________

____

Draft standard practice statement	***Comment deadline***
☐ ED 0081: Writing off tax debt	19 January 2006
Draft operational statement	***Comment deadline***
☐ ED 0084: GST treatment of supplies of telecommunications services	19 January 2006
Draft question we've been asked	***Comment deadline***
☐ ED 0085: Records for controlled foreign companies or foreign investment funds to be available in English	31 January 2006

No envelope needed—simply fold, tape shut, stamp and post.

Put stamp here

Public Consultation
National Office
Inland Revenue Department
PO Box 2198
Wellington

INLAND REVENUE NATIONAL OFFICE PO BOX 2198 WELLINGTON TELEPHONE (04) 498 5800