TAX INFORMATION BULLETIN

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

The website 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, details and the number recorded at the bottom of the mailing label.

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 31 August 2006.

Ref.	Draft type	Description
QB0046	Question we've been asked	Tax treatment of wooden scaffolding planks
DDG0104	General depreciation determination	"Builders' planks" used in the determination building and construction industries
DDG0109	General depreciation determination	Software able to be used in the preparation or filing of income tax returns relating to a particular year
DDG0110	General depreciation determination	"Psychological testing sets" used in the medical industry
DDG0111	General depreciation determination	Metal speed humps
DDG0112	General depreciation determination	"CCH Electronic New Zealand Master Tax Guide, designed for a specific tax year" and "CCH Essential New Zealand Tax Package, designed for a specific tax year"
DDG0113	General depreciation determination	"Wintering pads (rubber)" used in the agriculture industry
DDG0114	General depreciation determination	Kiwiplus – Kiwifruit Software Package – designed for a specific year
DDG0115	General depreciation determination	"Peurulus (baby crayfish) traps" used in the fishing industry.

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

The following draft items are available for review/comment this month, having a deadline of 30 September 2006.

Ref.	Draft type	Description
ED 0088	Operational statement	Interaction of tax and charities rules, covering tax examption and donee status

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**

"PAID-UP CAPITAL AMOUNT" DEFINITION SECTION CD 32(4) PUBLIC RULING – BR PUB 06/04

Note (not part of ruling): This ruling is essentially the same as Public Rulings BR Pub 96/6 published in TIB Vol 7, No 12, April 1996, BR Pub 98/1 published in TIB Vol 10, No 2, February 1998 and BR Pub 01/02 published in TIB Vol 13, No 4, April 2001. BR Pub 01/02 expired on 31 March 2006. This new ruling takes into account changes arising from the enactment of the Income Tax Act 2004. Its application period is on and following 1 April 2006 for an indefinite period.

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

Taxation Law

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

This Ruling applies to the definition of "paid-up capital" within the "available subscribed capital amount" formula in section CD 32(4)(a).

The Arrangement to which this Ruling applies

This Ruling applies to companies that liquidate on or after 1 July 1994 and distribute to shareholders the same class of capital that the company has, prior to 1 July 1994, written off against its losses.

How the Taxation Law applies to the Arrangement

The "total amount of capital paid up before 1 July 1994" in the definition of "paid-up capital" within the "available subscribed capital amount" formula includes all paid-up capital that has been, prior to 1 July 1994, written off against losses incurred by the company.

The period for which this Ruling applies

This Ruling applies to liquidations (as defined in section OB 1), and to distributions from such liquidations, on and following 1 April 2006 for an indefinite period.

This Ruling is signed by me on the 30th day of June 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 06/04

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 06/04 ("the Ruling").

The subject matter covered in the Ruling was previously dealt with in Public Ruling BR Pub 01/02 (TIB Vol 13, No 4, April 2001 at page 8 under the heading "Definition of Transitional Capital Amount") which was issued in accordance with the Income Tax Act 1994 ("1994 Act").

On 1 April 2005 the Income Tax Act 2004 ("2004 Act") came into force. Under the 2004 Act the subject matter covered in BR Pub 01/02 is now found in the "available subscribed capital amount" formula in section CD 32.

This Ruling applies on and following 1 April 2006 for an indefinite period.

Background

The Companies Act 1993 enacted major reforms in the company law area. One of the most significant

was the removal of the concept of "paid-up capital". Consequently the Income Tax Amendment Act 1994 was enacted to accommodate the changes to company law. In particular, the Income Tax Amendment Act 1994 introduced, with application from 1 July 1994, a definition of "available subscribed capital" for tax purposes.

The Income Tax Amendment Act 1994 also repealed section 4A(1)(h) of the Income Tax Act 1976. Section 4A(1)(h) allowed the Commissioner to exclude from dividends such amount distributed to a shareholder of the company, as the Commissioner considered just and reasonable where:

- the company had reduced the amount of the paid-up capital of the shareholder by writing off, with High Court approval, losses incurred by the company; and
- the company was subsequently wound up; and
- upon the winding up of the company, an amount (whether in money or money's worth) was distributed to the shareholder in excess of the amount paid up on the shares of the shareholder.

In effect, section 4A(1)(h) had allowed a company, upon winding-up, to restore a loss of paid-up capital without the shareholders suffering any tax consequences.

The issue addressed in the previous rulings was whether the "available subscribed capital" formula, as prescribed in section OB 1 of the 1994 Act, performed the same function as, the now repealed, section 4A(1)(h).

This ruling updates the previous rulings by taking account of the 2004 Act, under which the "available subscribed capital" formula is now prescribed in section CD 32.

Legislation

Income Tax Act 1994

Section OB 1 states:

"**Transitional capital amount**", of a share in a company means -

(a) Unless paragraph (b) applies, the amount calculated using the formula:

$$\frac{j + k}{l} \times m$$

where

j is the total amount of capital paid up before 1 July 1994 for shares of the same class as the share (whenever issued and including the share), not being

(i) An amount paid up by a bonus issue made after 31 March 1982 and before 1 October 1988, except if -

(A) The date of the acquisition, redemption, other cancellation, or liquidation falls more than 10 years after the date of the bonus issue; or

B) The amount was paid up by way of application of an amount of qualifying share premium; or

C) The relevant time is the time of liquidation of the company; or

(ii) An amount paid up by a bonus issue (other than a taxable bonus issue) made on or after 1 October 1988, except if the amount was paid up by way of application of an amount of qualifying share premium; and

k is the total of qualifying share premium paid to the company before 1 July 1994 for shares of that class (whenever issued and including the share), not being an amount that is later (but before 1 July 1994) applied to pay up capital on shares in the company; and

l is the number of shares of that class (including the share) ever issued before the close of 30 June 1994; and

m is the number of shares of that class (including the share) on issue at the close of 30 June 1994:

(b) In the case of a company that is a group investment fund to which either section CZ 4A or CZ 4B applies, the value of the superannuation fund interest at the close of business on 31 March 1999.

Income Tax Act 2004

The relevant part of section CD 32 provides:

SECT CD 32 AVAILABLE SUBSCRIBED CAPITAL AMOUNT

CD 32(1) FORMULA FOR CALCULATING AMOUNT OF AVAILABLE SUBSCRIBED CAPITAL For a share (**share**) in a company at any relevant time (**calculation time**), the amount of available **subscribed capital** is calculated using the formula -

1 July 1994 balance + subscriptions - returns.

CD 32(2) DEFINITION OF ITEMS IN FORMULA In the formula, -

(a) **1 July 1994 balance** is, -

(i) if the company existed before 1 July 1994, the amount calculated under subsection (3); and

(ii) in any other case, zero:

(b) **subscriptions**, subject to subsections (6) to (20), is the total amount of consideration that the company received, after 30 June 1994 and before the calculation time, for the issue of shares of the same class (the class) as the share:

(c) **returns**, subject to subsections (21) to (24), is the total amount of consideration that the company paid, after 30 June 1994 and before the calculation time, on the cancellation of shares in the relevant class and that was not a dividend because of section CD 14 or CD 16 or a corresponding provision of an earlier Act.

CD 32(3) 1 JULY 1994 BALANCE The 1 July 1994 balance is calculated using the formula -

$$\frac{\text{paid-up capital} + \text{premiums}}{\text{all shares issued}} \times \text{30 June 1994 shares}$$

CD 32(4) DEFINITION OF ITEMS IN FORMULA In the formula, -

(a) **paid-up capital**, subject to subsection (5) relating to bonus issues, is the total amount of capital paid up before 1 July 1994 for shares in the class:

(b) **premiums** is the total amount of qualifying share premium paid to the company before 1 July 1994 for shares in the class, but not including amounts applied before 1 July 1994 in paying up capital:

(c) **all shares issued** is the number of shares in the class ever issued at the end of 30 June 1994:

(d) **30 June 1994 shares** is the number of shares in the class on issue at the end of 30 June 1994.

Income Tax Act 1994

Under the 1994 Act, to calculate the available subscribed capital for companies existing prior to 1 July 1994, the "transitional capital amount" (as defined in section OB 1) had to be ascertained.

The terms "available subscribed capital" and "transitional capital amount" are discussed in more detail in TIB Vol 6, No 6 – Company Law Reform (December 1994).

In the "transitional capital amount" definition is "factor j", which section OB 1 of the 1994 Act prescribed as including "the aggregate amount of capital paid up before 1 July 1994". In Public Ruling BR Pub 96/6 (published in April 1996) the Commissioner ruled that:

> The "aggregate amount of capital paid up before 1 July 1994" in factor "j" of the formula within the definition of the "transitional capital amount" includes all paid-up capital that has been, prior to 1 July 1994, written off against losses incurred by the company.

That ruling was reissued as Public Ruling BR Pub 98/1 (published in February 1998).

The definition of "transitional capital amount" was amended in 1998 by adding a new paragraph (b) – which did not affect the previous ruling – and, at the same time, the wording was changed to bring it into line with the current legislative style. In particular the former wording of "**aggregate** amount of capital" was changed to read "**total** amount of capital".

The Commissioner considered that this wording change did not affect the interpretation of the definition or the calculation of item "j" so the previous ruling was reissued, with the word "total" replacing the word "aggregate", as Public Ruling BR Pub 01/02 (published in April 2001).

Income Tax Act 2004

In the 2004 Act the "available subscribed capital amount" formula is set out in section CD 32. Included in that formula, at section CD 32(2), is factor "1 July 1994 balance", which in turn contains factor "paid-up capital" that is defined in section CD 32(4)(a) as:

> (a) **paid-up capital**, subject to subsection (5) relating to bonus issues, is the **total amount of capital paid up before 1 July 1994** for shares in the class.
>
> **[Emphasis Added]**

The Commissioner considers that the total amount of capital paid up before 1 July 1994 in the definition of "paid-up capital" includes all paid-up capital that has been, prior to 1 July 1994, written off against losses incurred by the company.

The reason for this view is that the factors "1 July 1994" and "paid-up capital" in section CD 32 are equivalent to the section OB 1 definitions of "transitional capital amount" and "factor 'j'", respectively, in the 1994 Act. Hence, despite the change in terminology, this ruling is equivalent to the previous rulings given in relation to 'transitional capital amount'.

Further, it is observed that section OB 1 still contains a definition for 'transitional capital amount'. However, that definition no longer forms part of the 'available subscribed capital amount' formula.

Application of legislation

The "total amount of capital paid up before 1 July 1994" in the definition of "paid-up capital" within the "available subscribed capital amount" formula includes all paid-up capital that has been, prior to 1 July 1994, written off against losses incurred by the company. This allows a company to restore the written-off capital upon liquidation, without the distribution being treated as a dividend to the shareholders.

Example

1990	M Ltd issues 1,000 fully paid-up shares of the same class at $1 each.
1992	Pursuant to High Court approval, M Ltd writes off $500 (50 cents per share) of paid-up capital from its accumulated losses.
1994	Paid-up capital at 30 June 1994 is $500.
2003	Shareholders decide to liquidate M Ltd. There have been no movements in the capital of M Ltd since the capital reduction in 1992. After the sale of assets the distribution will be $750 (75c per share).

Because M Ltd existed before 1 July 1994, its "available subscribed capital amount" is calculated under section CD 32, as follows:

1. To calculate M's "available subscribed capital amount", the following formula from section CD 32(1) is used:

   1 July 1994 balance + subscriptions – returns

   Assuming that the "subscriptions" and "returns" after 30 June 1994 are nil, the "available subscribed capital amount" will be the same as the "1 July 1994 balance".

2. To calculate M's "1 July 1994 balance", the following formula from section CD 32(3) is used:

$$\frac{\textbf{paid-up capital + premiums}}{\textbf{all shares issued}} \quad \textbf{x} \quad \textbf{30 June 1994 share}$$

where-

paid-up capital	is the paid-up capital at the close of 30 June 1994	$ 500
	add back capital reduction	$ 500
	total capital paid up before 1 July 1994 as defined in this Ruling	$1,000
premiums	qualifying share premium assume is	0
all shares issued	number of shares ever issued before close of 30 June 1994	1,000
30 June 1994 shares	shares on issue at close of 30 June 1994	1,000

$$\frac{\$1,000 + 0}{1,000} \text{ x } 1,000 = \$1,000 = \text{“1 July 1994 balance”}$$

The "1 July 1994 balance" and, on this occasion, the "available subscribed capital amount" both equal $1,000.

The $750 (75c per share) distributed is not treated as a dividend as it does not exceed the "available subscribed capital amount" of $1,000 ($1.00 per share).

ASSESSABILITY OF PAYMENTS UNDER THE EMPLOYMENT RELATIONS ACT FOR HUMILIATION, LOSS OF DIGNITY, AND INJURY TO FEELINGS PUBLIC RULING – BR PUB 06/05

Note (not part of ruling): This ruling replaces Public Ruling BR Pub 01/04 published in TIB Vol 13, No 5, (May 2001). The preceding rulings were Public Rulings BR Pub 97/3 and 97/3A published in TIB Volume 9, No 3 (March 1997). This new ruling is essentially the same as the previous ruling. However, the new ruling has been updated and applies the Income Tax Act 2004, which came into force on 1 April 2005, rather than the Income Tax Act 1994 provisions. The changes between the provisions of the 1994 and 2004 Acts affecting this ruling do not affect the conclusions previously reached.

This ruling aplies for an indefinite period.

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 sections CA 1(2), CE 1 and NC 2.

The Arrangement to which this Ruling applies

The Arrangement is:

- The making of a payment to an employee or former employee for humiliation, loss of dignity, or injury to feelings under section 123(1)(c)(i) of the Employment Relations Act 2000; or
- The making of a payment to an employee or former employee pursuant to an out of court settlement genuinely based on the employee's rights to compensation under section 123(1)(c)(i) of the Employment Relations Act 2000.

This Ruling does not, however, apply to such payments that are in reality for lost wages or other income, but which are merely characterised by the parties as being for humiliation, loss of dignity, or injury to feelings (irrespective of whether such an agreement is signed by a mediator under the Employment Relations Act).

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- Payments that are genuinely and entirely for compensation for humiliation, loss of dignity, or injury to feelings under section 123(1)(c)(i) of the Employment Relations Act 2000 are not income under section CE 1 of the Income Tax Act 2004.
- Such compensation payments are not gross income under ordinary concepts under section CA 1(2) .
- There is consequently no liability under section NC 2 for employers or former employers to deduct PAYE from these payments.

The period for which this Ruling applies

This Ruling will apply to payments received on and following 1 October 2005 for an indefinite period.

This Ruling is signed by me on the 30th day of June 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 06/05

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 06/05 ("the Ruling").

The subject matter covered in the Ruling was previously dealt with in Public Ruling BR Pub 01/04 published in TIB Vol 13, No 5, (May 2001) at page 8. The Ruling applies for an indefinite period.

Background

The Employment Relations Act 2000 provides for a number of remedies when an employee has a personal grievance against a current or former employer. This includes compensation for humiliation, loss of dignity, or injury to the feelings of the employee.

The Employment Relations Act also establishes specialist institutions with exclusive jurisdiction to deal with the rights of parties litigating on employment contracts: the Employment Relations Authority and the Employment Court. The Employment Relations Service of the Department of Labour has jurisdiction to provide mediation services.

Section 103(1) of the Employment Relations Act defines "personal grievance" as:

> For the purposes of this Act, personal grievance means any grievance that an employee may have against the employee's employer or former employer because of a claim—
>
> (a) that the employee has been unjustifiably dismissed; or
>
> (b) that the employee's employment, or 1 or more conditions of the employee's employment (including any condition that survives termination of the employment), is or are or was (during employment that has since been terminated) affected to the employee's disadvantage by some unjustifiable action by the employer; or
>
> (c) that the employee has been discriminated against in the employee's employment; or
>
> (d) that the employee has been sexually harassed in the employee's employment; or
>
> (e) that the employee has been racially harassed in the employee's employment; or
>
> (f) that the employee has been subject to duress in the employee's employment in relation to membership or non-membership of a union or employees organisation.

Section 123(1) of the Employment Relations Act provides a number of remedies available to the Authority or Court when the Authority or Court determines that an employee has a "personal grievance" including:

> …
>
> (b) the reimbursement to the employee of a sum equal to the whole or any part of the wages or other money lost by the employee as a result of the grievance:
>
> (c) the payment to the employee of compensation by the employee's employer, including compensation for -
>
> (i) humiliation, loss of dignity, and injury to the feelings of the employee; and
>
> (ii) loss of any benefit, whether or not of a monetary kind, which the employee might reasonably have been expected to obtain if the personal grievance had not arisen:

The Ruling considers whether such payments for humiliation, loss of dignity, or injury to the feelings of the employee are amounts derived "in connection with the employee's employment" and thus "employment income" of the employee, pursuant to section CE 1 of the Income Tax Act 2004.

Section CE 1 of the Income Tax Act 2004 provides:

> **CE 1 AMOUNTS DERIVED IN CONNECTION WITH EMPLOYMENT**
>
> The following amounts derived by a person in connection with their employment or service are income of the person:
>
> (a) salary or wages or an allowance, bonus, extra pay, or gratuity:
>
> (b) expenditure on account of an employee that is expenditure on account of the person:
>
> (c) the market value of board that the person receives in connection with their employment or service:
>
> (d) a benefit received under a share purchase agreement:
>
> (e) directors' fees:
>
> (f) compensation for loss of employment or service:
>
> (g) any other benefit in money.

Section CA 1(2) states that "an amount is also income of a person if it is their income under ordinary concepts".

Application of the Legislation

If payments for humiliation, loss of dignity, or injury to feelings, under section 123(1)(c)(i) of the Employment Relations Act 2000 are "employment income", they would be included under section CE 1 as income of the person. They would be included in the calculation of "net income" under section BC 4 and would consequently form part of "taxable income" as calculated under section BC 5.

Section CE 1 defines "employment income" to include "any other benefit in money".

Payments under section 123(1)(c)(i) of the Employment Relations Act are a benefit in money. The issue is, therefore, whether these payments are made "in connection with the employment or service" of the recipient.

Relationship with Income Tax Act 1994

The Income Tax Act 2004 introduces the concept of an amount received by a person "in connection with their employment or service" being income of a person. Previously, the 1994 Act referred to an amount being monetary remuneration, and thus gross income, if it was an amount derived by a person "in respect of or in relation to" their employment or service.

The wording of the 2004 Act provision is different to that in the 1994 Act. However, while the 2004 Act has replaced the 1994 Act, section YA 3(3) of the 2004 Act nevertheless provides that provisions of the 2004 Act are the provisions of the 1994 Act in rewritten form. The provisions of the 2004 Act are intended to have the same effect as the corresponding provision of the 1994 Act. The exception is, pursuant to section YA 3(5), where an "identified policy change", as specified in schedule 22A, exists.

In this instance no identified policy change has been specified in schedule 22A. Therefore, the presumption is that the adoption of the term "in connection with" was not intended to give rise to an interpretation that differs

from that which would apply if the term "in respect of or in relation to", as used in the definition of "monetary remuneration" under the 1994 Act, still applied. It is therefore relevant to consider the meaning of the phrase "in respect of or in relation to" in the interpretation of the phrase "in connection with" in this situation.

The meaning of "in connection with"

The phrase "in connection with" is not defined in the Act. However, it has been considered in other contexts.

In *Strachan v Marriott* [1995] 3 NZLR 272, Hardie Boys J stated, at page 279:

> "In connection with" may signify no more than a relationship between one thing and another. The expression does not necessarily require that it be a causal relationship: *Our Town FM Pty Ltd v Australian Broadcasting Tribunal* (1987) 16 FCR 465, 479 per Wilcox J. But, as Davies J warned in *Hatfield v Health Insurance Commission* (1987) 15 FCR 487, at p 491:
>
> "Expressions such as 'relating to', 'in connection with' and 'in respect of' are commonly found in legislation but invariably raise problems of statutory interpretation. They are terms which fluctuate in operation from statute to statute.... The terms may have a very wide operation but they do not usually carry the widest possible ambit, for they are subject to the context in which they are used, to the words with which they are associated, and to the object or purpose of the statutory provision in which they appear."

In *Case E84* (1982) 5 NZTC 59,441 Bathgate DJ noted at page 59,445:

> It is a matter of degree whether, on the interpretation of a particular statute, there is a sufficient relationship between subject and object to come within the words "in connection with" or not. It is clear that no hard and fast rule can be or should be applied to the interpretation of the words "in connection with". Each case depends on its own facts and the particular statute under consideration.

In *Hatrick (A) & Co v R* [1923] AC 213, the Privy Council considered the meaning of "in connection with" in the context of section 10 of the Government Railway Act 1908, which empowered the Minister of Railways to fix charges to be paid for goods stored in any shed or store "in connection with a railway". Their Lordships stated, at page 225:

> In the view of their Lordships these words cannot apply to something done on a space or in a building merely contiguous to or abutting upon a railway, even though it be the property of a railway; if the thing done forms no part of or has no connection with the property business or a railway, as a carrier of passengers and goods by rail, or in other words that the expression "in connection with a railway" means connect with, subserving and being ancillary to, the business of a railway as such carriers … These words … must be direct to something different from propinquity or contiguity, and in their Lordships' view, having regard to all the provisions of the statute, mean in s 10 in connection with the business and operations of a railway as a carrier of goods by rail.

In *Hammington v Ross* (1992) 2 NZ ConvC 191,150, the High Court considered whether a lawyer's omission to disclose his investment in the client's product to the client was a "civil liability incurred in connection with the provision of professional services". McGechan J stated, at page 191,162:

> One next goes to the operative clause. It provides cover for claims arising from civil liability incurred "in connection with" provision of "professional services". The clause is a broad one. It extends to "civil liability", not mere classical "neglect, error or omission". It extends to claims incurred "in connection with" the provision of professional services, as contrasted with "in the" provision of professional services. It is not limited to strict integral components of those very services themselves. With that wider wording it was conceded, and rightly, that activity covered would include omission to provide, and "ancillary conduct not strictly professional work - eg, the business advice here". Clearly however there must be a nexus between such wider activity giving rise to liability and the professional services. The wider activity must be related, and not merely co-existent.

In *Pan Pacific Forest Industries (NZ) Ltd v Norwich General* (1997) 7 TCLR 560, the High Court considered whether an insurance policy applied where the product supplied was faulty. The relevant policy applied to "accidental loss of…property…resulting from accidents in connection with the business". Paterson J stated at page 569:

> The operative provisions of the policy apply if the accident was "in connection with the business". Giving those words their natural and ordinary meaning the accident did arise in connection with the business if it arose because the business supplied faulty materials and parts and gave faulty advice.

The phrase "in connection with", has also been considered in the context of section DJ 5 of the Income Tax Act 1994, a provision that allows a tax deduction for costs incurred "in connection with" the determination of a liability to tax. In that context, Bathgate DJ found in *Case E84* that the term required a narrow interpretation. He said, at page 59,445:

> It may be that only an empirical and common sense approach to the interpretation of the words can be applied in each particular case to determine where, if at all, the line should be drawn to allow or not allow expenditure "in connection with" an assessment. However I believe that a narrow interpretation of the words "... any expenditure ... in connection with ... the assessment ..." is the correct interpretation: only expenditure closely and immediately connected to the assessment itself is intended to be allowed as a deduction, and expenditure more remote, as for instance in this case, the expenditure of O in making his trip to visit A, is not expenditure allowed as a deduction under the section.

This case suggests that, in the context of section DJ 5, the phrase "in connection with" requires a close linkage between the expenditure and the "determination" or "calculation" of a liability to tax.

The above cases suggest that for something to be "in connection with" something else, a necessary degree of nexus is required, and that the two things must be related to each other in some way. For instance, in TRA *Case R34* (1994) 16 NZTC 6,190 (on appeal *CIR v Suzuki New Zealand Ltd* (2000) 19 NZTC 15,819) the issue was whether the reimbursing payment from the overseas manufacturer constituted a consideration for the warranty repair services provided by the taxpayer's agent. The TRA stated at page 6,200 that:

> Although the definition of consideration creates a very wide potential link between a payment and a particular supply it is, in any case, a matter of degree, common sense, and commercial reality whether a payment is direct enough to have the necessary nexus with a service, ie, whether the link is strong enough.

In *Berry v FCT* [1953] HCA 70; (1953) 89 CLR 653, the Australian High Court considered the meaning of "in connection with" in the context of a provision in the Income Tax Assessment Act 1936 (Cth). Kitto J held (at para 12) that consideration will be "in connection with" property where "the receipt of the payment has a substantial relation, in a practical business sense, to that property".

Overall, the Commissioner considers that the above cases suggest that the phrase "in connection with" should be given a broad interpretation.

The meaning of "in respect of or in relation to"

It is also necessary to consider the relevant words that were used in the Income Tax Act 1994. As noted, in that Act the relevant test was whether an amount was "in respect of or in relation to" employment, and thus "monetary remuneration".

The phrase "in respect of or in relation to" is capable of having a very wide meaning. For example, in *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11,303, the Court of Appeal was dealing with certain lump sum payments made by Shell to employees who transferred at the request of Shell. The Court discussed the definition of "monetary remuneration". The case concerned the part of the definition of "monetary remuneration" which says:

> ... emolument (of whatever kind), or other benefit in money in respect of or in relation to the employment or service of the taxpayer.

McKay J, delivering the judgment of the Court, said at page 11,306 that:

> The words "in respect of or in relation to" are words of the widest import.

Although McKay J acknowledged that the payments in *Shell* were not made under the contract of employment in that case, this did not mean that the employees received the payment outside the employment relationship. The learned Judge had earlier referred to the fact that the payments were not expressly provided under the employees' written employment contracts but were made pursuant to Shell's employment policy as a matter of discretion. They were still made "because he or she is an employee".

Other cases have also stressed the width of the words "in respect of or in relation to". In the Queens Bench case of *Paterson v Chadwick* [1974] 2 All ER 772, Boreham J considered the meaning of the phrase "in respect of" in relation to discovery, and adopted the comments of Mann CJ in the Australian case *Trustees, Executors & Agency Co Ltd v Reilly* [1941] VLR 110, where the learned Chief Justice said:

> The words "in respect of" are difficult of definition but they have the widest possible meaning of any expression intended to convey some connection or relation in between the two subject-matters to which the words refer.

Similarly, in *Nowegijick v The Queen* [1983] CTC 20 at page 25, the Supreme Court of Canada described the phrase "in respect of" as "probably the widest of any expression intended to convey some connection between two related subject-matters".

Other New Zealand cases (*Case U38* (2000) 19 NZTC 9,361 and *C of IR v Kerslake* (2001) 20 NZTC 17,158) have also considered the phrase "in respect of or in relation to". Both cases are consistent with the authorities cited above in this commentary.

Context may affect the meaning

However, many cases have demonstrated that the meaning to be given to the phrase "in respect of or in relation to" may vary according to the context in which it appears.

In *State Government Insurance Office v Rees* (1979) 144 CLR 549, the High Court of Australia considered the meaning of the phrase "in respect of" in determining whether the debt due to the Government Insurance Office fell within section 292(1)(c) of the Companies Act 1961-1975 (Q.) as "amounts … due in respect of workers' compensation under any law relating to workers' compensation accrued before the relevant date". The Court held that amounts which could be recovered by the Government Insurance Office from an uninsured company pursuant to section 8(5) of the Workers' Compensation Act 1916-1974(Q.) for money paid to workers employed by the uninsured company were **not** amounts due "in respect of" workers' compensation under the Companies Act.

At page 561 Mason J observed that:

> ... as with other words and expressions, the meaning to be ascribed to "in respect of" depends very much on the context in which it is found.

Stephen J also discussed the meaning of the phrase "in respect of", noting at pages 553-554 that it was capable of describing relationships over a very wide range of proximity, and went on to say:

> Were the phrase devoid of significant context, it could, I think, be taken to be descriptive of the relationship between the present indebtedness owed to the State Government Insurance Office and the subject matter of workers' compensation. However a context does exist which is in my view sufficient to confine the operation of s 292(1)(c) to bounds too narrow to be of service to the appellant.

In TRA *Case R34* (1994) 16 NZTC 6,190, certain payments were made to a New Zealand distributor by its overseas parent in relation to repairs which had to be made to cars sold to the New Zealand subsidiary and then sold to dealers. The issue was whether the payments were zero-rated. The definition of "consideration" in section 2 of the Goods and Services Tax Act 1985 was relevant. Part of the definition of "consideration" states:

> …any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services …

The TRA stated at page 6,200 that:

> A sub-issue is whether the reimbursing payment from the overseas manufacturer (MC) was made "in respect of, in response to, or for the inducement of" the repair work in the sense required by the definition of "consideration" in s 2 of the Act. … Although the definition of consideration creates a very wide potential link between a payment and a particular supply it is, in any case, a matter of degree, commonsense, and commercial reality whether a payment is direct enough to have the necessary nexus with a service, i.e, whether the link is strong enough.

The High Court's decision on the appeal of *Case R34* is *CIR v Suzuki New Zealand Ltd* (2000) 19 NZTC 15,819. In that case McGechan J said at page 15,831:

> …it is necessary there be a genuine connection. The legislature is not to be taken as taxing on an unrealistic or tenuous connection basis.

In *Cleland v CIR*, in respect of $50,000 awarded for loss of benefits, Hammond J concluded that it was compensation for loss of office or employment. In order to reach this conclusion Hammond J had to consider whether the amount was "in respect of or in relation to" the taxpayer's employment or service.

Hammond J referred to the Court of Appeal decision in Shell and noted that those words are to be interpreted widely. He stated at paragraphs 46 to 48 of his judgment:

> The award is clearly a "rolled up" one by the Employment Court in respect of or in relation to Mr Cleland's past employment.
>
> ...
>
> As a sub-part of the argument, it was said for Mr Cleland that, because the award was calculated on future wages and benefits, it was not compensation for (past) loss of office or employment. That is not the test. The test is whether the wages and benefits actually awarded arose out of Mr Cleland's employment. It does not at all follow that, because the award was made relating to a period after the termination of the employment, it was not made in respect of, or in relation to, the employment. As Mr Almao said, "compensation for loss of office or employment by its very nature encompasses future benefits; benefits that an employee might have received had his or her employment continued".

Similarly, the meaning of the words "in connection with" can be affected by the context in which they are used. In this regard, the context in which the words "in connection with" are used is to provide that a benefit in money will be income of a person where it is derived "in connection with their employment or service". Therefore, as noted above the term "in connection with" has a wide meaning, but only, in this context, in respect of "employment or service".

Not all payments to employees are "in connection with" employment or service

While it is true that an employee would not receive a payment under section 123(1)(c)(i) of the Employment Relations Act if he or she were not an employee, it would seem clear that this type of "but for" approach to "in connection with" is not universally applied in the context of employment, and that not all payments made by an employer to an employee are in connection with employment, or previously within the definition of "monetary remuneration". *In Fraser v CIR* (1995) 17 NZTC 12,356, at page 12,363, Doogue J in the High Court said:

> There is no dispute that the words "emolument (of whatever kind), or other benefit in money, in respect of or in relation to the employment or service of the taxpayer" are words of the widest possible scope: see *Shell New Zealand Ltd v C of IR* (1994) 16 NZTC 11,303 at p 11,306, and *Smith v FC of T* 87 ATC 4883; (1987) 164 CLR 513; (1987) 19 ATR 274. Mr Harley does, however, submit, correctly, that it does not follow that all payments made are necessarily income and refers, for example, to reimbursement payments.

In Shell, McKay J highlighted the fact that the payments in that case were **both**:

- made to the recipients because they were employees; **and**
- paid to compensate for the loss incurred by the employee in having to relocate in order to take up a new position with the employer.

Many cases have concluded that, in appropriate circumstances, amounts received were not income, or assessable, even though paid by an employer to an employee.

In *FC of T v Rowe* (1995) ATC 4,691, for example, the taxpayer was employed as an engineer for the Livingston Shire Council. As a result of a number of complaints against him he was suspended. An inquiry was commenced, and he incurred legal costs as a result of engaging counsel to defend himself against dismissal during the course of the inquiry. The taxpayer was cleared of any charges of misconduct but was dismissed a year later. The taxpayer claimed his legal costs as a deduction. Although the Council refused to reimburse the taxpayer for his legal costs, the Queensland government subsequently made an ex gratia payment to him.

The Full Federal Court considered, amongst other things, whether the ex gratia payment constituted assessable income. By majority, the Court concluded that the payment was not assessable under section 25(1) of the Australian Income Tax Assessment Act 1936 as income in accordance with ordinary concepts, nor was it assessable under section 26(e) of that Act as being compensation "in respect of, or for or in relation directly or indirectly to" any employment. Accordingly, Burchett and Drummond JJ (with Beaumont J dissenting) held that the payment was not assessable. Burchett J held that the payment was **not a reward for the taxpayer's services but was a recognition for the wrong done to him**. The payments were not remuneration but a reparation, and they were not sufficiently related to the performance of income-earning activities. On the same reasoning, it was too remote from the employment to be caught by section 26(e). Further, the payment was not assessable under section 26(e) because the employer/employee relationship between the Council and the taxpayer was merely part of the background facts against which the ex gratia payment was made. On appeal, the majority of the Full High Court confirmed the Federal Court's decision: *FC of T v Rowe* (1997) ATC 4,317.

Other cases, relating to wartime service, have also shown that payments made to present or former employees for reasons unconnected with their service as an employee will not necessarily be assessable income on a "but for" basis. In *Louisson v Commissioner of Taxes* [1943] NZLR 1, at page 9 Myers CJ and Northcroft J said of payments made by an employer to a former employee who had enlisted in the New Zealand Expeditionary Force in World War II:

> In our opinion, such payments were personal gifts to each of the employees coming within the description in the resolution - gifts made simply as an acknowledgment of personal appreciation of the sacrifice made in the service of the Country by persons whose employment with the company has ceased and who are under no engagement to return to that employment.

Similarly, in the Australian case of *FCT v Dixon* (1954) 5 AITR 443, the taxpayer received payments from his prior employer topping up his military pay. It would appear from the judgment that the Australian Commissioner argued that even a slight relationship to employment was sufficient to satisfy the test in section 26(e) of the Australian Income Tax Assessment Act 1936 [which made assessable certain sums granted to the taxpayer "in respect of, or for or in relation directly or indirectly to, any employment…".]. This argument was rejected by Dixon CJ and Williams J, who stated at page 446 that:

> We are not prepared to give effect to this view of the operation of s.26(e) …There can, of course, be no doubt that the sum of £104 represented an allowance, gratuity or benefit allowed or given to the taxpayer by Macdonald, Hamilton and Company. Our difficulty is in agreeing with the view that it was allowed or given to him in respect of, or in relation directly or indirectly to, any employment of, or services rendered by him …We are not prepared to give s.26(e) a construction which makes it unnecessary that the allowance, gratuity, compensation, benefit, bonus or premium shall in any sense be a recompense or consequence of the continued or contemporaneous existence of the relation of employer and employee or a reward for services rendered given either during the employment or at or in consequence of its termination.

In the same case, at page 450, McTiernan J stated that:

> The words of paragraph (e) are wide, but, I think, not wide enough to prevent an employer from giving money or money's worth to an employee continuing in his service or leaving it, without incurring liability to tax in respect of the gift. The relationship of employer and employee is a matter of contract. The contractual relations are not so total and all embracing that there cannot be personal or social relations between employer and employee. A payment arising from those relations may have no connexion with the donee's employment.

These principles have also been applied by the courts in cases involving contracts for services. In *Scott v FCT* (1969) 10 AITR 367, Windeyer J in the High Court of Australia, considered the meaning of the words "in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him" in section 26(e) of the Income Tax and Social Services Contribution Assessment Act 1936-1961. The case concerned a solicitor who received a gift of £10,000 from a grateful client. Windeyer J stated at page 374 that the meaning of the words of the legislation "must be sought in the nature of the topic concerning which they are used". Windeyer J at page 376 referred to a passage from the judgment of Kitto J in *Squatting Investment Co Ltd v FCT* (1953) 5 AITR 496, at 524, where Kitto J (speaking of certain English cases) said:

> The distinction these decisions have drawn between taxable and non-taxable gifts is the distinction between, on the one hand, gifts made in relation to some activity or occupation of the donee of an income-producing character … and, on the other hand, gifts referable to the attitude of the donor personally to the donee personally.

Adopting this as a general principle, his Honour held that the £10,000 was not given or received as remuneration for services rendered and it did not form part of the taxpayer's assessable income.

J & G Knowles & Associates Pty Ltd v FC of T (2000) ATC 4,151 discusses the words "in respect of the employment" in the Australian FBT legislation. The case concerned interest-free loans to directors of a corporate trustee. Units in the trust fund were held by discretionary family trusts established by the directors. The lower courts were satisfied by a causal relationship, or a discernible and rational link between the loans and each director's employment. However, the Full Federal Court said that there had to be more than just *any* causal relationship between the benefit and the employment: the link had to be *sufficient or material*.

In the Commissioner's view, the term "in connection with", in the context of a payment being made "in connection with" a person's employment or service, is to be given a very broad interpretation and has a very wide operation. However, it is still necessary for there to be a sufficient relationship or nexus between the payment and the person's employment or service.

The nature and context of the payments

Looking at the nature and context of payments contemplated by section 123(1)(c)(i), it is strongly arguable that they do not intrinsically result from the employee and employer relationship. It is true that if the employee were not an employee then there would be no entitlement to receive the payment, but payments under section 123(1)(c)(i) of the Employment Relations Act for humiliation, loss of dignity, or injury to feelings are **not** compensation for services rendered or for actions that occur in the normal course of the employment relationship. They are based on the existence of a personal grievance.

Provisions for such compensation can be seen as being included in the Employment Relations Act because the sometimes unequal power of the parties to the employment contract means that such personal grievances may be likely to occur in that setting. It is noteworthy that the Human Rights Act 1993 also includes provisions for dealing with discrimination and sexual harassment of employees, even though that is not "employment legislation" at all.

C of IR v Smythe (1981) 5 NZTC 61,038 involved an employment context where the taxpayer retired from his employment. At the time of his retirement he was entitled to 26 weeks long service leave and to the equivalent of 26 weeks salary in lieu of long service leave to which he was entitled but had not taken. This was paid in one payment of $19,920.16. The issue before the Court was whether the payment was assessable income. At p 61,040, Richardson J said:

> The first step in deciding the character in law of the lump sum payment in question is to determine *the true nature of the legal arrangements pursuant to which the payment was made*. It is that legal character of the transaction which is decisive - not the overall economic consequences to the parties, and not the legal consequences of an alternative transaction into which the taxpayer could have entered but chose not to do so. [Italics added]

Payments of compensation under section 123(1)(c)(i) of the Employment Relations Act differ markedly from the situation in *Shell v CIR*. In that case at page 11,306, McKay J said:

> It is true …that the payment is not made under the contract of employment.…It is nevertheless paid to an employee only because he or she is an employee, **and** is paid to compensate for the loss incurred in having to change the employee's place of residence in order to take up a new position in the company. (Emphasis added)

Thus, in the *Shell* case, the employees received the payments as employees, **and** in order to compensate for the loss sustained as a result of the employment-related relocation.

In the ordinary course, the Commissioner considers genuine payments under section 123(1)(c)(i) to be too remote from the employment relationship to be within the definition of monetary remuneration. The Commissioner considers that the employment relationship in such instances is merely part of the background facts against which the compensation payments are made. The payments are not made "in connection with" the employment or service of the taxpayer.

At first glance, it may be thought that this approach conflicts with the outcome in *Case L78* (1989) 11 NZTC 1,451, where Barber DJ held that an ex gratia payment, to compensate for the employer's failure to give adequate notice of redundancy, was assessable as "monetary remuneration". However, the result in that case turned substantially on the objector's evidence as to the receipt being in the nature of "extra wages". Barber DJ stated at page 1,455 that:

> The objector himself related the $7,009.52 to extra holiday pay and sick leave. … At the end of his cross-examination he said that it was "really a bonus" and he regarded $7,009.52 as "extra wages". The character of the payment must be of a revenue nature. It is not a payment in the nature of capital. I consider that it is clearly within the definition of monetary remuneration in sec 2.

There is also the later TRA decision in *Case L92* (1989) 11 NZTC 1,530, where Barber DJ again considered the definition of "monetary remuneration". This case also concerned an employee who was made redundant and an employer who did not comply with the requirement to give adequate notice. Barber DJ held that the payment came within the definition of "monetary remuneration" and was assessable income. However, the Authority did not consider any cases (other than his own previous decision in *Case L78*) on the correct characterisation of receipts for tax purposes, but rather concentrated upon the need to interpret "monetary remuneration" in a "wide manner" and the fact that the amount was received as compensation for loss of employment. Such compensation is specifically referred to in the definition of monetary remuneration. Recognising that it was possible for some receipts of a capital nature to be assessable income under a specific provision, Barber DJ at page 1,537 stated:

> In this case, the words in sec 2 "compensation for loss of office or employment, emolument (of whatever kind), or other benefit in money" must surely cover not only a revenue type of payment such as a payment for lost wages, but also any other form of compensation for loss of employment.

It may also be relevant to observe that both of these TRA decisions concerned settlements under the Industrial Relations Act 1973. This earlier legislation made no specific and separate provision for compensation payments for humiliation, loss of dignity, or injury to feelings.

It is also thought that payments of the type under consideration in this Ruling are to be distinguished from those considered in American cases such as the *Commissioner v Schleier* 95-USTC 50,309. In that case, the United States Supreme Court held that certain punitive damages were assessable to the recipient employee. However, apart from the differing statutory context in the United States Internal Revenue Code, these damages were punitive because they related to a deliberate breach of the Age Discrimination in Employment Act and that Act does not provide for a separate recovery of compensatory damages for pain and suffering or emotional distress. The New Zealand Court of Appeal in *Air New Zealand Ltd v Johnston* [1992] 1 NZLR 159 seemingly rejected the view that humiliation type payments to employees are punitive in nature rather than compensatory. In that case Cooke J held at page 168 that "the emphasis evidently placed by the Labour Court on the punitive aspect does justify, in my opinion, a radical interference with their award." The award of $135,000 was replaced with one of $25,000, made up of $15,000 for future economic loss and $10,000 for injury to feelings.

Income under ordinary concepts

Compensation payments genuinely made under section 123(1)(c)(i) of the Employment Relations Act 2000 are not income under ordinary concepts under section CA 1(2).

Although the legislation does not define income under ordinary concepts, a great number of cases have identified the concept by reference to such characteristics as periodicity, recurrence, and regularity, or by its resulting from business activities, the deliberate seeking of profit, or the performance of services. Nor do capital receipts form part of "income" unless there is a specific legislative provision to the contrary. It is clear that payments under section 123(1)(c)(i) will not generally be made periodically or regularly, or generally recur. Nor as we have seen above, are they compensation for services. And by analogy with common law damages, they are of a capital nature.

This point is acknowledged by Barber DJ in Case L92, where he stated at page 1,536 that:

> I appreciate only too well that it is possible to interpret the evidence as showing that the $7,179.30 was formulated as a payment in the nature of common law damages for human hurt and breach and unfairness… I appreciate that the latter concepts are akin more to payments of capital than to wage revenue.

Out of court settlements

Sometimes, an employee and an employer negotiate a settlement out of court. The settlement agreement may state that the payment is for humiliation, loss of dignity, or injury to feelings. In return for the employee surrendering his or her rights under the Employment Relations Act, the employer will agree to pay a sum of money. There should be no difference in the tax treatment of the payments dependent on whether or not the parties use the Employment Relations Authority or Employment Court. A payment can be for humiliation, loss of dignity, or injury to the feelings of the employee whether the Authority or Court are involved or not.

Shams

The Ruling will not apply to payments which are akin to sham payments. A sham is a transaction set up to conceal the true intention of the parties and is inherently ineffective. The nature of a sham was discussed by Diplock LJ in *Snook v London and West Riding Investment Ltd* [1967] 1 All ER 518 at 528 where he stated:

> I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham", which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.

Richardson J, in the New Zealand case of *Mills v Dowdall* [1983] NZLR 154, stated that the "essential genuineness of the transaction is challenged" in a sham situation.

It is noteworthy that in the Taxation Review Authority decision *Case S96* (1996) 17 NZTC 7,603, Judge Barber stated at page 7,606:

> Of course, seemingly excessive allocations to compensation for feelings injury should be reopened by the IRD.

If the parties to an agreement agree to characterise or describe payments as being for humiliation, loss of dignity, or injury to feelings when they are in reality for lost wages, this transaction would be a sham which would be open to challenge by the Commissioner. Where the Commissioner has some doubt about the amount attributed to humiliation, loss of dignity, or injury to feelings, he may ask the parties to an agreement what steps they took to evaluate objectively what would be a reasonable amount to attribute to humiliation, loss of dignity, or injury to feelings. This would be so regardless of whether the payment was made as a result of an out of court settlement and whether or not the agreement is signed by a mediator under the Employment Relations Act. Further, as provided by section 18 of the Taxation Review Authorities Act 1994 and section 136(16) of the Tax Administration Act 1994, the onus of proof in a hearing regarding the assessability of any such payment would be on the taxpayer.

EMPLOYMENT COURT AWARDS FOR LOST WAGES OR OTHER REMUNERATION – EMPLOYERS' LIABILITY TO MAKE TAX DEDUCTIONS PUBLIC RULING – BR PUB 06/06

Note: (not part of ruling): This ruling replaces Public Ruling BR Pub 01/06 published in TIB Vol 13, No 6 (June 2001). The preceding rulings were Public Rulings BR Pub 97/7 and 97/7A published in TIB Vol 9, No 6 (June 1997). This new ruling is essentially the same as the previous ruling. However, the new ruling has been updated and applies the Income Tax Act 2004, which came into force on 1 April 2005, rather than the Income Tax Act 1994 provisions. The changes between the provisions of the 1994 and 2004 Acts affecting this ruling do not affect the conclusions previously reached.

The ruling applies for an indefinite period.

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 sections CE 1, BD 3, EI 8, NC 2, NC 16 , OB 1 (definitions of "employee", "extra pay", and "shareholder-employee"), and OB 2 (definition of "source deduction payment").

The Arrangement to which this Ruling applies

The Arrangement is an order by the Employment Court or the Employment Relations Authority requiring an employer to make a payment for lost wages or other remuneration to an employee under the Employment Relations Act 2000.

The Court or Authority will make such an award when an employee has lost wages or other remuneration as a result of an action by the employer which has been the subject of a personal grievance by the employee against the employer (e.g. unjustifiable dismissal or other unjustifiable action by the employer). An award for lost wages or other remuneration will usually be made under sections 123(1)(b) or 128 of the Employment Relations Act, but may be made under another provision.

This Ruling does not apply to an award of compensation for humiliation, loss of dignity, or injury to feelings made under section 123(1)(c)(i) of the Employment Relations Act.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

A. Employment income

The payment of an award for lost wages or other remuneration under the Employment Relations Act 2000 is "employment income" of the employee under section CE 1.

B. Employer's liability to make tax deductions from the award

The payment of an award for lost wages or other remuneration, under the Employment Relations Act 2000 is an extra emolument pay and is a "source deduction payment" under section OB 2 (1). The employer must make tax deductions from the payment under section NC 2 and account for those deductions to Inland Revenue in the normal way.

If an employer fails to make the required tax deductions from a payment, the employee is liable, under section NC 16, to pay an amount equal to those tax deductions to the Commissioner (and is also required to furnish to the Commissioner an employer monthly schedule showing details of the payment).

C. When the payment is derived by the employee

Under section BD 3(4), an employee derives a payment of an award for lost wages or other remuneration under the Employment Relations Act 2000 when the employee receives the payment, or when the payment is credited to an account or otherwise dealt with on the employee's behalf.

A person who is a shareholder-employee for the purposes of section EI 8 (as defined in sections OB 1 and OB 2 (2)) derives a payment of an award for lost wages or other remuneration under the Employment Relations Act 2000, in the income year that the expenditure on that award is deductible to the employer. If the expenditure on the award is not deductible to the employer, the shareholder-employee derives the award in the year of receipt.

The period for which this Ruling applies

This Ruling will apply to payments received on and following 1 October 2005 for an indefinite period.

This Ruling is signed by me on the 30th day of June 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 06/06

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 06/06 ("the Ruling").

The subject matter covered in the Ruling was previously dealt with in Public Rulings BR Pub 01/06 published in TIB Vol 13, No 6 (June 2001) which replaced Public Rulings BR Pub 97/7 and 97/7A published in TIB Vol 9, No 6 (June 1997). This Ruling applies for an indefinite period.

The commentary refers to the Income Tax Act 2004, particularly section CE 1 and the concept of "employment income".

Background

The Employment Relations Act 2000 provides for a number of remedies when an employee has a personal grievance against a current or former employer. This includes compensation for wages lost by the employee as a result of actions by the employer which are the subject of a personal grievance. Such compensation will usually be awarded under sections 123(1)(b) or 128 of the Act but may be made under another provision.

For example, in *Cleland v CIR* (2001) 20 NZTC 17,086, Hammond J was concerned with the assessability of part of an award made by the Employment Court in 1992. The Employment Court awarded compensation for lost wages up to the date of hearing under the equivalent of section 128 of the Employment Relations Act. An award for lost wages from that date on was made under the equivalent of section 123(1)(c)(ii) which provides for compensation for the loss of a benefit. The law in this area seems to be evolving and while awards for lost wages or other remuneration are now generally made under section 123(1)(b), the Ruling will apply under whatever provision such an award is made.

This Ruling confirms the Commissioner's existing practice in respect of the assessability and deduction of tax from awards for lost wages or other remuneration made under the Employment Relations Act 2000.

Legislation

Relevant provisions of the Employment Relations Act 2000

Section 103(1) of the Employment Relations Act 2000 ("the ERA") defines "personal grievance" as:

> For the purposes of this Act, "personal grievance" means any grievance that an employee may have against the employee's employer or former employer because of a claim—
>
> (a) that the employee has been unjustifiably dismissed; or
>
> (b) that the employee's employment, or 1 or more conditions of the employee's employment (including any condition that survives termination of the employment), is or are or was (during employment that has since been terminated) affected to the employee's disadvantage by some unjustifiable action by the employer; or
>
> (c) that the employee has been discriminated against in the employee's employment; or
>
> (d) that the employee has been sexually harassed in the employee's employment; or
>
> (e) that the employee has been racially harassed in the employee's employment; or
>
> (f) that the employee has been subject to duress in the employee's employment in relation to membership or non-membership of a union or employees organisation.

Section 103(3) provides:

> In subsection (1)(b), unjustifiable action by the employer does not include an action deriving solely from the interpretation, application, or operation, or disputed interpretation, application, or operation, of any provision of any employment agreement.

Section 123(1)(b) of the ERA states:

> Where the Authority or the Court determines that an employee has a personal grievance, it may, in settling the grievance, provide for any 1 or more of the following remedies:
>
> …
>
> (b) the reimbursement to the employee of a sum equal to the whole or any part of the wages or other money lost by the employee as a result of the grievance ...

Section 128 of the ERA states:

> (1) This section applies where the Authority or Court determines, in respect of any employee, -
>
> (a) that the employee has a personal grievance; and
>
> (b) that the employee has lost remuneration as a result of the personal grievance.
>
> (2) If this section applies then, subject to subsection (3) and section 124, the Authority must, whether or not it provides for any of the other remedies provided for in section 123, order the employer to pay to the employee the lesser of a sum equal to that lost remuneration or to 3 months' ordinary time remuneration.

(3) Despite subsection (2), the Authority may, in its discretion, order an employer to pay to an employee by way of compensation for remuneration lost by that employee as a result of the personal grievance, a sum greater than that to which an order under that subsection may relate.

Section 124 of the ERA states:

Where the Authority or the Court determines that an employee has a personal grievance, the Authority or Court must, in deciding both the nature and the extent of the remedies to be provided in respect of that personal grievance,—

(a) consider the extent to which the actions of the employee contributed towards the situation that gave rise to the personal grievance; and

(b) if those actions so require, reduce the remedies that would otherwise have been awarded accordingly.

Relevant provisions of the Income Tax Act 2004

Section CA 1(1) provides:

CA 1 Amounts that are income

Amounts specifically identified

(1) An amount is income of a person if it is their income under a provision in this part.

Section CE 1 provides

CE 1 Amounts derived in connection with employment

The following amounts derived by a person in connection with their employment or service are income of the person:

(a) salary or wages or an allowance, bonus, extra pay, or gratuity:

(b) expenditure on account of an employee that is expenditure on account of the person:

(c) the market value of board that the person receives in connection with their employment or service:

(d) a benefit received under a share purchase agreement:

(e) directors' fees:

(f) compensation for loss of employment or service:

(g) any other benefit in money.

Section BD 3(4) provides:

Income credited into account

Despite subsection (3), income that has not previously been derived by a person is treated as being derived when it is credited in their account or, in some other way, dealt with in their interest or on their behalf.

Section EI 8 provides:

EI 8 Matching rule for employment income of shareholder employee

Matching if company allowed deduction

(1) If a company is allowed a deduction for expenditure on employment income that is paid or is payable to a shareholder employee under section CE 1 (Amounts derived in connection with employment), the income is allocated in the way set out in subsections (2) and (3).

Allocation to deduction year unless unexpired

(2) The income is allocated to the income year to which the deduction allowed to the company is allocated, except for an amount equal to any unexpired portion for the income year of the company's expenditure under section EA 4 (Deferred payment of employment income).

Allocation otherwise when ceases being unexpired

(3) The remaining income is allocated to the income year or years in which the corresponding amount of the company's expenditure on the income is no longer treated as an unexpired portion.

Section NC 2(1) provides:

NC 2 Tax Deductions to be made by employers or PAYE intermediaries

(1) For the purpose of enabling the collection of income tax from employees by instalments, where an employee receives a source deduction payment from an employer, the employer, PAYE intermediary, or other person by whom the payment is made must, at the time of making the payment, make a tax deduction from the payment in accordance with the PAYE rules: provided that no tax deduction need be made from any source deduction payment made to any employee in respect of the employee's employment as a private domestic worker: provided also that if a tax deduction is not made by the employer or the PAYE intermediary in any such case section NC 16 applies to the employee.

Section NC 16 provides

NC 16 Employee to pay deductions to commissioner

Where for any reason a tax deduction or a combined tax and earner premium deduction or combined tax and earner levy deduction is not made or is not made in full at the time of the making of any source deduction payment or payments, the employee must—

(a) Not later than the 20th day of the month that next follows the month in which payment of the source deduction payment was made, furnish to the Commissioner an employer monthly schedule containing those particulars that apply to the employee; and

(b) Unless the employee is exempted from liability to pay the same or is not liable to pay the same, pay to the Commissioner an amount equal to the total of the tax deductions or combined tax and earner premium deductions or combined tax and earner levy deductions that should have been made and were not made, and that amount shall be due and payable to the Commissioner on the 20th of the month following the month in which payment of the source deduction payment or payments was made.

Section NC 19 provides:

NC 19 Amount of tax deductions deemed to be received by employee

Where any amount has been deducted from a source deduction payment by way of tax deduction, or combined tax and earner premium deduction, or combined tax and earner levy deduction under the PAYE rules and, where applicable, section 115 of the Accident Rehabilitation and Compensation Insurance Act 1992 or section 285 of the Accident Insurance Act 1998 or section 221 of the Injury Prevention, Rehabilitation, and Compensation Act 2001, the amount so deducted—

(a) is deemed to have been received by the employee at the time of the source deduction payment:

(b) for the purposes of this Act, is deemed to have been derived by the employee at the same time and in the same way as the residue of the source deduction payment.

Section OB 1 defines:

"**employee**"—

…

(f) for an employer, means an employee of the employer

"**employee share loan**" is defined in section CX 29 (Meaning of employee share loan)

"**employment income**" –

means an amount that is income under section CE 1 (Amounts derived in connection with employment)

"**extra pay**"—

(a) means a payment that—

(i) is made to a person in connection with their employment; and
(ii) is not one regularly included in the salary or wages payable to the person for a pay period; and
(iii) is not overtime pay; and
(iv) is made in a lump sum; and
(v) is made in 1 lump sum or in 2 or more instalments; and
(vi) is made for a period of time or otherwise than for a period of time; and

(b) includes a payment of the kind described in paragraph (a) made—

(i) as a bonus, gratuity, or share of profits; or
(ii) as a redundancy payment; or
(iii) when the person retires from employment; or
(iv) by a retrospective increase in salary or wages, but the payment is included only to the extent to which the payment accrues from the start of the increase until the start of the first pay period in which the increase is included in salary or wages, and to the extent to which, when a week ends with a Saturday, the total of the increase for the week, and of the salary or wages for the week excluding the increase, and of any other salary or wages that the person earns for the week, is more than $4; and

(c) includes income that a person derives under section CE 9 (Restrictive covenants) or CE 10 (Exit inducements) if the income was derived in connection with an employment relationship between the person and the person who paid the income; and

(d) does not include a payment of exempt income

"**shareholder-employee**",—

(a) in sections EA 4 (Deferred payment of employment income) and EI 8 (Matching rule for employment income of shareholder-employee), means a person who receives or is entitled to receive salary, wages, or other income to which section OB 2(2) (Meaning of source deduction payment: shareholder-employees of close companies) applies:

(b) in the FBT rules and in section 177A of the Tax Administration Act 1994, means a person who is, in relation to a close company,—

(i) a shareholder in and an employee of the company; and
(ii) a person to whom section OB 2(2) (Meaning of source deduction payment: shareholder-employees of close companies) applies

Section OB 2 provides:

OB 2 Meaning of source deduction payment: shareholder-employees of close companies

(1) In this Act, except as provided in subsection (2), source deduction payment means a payment by way of salary or wages, an extra pay, or a withholding payment, but does not include an amount attributed in accordance with section GC 14D.

(2) If a taxpayer is a shareholder in and an employee of a close company and in the taxpayer's tax year (or in the taxpayer's corresponding accounting year)—

(a) the taxpayer does not derive as an employee of the company—
(i) salary or wages of a regular amount for regular pay periods of 1 month or less regularly throughout that tax year (or corresponding accounting year); or
(ii) salary or wages, by way of regular payments throughout that tax year (or corresponding accounting year) of a regular amount for regular pay periods, that are in total at least two-thirds of the annual gross income which the taxpayer derives in that tax year (or corresponding accounting year) as an employee of the company; or

(b) any amount is paid or credited to the taxpayer, or applied on the taxpayer's account, in anticipation or in respect of any income that may subsequently be allocated to the taxpayer as an employee of the company,—

for the purposes of this Act, except the FBT rules,—

(c) all assessable income that the taxpayer derives as an employee of the company in every subsequent tax year (or corresponding accounting year) is deemed to be assessable income derived otherwise than from source deduction payments; and

(d) if the taxpayer so chooses, all assessable income that the taxpayer derives from the company in that tax year (or corresponding accounting year) as an employee of the company is deemed to be assessable income derived otherwise than from source deduction payments.

Section YA 3(3) provides:

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.

Section YA 3(5) provides:

Limits to subsections (3) and (4)

(5) Subsections (3) and (4) do not apply in the case of—

(a) a new law specified in schedule 22A (Identified policy changes); or

(b) a new law that is amended after the commencement of this Act, with effect from the date on which the amendment comes into force.

Application of the Legislation

An award for lost wages or other remuneration is made to compensate the employee for wages or other remuneration he or she may have lost as a result of an action by the employer which has been the subject of a personal grievance by the employee against the employer. The wages or other remuneration that would have been received if it were not for the personal grievance are "employment income". Employment income is defined as an amount that is income under section CE 1 and section CE 1 provides that certain amounts derived by a person in connection with the employment are included in the person's income. Those amounts include:

(a) salary or wages or an allowance, bonus, extra pay, or gratuity:

The term "extra pay" covers an award for lost wages or other remuneration. The payment of the award for lost wages or other remuneration must be made "in connection with the employment or service of the person", even though the payment is made to resolve a personal grievance rather than for services actually performed.

Relationship with Income Tax Act 1994

The Income Tax Act 2004 introduces the concept of an amount received by a person "in connection with their employment or service" being income of a person. Previously, the 1994 Act referred to an amount being monetary remuneration, and thus gross income, if it was an amount derived by a person "in respect of or in relation to" their employment or service.

The wording of the 2004 Act provision is different to that in the 1994 Act. However, while the 2004 Act has replaced the 1994 Act, section YA 3(3) of the 2004 Act nevertheless provides that provisions of the 2004 Act are the provisions of the 1994 Act in rewritten form. The provisions of the 2004 Act are intended to have the same effect as the corresponding provision of the 1994 Act. The exception is, pursuant to section YA 3(5), where an "identified policy change", as specified in schedule 22A, exists.

In this instance no identified policy change has been specified in schedule 22A. Therefore, the presumption

is that the adoption of the term "in connection with" was not intended to give rise to an interpretation that differs from that which would apply if the term "in respect of or in relation to", as used in the definition of "monetary remuneration" under the 1994 Act, still applied. It is therefore relevant to consider the meaning of the phrase "in respect of or in relation to" in the interpretation of the phrase "in connection with" in this situation.

The meaning of "in connection with"

The phrase "in connection with" is not defined in the Act. However, it has been considered in other contexts.

In *Strachan v Marriott* [1995] 3 NZLR 272, Hardie Boys J stated, at page 279:

> "In connection with" may signify no more than a relationship between one thing and another. The expression does not necessarily require that it be a causal relationship: Our Town FM Pty Ltd v Australian Broadcasting Tribunal (1987) 16 FCR 465, 479 per Wilcox J. But, as Davies J warned in Hatfield v Health Insurance Commission (1987) 15 FCR 487, at p 491:
>
> "Expressions such as 'relating to', 'in connection with' and 'in respect of' are commonly found in legislation but invariably raise problems of statutory interpretation. They are terms which fluctuate in operation from statute to statute.... The terms may have a very wide operation but they do not usually carry the widest possible ambit, for they are subject to the context in which they are used, to the words with which they are associated, and to the object or purpose of the statutory provision in which they appear."

In *Case E84* (1982) 5 NZTC 59,441 Bathgate DJ noted at page 59,445:

> It is a matter of degree whether, on the interpretation of a particular statute, there is a sufficient relationship between subject and object to come within the words "in connection with" or not. It is clear that no hard and fast rule can be or should be applied to the interpretation of the words "in connection with". Each case depends on its own facts and the particular statute under consideration.

In *Hatrick (A) & Co v R* [1923] AC 213, the Privy Council considered the meaning of "in connection with" in the context of section 10 of the Government Railway Act 1908, which empowered the Minister of Railways to fix charges to be paid for goods stored in any shed or store "in connection with a railway". Their Lordships stated, at page 225:

> In the view of their Lordships these words cannot apply to something done on a space or in a building merely contiguous to or abutting upon a railway, even though it be the property of a railway; if the thing done forms no part of or has no connection with the property business or a railway, as a carrier of passengers and goods by rail, or in other words that the expression "in connection with a railway" means connect with, subserving and being ancillary to, the business of a railway as such carriers … These words … must be direct to something different from propinquity or contiguity, and in their Lordships' view, having regard to all the provisions of the statute, mean in s 10 in connection with the business and operations of a railway as a carrier of goods by rail.

In *Hammington v Ross* (1992) 2 NZ ConvC 191,150, the High Court considered whether a lawyer's omission to disclose his investment in the client's product to the client was a "civil liability incurred in connection with the provision of professional services". *McGechan* J stated, at page 191,162:

> One next goes to the operative clause. It provides cover for claims arising from civil liability incurred "in connection with" provision of "professional services". The clause is a broad one. It extends to "civil liability", not mere classical "neglect, error or omission". It extends to claims incurred "in connection with" the provision of professional services, as contrasted with "in the" provision of professional services. It is not limited to strict integral components of those very services themselves. With that wider wording it was conceded, and rightly, that activity covered would include omission to provide, and "ancillary conduct not strictly professional work - eg, the business advice here". Clearly however there must be a nexus between such wider activity giving rise to liability and the professional services. The wider activity must be related, and not merely co-existent.

In *Pan Pacific Forest Industries (NZ) Ltd v Norwich General* (1997) 7 TCLR 560, the High Court considered whether an insurance policy applied where the product supplied was faulty. The relevant policy applied to "accidental loss of…property…resulting from accidents in connection with the business". Paterson J stated at page 569:

> The operative provisions of the policy apply if the accident was "in connection with the business". Giving those words their natural and ordinary meaning the accident did arise in connection with the business if it arose because the business supplied faulty materials and parts and gave faulty advice.

The phrase "in connection with", has also been considered in the context of section DJ 5 of the Income Tax Act 1994, a provision that allows a tax deduction for costs incurred "in connection with" the determination of a liability to tax. In that context, Bathgate DJ found in *Case E84* that the term required a narrow interpretation. He said, at page 59,445:

> It may be that only an empirical and common sense approach to the interpretation of the words can be applied in each particular case to determine where, if at all, the line should be drawn to allow or not allow expenditure "in connection with" an assessment. However I believe that a narrow interpretation of the words "... any expenditure ... in connection with ... the assessment ..." is the correct interpretation: only expenditure closely and immediately connected to the assessment itself is intended to be allowed as a deduction, and expenditure more remote,

> as for instance in this case, the expenditure of O in making his trip to visit A, is not expenditure allowed as a deduction under the section.

This case suggests that, in the context of section DJ 5, the phrase "in connection with" requires a close linkage between the expenditure and the "determination" or "calculation" of a liability to tax.

The above cases suggest that for something to be "in connection with" something else, a necessary degree of nexus is required, and that the two things must be related to each other in some way. Overall, the Commissioner considers that they suggest that a broad interpretation should be given to the term.

The meaning of "in respect of or in relation to"

It is also necessary to consider the relevant words that were used in the Income Tax Act 1994. As noted, in that Act the relevant test was whether an amount was "in respect of or in relation to" employment, and thus "monetary remuneration".

A wide interpretation of the words "in respect of or in relation to the employment or service" was endorsed by the Court of Appeal in *Shell New Zealand Ltd v CIR* (1994) 16 NZTC 11,303, in response to Shell's argument that a payment was not made in respect of or in relation to employment because it was not made under a contract of employment. The Court stated that the words "in respect of or in relation to" are words of the widest import. The Court also found that the words "emolument (of whatever kind), or other benefit in money" were not to be read *ejusdem generis* with the preceding words, the genus being reward for services. Thus, for the purposes of the definition of "monetary remuneration", the words "emolument ... or other benefit in money" were not confined to rewards for services.

In *Shell* the Court found it important that the employees were only in a position to receive compensation payments (for changing the employees' place of employment) because of their employment relationship with the employer. So, although the employees received compensation for the costs of moving rather than payments for services, this was still monetary remuneration. Similarly, the lost wages or other remuneration awarded on the personal grievance claim arise directly out of and as a result of an employee's employment relationship with the employer. Again, although this is not a payment for services, it was within the definition of "monetary remuneration".

Other cases have also stressed the width of the words "in respect of or in relation to". In the Queens Bench case of *Paterson v Chadwick* [1974] 2 All ER 772, Boreham J considered the meaning of the phrase "in respect of" in relation to discovery, and adopted the comments of Mann CJ in the Australian case *Trustees, Executors & Agency Co Ltd v Reilly* [1941] VLR 110, where the learned Chief Justice said:

> The words "in respect of" are difficult of definition but they have the widest possible meaning of any expression intended to convey some connection or relation in between the two subject-matters to which the words refer.

Similarly, in *Nowegijick v The Queen* [1983] CTC 20 at page 25, the Supreme Court of Canada described the phrase "in respect of" as "probably the widest of any expression intended to convey some connection between two related subject-matters".

The earlier TRA decisions on the previous legislation also illustrate the wide meaning that may be attributed to the words "in respect of or in relation to the employment or service of the taxpayer". In *Case L92* (1989) 11 NZTC 1,530, Barber DJ considered the term "monetary remuneration" in relation to a payment of compensation for unjustified dismissal under the Industrial Relations Act 1973. The compensation was calculated on the basis of the personal hurt and procedural unfairness suffered by the objector. Barber DJ found that, even though the compensation was damages in nature, it was money received in respect of the objector's employment. He stated that the words "compensation for loss of office or employment", "emolument (of whatever kind), or other benefit in money" and "in respect of or in relation to the employment or service of the taxpayer" have a wide embrace and go beyond the narrower concept of "salary, wage, allowance, bonus gratuity, extra salary" which precede them. On the particular facts of this case he said that "monetary remuneration", interpreted widely, covered the payment in issue.

Barber DJ reached the same conclusion in relation to a similar compensation payment in *Case L78* (1989) 11 NZTC 1,451. This case examined the nature of an ex gratia payment made to an employee as a result of a personal grievance claim brought against the employer under section 117 of the Industrial Relations Act 1973 which covered reimbursement for lost wages. The ex gratia payment was made up of six weeks' holiday pay and pay for untaken sick leave. This holiday and sick leave was not owing to the taxpayer. The payment, which the taxpayer said he regarded as "extra wages", was held to fall within the definition of "monetary remuneration" in section 2 of that Act.

In *Case P19* (1992) 14 NZTC 4,127, Barber DJ examined whether a severance payment of $77,598 paid to an objector by his overseas employer was assessable income. The objector was a jockey who entered into a three-year oral contract to ride his employer's horses. The employer became dissatisfied with the objector's performance and unilaterally terminated the contract after about 4 months. After negotiation, the matter was settled on the basis that the employer made the severance payment. Barber DJ held that "the severance payment was made as compensation for the objector's loss of income due to the millionaire having terminated the contractual relationship". He inferred that "the payment was a top-up of the first year's

minimum income" made to "assist the objector re-build his income earning process" and said that that type of payment "must be revenue in nature". He stated that:

> In terms of the definition of "monetary remuneration", the payment made to the objector must be "compensation for loss of office or employment, emolument (of whatever kind), or other benefit in money, in respect of or in relation to the employment or service of the taxpayer;"

Although not concerning a Court award, *Case P19* supports the proposition that payments made as compensation for loss of income fall within the definition of monetary remuneration.

In *Case S96* (1996) 17 NZTC 7,603 and *Case U38* (2000) 19 NZTC 9,361 the taxpayers in each case did not dispute that the portion of their compensation payment that was for lost wages was taxable, and this was accepted by the TRA. Doogue J in the High Court decision in *Sayer v CIR* (1999) 19 NZTC 15,249 also accepted the assessability of the part of a settlement agreement attributed to lost remuneration.

In *Case U39* (2000) 19 NZTC 9,369 an IRD officer was awarded compensation of $126,000 being $46,000 (loss of wages), $30,000 (humiliation), and $50,000 (loss of benefits) by the Employment Court in 1992. The Commissioner accepted that the humiliation payment was not assessable and assessed the balance of $96,000.

Barber DJ readily found that the compensation for lost wages was monetary remuneration, and so was the compensation for loss of benefits. He said (at paragraph 26, p 9,374):

> Awards made by the Employment Court pursuant to ss 227(c)(ii) above and 229 (for lost income) of the Labour Relations Act 1987 are generally deemed to be "monetary remuneration" and assessable income pursuant to s 65(2)(b) of the Income Tax Act 1976. Indeed, because awards under s 229 are a reimbursement of, or compensation for, "lost remuneration" for the worker, any such award (in this case $50,000 [sic] of the $96,000 in issue) must, obviously, be revenue in character and within the above s 2 (of the Act) definition of "monetary remuneration", and assessable.

(Section 128 of the Employment Relations Act 2000 is the equivalent of section 229 of the Labour Relations Act).

In his decision on appeal dated 30 April 2001, Hammond J upheld the TRA's decision: *Cleland v CIR* AP44/00 High Court, Hamilton. He found that the reimbursement of lost wages was "monetary remuneration", saying, at paragraph 41:

> I cannot see how the loss of wages due up to the date of hearing under s229 ($46,000) is not "monetary remuneration" under s2 of the Income Tax Act 1976.

He went on to find that the $50,000 awarded by the Employment Court under section 227(c)(ii) for loss of benefits, which included an element of future wages, was also assessable as "monetary remuneration".

Other New Zealand cases (*Case U38* (2000) 19 NZTC 9,361 and *C of IR v Kerslake* (2001) 20 NZTC 17,158) have also considered the phrase "in respect of or in relation to". Both cases are consistent with the authorities cited above in this commentary.

As noted earlier in this commentary, the law in this area seems to have moved on from requiring a division of awards of lost wages between those up to the date of the hearing (under the reimbursement remedy), and those from that date on (under the loss of benefits remedy). Compensation for lost wages, including those that the employee would have been likely to receive over some future period but for the grievance, are generally awarded under section 123(1)(b) of the Employment Relations Act. See for example *Trotter v Telecom Corporation of NZ Ltd* [1993] 2 NZER 659.

These cases clearly indicate that an award for lost wages or other remuneration is considered assessable as gross income to the employee. The Commissioner considers that these payments are made "in connection with the employment or service" and therefore are included in employment income of the taxpayer.

When the employment relationship has ended

In some cases the employment relationship of the employer and employee will have ended by the time the employer pays the court award to the employee. The fact that the employment relationship may have ended by the time the employer pays the award does not change the fact that the award is made "in connection with the employment or service" of the former employee. In *Freeman & Ors. v FC of T* (1982) 82 ATC 4629 the Supreme Court of Victoria found that a payment is made "in relation to the employment" of a former employee when the entitlement to that payment arises out of the employment or from services performed by the employee before the termination of employment.

In *Freeman* the taxpayers were directors, shareholders, and employees of the appellant company which ceased to carry on business. The next day the business was sold to another company controlled by the taxpayers and carried on business as before. Six months later it was decided that the appellant company should pay to each of the taxpayers certain lump sum payments. The evidence suggested that the source of the greater part of the payments consisted of fees (or "salaries") received by the appellant company after it ceased carrying on business. The Court found that the payments received by the appellants were assessable income under section 26(e) of the Income Tax Assessment Act 1936-1978. Section 26(e) provided that assessable income included the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses and premiums given to him or her in relation directly or indirectly to their employment or services rendered by him or her. Kaye J

found that payments out of the income of the appellant company to employees by way of allowances for past services, which had been rendered by them, were within section 26(e). The decision on this aspect of the case was unchanged when the appeal was heard by the Federal Court.

Awards for lost wages or other remuneration arise out of the employee's previous service with the employer. A court award that compensates for lost wages or other remuneration is made as a result of the employee's service with the employer, and so is made in connection with the employment of the employee.

Employer's liability to make tax deductions from the award for lost wages or other remuneration

The Ruling states that the payment of an award for lost wages or other remuneration is a source deduction payment. Under section NC 2 (1), an employer must make the appropriate tax deduction from every source deduction payment made to an employee.

Award is a source deduction payment

The definition in section OB 2(1) of "source deduction payment" includes a payment by way of salary or wages, an extra pay, or a withholding payment.

Section OB 1 defines "extra pay" as a payment that:

> …
>
> (i) is made to a person in connection with their employment; and
> (ii) is not one regularly included in the salary or wages payable to the person for a pay period; and
> (iii) is not overtime pay; and
> (iv) is made in a lump sum; and
> (v) is made in 1 lump sum or in 2 or more instalments; and
> (vi) is made for a period of time or otherwise than for a period of time; and

An award for lost wages or other remuneration is generally paid in a lump sum but according to section 123(2) of the Employment Relations Act 2000 it can also be paid in instalments if the financial position of the employer requires it. Such a payment would however not regularly be included in the salary or wages payable to the person. As discussed above, the payment of an award for lost wages or other remuneration is made to a person in respect of or in relation to the employment of that person. As the payment of an award for lost wages or other remuneration is generally made in a lump sum, or if made in instalments it is not regularly included in the salary or wages payable to the person, such a payment is considered as being made in connection with the employment of a person, and is not a payment of salary or wages but an extra pay. As the payment of the award is an extra pay, it is included in the definition of "source deduction payment".

A former employee is an "employee"

Section NC 2 requires an employer to make tax deductions from source deduction payments to employees. Section OB 1 defines "employee" as a person who receives or is entitled to receive a source deduction payment.

As discussed above, the payment of an award for lost wages or other remuneration constitutes a source deduction payment. A payment can still be "monetary remuneration" and a source deduction payment when it is paid to a former employee. A former employee who is entitled to receive this source deduction payment is also an "employee" for the purposes of section NC 2 (even though he or she may no longer be in an employment relationship with the employer).

The appropriate tax deduction

Section NC 2 requires the employer to make the appropriate tax deduction from source deduction payments to employees. As the payment of an award for lost wages or other remuneration constitutes an "extra emolument", the employer must deduct tax at the extra emolument rate as provided for in section NC 2(5) and clause 8 of Schedule 19. (This currently provides a minimum rate of 21 cents in the dollar, or 33 cents or 39 cents in the dollar depending on the recipient's income level, or on whether the recipient makes an election for a particular rate under section NC 8(1A)).

The employer must also:

- deduct ACC earner premium and earners' account levy from the payment; and
- account for the deductions to Inland Revenue in the normal way and pay the remaining amount to the employee; and
- pay employer premium and residual claims levy in respect of the gross award for lost wages or other remuneration.

By deducting tax from the gross award and paying the net sum to the employee, the employer will satisfy the requirements under both the court award and the Income Tax Act. When an employer has deducted tax from a source deduction payment, section NC 19(a) deems the employer to have paid the amount deducted to the employee. Thus, the employer is deemed to have paid the total amount of the award to the employee for the purposes of satisfying the obligation imposed by the Court or Authority.

When the Court or Authority awards a net sum

In some cases a Court or Authority may make an award for lost wages or other remuneration net of tax, i.e. the sum that the employee would have received as remuneration after the deduction of tax. Because it is a "source deduction payment", in such cases the employer would normally "gross up" the award to take

account of the PAYE, the ACC earner premium, and the earners' account levy. The employer is then required to pay the tax on the gross of the net award to Inland Revenue and pay the net award to the employee. In this way the employer would fulfil his or her obligations to both the employee and the Commissioner.

If the employer breaches the Court's or the Authority's direction to pay the net sum to the employee, the onus will be on the employee to enforce the terms of the award by requiring the employer to pay the employee the full net amount of the award. The required tax deduction must be made from whatever amount is paid to the employee.

When an employer fails to make tax deductions

Under section 168 of the Tax Administration Act 1994, if the employer fails to make the correct tax deductions from the payment of the award, the unpaid tax deductions become a debt owed by the employer to the Commissioner. The debt is due and payable on the date that the tax deductions were due to be paid to the Commissioner.

Where an employer fails to make a deduction, the employee is liable, under section NC 16, to:

- furnish the Commissioner with an employer monthly schedule containing particulars of the source deduction payment (i.e. the award) by the 20th of the month following the payment of the award; and
- pay the Commissioner a sum equal to the tax deductions that the employer should have made on that source deduction payment (unless the employee is exempted from this requirement) by the 20th of the month following the payment of the award.

When the payment is derived by the shareholder-employee.

Under section EB 1, a person is a shareholder-employee if he or she is a shareholder-employee in a close company and has met the criteria set out in section OB 2(2).

Example 1

An employee is dismissed from her job. She issues proceedings against her former employer alleging unjustifiable dismissal. She seeks reinstatement and damages for wages lost as a result of the unjustifiable dismissal.

The Employment Relations Authority orders the employer to reinstate the employee and awards her $27,000, a sum equivalent to the employee's wages from the time of dismissal to the time of reinstatement, to compensate for the wages lost as a result of the unjustified dismissal.

The Authority makes the award for lost wages on 20 March 2006. The employer pays this award to the employee on 10 April 2006.

1. The award for lost wages is derived by the employee in the 2006-07 income year, as this is the year of receipt.
2. The employer must deduct tax and ACC earner premium and earners' account levy from the court award, and pay the following amounts to the employee and Inland Revenue respectively (in the 2007 income year):

Award for lost wages	$	27,000
Less tax at the extra emolument rate, in this case 21%	$	5,670
Less ACC earner premium ($27,000 x 0.011)	$	297
Total payable to Inland Revenue	$	5,967
Total payable to the employee	$	21,033

Example 2

The facts are the same as in Example 1, except that the Authority awards damages of $27,000 and states that this sum is net of tax. In order to ensure that it pays the employee a net sum of $27,000, the employer "grosses up" the payment by the extra emolument tax rate plus ACC earner premium and levy. The employer should make the following calculations and payments:

Award for net lost wages	$27,000.00
Divided by 0.779 (1 - 0.21 - 0.011) to give the gross wage	$34,659.82
Less tax at the extra emolument rate of 21%	$ 7,278.56
Less ACC earner premium ($34,659.82 x 0.011)	$ 381.26
Total payable to Inland Revenue	$ 7,659.82
Total payable to the employee	$27,000.00

In both examples:

- The employer must also pay the employer premium and residual claims levy on the gross award.
- Any other source deduction payments received by the employee from that employer in the 4 weeks prior to payment of the award must also be taken into account in calculating her annualised salary or wages and determining the appropriate tax deduction rate.
- If the employee is required to file an income tax return, she will include the amount of the award for lost wages in her return for the 2006-07 income year and claim the tax paid as a credit.

NEW LEGISLATION

ORDERS IN COUNCIL

Payroll subsidy rate set by regulation

The Income Tax (Payroll Subsidy) Regulations 2006 come into force on 1 October 2006 and provide the calculation of the payroll subsidy to be paid to listed payroll intermediaries under section NBB 6 of the Income Tax Act 2004.

The subsidy will be paid in respect of employers who contract the services of a listed payroll intermediary. The regulations set the payroll subsidy at $2 per employee per pay day.

The regulations were made by Order in Council on 19 June 2006.

(Income Tax (Payroll Subsidy) Regulations 2006 (2006/159))

Forests (payment of money) order 2006

A payment to protect high conservation-value land in Southland has been exempted from income tax under the Forests (Payment of Money) Order 2006.

The Order in Council, made under the Forests Amendment Act 2004 (see *Tax Information Bulletin* Vol. 16, No. 8, page 19) exempts the January 2005 payment made by the Nature Heritage Fund to the owners of a block of land in Waitutu Forest for entering into a conservation covenant over the land.

The Order in Council, which came into effect on 20 July 2006, implements part of the government's SILNA (South Island Landless Natives Act 1906) Policy Package announced in 2002.

(Forests (Payment of Money) Order 2006 (2006/155))

CORRECTION

FBT – Tax value of vehicle under different balance date scenarios

In the item published under the section, "New Legislation" in the *Tax Information Bulletin*, Vol 18, No 5 (June 2006), please note that in the second part of the example shown on page 78 the reference to "1 July 2006" should read "1 July 2005" and the reference to "1 July 2007" should read "1 July 2006", as shown in the next column.

Example

Assuming that the vehicle was held for the whole year:

1. For the owner of a vehicle with a balance date of 31 March who is completing a quarterly FBT return for the period April–June 2006, the tax value would be the vehicle's depreciated value at the beginning of the 2006–07 tax year, that is, as at 1 April 2006. This value would also apply to the September 2006, December 2006 and March 2007 FBT returns.

2. For the owner of a vehicle with a balance date of 30 June who is completing a quarterly FBT return for the period April–June 2006, the tax value would be the vehicle's depreciated value at the beginning of the 2005–06 tax year, that is, as at **1 July 2005**. For the September 2006 quarter's FBT return, the tax value would be the depreciated value as at **1 July 2006**. *(emphasis added)*

Assuming that the vehicle was acquired on 7 December 2005 at a cost of $30,000:

In case (1) the tax value for the June 2006 FBT quarter's return would be its depreciated value as at 1 April 2006 whereas in case (2) its tax value would be its cost price of $30,000.

The example implicitly assumes that the employer can use the tax value option in the return for April–June 2006, although the vehicle was owned before that date. This would be the case if:

- when the vehicle was owned for the whole year, at least five years had lapsed since the beginning of the vehicle's initial return period; and
- when the vehicle was acquired on 7 December 2005, the first return for the vehicle is for the April–June 2006 quarter (that is, the vehicle was not used to provide fringe benefits until that quarter even though it had been purchased some months earlier).

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.

PROVISIONAL DEPRECIATION DETERMINATION PROV13

This determination may be cited as "Determination PROV13: Tax Depreciation Rates Provisional Determination Number 13". This determination replaces "Determination Prov10: Tax Depreciation Rates Provisional Determination Number 10" issued on 11 September 2002.

1. Application

This determination applies to taxpayers who own the provisional asset classes listed below.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2005/2006 and subsequent income years.

2. Determination

Pursuant to section 91AAG(4) of the Tax Administration Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Deleting from the "Dairy Plant", "Fishing", and "Oil and Gas" industry categories, the provisional asset classes, estimated useful lives, and diminishing value and straight-line depreciation rates listed below:

	Estimated useful life (years)	DV banded dep'n rate %	SL equiv banded dep'n rate %
Pipeline Crawler	5	33	24
Inflatable Pipeline Plug	3	50	40

- Inserting into the "Dairy Plant", "Fishing", and "Oil and Gas" industry categories, the provisional asset classes, estimated useful lives, and diminishing value and straight-line depreciation rates listed below. Columns 3 and 4 apply to items purchased prior to 1 April 2005. Columns 5 and 6 apply to items purchased on or after 1 April 2005:

1	2	3	4	5	6
Provisional asset class	Estimated useful life (years)	DV banded dep'n rate before 1/4/05 (%)	SL equiv banded dep'n rate before 1/4/05 (%)	DV banded dep'n rate from 1/4/05 9%	SL equiv banded dep'n rate from 1/4/05 (%)
Pipeline Crawler	5	33	24	40	30
Inflatable Pipeline Plug	3	50	40	67	67

- Deleting from the "Compressed Air", "Factory and Other Sundries", "Reticulation Systems", and "Water and Effluent Treatment" asset categories, the provisional asset class, estimated useful lives, and diminishing value and straight-line depreciation rates listed below:

	Estimated useful life (years)	DV banded dep'n rate %	SL equiv banded dep'n rate %
Pipeline Crawler	5	33	24
Inflatable Pipeline Plug	3	50	40

- Inserting into the "Compressed Air", "Factory and Other Sundries", "Reticulation Systems", and "Water and Effluent Treatment" asset categories, the provisional asset class, estimated useful lives, and diminishing value and straight-line depreciation rates listed below. Columns 3 and 4 apply to items purchased prior to 1 April 2005. Columns 5 and 6 apply to items purchased on or after 1 April 2005:

1	2	3	4	5	6
Provis-ional asset class	**Estimated useful life (years)**	**DV banded dep'n rate before 1/4/05 (%)**	**SL equiv banded dep'n rate before 1/4/05 (%)**	**DV banded dep'n rate from 1/4/05 9%**	**SL equiv banded dep'n rate from 1/4/05 (%)**
Pipeline Crawler	5	33	24	40	30
Inflatable Pipeline Plug	3	50	40	67	67

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 1994 and the Tax Administration Act 1994.

This determination is signed by me on the 28th day of June 2006.

Susan Price
Senior Tax Counsel

PROVISIONAL DEPRECIATION DETERMINATION PROV14

This determination may be cited as "Determination Prov14: Tax Depreciation Rates Provisional Determination Number 14". The determination replaces "Determination Prov12: Tax Depreciation Rates Provisional Determination Number 12" issued on 15 December 2004.

1. Application

This determination applies to taxpayers who own assets in the provisional asset class set out below.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2005/2006 and subsequent income years.

2. Determination

Pursuant to section 91AAG(4) of the Tax Administration Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Deleting from the "Hotels, motels, restaurants, cafés, taverns and takeaway bars", "Residential rental property chattels" and "Shops" industry categories and the "Office equipment and furniture" asset category, in the appropriate alphabetical order, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below.

Office equipment and furniture	Estimated useful life (years)	DV banded dep'n rate (%)	SL equiv banded dep'n rate (%)
Integrated silk flower arrangements	2	63.5	63.5

- Inserting into the "Hotels, motels, restaurants, cafés, taverns and takeaway bars", "Residential rental property chattels" and "Shops" industry categories and the "Office equipment and furniture" asset category, in the appropriate alphabetical order, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below. Columns 3 and 4 apply to items purchased prior to 1 April 2005. Columns 5 and 6 apply to items purchased on or after 1 April 2005:

1	2	3	4	5	6
Provis-ional asset lass	**Estimated useful life (years)**	**DV banded dep'n rate before 1/4/05 (%)**	**SL equiv banded dep'n rate before 1/4/05 (%)**	**DV banded dep'n rate from 1/4/05 (%)**	**SL equiv banded dep'n rate from 1/4/05 (%)**
Integrated silk flower arrange-ments	2	63.5	63.5	100	100

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 2004 and the Tax Administration Act 1994.

This determination is signed by me on the 28th day of June 2006.

Susan Price
Senior Tax Counsel

PROVISIONAL DEPRECIATION DETERMINATION PROV15

This determination may be cited as "Determination Prov15: Tax Depreciation Rates Provisional Determination Number 15". The determination replaces "Determination Prov8: Tax Depreciation Rates Provisional Determination Number 8" issued on 11 October 2001.

1. Application

This determination applies to taxpayers who own assets in the "Agriculture, Horticulture and Aquaculture" industry category that are in the provisional asset class set out below.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2005/2006 and subsequent income years.

2. Determination

Pursuant to section 91AAG(4) of the Tax Administration Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Deleting from the "Agriculture, Horticulture and Aquaculture" industry category the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below:

Agriculture, Horticulture and Aquaculture	Estimated useful life (years)	DV banded dep'n rate (%)	SL equiv banded dep'n rate (%)
Trough covers (polyethylene)	5	33	24

- Inserting into the "Agriculture, Horticulture and Aquaculture" industry category, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below. Columns 3 and 4 apply to items purchased prior to 1 April 2005. Columns 5 and 6 apply to items purchased on or after 1 April 2005:

1	2	3	4	5	6
Provis-ional asset class	Estimated useful life (years)	DV banded dep'n rate before 1/4/05 (%)	SL equiv banded dep'n rate before 1/4/05 (%)	DV banded dep'n rate from 1/4/05 (%)	SL equiv banded dep'n rate from 1/4/05 (%)
Trough covers (plastic)	5	33	24	40	30

3. Interpretation

In this determination, unless the context otherwise requires, expressions have

the same meaning as in the Income Tax Act 2004 and the Tax Administration Act 1994.

This determination is signed by me on the 28th day of June 2006.

Susan Price
Senior Tax Counsel

PROVISIONAL DEPRECIATION DETERMINATION PROV16

This determination may be cited as "Determination PROV16: Tax Depreciation Rates Provisional Determination Number 16"

1. Application

This determination applies to taxpayers who own assets in the "Leisure" and "Medical and Medical Laboratory" industry categories that are in the provisional asset classes set out below.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2004 05 and subsequent income years.

2. Determination

Pursuant to section 91AAG(4) of the Tax Administration Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Inserting into the "Leisure" industry category, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below. Columns 3 and 4 apply to items purchased prior to 1 April 2005. Columns 5 and 6 apply to items purchased on or after 1 April 2005:

1	2	3	4	5	6
Provisional asset class	**Estimated useful life (years)**	**DV banded dep'n rate before 1/4/05 (%)**	**SL equiv banded dep'n rate before 1/4/05 (%)**	**DV banded dep'n rate from 1/4/05 (%)**	**SL equiv banded dep'n rate from 1/4/05 (%)**
Marble rock instruments (heated) or chilled and used in the massage process)	2.5	7.5	5.5	8	6

- Inserting into the "Medical and Medical Laboratory" industry category, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below. Columns 3 and 4 apply to items purchased prior to 1 April 2005. Columns 5 and 6 apply to items purchased on or after 1 April 2005:

1	2	3	4	5	6
Provisional asset class	**Estimated useful life (years)**	**DV banded dep'n rate before 1/4/05 (%)**	**SL equiv banded dep'n rate before 1/4/05 (%)**	**DV banded dep'n rate from 1/4/05 (%)**	**SL equiv banded dep'n rate from 1/4/05 (%)**
Marble rock instruments (heated) or chilled and used in the massage process)	2.5	7.5	5.5	8	6

3. Interpretation

In this determination, unless the context otherwise requires, expressions have

the same meaning as in the Income Tax Act 2004 and the Tax Administration Act 1994.

This determination is signed by me on the 28th day of June 2006.

Susan Price
Senior Tax Counsel

QUESTION WE'VE BEEN ASKED

This section of the *TIB* sets out answers to some enquiries we've received. We publish these as they may be of general interest to readers. A general similarity to items published here will not necessarily lead to the same tax result. Each case should be considered on its own facts.

EXEMPTION FROM GIFT DUTY FOR DISPOSITIONS OF PROPERTY MADE BY OR UNDER AN ORDER OF THE COURT: SECTION 75A(5) ESTATE AND GIFT DUTIES ACT 1968

As indicated in the Exposure Draft of this item, the interpretation of the law outlined in this item will be applied by the Commissioner to dispositions of property made after **5 October 2005** by or under an order of the Court pursuant to section 25 of the Property (Relationships) Act 1976. The Commissioner has considered the submissions received in respect of the Exposure Draft and has not significantly changed the view taken in the Exposure Draft, although amendments have been made to the item to clarify the Commissioner's position.

Background

We have been asked to clarify when the exemption from gift duty provided in section 75A(5) of the Estate and Gift Duties Act 1968 ("the EGDA") applies to dispositions of relationship property made by or under an order of the Court pursuant to section 25 of the Property (Relationships) Act 1976.

Application

The interpretation of the law outlined in this item will be applied by the Commissioner to dispositions of property made after 5 October 2005 by or under an order of the Court pursuant to section 25 of the Property (Relationships) Act 1976.

The Commissioner has published a Notice of Withdrawal giving notice of the withdrawal of the previous policy statements contained in the item entitled "Gift Duty Exemption Clarified" published in *Tax Information Bulletin* Vol 9, No 6, June 1997 and the item entitled "Gift Duty Exemption Further Clarified" published in *Tax Information Bulletin* Vol 9, No 8, August 1997.

Legislation

Section 75A of the EGDA provides for exemptions from gift duty for certain dispositions of property made pursuant to the provisions of the Property (Relationships) Act 1976 ("the PRA") (formerly called the Matrimonial Property Act 1976).

Section 75A of the EGDA as a whole was re-enacted by the Property (Relationships) Amendment Act 2001 with effect from 1 August 2001. The substituted provision took into account the changes made by the amendment Act to the Matrimonial Property Act 1976. The changes in wording widened the group of people who could be parties to an exempt transaction by including de facto partners but did not change the other requirements for an exempt transaction.

Section 75A(5) of the EGDA concerns a disposition of property by or under an order of the Court made pursuant to section 25 of the PRA.

Prior to 25 September 1993, section 75A(5) did not limit the dispositions that were exempt from gift duty if they were made under a court order pursuant to section 25 of the PRA. From 25 September 1993, amendments to the EGDA restricted the application of the exemption to dispositions "to" a spouse or former spouse or dispositions made "solely for the benefit of" minor or dependent children of the marriage. These amendments were made to counter the effect of the decision in *Wilson v Wilson (No.2)* (1991) 7 FRNZ 519 which allowed a gift duty free transfer of matrimonial assets directly to a discretionary family trust.

Section 75A(5) was subsequently amended by the Estate and Gift Duties Amendment Act 2005 to include references to civil unions and children of civil unions. These amendments took effect from 26 April 2005.

Section 75A(5) of the EGDA provides as follows:

> Any disposition of property by or under an order of the Court under section 25 of the Property (Relationships) Act 1976 does not constitute a gift to the extent that the disposition is to a spouse, civil union partner or de facto partner or former spouse, civil union partner or de facto partner or is solely for the benefit of minor or dependent children of the marriage or, as the case requires, minor or dependent children of the civil union or de facto relationship.

Application of the legislation

We have been asked to clarify the application of section 75A(5) of the EGDA, particularly in the context of dispositions made to a fixed or discretionary non-charitable trust. The wording of the subsection raises the issue of whether a disposition "to" or "solely for the benefit of" a person can be made through a disposition to a fixed or discretionary trust where the person concerned is a named beneficiary of the trust.

Disposition to a spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner

The exemption contained in section 75A(5) of the EGDA is available in respect of dispositions to a spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner where the disposition of property is made "to" the person. The word "to" in the context of section 75A(5) means a disposition towards a person, i.e. the giving of something in the direction of a particular person (the spouse/civil union partner/de facto partner, or former spouse/civil union partner/de facto partner). A disposition of property by way of **direct transfer** to the person concerned would be a disposition *to* that person.

The exemption is not available where the disposition of property is made **to a fixed trust** where the spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner is a named beneficiary because the disposition is not made directly to the person but is instead made directly to a third party, the trustee. The Commissioner does not consider that the receipt of a beneficial interest in the trust property is sufficiently direct to attract the exemption from gift duty. This is on the basis of the words used in the subsection which can be contrasted with the words used in respect of dispositions to children, being "for the benefit of", which clearly intend the use of a trust vehicle. The legislative history of the provision supports an interpretation of the text of the provision that the subsection differentiates between the type of disposition that is acceptable in terms of adults, and the types of disposition that are acceptable in terms of dispositions to minor or dependent children. The use of trusts was to be restricted to situations where the ultimate recipient of the property was a minor or dependent child, and a more direct disposition was required where the recipient was an adult.

The exemption is not available where the disposition of property is made **to a discretionary trust** where the spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner is a potential beneficiary because, again, the disposition is not made directly to the person but is instead made directly to a third party, the trustee. In addition, there is no certainty that the person will receive any part of the trust property. This would be the case whether or not the class of possible beneficiaries was closed. On the plain meaning of the words used in subsection (5), a disposition of property by way of a discretionary trust is not a disposition "to" a person who *may* later become a beneficiary.

The words "to the extent that" in subsection 75A(5) apply to all categories of disposition but in the context of a disposition "to" a person, apportionment will only be possible if a disposition is divided between a *direct* gift to a spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner and a gift to others (by way of trust or otherwise). The disposition to the spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner would then be exempt under section 75A(5).

The same analysis is relevant in terms of subsections 75(A)(2) and (3) of the EGDA which apply to dispositions of relationship property "to" a party to an agreement under section 21 of the PRA. The disposition of property would have to be made directly to the party concerned in order for the exemption to apply.

Disposition solely for the benefit of minor or dependent children of the marriage, civil union or de facto relationship

The use of the words "for the benefit of" recognise that, in many situations where relationship property is being transferred, the intended recipient will, at the time of disposition, be a minor and unable to hold property him or herself. In such a situation the use of a trust in the child or children's favour is often an appropriate way of disposing of the property. However, there are still some limitations on the use of trusts in this context which are imposed by the words used in the section.

The *Concise Oxford Dictionary* (10th ed) defines "benefit" as follows:

> • n. **1** an advantage or profit gained from something. **2** a payment made by the state or an insurance scheme to someone entitled to receive it, e.g. an unemployed person. 3 a public performance designed to raise money for a charity. • v. (**benefited** or **benefited, benefiting** or **benefiting**) receive an advantage; profit.

In *Re Remnants Settlements Trust* [1970] 2 All ER 554, Pennycuick J stated that:

> The Court is entitled and bound to consider not merely financial benefits but benefits of any other kind.

In *Re W* [1970] 2 All ER 504, Ungoed-Thomas J stated that:

> It seems clear to me that it is not restricted to material benefit, but it is of wide significance comprehending whatever would be beneficial in any respect, material or otherwise. The word "benefit", prima facie, carries such wide significance; it is not limited to any particular aspect of benefit.

The word "for" has many meanings; it is defined in the *Concise Oxford Dictionary* (10th ed) as meaning:

> • prep. **1** in favour of. **2** affecting or with regard to. **3** on behalf of or to the benefit of. **4** having as a purpose or function. **5** having as a reason or cause. **6** having as a destination. **7** representing. **8** in exchange for. > charged as (a price). **9** in relation to the expected norm of. **10** indicating the extent of (a distance) or the length of (a period of time). **11** indicating an occasion in a series.

The most appropriate definitions of the word "for" in the context of subsection (5) would be the fourth and fifth definitions. The definitions are of more relevance when

read as part of the phrase in section 75A(5), "solely for the benefit of" as follows:

> "solely *having as a purpose or function* the benefit of minor or dependent children"
>
> "solely *having as a reason or cause the benefit* of minor or dependent children"

The word "sole", of which "solely" is a derivative, is defined in the *Concise Oxford Dictionary* (10th ed) as meaning:

> • adj. **1** one and only. > belonging or restricted to one person or group. **2** archaic (especially of a woman) unmarried. > alone.

In *Ministry of Health v Fox* [1950] 1 All ER 1050 the meaning of the words "solely for the purposes of that hospital" in section 7 of the National Health Services Act 1946 (UK) were interpreted in relation to the application of money by a trust towards a maternity home. As the trustees were applying the funds and its income towards the maintenance and conduct of the maternity home, and for no other purpose, the funds were held to be employed "solely for the purposes of that hospital", in terms of section 7 of that Act. This case was cited with approval in *Re Majoribanks Indenture* [1952] 1 All ER 91, which was applied in *Re Galloway, Hollins v AG* [1952] 1 All ER 1379.

Therefore, from the preceding analysis, the word "solely" means something which belongs or is restricted to one person or group of persons.

Where the minor or dependent children of a marriage/civil union/relationship are the sole beneficiaries of a fixed trust, the disposition of property would be "for the benefit of" those children, as the purpose of the trust and the responsibilities of the trustees would be to apply the property "solely" for the benefit of those children, and they would likely receive a financial advantage. Despite the trustees holding the legal interest in the property, the ultimate recipients of any benefit would be the children. Such a disposition would be "solely" for their benefit because they would have a clear beneficial interest which could not be affected by another person.

The inclusion of the words "to the extent that" in subsection (5) indicates that the children do not have to be the sole beneficiaries of a fixed trust. The words clearly anticipate apportionment and such would be easily done in the context of a fixed trust where the interests of each beneficiary are identifiable.

However, under a discretionary trust, it is not possible to identify the interests of the beneficiary until such time as the trustee exercises his or her discretion. Where the only beneficiaries of the trust are the minor or dependent children of the marriage, civil union or relationship, and there is no ability for the trustees to add or substitute beneficiaries, such a disposition would be "solely for the benefit of" the children notwithstanding that their share is not quantifiable. The subsection is concerned with ensuring that no one other than the parents and the children can benefit and, in a discretionary trust where *only* the children can *ever* benefit (even if not all of them actually do) the disposition would satisfy the requirements of the section.

There may appear to be an anomaly in section 75A(5) of the EGDA because of the differences in the application of the subsection in terms of dispositions to adults and dispositions in favour of children. However, the text of section 75A(5) deliberately distinguishes between dispositions "to" and dispositions "for the benefit of" a person. This would indicate that the text requires a direct disposition in the case of dispositions to a spouse, civil union partner or de facto partner but accepts more indirect dispositions where children are concerned.

The legislative history of the provision supports an interpretation that the subsection differentiates between the type of disposition that is acceptable in terms of adults, and the types of disposition that are acceptable in terms of dispositions to minor or dependent children. The use of trusts was intended to be restricted to situations where the ultimate recipient of the property was a minor or dependent child, and a more direct disposition was required where the recipient was an adult.

There is case authority to the effect that a settlement on trust that would benefit not only the primary beneficiary but also her future children, came within the phrase "for the advancement or benefit … of any person" ("any person" being the primary beneficiary). In *IRC v Pilkington* [1964] AC 612 the House of Lords held that a settlement on trust for an infant child would be to her benefit even if others (namely her future children) also benefited. The decision referred to incidental benefits to other persons (unrelated third parties) that would also be considered to be "for the benefit of" the primary beneficiary. The Commissioner considers that this analysis does not apply in respect of section 75A(5) because of the use of the word "solely" - the disposition of property must benefit *only* the primary beneficiary and cannot benefit another person, either directly or indirectly.

Conclusions

The exemption from gift duty contained in section 75A(5) of the EGDA is available in respect of the following dispositions:

- A disposition to a spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner where the disposition of property is made directly to the person;
- A disposition directly to a minor or dependent child;
- A disposition to a fixed trust where the minor or dependent child or children receive a beneficial interest in the trust property. Where there are other beneficiaries of such a trust, the interests of the children can be apportioned and be exempted from gift duty; and

- A disposition to a discretionary trust where:
  - The closed class of beneficiaries includes **only** the minor or dependent children of the marriage/relationship,
  - There are no other possible beneficiaries named or described (including default beneficiaries); and
  - No ability exists for the trustee or some other person or persons to subsequently add further beneficiaries, or to resettle the trust in a way that adds further beneficiaries, unless the further beneficiaries are also minor or dependent children of the marriage/ relationship.

The exemption is **not** available in the following situations:

- The exemption is not available where the disposition of property is made to a fixed trust where the spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner is a named beneficiary. If the minor or dependent children of the relationship are also named as beneficiaries of that fixed trust, the disposition is exempt to the extent that it is made for the benefit of those children.
- The exemption is not available where the disposition of property is made to a discretionary trust where the spouse/civil union partner/de facto partner or former spouse/civil union partner/de facto partner is a potential beneficiary.

These conclusions differ from the previous published items because a disposition **to a fixed trust** where the spouse/de facto partner or former spouse/de facto partner is a named beneficiary is no longer considered to be exempt. However, a disposition made to the same fixed trust "solely for the benefit of" minor or dependent children of the marriage/relationship can be apportioned and exempted from gift duty. In addition, a disposition **to a discretionary trust** where the spouse/de facto partner or former spouse/de facto partner is a potential beneficiary as well as minor or dependent children of the marriage/ relationship is not exempt from gift duty and no part of the disposition can be apportioned.

Submissions Received

Submissions received by Inland Revenue on an exposure draft of this item raised the issue of an apparent inconsistency between the treatment of a disposition to the trustee of a will following the death of a testator (which would be exempt from gift duty) and the treatment of an *inter vivos* gift (which is subject to gift duty).

When estate duty was abolished in 1992, the Government accepted that testamentary dispositions of property would not be subject to any kind of duty or tax. Such dispositions have never been subject to gift duty and are expressly excluded from the definition of "gift" in the EGDA. It was never intended that these two types of disposition be treated in the same way - when estate duty was abolished a decision was made by the Government to retain gift duty because it acts as a barrier to people gifting their assets to associated parties such as family trusts to avoid income tax and government assistance targeting and defeat creditors.

Some submissions received also referred to a number of Family Court decisions regarding the disposition of relationship property (for example *Ford v Ford* (2001) 21 FRNZ 109 and *Re Roberts' Application* [1994] 1 NZLR 200). These cases do not relate specifically to gift duty, nor do they discuss the gift duty implications of the dispositions involved. The cases are therefore of limited value in the context of this item.

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.

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

INCOME TAX TREATMENT OF NEW ZEALAND PATENTS

1. SUMMARY

1.1 This Interpretation Statement covers the income tax treatment for New Zealand patent applications, New Zealand patents and New Zealand patent rights, particularly:

- patent applications, patents, patent rights and their depreciation;
- costs incurred in legal proceedings;
- proceeds and allowable deductions on the sale of patent applications and patent rights; and
- patent-related expenses and proceeds under old legislative rules, which still apply in some circumstances.

1.2 All legislative references in this statement are to the Income Tax Act 2004 ("the Act") unless otherwise indicated. The Act states that, except for the identified policy changes specified in Schedule 22A, its provisions are those of the Income Tax Act 1994 in rewritten form and they are intended to have the same effect as the corresponding provisions in the Income Tax Act 1994. Section YA 3(3) states:

> *Intention of new law*
>
> (3) Except when subsection (5) applies, the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994.

1.3 None of the provisions referred to in this statement are specified in Schedule 22A and it is considered that the position as to the law, set out in this statement, would equally apply to the income tax treatment of New Zealand patents under the provisions of the Income Tax Act 1994.

1.4 The Act refers generally to "patent rights" rather than "patents". Section OB 1 of the Act defines "patent rights" as meaning "the right to do or authorise the doing of anything that would but for the right, be an infringement of a patent". "Patent" is not defined in the Act, but is defined in the Patents Act 1953 as meaning "letters patent for an invention". It is considered that "patent rights" include the rights granted to the patent holder and also rights subsequently assigned to other parties. In discussing the legislative provisions, this statement uses the term "patent" in those places which refer to a "patent". Where the provisions refer to "patent rights", sometimes for clarity, the discussion uses the terms "patent" and "patent rights".

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

- References in the legislation to a "patent" refer to the legal rights that the owner of the patent obtains as a result of the grant of that patent. In the case of New Zealand patents, this will be the legal rights obtained as the result of a patent granted under the Patents Act 1953.
- Other intellectual property rights are not patent rights.
- The treatment of expenditure on research and development for tax purposes, including that on the construction of prototypes, will be in accordance with:

  - section DB 25 for scientific research;
  - sections DB 26 and DB 27 for other research and development if the taxpayer both complies with the relevant requirements of FRS-13, and chooses to apply these sections; or
  - sections BD 2, DA 1 to DA 4 and DY 2.
- The current statutory provisions relating to "patents" only affect income and expenditure incurred in the patenting process, i.e. typically the administrative and legal costs incurred in the application for the patent, not income and expenditure incurred in devising the invention to which the patent relates.
- Legal expenses incurred in either defending or attacking a patent are generally revenue in nature.
- For a person who devised an invention for which a patent has been granted and who uses the patent for deriving income, the person is allowed a deduction for expenditure incurred before 1 April 1993: section DB 29(2).
- If the person who devised the invention sells the patent rights relating to the invention, a deduction is allowed for the expenditure incurred in deriving the invention to the extent that a deduction has not already been allowed under section DB 29(2): section DB 29(3).
- When patent rights acquired on or after 1 April 1993 are sold, a deduction is allowed of the total cost to the person of those patent rights less total amounts of depreciation loss: section DB 31.
- The disposal of patent rights is the disposal of a capital item unless it is the rare situation where the taxpayer is in the business of buying and selling patent rights, in which case, patent rights are trading stock and their disposal is a revenue item. Patent rights, which are trading stock, are not depreciable.
- An amount that a person derives from the sale of patent rights is income of the person, section CB 26.

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

2. BACKGROUND

Patents, patent rights and income tax

2.1 Under the current legislation, patent applications, patents and the rights to use a patent are generally depreciable intangible assets which, when sold, give rise to assessable income.

2.2 A "patent" refers to the legal rights, granted to an applicant, to exclude others from using a particular mode of manufacture. The patent does not include the invention to which the patent relates. The depreciable value of a patent or a right to use a patent relates only to costs incurred in obtaining the patent. These costs are typically legal and administrative costs. As a result, research and development costs incurred in devising an invention, for which a patent is sought, are not included in the depreciable value of that patent or the right to use that patent.

Former tax treatments of patents and patent rights

2.3 The tax treatment of patents and patent rights has changed several times. Before 1945, there was no specific tax treatment applicable to patents. Patents were capital assets under ordinary principles, unless the taxpayer was in the business of selling patents.

2.4 Under the Land and Income Tax Amendment Act 1945, provisions were enacted that dealt with the costs of devising the invention and purchasing patents. These provisions also dealt with the costs of granting, maintaining and extending patents, and the receipts from the sale of patents. Generally, proceeds from the sale of patents were assessable, the costs deductible and the income and deductions could be spread. A provision was also introduced relating to scientific research expenditure.

2.5 Further provisions relating to the depreciation of patents were enacted in the Income Tax Amendment Act 1993 and the Taxation (Core Provisions) Act 1996, and, under the Taxation (Remedial Provisions) Act 1997, the ability to spread income derived on the sale of a patent provided for under section DJ 6(1) of the Income Tax Act 1994 (now section DJ 28 of the Act) was removed.

2.6 Under the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005, a patent application with a complete specification lodged on or after 1 April 2005 is included as depreciable intangible property under Schedule 17. The

Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 also inserted sections EE 27B to EE 27D in the Income Tax Act 2004, which provide formulae for the respective annual rates to be used for the depreciation calculations of patent applications and patents.

Patents generally

The Patents Act 1953

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

The patent application

2.8 A patent applicant usually engages a patent attorney to file the patent application. Amongst other things, the work of the patent attorney will include the search of published patent specifications at the Intellectual Property Office before the application is filed.

2.9 The patent application may be filed with either a provisional or a complete specification of an invention. A provisional specification is a general description of the invention. A complete specification is a detailed description of the invention. In all cases, a complete specification must be filed within 12 months of the application.

2.10 After examining the application, the Office may accept and publish the specification. If no one opposes the application, the Office may then grant a patent for which a fee is payable by the applicant.

The patent date

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

> (1) Every patent shall be dated with the date of filing the complete specification:
>
> Provided that no proceeding shall be taken in respect of an infringement committed before the date of the publication of the complete specification.
>
> …
>
> (3) The term of every patent shall be 20 years from the date of the patent.

The effect of a patent

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

When a patent or patent application is bought

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

Patents outside New Zealand

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

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

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

application with a complete specification lodged on or after 1 April 2005" separately from other depreciable property.

3. LEGISLATION

Patents Act 1953

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

> "**Patent"** means letters patent for an invention:
>
> "**Invention**" means **any manner of new manufacture** the subject of letters patent and grant of privilege within section 6 of the Statute of Monopolies and any new method or process of testing applicable to the improvement or control of manufacture; and includes an alleged invention: [emphasis added]

Income Tax Act 2004

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

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

> **BD 2 Deductions—**
>
> An amount is a deduction of a person if they are allowed a deduction for the amount under Part D (Deductions).

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

> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called the **general permission.**

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

> *Capital limitation*
>
> (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the capital limitation.
>
> …
>
> *Relationship of general limitations to general permission*
>
> (7) Each of the general limitations in this section overrides the general permission.

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

> *Supplements to general permission*
>
> (1) A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.
>
> *Express reference needed to supplement*
>
> (2) A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.
>
> *Relationship of general limitations to supplements to general permission*
>
> (3) Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.
>
> *Relationship between other specific provisions and general permission or general limitations*
>
> (4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
>
> *Express reference needed to override*
>
> (5) A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—
>
> (a) that it overrides the general permission or the relevant limitation; or
>
> (b) that the general permission or the relevant limitation does not apply.

Part E

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

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

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

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

DB 25 Scientific research—

Deduction: scientific research

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

Exclusion

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

Link with subpart DA

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

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

DB 26 Research or development—

Deduction

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

Person recognising expenditure as expense

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

Person not recognising expenditure as asset

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

Person recognising expenditure otherwise

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

Person with minor expenditure

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

Exclusion

(6) Subsection (1) does not apply to expenditure that the person incurs on property to which all the following apply:
- (a) the property is used in carrying out research or development; and
- (b) it is not created from the research or development; and
- (c) it is 1 of the following kinds:
  - (i) property for which the person is allowed a deduction for an amount of depreciation loss; or
  - (ii) property the cost of which is allowed as a deduction by way of amortisation under a provision of this Act outside subpart EE (Depreciation); or

(iii) land; or
(iv) intangible property, other than depreciable intangible property; or
(v) property that its owner chooses, under section EE 8 (Election that property not be depreciable) to treat as not depreciable.

Section need not be applied

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

Relationship with section EA 2

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

Link with subpart DA

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

DB 27 Some definitions—

Definitions

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

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

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

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

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

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

4 Definitions

STANDARD

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

4.1 "Development" is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

4.2 "Research" is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

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

5 Financial Reporting

Recognition of Research Costs

STANDARD

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

Recognition of Development Costs

STANDARD

5.2 The development costs of a project shall be recognised as an expense in the period in which they are incurred unless the criteria for asset recognition identified in paragraph 5.3 are met.

5.3 The development costs of a project shall be recognised as an asset when all of the following criteria are met:

(a) the product or process is clearly defined and the costs attributable to the product or process can be identified separately and measured reliably;
(b) the technical feasibility of the product or process can be demonstrated;
(c) the entity intends to produce and market, or use, the product or process;
(d) the existence of a market for the product or process or its usefulness to the entity, if it is to be used internally, can be demonstrated; and
(e) adequate resources exist, or their availability can be demonstrated, to complete the project and market or use the product or process.

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

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

DB 28 Patent expenses—

Deduction

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

Link with subpart DA

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

DB 28B Expenses of failed or withdrawn patent application

Deduction

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

Timing of deduction

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

…

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

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

When this section applies

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

Deduction: expenditure before 1 April 1993

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

…

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

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

No deduction

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

General permission

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

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

Summary

4.1 The Commissioner considers that a "patent" refers to the legal rights to exclude others from using a particular mode of manufacture. The patent does not include the invention to which the patent relates.

4.2 References to a patent application in the discussion below generally refer to "a patent application with a complete specification lodged on or after 1 April 2005", which is depreciable intangible property under Schedule 17.

4.3 The original patentee or the purchaser of the patent application, patent or patent rights may depreciate the cost of the patent application, patent or patent rights, using the straight line method of

depreciation. Under this method, the cost of the patent application, patent, or patent rights is spread over the legal life of the patent rights.

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

What is a patent?

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

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

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

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

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

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

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

The courts' interpretation of "patent"

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

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

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

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

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

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

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

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

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

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

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

A distinction between a patent and an invention in the legislation

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

4.16 Section DB 29 distinguishes between a patent and an invention. Section DB 28 applies to expenditure incurred by the taxpayer, in connection with the grant, maintenance or extension of a patent, for a patent acquired before 23 September 1997. This is expenditure incurred by the taxpayer solely for

the patent process. In contrast, section DB 29(2), although only applicable to expenditure incurred before 1 April 1993, provides that where a patent has been granted for any invention, a deduction is allowed for expenditure incurred by the taxpayer in connection with the devising of the invention.

4.17 Section DB 29(1) sets out when section DB 29(2) applies. Section DB 29(1) refers to two processes; the grant of the patent and the devising of the invention. By providing for separate tax treatments for each process, section DB 29 indicates recognition that a patent and an invention, although related concepts, are not synonymous for the purposes of income tax treatment.

The arguments supporting the view that "patent" includes inventing costs

4.18 It can be argued that "patent" in the Act means the patent rights and the invention.

4.19 The strongest of the arguments in support of the view that the cost of a "patent" includes associated inventing costs for depreciation purposes, is that when the legislation was enacted to make patents depreciable, section DJ 6(2) of the Income Tax Act 1994 (now replaced by section DJ 29(1) and (2) of the Act), which gave immediate deductions for inventing expenditure, was terminated. Therefore, although it might be suggested that those inventing expenses were intended to be depreciated with the cost of the patent to which they relate, this argument, in the Commissioner's opinion, is inconclusive.

4.20 Although following the termination of section DJ 6(2), some expenditure incurred in devising an invention remained deductible, the deduction was limited. Before the introduction of section DJ 9A of the Income Tax Act 1994, which provided for deductions for expenditure incurred on research and development (now replaced by sections DB 26 and DB 27 of the Act), the deduction was available only when the patent rights, to which the inventing expenditure related, were sold. This deduction, which is now provided under section DB 29 of the Act, is discussed in paragraphs 6.2 and 6.3. It is considered that the intention of the legislation was not to depreciate the expenditure on the inventing process, but to limit the deductibility of such expenditure by linking it to the time at which income is derived from a patent or patent rights that result from that expenditure.

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

4.21 The current rules in the depreciation provisions refer to the cost of a "patent" only. Although there is no reference to the tax treatment of inventions, there is no evidence that the meaning of "patent" was intended to be changed to mean "the patent and the invention" under the current depreciation legislation. Had this been the intention, it would be expected that such change would have been explicitly made. As this is not the case, it is the Commissioner's view that, in the depreciation rules, the patent costs means the costs of acquiring the patent and not expenditure incurred in devising an invention.

4.22 Further, the reference in section DB 26(8) to "… devising an invention that is patented" indicates an understanding that a patent and an invention, although intrinsically linked, are not synonymous. The invention may be the subject of the patent, but "patent" refers to the legal rights only.

A patent is an intangible asset with a limited life

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

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

Conclusion on the meaning of "patent"

4.25 Taking into consideration the ordinary meaning of "patent", the view of the Court of Appeal, the referral to "patent and patent rights" in the Act and the enactment of section DJ 9A of the Income Tax Act 1994, (now sections DB 26 and DB 27, which provide for expenditure on research and development to be expensed in the year in which it is incurred), it is the Commissioner's opinion that for tax purposes, "patent" refers to the legal rights granted to an applicant to exclude others from using a particular mode of manufacture. A "patent" does not include the invention that is the subject of the patent. Accordingly, the patent costs able to be depreciated are those costs incurred by the taxpayer that are directly attributable to the patent.

4.26 It is noted that this view, that a patent does not include the invention, is consistent with the way in which "patent rights" are defined in section OB 1. The definition of "patent rights", set out above, refers to a right to do "anything which would, but for that right, be an infringement of a patent". In addition, this reference to "an infringement of a patent" appears to endorse the view that, when the Act refers to a "patent", it is only referring to the legal rights that are a "patent" and not also to the invention. The infringement is not of the invention. The infringement is of the right to use that invention.

A patent application is made but a patent is not granted

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

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

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

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

4.29 Section EE 53 states:

> **EE 53 Meaning of depreciable intangible property—**
>
> *Meaning*
>
> (1) Depreciable intangible property means the property listed in schedule 17 (Depreciable intangible property).
>
> *Criteria for listing in schedule 17*
>
> (2) For property to be listed in schedule 17 (Depreciable intangible property), the criteria are as follows:
>
> (a) it must be intangible; and
>
> (b) it must have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its acquisition.
>
> *Schedule 17 prevails*
>
> (3) Property that is listed in schedule 17 (Depreciable intangible property) is depreciable intangible property even if the criteria are not met.

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

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

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

Depreciation method effective prior to 1 October 2005

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

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

> **EE 12 Depreciation methods—**
>
> *Meaning of depreciation method*
>
> (1) **Depreciation method** means a method that a person may use to calculate an amount of depreciation loss.
>
> *Methods described*
>
> (2) The depreciation methods are—
>
> …
>
> (b) the straight-line method, which—
>
> (i) may be used for any item of depreciable property; and
>
> (ii) **must be used for an item of fixed life intangible property**:
>
> …
>
> [emphasis added]

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

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

4.35 Section EE 58 states that in the Act:

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

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

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

4.37 Section EE 58 states that in the Act:

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

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

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

4.39 Section EE 58 states that in the Act:

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

4.40 Accordingly, the legal life of the patent or the right to use a patent is required to be calculated assuming rights of renewal are exercised. (For patents registered in New Zealand, renewal fees are payable in years 4, 7, 10 and 13 and the legal life of a patent is 20 years. If the holder of a patent does not exercise the rights of renewal, the patent expires and the Act treats this situation as a disposal of the patent and, as a result, the cost of the patent, not already depreciated, is deductible.)

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

> **EE 27 Annual rate for fixed life intangible property—**
>
> *What this section is about*
> (1) This section is about the annual rate that applies to an item of fixed life intangible property (not including an item of excluded depreciable property, for which a rate is set in section EZ 14 (Annual rate for excluded depreciable property: 1992-93 tax year)).
>
> *Rate*
> (2) The rate is the rate calculated using the formula—
>
> $$\frac{1}{\text{legal life}}$$
>
> *Definition of item in formula*
> (3) **In the formula, "legal life" is,—**
> **(a) if section EE 19 applies, the item's remaining legal life from the start of the income year in which a person incurs the additional costs referred to in that section**:
> (b) if section EE 19 does not apply, the item's remaining legal life from the time at which a person acquires it.
>
> *How rate expressed*
> (4) The rate given by the formula is expressed as a decimal and rounded to 2 decimal places, with numbers at the midpoint or greater being rounded up and other numbers being rounded down.

[emphasis added]

4.42 Section EE 19 states:

> **EE 19 Cost: fixed life intangible property—**
>
> *When this section applies*
> (1) This section applies when—
> (a) a person owns an item of fixed life intangible property; and
> (b) the person incurs additional costs in an income year for the item; and
> (c) the person is denied a deduction for the additional costs other than a deduction for an amount of depreciation loss.
>
> *Additional costs for fixed life intangible property*
> (2) For the purposes of the formula in section EE 16, the item's cost at the start of the income year is treated as being the total of—
> (a) the item's adjusted tax value at the start of the income year; and
> (b) the additional costs the person incurs.

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

> **FB 7 Depreciation: partial income-producing use—**
>
> (1) Subsection (2) applies when—
> (a) a person has an amount of depreciation loss for an item of depreciable property for an income

year, other than an amount arising under section EE 41(2); and

(b) at a time during the income year, the item is partly used, or is partly available for use, by the person—

(i) in deriving assessable income or carrying on a business for the purpose of deriving assessable income; or

(ii) in a way that is subject to fringe benefit tax; and

(c) at the same time, the item is partly used, or is partly available for use, by the person for a use that falls outside both paragraph (b)(i) and (ii); and

(d) the item is not a motor vehicle to which subpart DE applies.

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

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

(3) In the formula,—

(a) **depreciation loss** means the amount of depreciation loss for the income year:

(b) **qualifying use days** means the number of days in the income year on which the person owns the item and uses it, or has it available for use, for a use that falls within subsection (1)(b)(i) or (ii):

(c) **all days** means the number of days in the income year on which the person owns the item and uses it or has it available for use.

(4) A unit of measurement other than days, whether relating to time, distance, or anything else, is to be used in the formula if it achieves a more appropriate apportionment.

(5) Subsection (6) applies when—

(a) a person has an amount of depreciation loss for an item of depreciable property arising under section EE 41(2); and

(b) the item was, at any time during the period the person owned it, dealt with in—

(i) subsection (2); or

(ii) any applicable paragraph in section EZ 10; and

(c) the item is not a motor vehicle to which subpart DE applies.

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

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

(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—

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

Definition of items in formula

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

Annual rate

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

Value or cost

(4) **Value or cost** is,—

(a) when the person uses the diminishing value method, the item's adjusted tax value at the end of the income year before the deduction of an amount of depreciation loss for the item for the income year; and

(b) when the person uses the straight-line method, the item's cost to the person, excluding expenditure for which the person is allowed a deduction under a provision of this Act outside this subpart. (Variations to cost are in sections EE 18 and EE 19.)

Months: income year of normal length or shorter

(5) **Months**, for a person whose income year

contains 365 days or fewer (or 366 days or fewer in a leap year), is the lesser of the following:

(a) 12; and

(b) the number of whole or part calendar months in the income year in which—

(i) the person owns the item; and

(ii) the person uses the item or has it available for use for any purpose.

Months: income year of longer than normal length

(6) **Months**, for a person whose income year contains more than 365 days (or more than 366 days in a leap year) is the number of whole or part months in the income year in which—

(a) the person owns the item; and

(b) the person uses the item or has it available for use for any purpose.

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

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

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

EE 27 Annual rate for fixed life intangible property—

What this *section is about*

(1) This section is about the annual rate that applies to an item of fixed life intangible property, not including

(a) an item of excluded depreciable property for which a rate is set in section EZ 14 (Annual rate for excluded depreciable property: 1992-93 tax year):

(b) **a patent or patent application for which a rate is set in sections EE 27B or EE 27D**:

(c) plant variety rights for which a rate is set in section EE 27E.

…

4.47 Sections EE 27B to EE 27D provide the formulae for the calculation of the annual rate for patent applications and patents. Sections EE 27B, EE 27C and EE 27D provide for three different circumstances depending on when the patent application, complete with full specification, is lodged.

4.48 Section EE 27B provides for the annual rate for patents where the application for the patent is lodged with complete specification before 1 April 2005. This provision provides that the depreciation rate for the first income year of depreciation of the patent will also include depreciation from the time of the patent application with the full specification to the time of the grant of the patent. Section EE 27B states:

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

When this section applies

(1) This section applies if —

(a) an application for a patent with a complete specification is lodged with the Intellectual Property Office of New Zealand or a similar office in another jurisdiction; and

(b) the application is lodged with the complete specification before 1 April 2005; and

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

Income years for which usual rate applies

(2) The rate given by subsection (3) applies for the patent for an income year that begins —

(a) after the date on which the patent is granted; and

(b) before the date that is 240 months after the patent application date.

Usual rate

(3) The rate is calculated using the formula -

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

Rate for first income year of use

(4) For the patent and the income year that includes the date on which the patent is granted, the rate is found by adding together the following rates:

(a) the rate calculated using the formula –

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

(b) the rate calculated for the income year under subsection (3).

Effect of change in ownership of patent application

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

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

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

Months

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

Depreciation months

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

Months before grant

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

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

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

When this section applies

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

Income years for which rate applies

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

Rate

(3) The rate is calculated using the formula -

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

Months

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

Depreciation months

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

Effect of change in ownership of patent application

(6) If the person who owns the patent application when the patent is granted, or when the patent application is refused or withdrawn, is not the person who lodges the

application for the patent with the complete specification, the rate calculated under subsection (3) for the person depends on the period between the patent application date and the date on which the person acquires the application.

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

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

When this section applies

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

Income years for which rate applies

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

Rate

(3) The rate is calculated using the formula-

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

Months

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

Depreciation months

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

Effect of change in ownership of patent application

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

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

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

When the legal life starts for tax purposes

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

4.54 In the Commissioner's view, for patents granted before 1 April 2005, the time at which the intangible property is acquired by the taxpayer is the start of the legal life of the patent (section EE 27(3)(b)). This is because section FB 7 provides

that, if property is not wholly used or available for use by the taxpayer for the derivation of assessable income at any time during the income year, the depreciation deduction is apportioned and depreciation can only be claimed for the period for which the asset was available for use. Accordingly, the legal life/remaining legal life for tax purposes of patents granted before 1 April 2005 is less than the 20-year patent term.

4.55 However, effective 1 October 2005, the Act does not require "legal life" to be determined in respect of patents for the calculation of depreciation. Effective 1 October 2005, sections EE 27B, EE 27C and EE 27D refer to "depreciation months". This term is defined in these sections as 240 or 240 reduced by the number of whole months from the patent application date to the date on which the person acquires either the patent application or the patent. This figure is then used as part of the formulae also set out in these sections to determine the depreciation rate of the patent or patent application.

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

4.56 Depreciation is calculated on the cost of a patent application, patent or patent rights. If a taxpayer has purchased the patent application, patent or patent rights, the cost of purchasing them is depreciable. If the taxpayer developed the invention that is patented, the Commissioner considers that the cost of a "patent application", "patent" or "patent rights" does not include the cost of research or development work that may have led to the application for a patent. Although this research and development work may include, for example, the construction of a prototype of the invention, the specification of which is ultimately the subject of a patent application, for tax purposes, these costs are not considered part of the cost of a patent application or patent and are not part of the depreciable cost of the patent application, patent or patent rights. A patent refers solely to the legal right to exclude others from the use of that patented specification.

4.57 This view accords with the ordinary usage of the word "patent" (being the sole rights to make, use or sell an invention, which are conferred by statute) and the definition of "patent rights" in section OB 1:

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

Depreciable patent costs

4.58 If the taxpayer has lodged a patent application with full specification or had a patent for an invention granted, the costs of the patent include fees charged by the Intellectual Property Office of New Zealand, fees charged by other patent authorities and patent attorney fees. In short, it is the administrative and legal fees incurred in the patent process that are the depreciable patent costs.

4.59 On the granting of a patent, those patent application costs form part of the adjusted tax value of the patent and the amounts continue to be depreciated over the same term of 240 months. The Commissioner is of the view that there is no disposal of the patent application in terms of section EE 37.

4.60 If the taxpayer has purchased the patent application, patent or patent rights, the cost of the patent application, patent or patent rights is depreciable. In this case, the taxpayer has either purchased the application for or the right to use a particular specification, which is protected by a patent, and to exclude others from such use. It is the cost incurred in buying that right or application for that right that is depreciable. As above, there is no disposal of the patent application when the patent is granted. If the taxpayer also bought an item such as a prototype of the patented invention, the cost of the prototype is not part of the cost of the patent application, patent or the right to use the patent.

Treatment of invention expenditure

4.61 As set out above, it is the Commissioner's view that allowable deductions for the costs incurred in the "patent" process do not include expenditure incurred in the investigative process that may culminate in an invention. This means that invention expenditure, which is capital in nature, cannot be depreciated as part of the cost of a patent application, patent or the right to use a patent.

4.62 Although, under the present legislation, some invention expenditure may be deductible under other provisions, there may, in some circumstances, be expenditure incurred on an invention that is neither deductible nor depreciable. The following discussion considers the tax treatment of various invention expenditure. It must be reiterated that this does not apply to a person who simply purchases a patent application, patent or right to use a patent.

Research and development expenditure

4.63 Expenditure on research and development that may lead to an invention may be deductible:

- if a taxpayer chooses to utilise the provisions of section DB 26, expenditure incurred on research or development, up to the point of "asset recognition" (defined in FRS-13, paragraph 5.3), can be expensed in the year in which it is incurred (the five criteria in FRS-13 required to be complied with to satisfy "asset recognition", include the demonstration of both the technical feasibility of a product

and the existence of a market for the product, and, therefore, expenditure beyond the point of "asset recognition" which is required to be capitalised, can be made by the taxpayer with that knowledge); or

- if the taxpayer's annual research and development expenditure does not exceed $10,000 (section DB 26(5) provides for the entire quantum of such research and development costs to be expensed in the year in which it is incurred provided that the expenditure has not been treated as material for financial reporting purposes and the expenditure has been recognised as an expense for financial reporting purposes); or
- if the expenditure is revenue in nature, i.e. if the expenditure is incurred in deriving assessable income or in carrying on a business for the purpose of deriving assessable income and it is not capital in nature (an example might be expenditure on materials consumed in research related to a taxpayer's business: the expenditure would be deductible without the benefit of section DB 26 but, research expenditure contributing to the cost of an asset, or related to establishing a new line of business, is likely to be capital in nature and non-deductible); or
- if the expenditure is on scientific research, section DB 25 provides for deductions; or
- if a person who devised an invention for which a patent is granted and uses the patent in deriving income in an income year, under section DB 29(2), they are allowed a deduction for expenditure incurred before 1 April 1993 provided a deduction is not otherwise allowed; or
- if a person who devised and patented an invention, sells all of the patent rights relating to the invention, under section DB 29(3), they are allowed a deduction from their annual gross income for expenditure incurred in connection with devising the invention, whenever it is incurred, to the extent that it not already allowed under section DB 29(2) or some other provision such as section DB 26; or
- similarly, if only some of the patent rights are sold, a proportional deduction of the expenditure incurred is allowed, section DB 29(4).

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

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

4.65 Section BD 4(5) provides:

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

Depreciation of assets used for or developed in the inventing process

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

4.67 However, section DB 26, by the application of the FRS-13 criteria, provides for the cost of assets used on a project, in the inventing process up to the point of "asset recognition", to be treated as revenue expenditure in the year in which the cost is incurred. After the point of asset recognition, such costs are required to be capitalised and unless those costs are for an asset that is otherwise depreciable property, no depreciation allowance is available. (Where section DB 26(5) applies, i.e. where the person incurs expenditure of $10,000 or less, in total, on research and development for a tax year and the expenditure is not treated as material and is recognised as an expense for financial reporting purposes, the person is allowed a deduction for that expenditure.)

4.68 Section EE 6 defines "depreciable property":

> **EE 6 What is depreciable property?—**
>
> *Description*
>
> (1) "**Depreciable property**" is property that, in normal circumstances, might reasonably be expected to decline in value while it is used or available for use—
>
> (a) in deriving assessable income; or
>
> (b) in carrying on a business for the purpose of deriving assessable income.
>
> …

Prototypes and other tangible assets used in the inventing process

4.69 Expenditure on the construction of prototypes or other assets used to develop or trial an invention may be of a capital nature under general case law

principles. In Case N55 (1991) 13 NZTC 3,434, Judge Barber held that expenditure on the development of a prototype farm vehicle was capital in nature. Judge Barber found that the prototype was part of the establishment or expansion of a profit making structure and, as such, was made prior to the commencement of ordinary business operations in relation to the manufacture of that vehicle.

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

Additional costs that are depreciable

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

> **EE 19 Cost: fixed life intangible property—**
>
> *When this section applies*
>
> (1) This section applies when—
> (a) a person owns an item of fixed life intangible property; and
> (b) the person incurs additional costs in an income year for the item; and
> (c) the person is denied a deduction for the additional costs other than a deduction for an amount of depreciation loss.
>
> *Additional costs for fixed life intangible property*
>
> (2) For the purposes of the formula in section EE 16, the item's cost at the start of the income year is treated as being the total of—
> (a) the item's adjusted tax value at the start of the income year; and
> (b) the additional costs the person incurs.

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

Patent renewal fees

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

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

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

What happens if a patent is not renewed?

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

4.77 Section EE 37 states:

> **EE 37 Application of sections EE 41 to EE 44—**
>
> *When sections apply*
>
> (1) Sections EE 41 to EE 44 apply when a person derives consideration from the disposal of an item or from an event involving an item, if—
> (a) the consideration is consideration of a kind described in section EE 38; and
> (b) either—
> (i) the item is an item of a kind described in section EE 39; or
> (ii) the event is an event of a kind described in section EE 40.
>
> *Exclusion*
>
> (2) Sections EE 41 to EE 44 do not apply when a person disposes of an item of intangible property as part of an arrangement to replace it with an item of the same kind.

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

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

4.79 Section EE 41(2) provides:

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

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

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

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

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

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

4.84 Sometimes a patent might be applied for or registered "just in case" the protection that a patent offers, for a particular invention, may one day prove to be valuable. The same situation could also occur with the acquisition of patent rights. It could be argued that these patents or patent rights should not be treated as assets, until the feasibility of the invention is known.

4.85 The Act does not make this distinction. In sections EE 14, EE 16, EE 19, EE 27, EE 27B, EE 27C and EE 27D, the Act provides rules for the depreciation of the cost of patents and patent rights, if these were used or available for use in deriving assessable income or in a business carried on for the purpose of deriving assessable income. The cost includes all of the costs incurred in acquiring the patent or the right to use a patent. It has been held that the test of whether something is used in deriving income or in a business is satisfied not only if the asset directly produces income, but also if the asset is used in the course of deriving income or in a business (C of IR v Banks (1978) 3 NZTC 61,236). Sections EE 14 states:

> **EE 14 Diminishing value or straight-line method: calculating amount of depreciation loss—**
>
> *Most depreciable property*
>
> (1) The amount of depreciation loss that the person has for an income year for an item of depreciable property is the lesser of the amounts dealt with in sections EE 15 and EE 16.
>
> *Exclusion: petroleum-related depreciable property*
>
> (2) The amount of depreciation loss that the person has for an income year for an item of petroleum-related depreciable property is the lesser of the amounts dealt with in sections EE 15 and EE 17.

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

5. LEGAL FEES INCURRED IN DEFENDING OR ATTACKING A PATENT

5.1 The legal fees may relate to an opposition action or a revocation action. An opposition action is taken when a patent has not yet been granted and the action is taken against another person's application for a patent, to prevent that patent being granted. A revocation action is taken against someone who has had a patent granted, to revoke that patent.

5.2 The Commissioner's opinion is that the same principles apply to both opposition and revocation actions. In both cases, the action relates to an asset of the person who is bringing the action, whether it is a patent or a patent application. The terms "defending" and "attacking" respectively are used to mean defending, and taking, a revocation action (including an opposition action).

General principles

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

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

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

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

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

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

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

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

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

5.9 It was considered that the payment would be made from circulating capital, and although an identical situation might not have to be faced by a business again, Moller J considered that the fact that this one arose, indicates that a similar threat might well occur in the future. It was also considered that under ordinary principles of commercial accounting the expenditure would be treated as being of a revenue nature.

5.10 Moller J's comment in *Murray* could equally apply in either a situation of attacking another's patent or the defence of a patent. An identical situation may not arise for the company again, but the fact that the situation arose indicates that a similar threat, requiring either defence or attack, may arise in the future. Therefore, the expenditure was not incurred in the production of assets or advantages of an enduring benefit.

5.11 It is noted that the approach taken following *BP Australia*, is not consistent with the decision of the Supreme Court in *Commissioner of Taxes v Ballinger and Co Ltd* (1903) 23 NZLR 188. In that case, it was held that expenses, incurred in unsuccessfully defending the taxpayer's patent against an action by the prior patent holder who claimed that the taxpayer's patent had infringed the prior patent, were capital in nature:

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

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

Conclusion

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

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

Sum received income

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

> **CB 26 Sale of patent applications or patent rights—**
>
> If a person derives an amount from the sale of a patent application with a complete specification or from the sale of patent rights, the amount is income of the person.

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

Amount of deduction

6.2 The amount of allowable deductions on the sale of a patent application or patent rights depends on the circumstances of the taxpayer. Such deductions may, in some circumstances, be allowable for a taxpayer in the business of buying and selling patent applications, patents or patent rights. For example, if a taxpayer is in the business of buying and selling patent applications, patents or patent rights, but they buy and retain a patent and derive income from it by licensing the patent rights to a third party to exploit, when those patent rights are sold, allowable deductions are in accordance with sections DB 30 and DB 31. These deductions are allowable despite the fact that other patents or patent rights of that taxpayer may be trading stock and, therefore, required to be treated in accordance with the trading stock rules in Subpart EB – Valuation of trading stock (including dealer's livestock).

6.3 Similarly, if a taxpayer in the business of buying and selling patent applications, patents or patent rights, also devises the invention to which a patent application or patent relates, but is not in the business of inventing, allowable deductions in respect of the sale of the patent application or those patent rights will be in accordance with section DB 29.

6.4 Sections DB 29, 30 and 31 provide:

> **DB 29 Patent rights: devising patented inventions—**
>
> *When this section applies*
>
> (1) This section applies when a person incurs expenditure in devising an invention for which a patent has been granted. The section applies whether the person devised the invention alone or in conjunction with another person.
>
> *Deduction: expenditure before 1 April 1993*
>
> (2) When the person uses the patent in deriving income in a tax year, they are allowed a deduction for expenditure incurred before 1 April 1993, but not if a deduction has been allowed for the expenditure under any other provision of this Act or an earlier Act.
>
> *Deduction: devising invention*
>
> (3) If the person sells all the patent rights relating to the invention, they are allowed a deduction for the expenditure that they have incurred (whenever it is incurred) in connection with devising the invention to the extent to which a deduction has not already been allowed under subsection (2).
>
> *Deduction: devising invention: proportion of expenditure*
>
> (4) If the person sells some of the patent rights relating to the invention, they are allowed a deduction for part of the expenditure described in subsection (3). The part is calculated by dividing the amount derived from the sale by the market value of the whole of the patent rights on the date of the sale.

Link with subpart DA

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

DB 30 Patent rights acquired before 1 April 1993—

When this section applies

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

Deduction

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

Amount of deduction

(3) The amount is calculated using the formula—

$$\frac{\text{unexpired term of the patent rights at the date of sale}}{\text{unexpired term of the patent rights at the date of acquisition}} \times \text{cost}$$

Link with subpart DA

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

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

When this section applies

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

Deduction

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

Amount of deduction

(3) The amount is calculated using the formula—

total cost – total amounts of depreciation loss

Definition of items in formula

(4) In the formula,—

(a) **total cost** is the total cost to the person of the patent application with a complete specification or patent rights:

(b) **total amounts** of depreciation loss is the total of the amounts of depreciation loss for the patent application with a complete specification or patent rights for which the person is allowed a deduction.

Link with subpart DA

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

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

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

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

> **EA 2 Other revenue account property—**
>
> *When this section applies*
>
> (1) This section applies to revenue account property that is not—
>
> (a) trading stock valued under subpart EB (Valuation of trading stock (including dealer's livestock)); or
>
> …
>
> *Timing of deduction*
>
> (2) A deduction for the cost of revenue account property of a person is allocated to the earlier of—
>
> (a) the **income year** in which the person **disposes of the property**; and
>
> (b) the **income year** in which the property ceases to exist.
>
> [emphasis added]

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

6.7 If the proceeds of sale of property are income, then the property is "revenue account property". In the rare case of a business dealing in patent applications, patents or patent rights, those patent applications, patents or patent rights will also constitute trading stock and, accordingly, their cost, and any additional expenditure relating to them, is deductible and not depreciable. The deductions will be subject to the trading stock rules in Subpart EB.

6.8 Similarly, if a person is in the business of buying and selling patent applications, patents or patent rights and also in the business of inventing, income and expenditure relating to research carried out for the business of inventing would be on revenue account and anything produced for sale would be subject to the trading stock rules.

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

Summary

7.1 Before patents and the right to use a patent became depreciable property in 1993, there were specific provisions in the Act applicable to patents. The costs of applying for, maintaining or extending a patent, were deductible. Expenses incurred in devising an invention and the cost of buying a patent were also deductible, although spread. Proceeds from the sale of a patent were income, but these too could be spread.

7.2 Some of these old provisions remain relevant because the Commissioner required these expenses to be spread over the 20-year term of a patent and some of these terms have not yet expired. In addition, fees for maintaining or extending a patent remain deductible if the patent was acquired by the taxpayer before 23 September 1997.

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

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

7.4 The types of expenditure covered under section DB 28 are renewal fees and extension costs charged either by the Intellectual Property Office of New Zealand or an overseas patent authority, plus associated legal fees. Prior to 1 January 1995, a patentee could apply under the Patents Act 1953 to have the term of their patent extended. The facility to extend the term of patents is no longer available under New Zealand legislation, although there may be a few extensions still operative. Extensions may continue to be available from overseas patent authorities and, therefore, provided the patent was acquired before 23 September 1997, the fees for these extensions will remain deductible, under section DB 28.

7.5 The Commissioner considers that section DB 28 includes the cost of amending a patent. An amendment ensures the validity of a patent by narrowing the claims or correcting an obvious mistake. An amendment, therefore, can be viewed as maintenance, or as a continuation of the pre-grant proceedings.

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

7.6 If a patentee both devised an invention and derived income from the use of its patent, section DB 29(2) provides for a deduction for expenditure incurred before 1 April 1993 in connection with the devising of the invention.

7.7 However, under section DJ 6(2) of the Income Tax Act 1994 (now replaced by section DB 29(2)), allowance of the deduction was originally available as the Commissioner thought fit. The expenditure was required to be spread over the life of the patent. (The allowance of a deduction is no longer discretionary.) In addition, although the allocation usually commenced from the date of grant, if the use of the invention began in a subsequent income year, the Commissioner considered that the spread should commence from that later year.

7.8 It is also noted that those taxpayers who commenced the spreading exercise while the patent term was 16 years, and, under the Patents Amendment Act 1994, have since obtained the automatic extension to 20 years effective from 1 January 1995, should re-spread their allocated deductions over the remaining life of the patent. This approach is consistent with the depreciation legislation and generally accepted accounting principles. Inland Revenue will not disturb allocations that have already resulted in the full cost being deducted.

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

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

> **DZ 8 Buying patent rights before 1 April 1993—**
>
> *When this section applies*
>
> (1) This section applies when a person buys patent rights before 1 April 1993 and uses them in deriving their income. In this section, if the person dies after incurring

expenditure on buying the rights, references to the person include their personal representative, a trustee of their estate, and a beneficiary of their estate.

Deduction

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

Link with subpart DA

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

EZ 5 Buying patent rights before 1 April 1993—

When this section applies

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

Amount of deduction

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

Amount when patent rights expired or disposed of

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

Timing of deduction: subsection (2)

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

Timing of deduction: subsection (3)

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

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

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

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
	=	12 / 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				

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

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

Depreciation already claimed for year ended:

31 March 2006		72
31 March 2007 (96 + 32)		128
31 March 2008		240
31 March 2009		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 application for the light bulb was lodged with complete specification on **20 December 2004**, i.e. before 1 April 2005 and, therefore, section EE 27C, which provides for the depreciation of a patent application, is not applicable. As stated in Example 1, the patent is granted 3 December 2006.

Pursuant to section EE 27B, in this situation, the first year in which a depreciation loss is allowed is the year in which the patent is granted, i.e. the 2006-07 income year. There is no depreciation loss allowed for either the patent or the patent application, before the year in which the patent is granted. However, section EE 27B provides for a rate in this first year that provides a one-off "catch up" depreciation loss allowance for the period from the date the patent application with complete specification was lodged.

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

Depreciation of the patent.

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

and

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

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

0.10 + 0.02 = 0.12

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

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

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

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

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

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

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

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

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

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

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

31 March 2006	72

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

Cost of the patent		4,800
Less depreciation claimed	72	
Deduction for loss on disposal	$4,728	

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

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

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

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

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

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

and in the 2007-08 income year:

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

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

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

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

Patent search	500
Preparing the working drawings for the provisional specification	1,300
Intellectual Property Office provisional application filing fee	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 deductible. As the taxpayer's patent was acquired on 15 February 1997, section DB 28 applies.

Therefore:

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

The renewal fees are incurred in connection with the maintenance of a patent and are also deductible under section DB 28, but only because the patent was acquired by the taxpayer, who incurred the costs, before 23 September 1997 and the taxpayer was using the patent in deriving income in the tax year in which they incurred the expenditure.

Therefore:

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

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

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

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

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

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

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

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

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

Therefore:

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

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

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

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

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

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

Therefore, the deduction on sale is:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Effective 1 October 2005, a patent application with complete specification is an item of Schedule 17 depreciable intangible property and section EE 27C provides the calculation for the rate at which the $15,000 costs incurred in making the patent application can be depreciated.

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

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

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 27C)	=	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 (sections DB 28B, EE 16, EE 27C, EE 41, EE 47, and EE 48)

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

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

> As for the 2005-06 and 2006-07 income years, under sections DB 26(1)-(4) and DB 26(9), the taxpayer company can expense all research and development expenditure but only that incurred prior to "asset recognition" in June 2007.
>
> Although the taxpayer company had the patent application for 2 months before the patent grant was refused on 1 December 2007, section EE 11(1) provides that a person does not have an amount of depreciation loss for an item of depreciable property for the year in which they dispose of it.
>
> Section DB 28B provides that the company is allowed a deduction, in the year in which the grant is refused or the application is withdrawn, for expenditure incurred in relation to the application that would have been part of the cost of the patent if the application had been granted **and for which the company is not allowed a deduction under another provision**.
>
> However, for patent applications with complete specifications lodged on or after 1 April 2005 section EE 41 allows an amount of depreciation loss. The consideration received is nil, so will be less than the patent application's adjusted tax value. The adjusted tax value is provided by the formula in section EE 47(1) which is:
>
> base value – total deductions
>
> There have been no "total deductions" in this case. The base value is found by applying section EE 48 which provides that the base value is the cost of the item to the person. Therefore, the company is allowed a deduction of the $15,000 incurred in making the patent application.

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.

GST PAID ON DEPOSIT

Case: TRA No. 018/05, Decision No. 8/2006

Decision date: 9 June 2006

Act: GST Act 1985; Tax Administration Act 1994

Keywords: Input/Output tax, Refund, Invoice/Payment basis, Property transactions, Deferrable contracts, Deposit, Contract cancellation, Tax avoidance arrangement, section 76, Tax advantage

Summary

The disputants, registered on a payments basis, entered into sale and purchase agreements to buy a number of apartments. The disputants then entered into sale and purchase agreements to on-sell the apartments to one of three purchaser companies, registered on an invoice basis. Deposits were paid to the disputants by the three companies when GST refunds were paid. The disputants paid output tax on the deposits. The vendor of the first sale and purchase agreement cancelled the contracts with the disputants for non performance. The disputants filed returns claiming back the output tax paid on the deposits. The Commissioner disallowed the claim.

Background

This case is concerned with the application of the Goods and Services Tax Act 1985 ("the GST Act") in relation to a property transaction entered into by the disputants. The cases that are the subject of this litigation concern a series of interlocking events which exploit a timing mismatch arising from GST registration on an invoice basis compared to another on a payments basis. In particular, this challenge concerns the correctness of the Commissioner's assessment disallowing the refund of output tax originally paid by each disputant on deposits which were later refunded to them.

The Facts

The disputants are 30 companies ("the disputants"). Mr X was the director of all disputants until he was adjudicated bankrupt in May 2001.

The disputants were each incorporated with 1,000 shares and a capital value of $100 on 30 April 1997. They were registered for GST as "property traders" on a payments basis. Two days prior to incorporation the disputants entered into Sale and Purchase Agreements with a developer, ("vendor") for 45 apartments. No tax invoices were issued.

On the same day the purchase agreements were entered into, each of the disputants entered into agreements to sell the apartment to one of three companies, A Ltd, B Ltd and C Ltd ("the three final purchasers"). The agreements contained conditions for deposits payable to the vendors. $100 of this deposit was to be paid upon execution with the remainder being paid on or before 30 June 1997. The balance was to be paid on the date of settlement being 1 May 2007. A tax invoice was issued by each of the 30 disputants to one of the three final purchasers.

The three final purchasers filed GST returns claiming input credits in respect of the apartments purchased. Upon receiving the refunds, the three final purchasers paid the remaining deposit to the 30 disputants.

On 30 September 1997, the 30 disputants filed GST returns for the periods ending 31 August 1997. They each claimed GST input tax totalling $0 and returned GST output tax totalling $152,756 based on the payment of the second instalment of the deposit which the 30 disputants received from the three final purchasers.

On 17 September 1999 the vendor cancelled its agreements with the 30 disputants for non performance.

On 4 July 2001 the 30 disputants filed GST returns claiming back the output tax they had earlier paid on the sales to the three final purchasers.

Decision

The TRA makes it clear from the outset that the scheme was one designed to take advantage of the timing mismatch in the GST legislation which it viewed as unacceptable.

The disputants argued that the forfeited deposits became an item of damages in its hands and therefore was not subject to GST. At the time of cancellation the purchaser lost the right to retain the input credit paid to it. The vendor's liability for output tax was then cancelled and it was entitled to a refund of the GST paid.

The Authority went on to state that the disputants were never entitled to a refund of the GST paid by them on the sales to the end purchaser. The Authority considered GST was always properly payable, and the fact that a series of events had intervened making it impossible for the disputants to perfect the overall scheme of arrangements for the purchase of the apartments did not make it less so.

In addition, the Authority considered that from its inception this was a scheme which blatantly exploited provisions of the GST regime enacted to provide some administrative relief for smaller taxpayers from the burden of GST compliance.

This arrangement sought to take advantage of the timing mismatch possible in the relevant section. The primary motivation in entering the transaction was not the making of taxable supplies but the derivation of large input tax credits. The input tax refunds were then used to pay the deposit to the 30 disputants. The payment of the output tax on these deposits could not be viewed separately from the other transactions that made up the arrangement as a whole.

The Commissioner sought to counteract the tax advantage by disallowing the refunds claimed by the 30 disputants. To permit these refunds would be to allow the disputants to benefit from an arrangement designed to defeat the intent and application of the GST Act. Therefore, the scheme in this case was void against the Commissioner pursuant to section 76.

The Judge confirmed the Commissioner's decision in each of the cases before the Authority.

REGULAR FEATURES

DUE DATES REMINDER

August 2006

21 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

September 2006

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

29 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2006–2007*. This calendar reflects the due dates for small employers only—less than $100,000 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.

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	Draft question we've been asked	*Comment deadline*
☐	QB0046: Tax treatment of wooden scaffolding planks	31 August 2006

	Draft depreciation determinations	*Comment deadline*
☐	DDG0104: "Builders' planks" used in the building and construction industries	31 August 2006
☐	DDG0109: Software able to be used in the preparation or filing of income tax returns relating to a particular year	31 August 2006
☐	DDG0110: "Psychological testing sets" used in the medical industry	31 August 2006
☐	DDG0111: Metal speed humps	31 August 2006
☐	DDG0112: "CCH Electronic New Zealand Master Tax Guide, designed for a specific tax year" and "CCH Essential New Zealand Tax Package, designed for a specific tax year"	31 August 2006
☐	DDG0113: "Wintering pads (rubber)" used in the agriculture industry	31 August 2006
☐	DDG0114: Kiwiplus – Kiwifruit Software Package – designed for a specific year	31 August 2006
☐	DDG0115: "Peurulus (baby crayfish) traps" used in the fishing industry.	31 August 2006

	Draft operational statement	*Comment deadline*
☐	ED 0088: Interaction of tax and charities rules, covering tax exEmption and donee status	30 September 2005

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