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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly 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 a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **www.ird.govt.nz/public-consultation**

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

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This item sets out the operational position being adopted by the Commissioner in relation to *QB 17/04: Goods and services tax – whether a racing syndicate can be a registered person*, which confirms the Commissioner's view on when a horse racing syndicate can register for GST.

QB 17/05: Income tax – whether YouTube receipts are taxable 45

This item considers whether YouTube receipts are subject to income tax. It concludes that in many cases YouTube receipts will be taxable. This may be because the receipts are from a business. However, taxpayers do not need to be carrying on a business; two other provisions in the Income Tax Act 2007 tax YouTube receipts if they are income under ordinary concepts, or are from a profit-making undertaking or scheme.

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Court of Appeal finds High Court has no jurisdiction to approve a payment proposal under s 29(1)(b)(iii) of the Insolvency Act 2006 60

The Court of Appeal allowed the Commissioner of Inland Revenue's appeal, finding that the High Court has no jurisdiction, neither inherent nor express under s 29(1)(iii) of the Insolvency Act 2006 to approve a payment proposal in the context of an application by a judgment debtor to set aside a bankruptcy notice.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Order in Council

Threshold set for disclosure of significant tax debts

A threshold for the disclosure of significant tax debts to approved credit reporting agencies has been set at $150,000. The threshold was set by Order in Council on 29 May 2017.

When a taxpayer owes more than this amount, along with meeting remaining criteria, their tax debt information may be disclosed to certain credit reporting agencies.

This minimum threshold was set by taking into account a range of businesses and their outstanding tax debts. (More information on the background to this issue was published in the *Tax Information Bulletin*, Vol 29 No 4 May 2017.)

The threshold came into force on 29 June 2017.

Taxation (Disclosure of Information to Approved Credit Reporting Agencies) Regulations 2017 (LI 2017/112).

INTERPRETATION STATEMENTS

This section of the *TIB* 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.

IS 17/05: Income tax – treatment of New Zealand patents

This Interpretation Statement updates and replaces the 2006 Interpretation Statement "Income tax treatment of New Zealand patents", *Tax Information Bulletin* Vol 18, No 7 (August 2006): 36.

This statement updates legislative references to reflect changes to income tax and patents legislation since 2006, in particular, the:

- Income Tax Act 2007 replacing the Income Tax Act 2004; and
- Patents Act 2013 replacing the Patents Act 1953.

This statement also discusses legislative changes addressing "black hole" expenditure in the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Act 2016.

Some of the Commissioner's views have changed because of the above legislative changes, including views on the treatment of:

- renewal fees, which are now considered to be revenue expenditure and deductible in the year incurred (the previous statement treated renewal fees as part of the depreciable cost of the patent); and
- expenditure for underlying intangible items after asset recognition, which are now considered to be depreciable.

These changes are discussed in the statement.

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this statement.

Scope of this statement

1. This statement covers the income tax treatment of New Zealand patent applications, patents and patent rights, particularly:
   - their costs and depreciation (see [36]–[72]);
   - research and development (R&D) expenditure (see [73]–[97]);
   - patent maintenance and renewal fees (see [98]–[107]);
   - legal fees incurred in defending or attacking a patent (see [108]–[129]);
   - proceeds and allowable deductions on the sale of patent rights or a patent application (see [130]–[139]); and
   - patent-related expenses and proceeds under the old legislative rules, which still apply in some circumstances (see [140] and [141]).
2. This statement does not cover the income tax treatment of patents filed outside of New Zealand.

Summary

3. This statement makes a number of conclusions relating to the income tax treatment of New Zealand patents. The major conclusions are summarised below.

"Patent" means the legal rights obtained from the grant of that patent

4. References in the legislation to a "patent" refer to the legal rights that the owner of the patent obtains from the grant of that patent. In the case of New Zealand patents, these are the legal rights obtained as the result of a patent granted under the Patents Act 2013 (Patents Act) (or its predecessor, the Patents Act 1953).

INTERPRETATION STATEMENTS

Other intellectual property rights are not patent rights

5. Other intellectual property rights are not patent rights.

Legal, administrative and some other costs incurred in applying for a patent are depreciable

6. Depreciable patent costs include:
   - the legal and administrative costs incurred in applying for the patent;
   - additional costs incurred for a patent (s EE 19); and
   - expenditure incurred for underlying intangible items (s EE 18B).

Tax treatment of research and development expenditure varies

7. The treatment of expenditure on R&D for tax purposes will be in accordance with:
   - ss BD 2 and DA 1 to DA 4;
   - s DB 33 for scientific research; and
   - ss DB 34 and DB 35 for other R&D, if the taxpayer complies with the requirements of the relevant reporting standard and chooses to apply these sections.

Patent renewal and maintenance fees are revenue in nature and deductible

8. Patent renewal and maintenance fees are revenue in nature and deductible for income tax purposes in the year they are incurred.

Legal expenses incurred in defending or attacking a patent are generally revenue in nature, so are deductible

9. Legal expenses incurred in defending or attacking a patent are generally revenue in nature, so are deductible. However, some legal expenses may be capital in nature (as discussed at [124] and [125]) and non-deductible.

Deduction may be allowed where a patent application is refused or withdrawn or not lodged

10. Where a patent application is refused or withdrawn or not lodged, the taxpayer may be allowed a deduction for expenditure they have incurred in relation to the application or intended application. This is in terms of s DB 37, which applies only if the taxpayer is not allowed a deduction for the expenditure under another provision.

If a person devises an invention, then disposes of the patent rights, a deduction may be allowed for the expenditure incurred

11. If a person devises an invention and subsequently disposes of the patent rights relating to that invention, a deduction is allowed for the expenditure incurred in devising the invention. This is, in terms of s DB 38(3), to the extent that a deduction has not already been allowed under s DB 38(2) (expenditure before 1 April 1993).

When patent applications or rights are sold, a deduction is allowed of the total cost less total amounts of depreciation loss

12. When patent applications or 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 (s DB 40).

Amount derived from the sale of patent applications or rights is income

13. An amount a person derives from the sale of patent applications (with a complete specification) or the sale of patent rights is income of the person (s CB 30).
14. This is despite the disposal of patent rights being 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 that case, patent rights are trading stock, and their disposal is of a revenue item (amounts derived on their sale is still income). Patent rights that are trading stock are not depreciable.

Introduction

Meaning of "patent"

15. 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. This view accords with the:
    - ordinary meaning of "patent"; and
    - text of the legislation.

16. The *Concise Oxford Dictionary* (12th ed, 2011) 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 right to exclude others from making, using, or selling an invention

17. The ordinary meaning of "patent" is the legal rights, granted to an applicant, to exclude others from using a particular mode of manufacture.

18. Although the Income Tax Act does not define "patent", the term "patent right" is defined in s YA 1:

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

19. The Patents Act (s 5) distinguishes between a "patent" and a "patentable invention":

    patent means letters patent for an invention

    patentable invention has the meaning set out in section 14:

20. In terms of s 14 of the Patents Act, an invention is a **patentable invention** if it:
    (a) is a manner of manufacture within the meaning of section 6 of the Statute of Monopolies; and
    (b) when compared with the prior art base—
        (i) is novel; and
        (ii) involves an inventive step; and
    (c) is useful; and
    (d) is not excluded from being a patentable invention under section 15 or 16.

21. In the context of patents, and this statement, an invention is a manner of manufacture (an intangible asset) and not the physical manifestation of that invention (for example, a prototype or saleable article).

22. The Income Tax Act refers to different types of intellectual property in specific terms. For example, sch 14 distinguishes, in some detail, between types of depreciable intangible property and lists separately from other depreciable intangible property (for example, a design registration) both:
    - "a patent or the right to use a patent" (item 3); and
    - "a patent application with a complete specification lodged on or after 1 April 2005" (item 4).

23. A reference to a patent application in this statement is (unless otherwise indicated) to "a patent application with a complete specification lodged on or after 1 April 2005".

Patents Act 2013

24. In New Zealand, the Patents Act governs the granting of patents. The Intellectual Property Office of New Zealand administers the Patents Act. Under s 13 of the Patents Act, a patent may be granted for only "patentable inventions" (defined as having the meaning set out in s 14 of the Patents Act).

25. 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 exclusive rights to exploit the invention (and to authorise another person to exploit the invention – see s 18 of the Patents Act) for the term of the patent.

Patent application

26. A patent applicant usually engages a patent attorney to file the patent application. Amongst other things, the patent attorney will search published patent specifications in the database of the Intellectual Property Office of New Zealand before the application is filed.

27. There are a number of ways to apply for a patent. These are:
    - An application with a provisional specification.
    - An application with a complete specification.
    - A Convention application.
    - A Treaty application.
    - A Divisional application.

28. In terms of s 36(1) of the Patents Act, every patent application must be accompanied by a complete specification or a provisional specification unless the application is a Convention application. A Convention application must be accompanied by a complete specification.

29. A provisional specification is a general description of the invention. A complete specification is a detailed description of the invention. If a patent application is accompanied by a provisional specification, then a complete specification must be filed within 12 months (extendable to 15 months, at the applicant's request) of the filing date of the application.
30. After examining the application, the Commissioner of Patents must, if satisfied on the balance of probabilities that the requirements in the Patents Act and regulations have been met, accept and publish the complete specification. If no one opposes the application, the Commissioner of Patents must grant a patent.

Patent date and term

31. In terms of s 103 of the Patents Act, the patent date is the:
    - filing date of the relevant complete specification; or
    - date determined under the regulations, if the regulations provide for the determination of a different date as the patent date.
32. Although the patent is not necessarily granted on this date, the 20-year term of the patent runs from this date. A patent is not in force until it is granted, although certain pre-grant rights are conferred under the Patents Act (see s 81 of the Patents Act) after the relevant complete specification becomes open to public inspection. As a result, the patent expires at some time less than 20 years after the patent is granted. This is in accordance with s 20 of the Patents Act, which states that the term of every patent is 20 years from the patent date.

Effect of a patent

33. Following the grant of a patent, a patentee, as the patent holder, may commercially exploit the invention (or authorise another person to exploit the invention) for the term of the patent (up to 20 years). The term "exploit" is defined in s 18(2) of the Patents Act. The patentee has a number of options to exploit the invention, including:
    - licensing 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);
    - using the patented process themselves or by merely retaining the patent rights; or
    - selling or assigning the patent rights to a third person to exploit similarly.

In each case, the holder of the patent rights can exclude others from exploiting the particular patented invention.

Patents outside New Zealand

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

Patent applications, patents and patent rights – their costs and depreciation

Summary – patents, the right to use a patent, and a patent application are all depreciable for income tax purposes

36. Patents, the right to use a patent and a patent application are all depreciable for income tax purposes. As mentioned in [22], they are all listed in sch 14 as items of depreciable intangible property.
37. The depreciable cost typically includes the legal and administrative costs. However, the depreciable cost can also include expenditure incurred for an underlying intangible item (for example, a method or formula giving rise to a patent), if s EE 18B is satisfied. Section EE 18B is discussed at [65]–[67].
38. The original patentee or the purchaser of the patent application, patent or patent rights may depreciate the item using the straight-line method of depreciation. Under this method, the cost of the item is spread over its legal life.
39. Sections EE 33 and EE 34 provide the formulas for determining the annual depreciation rate for patent applications (and patents granted before the 2005/06 income year) and patents (granted in the 2005/06 or later income years) respectively.

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

What is depreciable

40. Under the Income Tax 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" (s YA 1 and sch 14). Section YA 1 states:

    depreciable intangible property is defined in s EE 62 (Meaning of depreciable intangible property)

41. Section EE 62 states:

    EE62 Meaning of depreciable intangible property

    Meaning

    (1) **Depreciable intangible property** means the property listed in schedule 14 (Depreciable intangible property).

    Criteria for listing in schedule 14

    (2) For property to be listed in schedule 14, 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 14 prevails

    (3) Property that is listed in schedule 14 is depreciable intangible property even if the criteria are not met.

42. Schedule 14 lists intangible property that is depreciable. Items 3 and 4 on the list are:

    3 a patent or the right to use a patent

    4 a patent application with a complete specification lodged on or after 1 April 2005

43. Therefore, on the lodgement of a patent application with a complete specification (lodged on or after 1 April 2005), the taxpayer will have a depreciable intangible asset. If the patent application is refused or withdrawn or not lodged, the taxpayer is allowed a deduction for expenditure they have incurred in relation to the application or intended application (s DB 37 – see [47]–[49]).

44. Once the patent application is granted, the taxpayer will depreciate the patent itself. Alternatively, if the taxpayer purchases the right to use a patent, that right is depreciable provided the other requirements for depreciation are met. Depreciation of a patent or patent right can be claimed only when the patent or 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, s EE 50 provides for an adjustment in the depreciation calculation to reflect this.

45. Section EE 50 contains the formula to reduce the depreciation deduction to reflect the period during which the patent or patent rights were used or available to derive income. This partial use formula is:

    depreciation loss × qualifying use days ÷ all days

46. The formula items are defined in s EE 50(3).

A patent application is made but a patent is not granted

47. Section DB 37 provides that, in some situations, where the application for the grant of a patent made by a taxpayer is refused or withdrawn or not lodged, the taxpayer is allowed a deduction for expenditure they have incurred in relation to the application or intended application. The deduction is allowed:

    - for expenditure incurred that would have been part of the cost of the patent (or patent application) if the application or intended application had been granted; and
    - provided the taxpayer is not allowed a deduction for the expenditure under another provision.

48. The expenditure includes patent application fees, legal fees and expenditure for underlying intangible items (in terms of s EE 18B) incurred in relation to the application or intended application.

49. Section DB 37 applies only if the person is not allowed a deduction under another provision. For example, s EE 48 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 (but not where a patent application is never lodged). Section DB 37 does not apply in this situation.

Depreciation method for patents generally

50. The following discussion relates to the depreciation method for patents generally. Sections EE 33 and EE 34 provide the formulas for determining the annual depreciation rate for patent applications (and patents granted before the 2005/06 income year) and patents (granted in the 2005/06 or later income years) respectively.

51. Section EE 12(2)(b)(ii) provides that the straight-line method of depreciation must be used to calculate depreciation for "fixed life intangible property". The straight-line method is defined in s YA 1:

    straight-line method, for depreciation, is defined in section EE 67 (other definitions)

    Section EE 67 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 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

52. Because a patent or the right to use a patent is depreciable property with a legal life that, 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 s YA 1:

    fixed life intangible property is defined in section EE 67 (Other definitions)

    Section EE 67 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

53. "Legal life" is defined in s YA 1:

    legal life is defined in section EE 67 (Other definitions)

    Section EE 67 states in paras (a) and (b) of the definition of legal life that in the Act:

    legal life,—

    (a) for an item to which paragraphs (b) to (d) do not apply, 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:

    (b) for an item that is a patent application, a design registration application, a patent, or a design registration, means the legal life under paragraph (a) that a patent or design registration would have if granted when the relevant application is first lodged:

54. Accordingly, the legal life of the patent or the right to use a patent is required to be calculated assuming rights of maintenance and renewal are exercised (see the discussion at [98]–[107]). The legal life of a patent is 20 years.

Depreciation rates for patents and patent rights acquired before 2005/06 and patent applications

55. For patents or patent rights acquired before the 2005/06 income year and patent applications (lodged with complete specification on or after 1 April 2005), the annual depreciation rate is set out in s EE 33.

56. In terms of s EE 33(2), the annual depreciation rate is calculated using the formula:

    1 ÷ legal life

57. For purposes of s EE 33, the definition of "legal life" differs according to whether s EE 18B (expenditure for an underlying intangible item) or s EE 19 (additional costs) applies. If s EE 18B or s EE 19 applies, then "legal life" is defined as the item's remaining legal life from the start of the income year in which the relevant costs are recognised. If neither of the relevant sections applies, then "legal life" is defined as the item's remaining legal life from the time it is acquired.

58. The depreciation loss is calculated, in terms of the standard calculation in s EE 16, by multiplying the depreciation rate by the value or cost of the property and the fraction of the year that the property is owned by the taxpayer. This formula is set out in s EE 16(1)

    annual rate × value or cost × months ÷ 12

59. In summary, the depreciation of patents and patent rights (acquired before the 2005/06 income year) and patent applications:

    - is by the straight-line method (s EE 12);
    - with the annual rate calculated in accordance with s EE 33; and
    - the amount of depreciation loss calculated in terms of s EE 16.

Depreciation rates for patents and patent rights acquired in the 2005/06 or later income years

60. For patents acquired in the 2005/06 or later income years, the annual depreciation rate is set out in s EE 34. Section EE 33, discussed above, specifically provides at s EE 33(1)(b) that fixed life intangible property to which that section applies does not include "a patent for which a rate is set out in section EE 34".

61. The formula for calculating the annual depreciation rate is the same as that in s EE 33:

    1 ÷ legal life

62. For purposes of s EE 34, the definition of "legal life" also differs according to whether s EE 18B (expenditure for an underlying intangible item) or s EE 19 (additional costs) applies, and whether a depreciation loss has been allowed for the patent application (the patent application depreciation loss is not a criterion for the formula in s EE 33). The different circumstances and resulting definition of "legal life" are set out in ss EE 34(4)–(7).

63. The depreciation loss is calculated similarly to patents acquired before the 2005/06 income year, in terms of s EE 16 (see at [58]):

    annual rate × value or cost × months ÷ 12

64. In summary, the depreciation of patents or patent rights acquired in the 2005/06 or later income years:
    - is by the straight-line method (s EE 12);
    - with the annual rate calculated in accordance with s EE 34; and
    - the amount of depreciation loss calculated in terms of s EE 16.

Inclusions in the cost of a patent application, patent or patent rights

65. Included in the cost of a patent are:
    - the legal and administrative costs incurred in applying for the patent;
    - additional costs incurred for a patent (s EE 19); and
    - for the 2015/16 and later income years, expenditure for underlying intangible items (s EE 18B).

    Depreciation is calculated on these three costs.

66. Section EE 18B provides that the cost of the patent also includes expenditure by the taxpayer for underlying items of intangible property. To meet the requirements of s EE 18B, the underlying item must give rise to, support or be an item in which the person incurring the expenditure holds the patent.
67. An example of expenditure on an underlying item would be an invention supporting or giving rise to the patent. R&D costs incurred in devising an intangible invention, in respect of which a patent is sought, are included in the depreciable value of that patent or the right to use that patent. This is provided no other deduction has been allowed for the research and development expenditure. See Example 1, illustrating the operation of s EE 18B.

Additional costs that are depreciable

68. Although s EE 19 provides for "additional costs" to be added to the depreciation cost base of an intangible asset, "additional costs" are not defined.
69. In terms of s EE 19, additional costs are costs that the taxpayer incurs in relation to fixed life intangible property that the taxpayer owns. The taxpayer must also have been denied a deduction for those additional costs, other than a deduction for depreciation loss. Additional costs are added to the relevant item's adjusted tax value and depreciated over the remaining legal life of the item.

Whether speculative patent applications, patents or the rights to use a patent are recognised as assets and depreciated

70. 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.
71. It can be argued that these patents or patent rights should not be treated as assets, until the feasibility of the invention is known. The Act, however, does not make this distinction. Sections EE 14, EE 16, EE 19, EE 33 and EE 34 provide 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 depreciable cost includes all of the costs incurred in acquiring the patent or the right to use a patent.
72. 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 (*CIR v Banks* (1978) 3 NZTC 61,236).

Treatment of research and development expenditure

73. R&D costs incurred on an invention, before recognition of an intangible asset for accounting purposes, may be deductible under s DB 33 or s DB 34.
74. Once an intangible asset is recognised for accounting purposes, further development costs relating to the invention must be capitalised and may not be deductible under s DB 34. One exception is where the taxpayer's development expenditure is less than $10,000 in the relevant income year. The further development costs, after recognition of the intangible asset, may form part of the cost of a patent (in terms of s EE 18B) and be depreciable (see [65]–[67]).
75. The following discussion considers the tax treatment of various types of invention expenditure. This treatment does not apply to a person who simply purchases a patent application, patent or right to use a patent from someone else.

Research and development expenditure

General principles

76. Section DB 33 allows a deduction for expenditure on scientific research.

77. Section DB 34 allows a deduction for expenditure on R&D. This deduction could apply to expenditure incurred by a taxpayer on R&D that leads to an invention (and potentially a patent application). Section DB 35(1) contains definitions applicable to s DB 34. Section DB 34 is not mandatory, so a taxpayer may choose not to apply it to their R&D expenditure in an income year.

78. If the relevant R&D expenditure is revenue in nature, that is, 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 (for example, expenditure on materials consumed in research related to a taxpayer's business), the expenditure would be deductible without the benefit of s DB 34. In contrast, R&D 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 (unless s DB 34 applies).

79. If a person who devised and patented an invention:
    - sells all of the patent rights relating to the invention, then s DB 38(3) allows a deduction for expenditure incurred in connection with devising the invention, whenever it is incurred, to the extent that it not already allowed under s DB 38(2) or some other provision (such as s DB 34); or
    - sells only some of the patent rights, then s DB 38(4) allows a proportional deduction of the expenditure incurred.

Section DB 34

80. In terms of s DB 34, a taxpayer is allowed a deduction for R&D expenditure incurred, in the income year it is incurred, provided the taxpayer:
    - recognises the expenditure as an expense;
    - has derecognised expenditure on the non-depreciable asset;
    - recognises the expenditure otherwise; or
    - has minor R&D expenditure.

Taxpayer recognises the expenditure as an expense

81. The taxpayer must recognise the expenditure as an expense for financial reporting purposes under one of the relevant accounting standards (either the old or new standards), because the criteria for asset recognition in the standard have not been met (s DB 34(2)).

82. The accounting standard criteria for asset recognition, which includes demonstrating the technical feasibility of a product and the existence of a market for the product, are set out in:
    - the old reporting standard, Financial Reporting Standard No 13 1995 (FRS-13), at [5.3]; and
    - the new reporting standard, New Zealand Equivalent to International Accounting Standard 38, at [57].

Taxpayer has derecognised expenditure on the non-depreciable asset

83. The taxpayer has incurred expenditure developing an intangible asset that is not depreciable intangible property, and that intangible asset is derecognised for accounting purposes (ss DB 34(3) and CG 7C). (See also discussion on s DB 34(3) and CG 7C at [87]–[93].)

Taxpayer recognises the expenditure otherwise

84. The taxpayer recognises the expenditure as an expense for financial reporting purposes because it is an immaterial amount, and, if the amount were material, the taxpayer would be required to have recognised an asset under the old or new reporting standard (s DB 34(4)).

Taxpayer has minor research and development expenditure

85. If the taxpayer's annual R&D expenditure does not exceed $10,000, then the entire amount may be expensed in the year in which it is incurred (s DB 34(5)).

86. The expenditure must have been written off as immaterial and expensed for financial reporting purposes.

INTERPRETATION STATEMENTS

Derecognition and the subsequent disposal or re-recognition of non-depreciable intangible assets

Derecognition

87. Section DB 34(3) applies if a taxpayer has developed an intangible asset (recognised for accounting purposes) that is not depreciable for income tax purposes and the intangible asset is derecognised for accounting purposes. The taxpayer may obtain a one-off income tax deduction for capitalised development expenditure (incurred on or after 7 November 2013) that they have incurred on the asset on derecognition.

88. The taxpayer can deduct expenditure they incur in carrying out only **development** of an intangible asset (s DB 34(3)). Expenditure incurred on **purchasing** a non-depreciable intangible asset is not deductible to the purchasing taxpayer on derecognition of the asset for financial reporting purposes. A taxpayer who purchases a non-depreciable intangible asset can, however, claim a deduction, on derecognition of the asset, for any development expenditure they incurred on further developing the asset after purchasing it. See Example 2, illustrating the operation of s DB 34(3).

Disposal or re-recognition

89. Section CG 7C applies, if:
    - a taxpayer has been allowed a deduction under s DB 34 because s DB 34(3) applies; and
    - the previously derecognised non-depreciable intangible asset is subsequently:
        - disposed of for consideration that is not income under another provision of the Act; or
        - re-recognised for financial reporting purposes.

90. Under [118] of the new reporting standard, an entity is required to disclose information related to each class of its intangible assets. The entity is also required to distinguish between internally generated intangible assets and other intangible assets. In terms of [118(e)(viii)], the entity must disclose a reconciliation of the carrying amount at the beginning and end of a period showing other changes in the carrying amount during the period. Although this information is for a group of assets, to calculate the change in the carrying amount for the group of assets during a period, the entity would have to sum the changes in the carrying amounts of each individual asset in the group during the period. If a previously derecognised intangible asset has a positive carrying amount at the end of a period in which it had a carrying amount of zero at the beginning, this implies it must have been rerecognised for financial reporting purposes during the period. This amounts to a rerecognition for the purposes of s CG 7C.

91. When a taxpayer derives consideration from a disposal, the amount that will be treated as income is the lesser of the consideration derived from the disposal and the amount of the deduction previously taken.

92. When a taxpayer rerecognises an intangible asset, the entire amount of the deduction previously taken will be treated as income. For the purposes of the depreciation rules, the taxpayer is treated as never having had the deduction. Therefore, if the taxpayer eventually acquires an item of depreciable intangible property to which the expenditure relates (for example, if the intangible asset rerecognised by a taxpayer is an invention that they subsequently patent), they will be able to deduct the expenditure over time as depreciation.

93. An amount treated as income under s CG 7C is treated as income of the taxpayer in the income year of the disposal or rerecognition, as the case may be.

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

94. Under s DB 38, a taxpayer who devises an invention to which the patent relates and then disposes of all or some of the patent rights is allowed a deduction of the amount of the expenditure (or part of the expenditure) incurred in connection with devising the invention that has not already been allowed under s DB 38(2). To the extent that the taxpayer who devised the invention has already claimed the invention costs in full (under s DB 33 or s DB 34), those costs would not be deductible again (s BD 4(5)).

Depreciation of assets used for or developed in the inventing process

95. 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 sch 14 as an item of "depreciable intangible property".

96. However, s DB 34, by the application of the criteria in FRS-13 or the new reporting standard, 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. Before the enactment of s EE 18B (see discussion below), after the point of

asset recognition, such costs were required to be capitalised and, unless those costs were for an asset that was otherwise depreciable property, no depreciation allowance was available. (Where s DB 34(5) applies (that is, where the person incurs expenditure of $10,000 or less, in total, on R&D for an income 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.)

97. Section EE 18B, applying for the 2015/16 and later income years, specifies that the "cost" to a taxpayer of an item of depreciable intangible property for depreciation purposes includes expenditure they have incurred for an underlying item of intangible property. The underlying item must give rise to, support or be an item in which the person holds the item of depreciable intangible property. An amount of expenditure cannot be included in the depreciable cost of the item of depreciable intangible property, if a deduction for the expenditure has already been allowed. In the case of patents and patent applications, the person must have incurred the expenditure on or after 7 November 2013, for the expenditure to be included in the depreciable cost of the item of depreciable intangible property.

Patent maintenance and renewal fees

General principles

98. Patent maintenance fees and renewal fees are payable to the Intellectual Property Office of New Zealand at intervals to keep patent rights in existence. Maintenance fees are due on the fourth and each succeeding anniversary date of the filing of a patent application with complete specification, before a patent is granted. Once a patent is granted, renewal fees become due on each anniversary date, until the 19th anniversary date.

99. Under transitional arrangements, for patents granted under the Patents Act 1953, the next renewal fee must be paid in accordance with the Patents Act 1953, but subsequent fees must be paid annually in accordance with the Patents Act 2013.

100. In the Commissioner's opinion, patent renewal fees and patent maintenance fees (and service provider fees directly related to the renewal and maintenance fees) are revenue in nature and are deductible for income tax purposes in the year they are incurred. This is mainly because of the recurrent nature of the fees, being payable on an annual basis in terms of the Patents Act 2013. (This differs from the less frequent payment structure under the Patents Act 1953.)

What happens if patent maintenance fees or renewal fees are not paid?

101. A patent application is treated as having been abandoned if the applicant does not pay the maintenance fee within the prescribed period. If the patent renewal fees are not paid, the patent rights end (the patent is described as lapsing).

102. Abandoned patent applications and lapsed patents, where the right to request restoration has expired, are treated as having been disposed under the Income Tax Act. Therefore, the cost of the patent application, not already depreciated, is deductible.

103. The owner of an abandoned patent application or lapsed patent can no longer exercise the associated rights of the relevant asset. Section EE 47(9) provides that in that situation, ss EE 48 to EE 52 apply. Section EE 48(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".

104. Therefore, when patent rights are voided or disposed of, being the eighth event as described in s EE 47(9), any cost of the patent or patent rights that has not already been depreciated can be deducted under s EE 48.

105. Section EE 44 refers to consideration derived from the disposal of an item. In the case of a patent that is allowed to lapse (or patent application that is abandoned), s EE 45(2) provides that, for the purposes of s EE 44, the consideration may be zero or a negative amount.

106. However, s EE 44(2)(a) provides that ss EE 48 to EE 52 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.

107. In summary, subject to the exceptions above, the non-renewal of a patent and the abandoning of a patent application are events, for the purposes of s EE 48 to EE 52, and any costs, not already depreciated, can be deducted.

Legal fees incurred in defending or attacking a patent

108. The Patents Act details how the validity of a patent can be challenged. Such a challenge is likely to involve legal fees, which may relate to:

- an assertion (before acceptance); or
- ex parte re-examination (before and after grant); or
- pre-grant opposition action; or
- post-grant revocation proceedings (before the Commissioner of Patents or High Court).

109. Assertions by third parties (which relate to the requirements for the invention to be a novelty and involve an inventive step) may be made in the prescribed period after a complete specification becomes open to public inspection. The prescribed period for assertions ends on the date that the notice of acceptance is issued.

110. 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.

111. Re-examinations of a patent application (and the complete specification relating to the application) can be conducted before and after a patent is granted. Re-examination of an accepted (but not granted) patent application is an alternative to opposing an accepted application. A re-examination requestor takes no further part in the re-examination once the request has been filed (this is in contrast to opposition proceedings). The Commissioner of Patents may also institute re-examination without being requested to do so.

112. A revocation action is taken against someone who has had a patent granted to revoke that patent.

113. The Commissioner's opinion is that the same principles apply to the above proceedings. In all cases, the relevant proceeding relates to an asset of the person, whether it is a patent or a patent application. The terms "defending" and "attacking" are used to mean, respectively, defending and taking a revocation action (including an opposition action, a re-examination or an assertion).

General principles

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

115. The Privy Council in *BP Australia v FC of T* [1965] 3 All ER 209 has provided several factors to consider in the determination of whether expenditure is capital or revenue in nature. The Court of Appeal has since summarised the factors for consideration in *CIR v McKenzies NZ Ltd* (1988) 10 NZTC 5,233. In the judgment of the court, Richardson J said (at 5,235 and 5,236):

> 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.

116. The approach of the Privy Council in *BP Australia* has been adopted in other New Zealand cases: *CIR v LD Nathan & Co Ltd* [1972] NZLR 209, *Buckley & Young v CIR* (1978) 3 NZTC 61,271 (CA), *Christchurch Press Co Ltd 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.

117. 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 (at 629):

> 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

118. The "enduring benefit" test that has been approved and affirmed by both the House of Lords (*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.

119. Moller J applied the *BP Australia* approach to the determination of expenditure as capital or revenue in the Supreme Court decision of *CIR v Murray Equipment Ltd* [1966] NZLR 360. In that case, the expenditure incurred on legal costs in attacking patent applications of others was held to be revenue in nature (at 369).

> 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.

120. 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 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.

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

122. 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 (at 193, 194):

> 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.

123. The *Ballinger* decision has been the subject of considerable criticism, particularly in the later patent case of *Murray Equipment*. The approach in *Murray Equipment* following *BP Australia* is to be preferred.

124. A further fundamental distinction between capital and revenue expenditure is whether the expenditure relates to the business structure or to the business process of the taxpayer. Expenditure of the former type is capital in nature. The Court of Appeal in *Buckley & Young* referred to this distinction (at 61,274):

> what is involved in the fundamental distinction between the source of income and the income earning process; between capital and income; between expenses affecting the business structure or entity and operating expenses. Whether the enquiry is under sec. 111 or sec. 112(a) [what is now the general permission and capital limitation] the essential question is as to the true character of the payments made and the benefits provided.

125. The Privy Council case of *Ward v CT* [1923] AC 145 is support for the proposition that expenditure incurred to protect the entire business from being extinguished is likely to be capital in nature. Although not a case involving patents, *Ward* does deal with the fundamental distinction of whether payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.

Conclusion on general principles

126. 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, are **generally** revenue in nature. A similar analysis would also apply in the case of the right to use a patent.

127. However, legal expenses may be capital in nature where, for example, the taxpayer's business has only one patented asset from which it earns its income such that expenses incurred in defending that patent are incurred in protecting the taxpayer's business structure as a whole.

Specific deduction for legal fees

128. From 1 April 2009, s DB 62 has allowed a deduction for legal expenses where the taxpayer's total legal expenses for an income year are equal to or less than $10,000. This section overrides the capital limitation. In other words, if a taxpayer incurs legal expenditure for attacking or defending a patent and the taxpayer's total legal expenses are equal to or less than $10,000 in that income year, then the legal expenses are deductible regardless of whether they are capital in nature. This assumes the general permission is satisfied and the other general limitations are met.

129. If the legal expenditure does not satisfy the requirements of s DB 62, then the normal deductibility principles apply. (In other words, the expenditure will be deductible only if the general permission is satisfied and the general limitations do not apply.) In which case, the general principles discussed above apply, and the expenditure is likely to be revenue in nature.

Proceeds and allowable deductions on the sale of patent rights or a patent application

Amount derived is income

130. 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 s CB 30:

> **CB 30 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.

131. Sections EE 44 to EE 52 may also apply to the disposal of depreciable property such as patents and patent applications other than by way of sale.

Amount of deduction

132. The amount of allowable deductions on the sale of a patent application or patent rights depends on the circumstances of the taxpayer. If a taxpayer sells a patent application or patent rights that they acquired on or after 1 April 1993, s DB 40 will apply to the sale. In terms of s DB 40, the taxpayer is allowed a deduction on disposal of the patent application or patent rights. The amount of the deduction is calculated using the formula:

    total cost − total amounts of depreciation loss

133. The terms used in the formula are defined in s DB 40(4). For clarity, the "total cost" in the formula is the historic cost of the patent application or patent rights, not the book value of the item in the taxpayer's financial statements.
134. Deductions under s DB 40 may also be allowable for a taxpayer in the business of buying and selling patent applications, patents or patent rights (that is, the items are the taxpayer's trading stock). This could apply if the taxpayer retains a patent and derives income from it by licensing the patent rights to a third party to exploit. When those patent rights are sold, allowable deductions would be in accordance with s DB 40. The deductions are allowable despite the fact other patents or patent rights of that taxpayer may be trading stock. The trading stock patents must be treated in accordance with the trading stock rules in subpart EB (valuation of trading stock – including dealer's livestock).
135. 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 s DB 38.
136. Sections EE 44 to EE 52 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

137. 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, then the cost is deductible when the taxpayer on-sells them. Section EA 2 requires deductions for "revenue account property" that is not trading stock to be deferred until those patent or patent rights are disposed of or cease to exist.

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

138. If the proceeds of sale of property are income, then the property is "revenue account property" (as defined in s YA 1). In the rare case of a business dealing in patent applications, patents or patent rights, those items will also constitute trading stock. 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.
139. Similarly, if a person is in the business of buying and selling patent applications, patents or patent rights and in the business of inventing, then 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.

Treatment of patent-related expenses and proceeds under the old rules

140. In terms of s DB 36, 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.
141. If a patentee devised an invention and derived income from the use of its patent, s DB 38(2) provides for a deduction for expenditure incurred before 1 April 1993 in connection with the devising of an invention.

Examples

142. The following examples help to explain the application of the law.

Example 1: Operation of s EE 18B – expenditure for underlying items of intangible property

143. Business C begins an R&D project during May 2016. After 18 months of R&D, Business C recognises an invention resulting from the R&D as an intangible asset for financial reporting purposes. The R&D expenditure incurred by Business C, up to the point of asset recognition, may be deductible under the general permission (s DA 1) or under the specific R&D provisions in s DB 33 or s DB 34 (refer discussion at [75]-[102]).

144. Subsequently, Business C incurs some capitalised development expenditure further refining the invention. An invention is an intangible asset that is not an item of depreciable intangible property.

145. Business C then applies for a patent for the invention, filing a patent application with a complete specification. A patent application with a complete specification lodged on or after 1 April 2005 is an item of depreciable intangible property. The depreciable cost of the patent application comprises the administrative and legal fees Business C incurred in applying for the patent and the capitalised development expenditure Business C incurred on refining the intangible invention.

146. The capitalised development expenditure is included in the depreciable cost of the patent application because the invention is an underlying item of intangible property in which Business C holds the patent application. If the patent is subsequently granted, the depreciable cost of the patent will also include the capitalised development expenditure Business C incurred on refining the invention, if it has not already been deducted as depreciation of the patent application.

147. On the granting of a patent, the patent application costs form part of the adjusted tax value of the patent and the amounts continue to be depreciated over the legal life. In terms of s EE 44(2)(b), there is no disposal of the patent application when that application has "concluded because a patent is granted to the person in relation to the application".

148. If the taxpayer has purchased the patent application, patent or patent rights, then the cost to the taxpayer is depreciable. In this case, the taxpayer has purchased either the application for or the right to use a particular invention, which is protected by a patent, and to exclude others from such use. It is the cost incurred in buying that application or right that is depreciable. There is no disposal of the patent application when the patent is granted (in the case of a taxpayer purchasing a patent application).

Example 2: Operation of s DB 34(3) – derecognition

149. Business A begins an R&D project during March 2016. After 24 months of R&D, Business A recognises an intangible asset for financial reporting purposes, which has been created from the R&D. In the six months after recognising the intangible asset for financial reporting purposes, Business A incurs $200,000 in capitalised development expenditure further developing the asset. The intangible asset is not listed in sch 14, so it is not depreciable for tax purposes.

150. Business A then sells the incomplete intangible asset to Business B (which intends to continue the R&D and complete the asset) for $10 million. Business A is not in the business of buying and selling those intangible assets (that is, the intangible assets are not trading stock). Business A makes an untaxed capital gain of $9.8 million from the sale. Business B incurs $300,000 in capitalised development expenditure further developing the asset before abandoning the project and derecognising the asset for financial reporting purposes.

151. Business B is allowed a deduction under s DB 34(3) for the $300,000 it incurred in capitalised development expenditure. Business B is not allowed a deduction for the $10 million cost of purchasing the asset from Business A.

Example 3: How depreciation is calculated and what happens when a patent is not renewed

152. The relevant sections in this example are ss EE 12, EE 14, EE 16, EE 33 and EE 34.

153. A company devises an invention for a new energy-efficient 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 2016. It spends $250 on filing fees and $10,000 on patent attorney fees. The company's total legal fees for the 2016/17 income year exceed $10,000. The Intellectual Property Office of New Zealand grants a patent for the invention on 3 December 2017. The company begins making the light bulbs in June 2018.

154. The term of the patent rights under the Patents Act 2013 is 20 years (240 months) and runs from the patent date, being the filing date of the complete specification. The patent life is, therefore, from 20 October 2016 to 20 October 2036. The patent will expire on 20 October 2036.

155. The patent rights are available for use by the company in the 2017/18 income year to derive income or to carry on the business, although the company begins manufacturing the light bulbs only in the 2018/19 income year.

156. Therefore, the depreciation calculations are for the three income years:

- 2016/17 – the year in which the patent application is filed with complete specification;
- 2017/18 – the year in which the patent is granted; and
- 2018/19 – a typical year following the grant of the patent.

2016/17 – the year the patent application is filed with complete specification

Depreciation of the patent application (with complete specification)

Annual rate (s EE 33) = 1 ÷ legal life
= 1 ÷ 20
= 0.05

157. The patent application is designated as a form of depreciable intangible property (and fixed life intangible property as defined in s EE 67), because it was lodged on or after 1 April 2005 with a complete specification.

158. Therefore, for the 2016/17 income year, the annual depreciation rate is calculated in terms of s EE 33. The legal life is as defined in s EE 67, being the 20-year term of a patent under the Patents Act.

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	= 0.05	× $10,250	× 5 ÷ 12
	= $214		

159. The depreciation loss for the patent application is calculated using the standard calculation in s EE 16. The cost of the patent application comprises the legal and administrative costs incurred ($10,250). The patent application was owned for five whole calendar months in the taxpayer's 2016/17 income year (see s EE 16(7)).

2017/18 – the year the patent is granted

160. In the 2017/18 income year, the year the patent is granted, depreciation calculations need to be performed for the:

- patent application (held for eight months in 2017/18 before the grant of the patent); and
- patent (held for four months in 2017/18).

Depreciation of the patent application

Annual rate (s EE 33) = 1 ÷ legal life
= 1 ÷ 20
= 0.05

161. For the 2017/18 income year, the patent application has been owned for eight whole calendar months. The conclusion of the patent application because a patent was granted is excluded from being a disposal under s EE 44(2)(a). Therefore, the company is not denied a deduction for depreciation loss for the application under s EE 11.

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	= 0.05	× $10,250	× 8 ÷ 12
	= $342		

Depreciation of the patent or patent rights

Annual rate (s EE 34) = 1 ÷ legal life
= 1 ÷ 20
= 0.05

162. For the 2017/18 income year, s EE 34(6) provides that the annual depreciation rate for the patent or patent rights is calculated on the basis of the legal life being the remaining legal life of the patent application from the start of the income year in which the person acquires the patent application (that is, 20 years).

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	= 0.05	× $9,694	× 4 ÷ 12
	= $162		

163. In terms of s EE 16(4)(b)(i), the patent's value or cost is its adjusted tax value at the start of the month the company acquired it (at 1 December 2017). The adjusted tax value is the cost ($10,250) less the depreciation loss on the patent application up to 1 December 2017 ($214 + $342). The adjusted tax value is $9,694.

164. Therefore, for 2017/18, the taxpayer has a depreciation loss of $342 for the patent application and $162 for the ensuing patent or patent rights (that is, $504 in total for that income year).

2018/19 – a typical year in which the patent or patent rights are owned

Depreciation of the patent or patent rights

Annual rate (s EE 34) = 1 ÷ legal life
= 1 ÷ 20
= 0.05

165. For the 2018/19 income year, in terms of s EE 34(6), the legal life is still the remaining legal life of the patent application from the start of the income year in which the person acquires the patent.

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	0.05	× $9,694	× 12 ÷ 12
	$485		

166. For 2018/19, the taxpayer has a depreciation loss of $485 for the patent.

Subsequent income years

167. For the 2019/20 income year, the depreciation for the patent is again for a full 12 months and the depreciation deduction is as for the 2018/19 year (that is, $485).

168. Before the fourth anniversary of the filing of the patent application with complete specification (that is, 20 October 2020), the company decides not to renew the patent. The patent, therefore, expires on 20 October 2020. Under s EE 44 and EE 47(9), this is an event to which s EE 48 applies.

169. 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 (that is, once as the year's depreciation and once under s EE 48(2) for a loss on disposal).

170. Section EE 11(1) provides that a person does not have a depreciation loss for the income year in which they dispose of the depreciable property. Section EE 48 applies so that the taxpayer can deduct the remaining cost of the patent that has not already been depreciated.

171. The depreciation already claimed for the year ended is:

31 March 2018	$162
31 March 2019	$485
31 March 2020	$485
Total depreciation claimed	$1,132

172. Therefore, for the 2020/21 income year, the taxpayer can deduct the following amount from assessable income for loss on disposal of the patent:

Cost of the patent	$9,694
Less depreciation claimed	$1,132
Deduction for loss on disposal	$8,562

Example 4: How depreciation is calculated if a patent application with complete specification is lodged after 1 April 2005, but the application is later withdrawn or refused

173. The relevant sections in this example are ss EE 11, EE 12, EE 14, EE 16, EE 33, EE 44 and EE 47.

174. The facts in example 4 are the same as in example 3, except that the patent application for the light bulb was not granted but was refused on 3 December 2017.

2016/17 – the year the patent application is filed with complete specification

175. The calculation for the depreciation for the patent application in the 2016/17 income year, the year the patent application is filed with complete specification, is the same as in example 3.

2017/18 – the year the patent is refused

176. 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.

177. Under s EE 44 and EE 47(9), the refusal of the patent application on 3 December 2017 is an event to which s EE 48 applies. The taxpayer can deduct the cost of the patent application not already depreciated as in example 3.

178. Depreciation already claimed for year ended 31 March 2017, being the total depreciation claimed, is:

31 March 2017	$214

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

Cost of the patent	$10,250
Less depreciation claimed	$214
Deduction for loss on disposal	**$10,036**

Example 5: How depreciation is calculated when the patent or patent rights are purchased from another person

180. The relevant sections in this example are ss EE 16 and EE 33.

181. On 1 May 2016, 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 2020. The taxpayer begins making and selling the beds. The taxpayer's balance date is 31 March. Because the patent was granted before the 2005/06 income year, s EE 33 determines the annual rate.

182. The remaining legal life of the patent rights, from the time at which the taxpayer acquires the patent, is 4 years and 6 months (that is 4.5 years).

Annual rate (s EE 33)	=	1 ÷ legal life
	=	1 ÷ 4.5
	=	0.22 (to two decimal places)

183. The annual depreciation deduction on the patent rights in the 2016/17 income year is:

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	= 0.22	× $240,000	× 11 ÷ 12
	= $48,400		

184. The annual depreciation deduction on the patent rights in the 2017/18 income year is:

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	= 0.22	× $240,000	× 12 ÷ 12
	= $52,800		

Example 6: Additional costs for a patent

185. The relevant section in this example is s EE 19.

186. A taxpayer manufacturing locks devises an invention for a lock that will respond to only a personal voice signal. The taxpayer lodges a patent application with a complete specification for a patent in New Zealand on 30 October 2016. The taxpayer incurs costs in relation to the patent application, including patent attorney fees. These costs form part of the cost of the patent application. The taxpayer has a 31 March balance date.

187. Some further costs are incurred, and the taxpayer's patent attorney, on 1 March 2017, charges an additional fee of $2,500 for reporting and responding to an examiner's report. The taxpayer's total legal fees for the 2016/17 income year exceed $10,000.

188. The Intellectual Property Office of New Zealand grants the patent on 15 April 2017, and the taxpayer immediately begins manufacturing the new locks.

189. The taxpayer pays the annual renewal fee of $100 in October 2020.

190. Section EE 19 provides that the costs are added to the item's adjusted tax value at the start of the income year for purposes of the depreciation loss formula in s EE 16 when a person:

- owns an item of fixed life intangible property; and
- 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).

191. Once this taxpayer lodged a patent application with complete specification after 1 April 2005, they owned an item of fixed life intangible property.

192. Therefore, although the taxpayer's patent attorney fees were incurred only at the end of the 2016/17 income year, the additional fee of $2,500 can be added to the patent application's adjusted tax value at the start of the 2016/17 income year, for the purposes of s EE 16. This is because the fees are an additional cost incurred in the income year in which the taxpayer owned the patent application.

193. The renewal fees for the patent, incurred in the 2020/21 income year, are considered to be a revenue expense and deductible in the income year incurred.

Example 7: Income and deductions on sale of patent rights

194. The relevant sections in this example are ss CB 30, EE 18B and DB 40.

195. The light bulb company in example 3 spends $45,000 in the 2018/19 income year refining the light bulb components. The company filed for a patent with a complete specification on 20 October 2016. The patent was granted on 3 December

2017, and production began on 20 June 2018. Instead of letting the patent expire on 20 October 2020, the company renews the patent and eventually sells it on 20 October 2022 for $750,000.

196. The company cannot claim depreciation for the 2022/23 income year, because s EE 11(1) says that depreciation cannot be claimed in the year a depreciable asset is sold.

197. The proceeds of $750,000 from the sale is income, under s CB 30. The company can claim the cost of the patent, less depreciation already deducted, as a deduction, under s DB 40.

198. The depreciable cost of the patent to the company was $9,694 and the depreciation loss for the 2017/18 income year is the same as for example 3 (that is, $162).

199. In the 2018/19 income year, the taxpayer has incurred expenditure ($45,000) on an item (components making up the new light bulb) on which the taxpayer holds a patent. Therefore, $45,000 is included in the cost of the patent for depreciation purposes in terms of s EE 18B. In the 2018/19 income year the depreciation calculation, in terms of s EE 16, would be as follows.

2018/19 income year

Depreciation of the patent or patent rights.

Annual rate (s EE 34)	=	1 ÷ legal life
	=	1 ÷ 18.55
	=	0.05 (rounded to two decimal places)

200. For the 2018/19 income year, in terms of s EE 34(4), the legal life is the patent's remaining legal life from the start of the income year in which the relevant costs (the $45,000 under s EE 18B) are recognised under s EE 18B. The patent's remaining legal life at 1 April 2018 is 18 years, 6 months and 20 days (that is, 18.55 years).

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	0.05	× $54,694	× 12 ÷ 12
	$2,735		

201. For the 2018/19 income year, the taxpayer has a depreciation loss of $2,735 for the patent.

202. For the 2019/20, 2020/21 and 2021/22 income years, the depreciation for the patent is again for a full 12 months, and the depreciation deduction is as for the 2018/19 (that is, $2,735 in each year).

203. Depreciation already deducted up to and including the 2019/20 income year is $8,367.

204. Therefore, the deduction on sale is:

Cost of the patent	$54,694
Less: Depreciation already claimed	$8,367
Deduction	$46,327

Example 8: Legal expenses incurred in defending and attacking a patent

205. The relevant section in this example is s BD 2.

206. A pharmaceutical company, Company A, was granted a patent on 1 April 2016 for a cold medication. The medication was a syrup that is a combination of known substances (analgesics and decongestants) and a new substance. Company B, another pharmaceutical company that manufactured cold medications, applied to the Commissioner for the revocation of the patent on the ground that it was not a patentable invention under s 14 of the Patents Act. Both companies held numerous patents. The court held that the patent was valid.

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

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

Example 9: Research and development expenses incurred in devising an invention

209. The relevant sections in this example are ss DB 34, EE 16, EE 18B, EE 33 and EE 34.

210. A tyre manufacturing company, in its income year ended 31 March 2017, spends $10,000 on research and development into coloured snow tyres. The company hopes eventually to obtain a patent for the new tyres. The $10,000 is the total amount of expenditure the company has incurred in that year on research and development. The company recognises the expenditure as an expense and writes it off as immaterial for financial reporting purposes.

2016/17 income year

211. For income tax purposes, in terms of s DB 34(5), the company can deduct the $10,000 in full in its 2016/17 income year.

2017/18 income year

212. In the 2017/18 income year, the same company spends $50,000 on equipment to assist the research (the equipment is not an asset in its own right and nor is it otherwise depreciable). The company treats the amount as an expense for financial reporting purposes (because the project has not yet satisfied the criteria for asset recognition under either the old or new reporting standard).

213. For income tax purposes, in terms of s DB 34(1) and (2), the company can expense all research and development expenditure on the project for the 2017/18 income year.

2018/19 income year

214. In June 2018, the project satisfies the criteria for "asset recognition", but additional development is required before the company's application for a patent for the coloured snow tyres. On 1 October 2018, after additional development expenditure of $100,000, the company lodges a patent application with complete specification, incurring $15,000 in application costs. The patent is granted on 1 December 2018.

215. For income tax purposes, the treatment of the company's research and development costs for the 2018/19 income year is as for 2016/17 and 2017/18: under s DB 34, the taxpayer company can expense all research and development expenditure incurred before asset recognition in June 2018.

216. The $100,000 of development expenditure, incurred after the point of "asset recognition", cannot be deducted under s DB 34. However, as the development expenditure gives rise to the patent application and is incurred on or after 7 November 2013, the development expenditure is included in the depreciable cost of the patent application (and subsequent patent) in terms of s EE 18B.

217. A patent application with complete specification lodged on or after 1 April 2005 is an item of sch 14 depreciable intangible property. Section EE 33 provides the calculation for the rate at which the $15,000 patent application costs and $100,000 underlying development costs incurred can be depreciated.

218. Depreciation of the **patent application** for the period 1 October 2018 to 1 December 2018 (that is, two whole calendar months) is as follows.

Annual rate (s EE 33)	=	1 ÷ legal life
	=	1 ÷ 20
	=	0.05

219. As s EE 18B applies to the patent application, s EE 33(a) determines the patent application's legal life, being 20 years from the start of the 2018/19 income year. For 2018/19, the patent application has been owned for two whole calendar months.

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	0.05	× $115,000	× 2 ÷ 12
	$958		

Depreciation of the **patent** for the period 1 December 2018 to 31 March 2019 (that is, four whole calendar months) is as follows.

Annual rate (s EE 34)	=	1 ÷ legal life
	=	1 ÷ 20
	=	0.05

220. As s EE 18B applied to the patent application, s EE 34(7) determines the patent's legal life, which is still 20 years. For the 2018/19 income year, the patent has been available for use for four whole calendar months.

Depreciation loss (s EE 16)	**= annual rate**	**× value or cost**	**× months ÷ 12**
	0.05	× $114,042	× 4 ÷ 12
	$1,901		

221. The value or cost of the patent is determined under s EE 16(4)(b)(i), being the patent's adjusted tax value at the start of the month it is acquired (that is, $115,000 – $958). Therefore, for the 2018/19 income year, the taxpayer has a depreciation loss of $958 for the patent application and $1,901 for the ensuing patent.

References

Related rulings/statements

"Income tax treatment of New Zealand patents", *Tax Information Bulletin* Vol 18, No 7 (August 2006): 36.

Subject references

asset recognition
depreciation
patents
patent applications
patent rights

Legislative references

Income Tax Act 2004

Income Tax Act 2007, ss BD 2, BD 4, CB 30, CG 7C, DA 1 to DA 4, DB 33 to DB 38, DB 40, DB 62, EA 2, subpart EB, EE 12, EE 14, EE 16, EE 18B, EE 19, EE 33, EE 34, EE 44 to EE 52, EE 62, EE 67, YA 1 (definitions of "fixed life intangible property", "legal life", "patent right", "revenue account property", "straight-line method"), sch 14

Patents Act 1953

Patents Act 2013, ss 5 (definition of "patent"), 13 to 16, 18, 20, 81, 103

Statute of Monopolies, s 6

Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Act 2016

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Financial Reporting Standard No 13 1995 (FRS-13)

New Zealand Equivalent to International Accounting *Standard 38*

INTERPRETATION STATEMENTS

Appendix: Legislation

Income Tax Act 2007

1. Section BD 1 provides:

BD 1 Income, exempt income, excluded income, non-residents' foreign-sourced income, and assessable income

Amounts of income

(1) An amount is **income** of a person if it is their income under a provision in Part C (Income).

Exempt income

(2) An amount of income of a person is **exempt income** if it is their exempt income under a provision in subpart CW (Exempt income) or CZ (Terminating provisions).

Excluded income

(3) An amount of income of a person is **excluded income** if—

(a) it is their excluded income under a provision in subpart CX (Excluded income) or CZ; and

(b) it is not their non-residents' foreign-sourced income.

Non-residents' foreign-sourced income

(4) An amount of income of a person is **non-residents' foreign-sourced income** if—

(a) the amount is a foreign-sourced amount; and

(b) the person is a non-resident when it is derived; and

(c) the amount is not income of a trustee to which section HC 25(2) (Foreign-sourced amounts: non-resident trustees) applies.

Assessable income

(5) An amount of income of a person is **assessable income** in the calculation of their annual gross income if it is not income of any of the following kinds:

(a) their exempt income:

(b) their excluded income:

(c) their non-residents' foreign-sourced income.

2. The general provision, s 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. Section BD 4(5) provides:

   Allocation

   (5) If an expenditure or loss gives rise to more than one 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.

4. Section CB 30 provides:

   CB 30 Disposal of patent applications or patent rights

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

5. Section CG 7C provides:

   CG 7C Disposal or rerecognition of derecognised non-depreciable assets

   When this section applies

   (1) This section applies when, for a non-depreciable intangible asset, a person has been allowed a deduction under section DB 34 (Research or development) because section DB 34(3) applies and—

   (a) the intangible asset is disposed of in an income year for consideration that is not income under another provision of this Act:

   (b) the intangible asset is rerecognised for financial reporting purposes in an income year.

   Disposal for consideration

   (2) If subsection (1)(a) applies, an amount equal to the deduction described in subsection (1) is income of the person for the income year, unless subsection (3) applies.

   Special case: disposal for consideration less than deduction

   (3) If subsection (1)(a) applies and the consideration is less than the deduction described in subsection (1), then, despite subsection (2), an amount equal to the consideration is income of the person for the income year.

   Rerecognition

   (4) If subsection (1)(b) applies, an amount equal to the deduction described in subsection (1) is income of the person for the income year.

   Relationship with subpart EE

   (5) For the purposes of subpart EE (Depreciation), the person is treated as never having the deduction described in subsection (1).

6. Section DA 1 sets out the general permission. Section DA 1(1) and (2) 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.

7. Section DA 2 sets out general limitations in respect of deductions. Section DA 2(1) and (7) state:

   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.

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

DA 3 Effect of specific rules on general rules

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 one 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 that—

(a) it overrides the general permission or the relevant limitation; or

(b) 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.

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

DA 4 Treatment of amount of depreciation loss

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

10. Section DB 33 provides for a deduction for expenditure incurred in connection with scientific research. The section states:

DB 33 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.

11. Section DB 34 provides:

DB 34 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-

(a) under paragraph 5.1 or 5.2 of the old reporting standard or because paragraph 5.4 of that standard applies; or

(b) under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard.

Expenditure on derecognised non-depreciable assets

(3) Subsection (1) applies to a person who—

(a) incurs expenditure, on the development of an intangible asset that is not depreciable intangible property,—

(i) on or after 7 November 2013; and

(ii) before the intangible asset is derecognised or written off by the person as described in paragraph (b); and

(b) derecognises or writes off the intangible asset for financial reporting purposes under—

(i) paragraph 112(b) of the new reporting standard; or

(ii) paragraph 5.14 of the old 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 it is an amount written off as an immaterial amount for financial reporting purposes; and

(b) would be required, if the expenditure were material, to recognise it for financial reporting purposes—

(i) under paragraph 5.1 or 5.2 of the old reporting standard or because paragraph 5.4 of that standard applies; or

(ii) under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard.

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 in an income year; and

(b) has written off the expenditure as an immaterial amount for financial reporting purposes; 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

(iv) property that its owner chooses, under s EE 8 (Election that property not be depreciable) to treat as not depreciable.

Choice for allocation of deduction

(7) A person who is allowed a deduction under this section for expenditure that is not interest and is described in subsection (2), (4), or (5) may choose to allocate all or part of the deduction—

(a) to an income year after the income year in which the person incurs the expenditure; and

(b) in the way required by section EJ 23 (Allocation of deductions for research, development, and resulting market development).

Allocation of deduction for derecognised non-depreciable assets

(7B) A person who is allowed a deduction as provided by subsection (3) must allocate the deduction to the income year in which the relevant intangible asset is derecognised or written off by the person for financial reporting purposes under—

(a) paragraph 112(b) of the new reporting standard; or

(b) paragraph 5.14 of the old reporting standard.

Section need not be applied

(8) 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 income year to which the return relates.

Relationship with s EA 2

(9) 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

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

12. Definitions are provided in s DB 35. Section DB 35(1) provides:

    (1) In this section, and in s DB 34,—

    development is defined in paragraph 8 of the new reporting standard

    new reporting standard means the New Zealand Equivalent to International Accounting Standard 38, in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place

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

    research is defined in paragraph 8 of the new reporting standard.

13. Section DB 36 provides:

    DB 36 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 income 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.

14. Section DB 37 provides:

    DB 37 Expenses in application for patent or design registration

    Deduction

    (1) A person who incurs expenditure for the purpose of applying for the grant of a patent or of a design registration and does not obtain the grant because the application is not lodged or is withdrawn, or because the grant is refused, is allowed a deduction for the expenditure—

    (a) that the person incurs in relation to the application or intended application; and

    (b) that would have been part of the cost of fixed life intangible property, or otherwise a deduction, if the application or intended 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 person decides not to lodge the application, withdraws the application, or is refused the grant.

    Link with subpart DA

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

15. Sections DB 38 provides:

    DB 38 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 an income 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.

16. Sections DB 39 provides:

DB 39 Patent rights acquired before 1 April 1993

When this section applies

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

Deduction

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

Amount of deduction

(3) The amount is calculated using the formula—

(unexpired term of the patent rights at the date of disposal ÷ unexpired term of the patent rights at the date of acquisition) × 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.

17. Sections DB 40 provides:

DB 40 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 of the patent rights, excluding any expenditure for which the person has been allowed a deduction under section DZ 15 (Patent applications before 1 April 2005):

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

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.

18. Section DB 62 provides:

DB 62 Deduction for legal expenses

When this section applies

(1) This section applies to a person when their total legal expenses for an income year is equal to or less than $10,000.

Deduction

(2) The person is allowed a deduction for the legal expenses.

Definition

(3) For the purposes of this section, **legal expenses** means fees for **legal services** (as defined in the Lawyers and Conveyancers Act 2006) provided by a person who holds a practising certificate issued by the New Zealand Law Society or an Australian equivalent.

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.

19. Section EA 2(1)(a) and (2) provides:

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.

20. Section EE 12(1)(a) and (2)(b) provides:

EE 12 Depreciation methods

Meaning of depreciation method

(1) **Depreciation method** means –

(a) 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:

21. Section EE 14(1) provides:

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.

22. Section EE 16(1)–(3), (4)(b)(i) and (c), and (5)–(7) provides:

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—

annual rate × value or cost × months ÷ 12.

Definition of items in formula

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

Annual rate

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

Value or cost

(4) **Value or cost** is,—

(a) …

(b) when the person uses the straight-line method,—

(i) for a patent, design registration, or plant variety rights in relation to which the person has been allowed a deduction for an amount of depreciation loss for the relevant application, the item's adjusted tax value at the start of the month in which the person acquires it:

…

(c) for the purposes of paragraph (b), variations to **cost** are in sections EE 18 to 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.

Months: applications

(7) For the purposes of subsections (5) and (6), for a patent application and a design registration application, **months** refers to whole calendar months and whole months, as applicable.

23. Section EE 18B provides:

EE 18B Cost: some depreciable intangible property

For the purposes of section EE 16 and this subpart, the cost to a person for an item of depreciable intangible property or a plant variety rights application (the amortising item) includes an amount of expenditure incurred by the person for an item of intangible property (the underlying item) if—

(a) the underlying item gives rise to, supports, or is an item in which the person holds, the amortising item; and

(b) the amount of expenditure is incurred by the person on or after 7 November 2013, if the amortising item is 1 of—

(i) a patent or a patent application with a complete specification lodged on or after 1 April 2005:

(ii) plant variety rights:

(iii) a plant variety rights application:

(iv) a design registration:

(v) a design registration application:

(vi) industrial artistic copyright; and

(c) the person is denied a deduction for the expenditure under a provision outside this subpart

24. 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 s 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.

25. Section EE 33 provides:

EE 33 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 s EZ 15 (Annual rate for excluded depreciable property: 1992–93 tax year):

(ab) a design registration for which a rate is set out in section EE 34B:

(b) a patent for which a rate is set in section EE 34.

INTERPRETATION STATEMENTS

Rate

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

1 ÷ legal life

Definition of item in formula

(3) In the formula, **legal life** is,—

(a) if section EE 18B or EE 19 apply, the item's remaining legal life from the start of the income year in which the relevant costs are recognised under the section:

(b) if sections EE 18B and EE 19 do 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.

26. Section EE 34 provides:

EE 34 Annual rate for patent granted in 2005–06 or later income year

When this section applies

(1) This section applies to an item that is a patent when the patent is acquired by a person in their 2005–06 income year or a later income year.

Rate

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

1 ÷ legal life.

Definition of item in formula

(3) In the formula, **legal life** is set out in whichever of subsections (4) to (7) applies to the patent.

Fixed life intangible property

(4) If the patent is an item of fixed life intangible property to which section EE 18B or EE 19 applies, **legal life** is the patent's remaining legal life from the start of the income year in which the relevant costs are recognised under the section.

No depreciation loss for patent application

(5) If sections EE 18B and EE 19 do not apply to the patent and the person has been denied a deduction for an amount of depreciation loss for the patent application, **legal life** is the patent's remaining legal life from the time at which the person acquires the patent.

Depreciation loss for patent application

(6) If sections EE 18B and EE 19 do not apply to the patent, and have not applied to the patent application while the person has owned it, and the person has been allowed a deduction for an amount of depreciation loss for the patent application, **legal life** is the remaining legal life of the patent application from the start of the income year in which the person acquires the patent application.

When section EE 18B or EE 19 applied to patent application

(7) If sections EE 18B and EE 19 do not to the patent, but have applied to the patent application while the person has owned it, and the person has been allowed a deduction for an amount of depreciation loss for the patent application, **legal life** is the remaining legal life of the patent application from the start of the income year in which the person acquires the patent.

How rate expressed

(8) The rate calculated using 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

27. Section EE 44(1) and (2)(a) and (b) provides:

EE 44 Application of sections EE 48 to EE 52

When sections apply

(1) Sections EE 48 to EE 52 apply when a person has 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 s EE 45; and

(b) either—

(i) the item is an item of a kind described in s EE 46; or

(ii) the event is an event of a kind described in s EE 47.

Exclusions

(2) Sections EE 48 to EE 52 do not apply when-

(a) a person disposes of an item of intangible property as part of an arrangement to replace it with an item of the same kind:

(b) a person's patent application has concluded because a patent is granted to the person in relation to the application:

28. Section EE 47 lists those events to which s EE 48 to EE 52 apply. Section EE 47(9) provides:

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.

29. Section EE 48(2) provides:

Amount of depreciation loss

(2) For the purposes of s EE 44, 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 that is the amount by which the consideration is less than the item's adjusted tax value on that date.

30. Section EE 50(1) to (7) provides:

EE 50 Amount of depreciation loss when item partly used to produce income

When subsection (2) applies

(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 s EE 48(2); and

(b) at a time during the income year, the item is partly used, or 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 (Motor vehicle expenditure) applies.

Partial use: Formula

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

depreciation loss × qualifying use days ÷all days

Definition of items in formula

(3) In the formula in subsection (2),—

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

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

Other units of measurement

(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.

When subsection (6) applies

(5) Subsection (6) applies when—

(a) a person has an amount of depreciation loss for an item of depreciable property arising under s EE 48(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 s EZ 11 (Amounts of depreciation recovery income and depreciation loss for part business use up to 2004-05 income year); and

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

Deduction for depreciation loss: formula

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

disposal depreciation loss × all deductions ÷ (base value − adjusted tax value at date).

Definition of items in formula

(7) In the formula in subsection (6),—

(a) **disposal depreciation loss** is the amount resulting from a calculation made for the item under s EE 48(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 whichever is applicable of the meanings in s EE 57 to EE 59:

(d) **adjusted tax value at date** is the item's adjusted tax value on the date on which the disposal or event occurs.

31. Section EE 62 provides:

EE 62 Meaning of depreciable intangible property

Meaning

(1) **Depreciable intangible property** means the property listed in schedule 14 (Depreciable intangible property).

Criteria for listing in schedule 14

(2) For property to be listed in schedule 14, 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 14 prevails

(3) Property that is listed in schedule 14 is depreciable intangible property even if the criteria are not met

32. Section YA 1 includes the following definitions:

depreciable intangible property is defined in s EE 62 (Meaning of depreciable intangible property)

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

33. Schedule 14 lists depreciable intangible property, including at items 3 and 4:

3 a patent or the right to use a patent

4 a patent application with a complete specification lodged on or after 1 April 2005

Patents Act 2013

34. Section 5 of the Patents Act 2013, defines a "patent" as follows:

patent means letters patent for an invention

35. "Invention" is not defined, but "patentable invention" is defined in s 5 as follows:

patentable invention has the meaning set out in section 14

36. In terms of s 14 of the Patents Act 2013, an invention is a patentable invention if it:

(a) is a manner of manufacture within the meaning of s 6 of the Statute of Monopolies; and

(b) when compared with the prior art base—

(i) is novel; and

(ii) involves an inventive step; and

(c) is useful; and

(d) is not excluded from being a patentable invention under section 15 or16.

37. Section 20 of the Patents Act 2013provides:

20 Term of patent

(1) The term of every patent is 20 years from the patent date.

(2) However, a patent ceases to have effect on the expiry of the period prescribed for the payment of any renewal fee if that fee is not paid within that period or within that period as extended under section 21.

(3) Subsection (2) applies despite anything in the patent or any other provision in this Act.

38. Section 103(1) provides:

103 Patent date

(1) Every patent must be given a patent date that is—

(a) the filing date of the relevant complete specification; or

(b) if the regulations provide for the determination of a different date as the patent date, the date determined under the regulations

Reporting standards

39. Relevant parts of the old reporting standard, Financial Reporting Standard No 13 (FRS-13), to which s DB 34 of the Income Tax Act 2007 refers, follows.

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.

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

5 FINANCIAL REPORTING

RECOGNITION OF RESEARCH COSTS

STANDARD

5. 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 para 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.

41. Relevant parts of the new reporting standard, New Zealand Equivalent to International Accounting Standard 38, to which s DB 34 refers, are:

68. Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18–67); or

(b) the item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, it forms part of the amount recognised as goodwill at the acquisition date (see NZ IFRS 3).

54. No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

57. An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

RETIREMENTS AND DISPOSALS

112 An intangible asset shall be derecognised:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

42. The terms "research" and "development" are similarly defined in the new reporting standard to how they were defined in FRS-13 (see relevant definitions above).

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 17/04: Goods and services tax — whether a racing syndicate can be a registered person

All legislative references are to the Goods and Services Tax Act 1985 (the Act) unless otherwise stated.

This Question We've Been Asked is about ss 6(1), 6(3) and 51.

Question

1. Can a racing syndicate, whose activities are limited to the ownership (or leasing) of one or more horses to race and the racing of these horses, be registered for goods and services tax (GST)?
2. The scope of this question is the racing of horses as a standalone activity. The view expressed does not extend to activities where the horse racing is an aspect of a wider activity like horse selling, breeding or training. The question relates to horse racing carried on by a syndicate. However, the same principles will apply where the horse racing activity is carried on by an individual, a partnership, a trust, a company or any other entity.

Answer

3. To be registered for GST, a taxpayer must be carrying on a "taxable activity". A key requirement of a taxable activity is that the taxpayer must intend to make supplies for a consideration. The definition of "taxable activity" also expressly excludes any activity carried on essentially as a private recreational pursuit or hobby.
4. Whether any syndicate is carrying on a taxable activity will always depend on an examination of the totality of the evidence. The determining factor in deciding whether there is a taxable activity of racing is the goal or the object of the taxpayer (in this case the syndicate). In deciding whether a racing syndicate is carrying on a private recreational pursuit or hobby, the activity must be treated as if it were carried on by a natural person.
5. In the Commissioner's view the activity of horse racing (as a standalone activity) will not be carried on as a private recreational pursuit or hobby where the taxpayer can establish all of the following matters:
    - The syndicate is formed not for the personal interest or pleasure of the participants, but for the purpose of making a profit from the activity, and it is operated in that manner;
    - The activity of the syndicate is organised to achieve a pecuniary profit, and it operates in a systematic fashion that, on an objective assessment, appears to materially reduce the element that luck plays in whether any prize-money is won; and
    - A significant amount of time is involved in performing the activity undertaken by the manager of the syndicate (including acquiring and managing the horses that are assisting in meeting financial imperatives and disposing of horses that are not).
6. The Commissioner's view is that, in the absence of these circumstances, the racing of horses **as a standalone activity** by a racing syndicate is a private recreational pursuit or hobby. Therefore, it is excluded from the definition of taxable activity and the syndicate cannot be registered for GST.
7. This answer is based on the Commissioner's view that, in the absence these particular circumstances, the activity of horse racing constitutes the participation in a sporting endeavour undertaken as a private pastime or pursuit carried on for the personal interest or pleasure of the person (or persons) concerned. The Commissioner considers that for a racing syndicate where the activity is limited to the ownership (or leasing) and racing of horses, the essence of the activity will most often be the personal interest or pleasure derived from seeing the horse compete in, and potentially win, races.
8. The view set out in this item is not applicable to those syndicates where horse racing is an aspect of a wider activity, for example, a horse breeding syndicate. However, the fact that a syndicate agreement provides for a race horse to be sold in certain circumstances will not, of itself, indicate that the taxpayer is carrying on a wider activity. It should also be noted that the Commissioner considers that if the horse racing activity is part of a wider activity, this does not preclude the wider activity of the syndicate being a recreational pastime or hobby.

9. Where a horse racing syndicate is incorrectly registered for GST, the view in this QWBA will be applied prospectively only. Consequently, those taxpayers will not be required to retrospectively deregister. Further information on the application of the QWBA to these taxpayers is set out in a separate operational position.

Explanation

10. This item considers the GST status of a horse racing syndicate formed solely to own (or lease) one or more horses to race them. In particular, the item considers whether a racing syndicate is able to be a GST "registered person". To address this matter the item will discuss whether the activity of a racing syndicate is a taxable activity.

Racing Syndicate

11. A horse racing syndicate is a common form of multiple-person ownership used in both thoroughbred and harness racing to provide the means for the members to enjoy the benefits and share the costs involved in the ownership (or leasing) and racing of horses. Racing syndicates are a form of racing ownership recognised in the relevant rules of racing.

Registration

12. Under s 8(1) of the Act, GST is charged on the supplies in New Zealand of goods and services made by a registered person in the course or furtherance of a taxable activity carried on by that person. Deductions for input tax can generally be claimed for the GST charged on the acquisition of goods and services by the person.

13. Registration is a key ingredient of the GST system because the tax is charged on the supplies of a registered person. Section 2 provides that a "registered person" means a person who is registered or is liable to be registered under the Act. A racing syndicate is a "person" for GST purposes, as that term is defined to include "an unincorporated body of persons".

14. Section 51(1) states that any person carrying on a taxable activity is liable to be registered if the total value of supplies made in New Zealand in a 12-month period exceeds $60,000. Further, s 51(3) provides that a person under the $60,000 threshold may apply to be registered if they can satisfy the Commissioner that they are carrying on a taxable activity.

Taxable activity

15. Section 6(1) sets out the meaning of "taxable activity" in the following terms:

> For the purposes of this Act, the term **taxable activity** means—
>
> (a) any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:
>
> …

16. Section 6(1) necessitates the organisation of an activity in some coherent way. The activity must be carried on continuously or regularly and involve (or be intended to involve) the supply of goods and services to any other person for consideration. The definition of a taxable activity is very broad and applies to any activity carried on continuously and regularly by any person, "whether or not for pecuniary profit". This means that a taxable activity is not limited to a "business" as used, for example, in the income tax context of a profession, trade or undertaking carried on for profit. Section 6(1) includes any activity carried on in the form of a "business, trade, manufacture, profession, vocation, association, or club". In the context of the section, these activities must be carried on with the goal of supplying goods and services to any person for a consideration.

17. It is not entirely clear whether a horse owner who carries on horse racing as a standalone activity makes any supplies for consideration. The Commissioner's view is that, by entering a horse in a race, the owner is supplying a service to the race organiser. There do not appear to be any other possible supplies made by the horse owner.

18. Also uncertain is whether that supply is made for consideration. It could be argued that the payment of stake money is too contingent or remote to be consideration. However, the Commissioner's position is that, due to the breadth of the "consideration" definition, stake money can be consideration for the supply of entering a horse into a race. This is consistent with the position taken by the Australian Tax Office in its Goods and Services Tax Ruling GSTR 2002/3 *Goods and services tax: prizes*.

19. The focus of this QWBA is on whether horse racing is excluding from being a taxable activity under s 6(3).

Exclusion from taxable activity definition

20. Despite the breadth of s 6(1), not all activities will be a taxable activity. Section 6(3) sets out some exclusions from the term. It provides, relevantly:

> Notwithstanding anything in subsections (1) and (2), for the purposes of this Act the term **taxable activity** shall not include, in relation to any person,—
>
> (a) being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or
>
> (aa) not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby; or
>
> …

21. The effect of s 6(3)(a) and (aa) is that, despite an activity meeting the requirements of s 6(1), it is not a "taxable activity" if the activity is carried on essentially as a private recreational pursuit or hobby.

Is horse racing a private recreational pursuit or hobby?

22. There is no New Zealand GST Court decision dealing directly with the application of s 6(3) in the context of horse racing as **a standalone activity**. The only New Zealand GST decision to consider this provision and a racing syndicate is *Case N27* (1991) 13 NZTC 3,229. That case concerned a partnership of six people with a taxable activity stated to be "horse trading". The Commissioner contended in that case that the taxpayer did not have a taxable activity as the activity carried on was essentially a private recreational pursuit or hobby. However, the Taxation Review Authority (TRA) found the taxpayer was involved in the purchase, racing, and sale of a horse and, on the facts, that was a taxable activity.

23. The TRA decided that for an activity to be carried on essentially as a private recreational pursuit or hobby that activity must be "in essence" of such a nature. The TRA then considered the meaning of the phrase "private recreational pursuit or hobby" and stated at 3,240:

> I do not attempt to give an all-embracing or exclusive definition of the phrase "... essentially as a private recreational pursuit or hobby", but observe that would seem to require, in essence, a private pastime or pursuit carried on for the personal refreshment, pleasure or recreation of the person (or persons) concerned. In the context of the Act it is not an activity of a business, organised in some coherent fashion to achieve a pecuniary profit. Whether an activity is essentially that of a private recreational pursuit or hobby, or not, is a question of fact in each case. It depends on the totality of the evidence.

24. The key distinguishing feature, therefore, concerns the "essence" of the form of the activity carried on. Where the essence of the activity involves the supply of goods and services for consideration carried on in the form of a business, trade, manufacture, profession, vocation, association or club, then such an activity is a taxable activity. However, where the essence of the activity is a private pastime or pursuit carried on for the personal refreshment, pleasure or recreation of the person concerned, then the activity is a private recreational pursuit or hobby.

25. In deciding on the essence of an activity in the context of a private recreational pursuit or hobby, the courts begin their enquiry by asking: what is the object of the activity in the mind of the participating taxpayer? In other words, a key determining factor concerns the goal or the object in mind.

26. As previously noted, the definition of "taxable activity" does not require an activity to be carried on for a pecuniary profit. For this reason charities, for example, can carry on a taxable activity as they have a purpose that is neither profit-making, nor a private recreational pursuit. However, in the Commissioner's view, horse racing can only be carried on either for the purpose of making a profit (in which case, it is likely to amount to business) or as a private recreational pursuit or hobby.

27. Over time the courts have contrasted a private recreational pursuit or hobby with the activity of a business. In applying this distinction the courts have noted that the object of the activity of being in business or working in a trade is that it is an occupation by which the person intends to profit as a means of earning a living. The object of a business activity is contrasted with what has been called "the pursuit of a pastime" in which, in essence, the activity is not organised towards the end of making a profit as a means of earning a living. Rather, the activity is undertaken for pleasure or enjoyment.

28. In some circumstances the distinction can seem difficult to draw. For example, the cost involved in "the pursuit of a pastime" can amount to many thousands of dollars. However, the object of the activity is not determined on the basis of cost. Also, a private recreational pursuit or hobby can be undertaken in a very organised, systematic and cost efficient manner. Therefore, it may be run in a business-like manner. However, despite how the activity is undertaken, the underlying object of a particular activity remains. The essence of the activity, as undertaken by the relevant taxpayer, is either business-like or a private recreational pursuit or hobby.

29. A racing syndicate is an "unincorporated body of persons" for GST purposes and is, accordingly, a "person". Section 6(3)(aa) provides that where a person is not a natural person then the term "taxable activity" shall not include, in relation to that person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby. In deciding whether horse racing (as a standalone activity) of a racing syndicate is being carried on as a private recreational pursuit or hobby, the activity must be treated as if it were carried on by a natural person.
30. The object of any activity is always a question of fact. There may be factors that point in either direction and accordingly it is not possible to be definitive (refer to the discussion on *Case N27* above).
31. However, the Commissioner considers that for a racing syndicate where the activity is limited to the ownership (or leasing) and racing of horses, the essence of the activity will most often be the personal interest or pleasure derived from seeing the horse compete in, and potentially win, races. For GST purposes, this is an activity carried on essentially as a private recreational pursuit or hobby and accordingly is not a taxable activity. The factors that lead to this conclusion are:
    - It is difficult to control or organise the activity of horse racing in a systematic fashion to achieve a pecuniary profit. This is because of the significant element that luck plays in whether any prize-money is won, given the effect of uncontrollable factors, the aspect of competition and the likelihood of winning. This has been noted by the courts (see, for example, *Shepherd v FCT* 75 ATC 4244). Purchasing a well-bred horse and employing a top trainer and jockey may increase the possibility of obtaining a profit from the activity. However, they will not, of themselves, be sufficient to demonstrate an intention to profit. It is acknowledged that an element of luck or risk is present in most businesses. However, the fact that luck plays such a significant part in whether any profit can be made from horse racing activities means that this is a relevant objective factor in determining the taxpayer's purpose in carrying out the activity.
    - The amount of time required to perform the activity undertaken by the racing syndicate, if that activity were undertaken by a natural person, is not sufficient to suggest that the object is to undertake a business.
    - The activity undertaken is associated with a sporting endeavour. Sport is usually undertaken for the personal pleasure of the participant.
    - The activity most often arises from the members of the syndicate seeking personal interest or pleasure from participating in the racing industry (following the industry itself promoting their participation on that basis, rather than promoting participation in a business). Deriving personal pleasure from an activity does not, of itself, mean that an activity is a hobby (many people obtain enjoyment from their business). Similarly, the fact that a person may hope to make a return from an activity does not convert it from a hobby into a taxable activity. The key factor is whether the taxpayer's participation in the activity is driven by personal enjoyment or the desire to make a profit.
    - Racing horses may be undertaken in an organised or coherent fashion. However, despite this there is usually insufficient organisation in the activity to objectively demonstrate a profit-making purpose. This is because financial success is largely dependent on factors outside of the syndicate's control. Generally people race horses for personal interest or the pleasure that they gain from their participation and are often willing to incur financial losses because of this.
32. The TRA in *Case N27* noted that whether an activity is essentially that of a private recreational pursuit or hobby, or not, is a question of fact in each case depending on the totality of evidence. The TRA also formed the view that it was wrong for the Commissioner to make what, in effect, appeared to be a policy decision that racing syndicates were necessarily carried on essentially as a private recreational pursuit or hobby of those involved.
33. The Commissioner agrees that whether any syndicate is carrying on a hobby or taxable activity will always depend on an examination of the totality of the evidence. However, for a racing syndicate not to be engaged in a private recreational pursuit or hobby would require it to demonstrate the presence of sufficient factors to draw a different inference. The onus of proof lies with the taxpayer to demonstrate this. The Commissioner considers that, for syndicates whose activities are **limited to racing horses**, a taxpayer would need to establish all of the following matters:
    - The syndicate is formed not for the personal interest or pleasure of the participants, but for the purpose of making a profit from the activity, and it is operated in that manner;
    - The activity of the syndicate is organised to achieve a pecuniary profit, and it operates in a systematic fashion that, on an objective assessment, appears to materially reduce the element that luck plays in whether any prize-money is won; and
    - A significant amount of time is involved in performing the activity undertaken by the manager of the syndicate (including acquiring and managing the horses that are assisting in meeting financial imperatives and disposing of horses that are not).

34. In the Commissioner's view the key determining factor in deciding whether there is a taxable activity of racing concerns the goal or the object of the taxpayer. In this regard, indications of intention drawn from the syndicate agreement and other relevant documents will be relevant. However, the relevant evidence will go beyond this and include anything that supports or negates the stated intention of the syndicate and its members. Therefore, merely including a statement in the syndicate agreement that it is intended to make a profit from horse racing will not be sufficient.

35. Before finding that there is a taxable activity, the Commissioner would expect evidence to show that the factors in paragraph 33 above are satisfied. In the absence of this, the Commissioner's view is that the horse racing activity will be being carried on as a private recreational pursuit or hobby.

36. The Commissioner's view that there is a relatively high bar to demonstrating that horse racing as a standalone activity is not carried on as a private recreational pursuit or hobby is consistent with the approach taken by courts in both the United Kingdom and Australia.

37. For example, in the early cases of *The Earl of Jersey's Executors v Bassom (H.M. Inspector Taxes)* and *The Earl of Derby v Bassom (H.M. Inspector of Taxes)* (1924-26) 10 TC 357 (KBD) both appellants bred, owned and raced thoroughbred horses. The findings made were that the breeding and racing of horses was carried on by the taxpayers as a hobby. While accepting that one of the objects of the activities was to improve the breed of horse, the chief object of the activities was the pleasure derived from seeing the horses bred by them win big races.

38. The treatment of horse racing as a recreational activity has also been considered in a VAT context in the United Kingdom. In *Brian Gubby Ltd* (1985) 2 BVC 205, 360 the VAT Tribunal was required to decide whether or not the horse related activities of the company constituted a business for tax purposes.

> Against that background we ask ourselves whether or not during the period of the assessment either the activity of training horses or the activity of racing horses constituted a 'business' or an intended 'business' of the Appellant Company which generated or would generate taxable supplies. We consider that in relation to neither such activity was either of such requirements satisfied. As to training, we consider and hold that, throughout the period of assessment, Mr Brian Gubby personally carried out the training as his hobby and a personal interest, and that he had no intention of training horses for any outsider. Therefore no taxable supply was made, or intended to be made in the future, in the course of this activity. As to racing, we consider and hold again that, throughout the period of assessment, Mr Brian Gubby was involved therein as his hobby and personal interest.

39. The decision of the Supreme Court of New South Wales in *Shepherd* shows that, in relation to winning prize money from the racing of horses, it is ordinarily difficult to displace the implication that there is no ability to organise the activity toward the end of making a profit (because of the significant element of chance involved, per [31] above).

40. In *Shepherd*, the taxpayer owned and raced various racehorses, but on the facts of the case neither her prize money nor betting wins were found to be the product of a business. Rath J held that the taxpayer, while having a passion for horses, indulged in horse racing as a pastime; although a keen follower of horse racing, racing was not her business. His Honour referred to *Martin v FCT* (1953) 90 CLR 470 and the judgment of Rowlatt J in *Graham v Green* (1925) 2 K.B. 37 in reaching his conclusion, at 4252:

> The common reason why betting winnings were not regarded as "profit or gain" in *Graham v. Green*, or "income" in *Martin's* case is that in those cases there was no organization of the activity towards the end of making a profit. In that sense, such gains as arose in the course of the activity had a significant element of chance, and there was no system, or no sufficient system, in relation to the chances involved as to lead to the conclusion that a system for profit making had been devised. **There is a similar element of chance in relation to winning prize money from the racing of horses. Owner competes against owner, and the chance of one owner's horse winning is dependent to an extent on considerations as to which no system or organization would usually apply, for example the form of the various horses and the weather conditions**. Skill is involved, in bringing a horse to its peak and in the selection of riders; but skill which is displayed in a pastime, as the passage quoted from the judgment of *Rowlatt* J. shows, is not decisive of the question as to whether a business is being carried on, and may not in many cases be even relevant to that question. [Emphasis added]

41. *Drummond v CIR* (2013) 26 NZTC 21,023 was a New Zealand income tax case concerning whether s EC 39(1)(c) of the Income Tax Act 2007 requires an existing breeding business. In the course of its decision the High Court stated:

> [87] The defendant has argued that there was no business at all. I disagree. On my analysis there was clearly a racing business. I have read the Adjudication Report from the Office of the Chief Counsel dated 23 November 2011. I agree with the conclusion in that regard.

42. The High Court commented in *Drummond* that the syndicate was in the business of racing which demonstrates that it is possible to have such a business. However, the Court did not consider or discuss the distinction between a business and a hobby and, therefore, did not give reasons why it thought that the taxpayers were not carrying on a hobby. In this regard, it does not assist in determining what considerations are relevant to deciding whether a taxpayer is carrying on a taxable activity or a hobby.

43. Furthermore, the actual issue before the Court in *Drummond* was whether at the relevant time there was an existing breeding business. The Court found that the taxpayers had a contingent intention to breed, even though the breeding business had not yet commenced. Accordingly, the partnership's potential activity was wider than just racing. It is not clear the extent to which this contributed to the Court's finding that the taxpayer was carrying on a racing business.

44. *Case K40* (1988) 10 NZTC 343 could also be taken to suggest that a lower bar exists for establishing a business of horse racing than the Commissioner is putting forward in this item. There, Keane DJ stated:

> First, it is scarcely contestable that horse racing investment is pursued as a business enterprise, just as frequently as it is indulged in as a hobby. Perhaps more frequently.

45. However, that case related to a breeding business that also involved racing. In finding that the taxpayer was carrying on a business rather than a hobby, Keane DJ found the following considerations relevant:

- The taxpayer had no interest in racing;
- The taxpayer committed her entire savings to the venture and the scale of operations increased with the taxpayer's means; and
- The care taken in selecting the horses.

46. In finding that there was a business in the relevant years, Keane DJ considered the pattern of activity over the whole period. By that time the taxpayers owned a number of horses and had successfully bred and sold progeny from their horses.

47. As set out above, GST is charged on the supplies in New Zealand of goods and services made by a registered person in the course or furtherance of a taxable activity carried on by that person. A racing syndicate involved solely in racing horses, in the absence of the circumstances set out above at [33], is not undertaking a taxable activity, as it is undertaking a private recreational pursuit or hobby. Therefore it cannot be registered for GST purposes.

Section 5(11CB)

48. Section 5(11CB) treats a prize received by a registered horse owner as consideration for a supply of services provided to the racing club. It applies only when a registered person is carrying on the racing in the course of a taxable activity. It does not deem horse racing to be carried on as a taxable activity. As such s 5(11CB) will not apply to prize money received by horse owners where the horse racing is carried on essentially as a private recreational pursuit or hobby.

Examples

49. The following examples are included to assist in explaining the Commissioner's view of the application of the law.

Example 1 – Horse racing syndicate not carrying on a taxable activity

50. Fast Horses Ltd breeds race horses. Some of its horses are sold outright to third parties. Others are syndicated with shares being offered to members of the public. Fast Horses Ltd is currently offering shares in one of its horses "Apportionment Method". Sixty shares are being offered for $2,000 each. These are being promoted online and in newspapers. The advertisements emphasise the "buzz" and "excitement" that come from following the horse's performance and the opportunity to join the other owners in the "winner's circle" if Apportionment Method performs well.

51. Simon is thinking about investing in the syndicate and wants to know whether it will be carrying on a taxable activity. The syndicate will not be carrying on a taxable activity. The syndicate is being formed for the personal interest or pleasure of the members. There is no evidence that the syndicate will be operated for the purpose of making a profit from racing.

Example 2 – Horse racing syndicate not carrying on a taxable activity

52. Tom's uncle has left him $10,000 in his will. Tom's wife Edith has wanted to own a race horse for some time. Many of Edith's friends invest in horse racing syndicates and Edith thinks that she would enjoy this too. Tom and Edith decide to form a syndicate for the purpose of purchasing and racing a horse. Tom and Edith do not know much about horses, so they seek advice from their friends about the type of horse to buy.

53. Based on the advice received, Tom and Edith purchase a $5,000 thoroughbred yearling colt called "Straight-line Method". Tom and Edith would also like to make some money from horse racing and they are optimistic about their chances. They hire a trainer to train and manage the day to day racing of their colt. Straight-line Method is gelded and is then entered into several 2yo races. When Straight-line Method is being raced locally, Tom and Edith go and watch. Otherwise the trainer provides them with the results after each race. Tom and Edith want to know whether their syndicate is carrying on a taxable activity.

54. Tom and Edith's syndicate is not carrying on a taxable activity. The syndicate was formed for Tom and Edith's personal interest or pleasure, not for the purpose of making a profit from racing. The syndicate has a trainer and some degree of organisation. However, there is no evidence that the syndicate is run in a way to maximise the likelihood of achieving a pecuniary profit. The syndicate has only a single horse and there is nothing to suggest that either the horse will be replaced if it performs poorly, or additional horses will be purchased.

Example 3 – Horse racing syndicate not carrying on a taxable activity

55. Les, Sally and Bruce are former professional jockeys. They have all been involved in the horse racing industry for most of their lives. In their spare time, they love attending the races. Les, Sally and Bruce decide to pool their money and purchase a race horse. Their main purpose is to make attending the races even more exciting; however, they also hope to win some money and feel confident that they will be able to. They purchase a ready to race gelding called "Bright-line" from a well-known local stud farm for $15,000.

56. Les, Sally and Bruce decide to undertake the management duties themselves and spend, on average, 5 hours each a week on this. They hire a trainer and together they develop a business plan and a training programme aimed at giving Bright-line the best chance of winning his races. Les, Sally and Bruce attend all of Bright-line's races. Bright-line is moderately successful, winning 10% of his races and placing in another 20%. Les, Sally and Bruce use their winnings to purchase a second horse, which is also raced. Les, Sally and Bruce want to know whether their syndicate is carrying on a taxable activity.

57. Les, Sally and Bruce's syndicate is not carrying on a taxable activity. Whether a taxpayer is carrying on a taxable activity or a private recreational pursuit or hobby depends on the object of the taxpayer in undertaking the activity. Les, Sally and Bruce's syndicate was formed primarily for personal interest or pleasure, not for the purpose of making a profit from racing. The syndicate is operated in a coherent way with a view to increasing the chances of making a profit and a moderate amount of time is invested in the activity. However, this does not change the fact that that the essence of the racing activity is being carried on as a private recreational pursuit or hobby.

Example 4 – Horse racing syndicate carrying on a taxable activity

58. Burt, Trevor and Cyril are retired. They have found that their pensions are not sufficient to support them in their retirement. Therefore, they each wish to invest a significant portion of their savings to earn income to supplement their pensions. They are attracted by an advertisement from a local stud farm that suggests that a well organised horse racing syndicate could return a healthy profit.

59. Burt, Trevor and Cyril form a syndicate and engage a bloodstock agent to find them horses of suitable pedigree or form. The syndicate purchases two yearlings of good pedigree from the national yearling sales held at Karaka for $50,000 each and a three-year old with great racing form from a private seller for $300,000. The syndicate is also searching for one more horse. The syndicate hires a trainer to manage the day to day activities of their horses and detailed plans are developed for each horse's racing career.

60. The syndicate undertakes substantial research and analysis to develop a business plan that identifies relevant risks and how to minimise them and optimise the likely returns. The business plan includes financial projections that show how the syndicate could make a profit from its horse racing activity and also outlines possible further capital requirements for a range of contingencies. Burt, Trevor and Cyril have ensured that they access to funds to meet any potential further capital requirements. The business plan also requires the trainer to regularly monitor each horse's performance with a view to replacing horses that are not performing.

61. Neither Burt nor Trevor has ever had much interest in racing; however, they occasionally attend races where one of their horses is running. Cyril, on the other hand, has always enjoyed attending the races and continues to do so regularly. Burt, Trevor and Cyril want to know whether their syndicate is carrying on a taxable activity.

62. Burt, Trevor and Cyril's syndicate is carrying on a taxable activity. Notwithstanding, Cyril's interest in racing, the syndicate was not formed for the personal pleasure of the members. Rather it was formed primarily for the purpose of making a profit from horse racing. Further, the syndicate is operated in a systematic fashion that, objectively, increases the likelihood of achieving a profit and materially reduces the element that luck plays. This is demonstrated by the way the horses are initially selected, the detailed planning aimed at maximising their chances of winning races, and the fact that non-performing horses will be replaced.

References

Subject references
Racing Syndicates
Registered persons

Legislative references
Goods and Services Act 1985, ss 6(1), 6(3), 51

Case references
Brian Gubby Ltd (1985) 2 BVC 205,360
Case K40 (1988) 10 NZTC 343
Case N27 (1991) 13 NZTC 3,229
Drummond v CIR (2013) 26 NZTC 21,023
Graham v Green (1925) 2 K.B. 37
Martin v FCT (1953) 90 CLR 470
Shepherd v FCT 75 ATC 4244 (NSWSC)
The Earl of Jersey's Executors v Bassom (H.M. Inspector Taxes) and *The Earl of Derby v Bassom (H.M. Inspector of Taxes)* (1924-26) 10 TC 357 (KBD)

Commissioner's operational position on horse racing syndicates incorrectly registered for GST

The purpose of this item is to inform taxpayers of the operational position being adopted by the Commissioner in relation to this matter.

The Commissioner has released QB 17/04 Goods and Services Tax – Whether a racing syndicate can be a registered person. This Question We've Been Asked (QWBA) confirms the Commissioner's view on when a horse racing syndicate can register for GST.

The Commissioner is aware that some horse racing syndicates have incorrectly taken the view that they are carrying on a taxable activity and have registered for GST. The Commissioner does not require these taxpayers to retrospectively deregister. However, taxpayers that are not carrying on a taxable activity must deregister with a deregistration date on or before 30 June 2017.

On deregistration a taxpayer must return GST on the market value of any goods and services that they retain that formed part of their taxable activity (s 5(3) of the Goods and Services Tax Act 1985). The main (or, in most cases, sole) asset held by racing syndicates is likely to be the racehorse.

The legislation requires a taxpayer to determine the market value of their horse. The Commissioner has given consideration as to how taxpayers' compliance costs occasioned by this can be minimised, and is consequently willing to allow a number of options for determining market value. These include:

1. obtaining a professional valuation;
2. making a reasonable estimate of the market value. The estimate should be based on objective factors (such as the horse's race results and sales data of similarly bred horses (with similar race results)). The taxpayer should keep documentation supporting the estimate so that it can be made available at the Commissioner's request; or
3. amortising the cost of the horse equally over a three-year period. As race horses generally decline in value over their racing life, the Commissioner will accept this method as a reasonable approximation of market value. The Commissioner is allowing taxpayers to use this method to reduce the compliance costs that may otherwise be involved in establishing the market value of a horse that in many situations is likely to be relatively small. As such, the Commissioner will only accept the use of this method where the original cost of the horse was less than $50,000. In addition, taxpayers cannot use this method when they have reasonable grounds to believe that the market value of the horse is materially greater than the amount calculated under this method. When using this method, market value can be calculated as follows:

Years horse owned	MV as % of cost
0 – 1	100%
1 – 2	66.6%
2 – 3	33.3%
3+	0%

The taxpayer can choose which of the three methods they prefer for valuing a horse. If a taxpayer has any other assets that formed part of their racing activity they should use a reasonable estimate of market value.

If you have any queries about deregistration, please contact Diane Trillo on (07) 959 0272.

QB 17/05: Income tax – whether YouTube receipts are taxable

All legislative references are to the Income Tax Act 2007 (the Act) unless otherwise stated.

This Question We've Been Asked (QWBA) is about ss CA 1(2), CB 1 and CB 3.

This QWBA considers the income tax treatment of YouTube receipts. It does not consider the GST treatment of YouTube receipts. It also does not consider source or residence issues related to YouTube receipts. It is assumed that the recipient is a New Zealand resident for income tax purposes.

Question

1. Do I need to pay tax on YouTube receipts?

Answer

2. Yes, in many cases, YouTube receipts will be taxable. This may be because the receipts are from a business. However, you do not need to be carrying on a business to be taxable on YouTube receipts. Two other provisions in the Act tax YouTube receipts if they are
   - income under ordinary concepts, or
   - from a profit-making undertaking or scheme.

Explanation

Background

3. YouTube receipts (or receipts from similar online sources, such as Vimeo or Twitch) are no different from any other type of receipt. There are no separate provisions within the income tax laws that deal specifically with receipts from online or web-based activities. Where relevant, current tax laws and interpretations apply.
4. New Zealand tax residents are taxable on their worldwide income. Despite the online origin of YouTube receipts, a resident will be taxable if those receipts are "assessable income" as defined in the Act.
5. There are various types of YouTube receipts, including:
   - Advertising revenue (AdSense income from Google).
   - Affiliate income (earning a commission by promoting other people's or companies' merchandise on your YouTube channel via external annotation links).
   - Paid content (fee received for purchase/rent of a video or subscription to a YouTube channel).
   - Sponsorship (fee earned from product placements or endorsements).
6. YouTube receipts are often passively earned, in that once the video has been created and monetised, the creator can earn revenue without doing anything more. There may be a perception that passive YouTube receipts are more akin to income from a hobby or pastime (ie, not a business) and are therefore not taxable. However, a business is not necessary for YouTube receipts to be taxable. For instance, YouTube receipts may also be taxable as income under ordinary concepts or as income from a profit-making undertaking or scheme.

The relevant law

7. The Act does not define "income" exhaustively, although a number of types of income receipts are included within Part C.
8. Under s CB 1, amounts derived from a business are income for tax purposes. Inland Revenue has released guidance on whether a taxpayer is carrying on a business (eg, *Tax Information Bulletin* Vol 7, No 3 (September 1995): 8; IR1022 – Online Trading Tax Implications (October 2013); IR320 - Smart Business: A guide for businesses and non-profit organisations (March 2016)). These are available on the Inland Revenue website: **www.ird.govt.nz**
9. Under s CB 3, an amount a person derives from carrying on or carrying out a profit-making undertaking or scheme is their income. Essentially, an undertaking or scheme is a programme of action, a series of steps, or an enterprise directed to an end result. The words "undertaking or scheme" suggest activities that are co-ordinated by plan or purpose. The plan or purpose must be coherent and have some unity of conception (see *Investment & Merchant Finance v FCT* (1970) 120 CLR 177 (HCA)), but does not need to be precise - a fairly generalised plan is all that is needed (see *Case S86* (1996) 17 NZTC 7,538). Also, any purpose of making a profit must be the dominant purpose (see *CIR v Walker* [1963] NZLR 339 (CA)).

10. Under s CA 1, an amount is also income of a person if it is their income under ordinary concepts. The phrase "income under ordinary concepts" is not defined in the Act and its meaning has developed under the common law.
11. In *Reid v CIR* (1985) 7 NZTC 5,176 (CA), Richardson J described the concept of income as comprising three features:
    - Income is something that comes in.
    - Income imports the notions of periodicity, recurrence and regularity.
    - Whether a particular receipt is income depends upon its quality in the hands of the recipient.
12. Some other key principles from cases that considered income under ordinary concepts include:
    - The periodic nature of payments made is the major determinant in many cases. Regularity or recurrence indicates that payments may become part of the receipts upon which the recipient may depend for their living expenses (*Reid*, *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA), *FCT v Hyteco Hiring Pty Limited* 92 ATC 4,694 (FFC)).
    - Consideration must be given to the relationship between payer and payee (*Reid*).
    - The purpose of any payments made must be taken into account (such as in *Reid*, where the payments were contractual and received in return for performing certain student obligations).
13. Windfall gains are excluded from being income under ordinary concepts. A windfall gain would include gifts and gratuitous receipts (eg, an inheritance or bequest), as well as winnings from games of chance (eg, lottery winnings). The key point is the random nature of these types of receipts, which precludes them from being classified as income under ordinary concepts.
14. You should be aware that even if you are not conducting a business of earning income from YouTube videos, your receipts may still be taxable as income from a profit-making undertaking or scheme, or as income under ordinary concepts. Each case needs to be considered on its own facts.
15. The costs related to gaining or producing your YouTube income may be deductible for tax purposes. This is subject to:
    - *The capital limitation*: expenditure of a capital nature is not deductible. The cost of capital items may, however, be depreciated.
    - *The private limitation*: expenditure for any private benefit is not deductible. Your expenditure may need to be apportioned if it is partly for private purposes (with the private portion not being deductible).
16. Some examples have been included below.

Example 1 – non-taxable hobby income

17. Damian is employed full time as a marketing manager. He is also a keen wildlife photographer. His busy job does not allow him much time to pursue his interest in photography. However, once a year, Damian takes a safari holiday in Africa and spends an enjoyable three weeks viewing and photographing wildlife. When he gets back from holiday, he likes to upload his favourite photographs and set them to music on his YouTube channel. To recover some of the costs of the holiday and his expensive photography equipment, Damian sells the photographs via his YouTube channel. He includes his email contact details and viewers who want to purchase the images can contact him for high resolution copies.
18. Damian's intention is not to make a profit and his YouTube activities are not business-like. His photography is a recreational pursuit, which he does in his spare time for personal enjoyment. On the specific facts set out, Damian is, therefore, not conducting an online photography business via YouTube. The income he receives from selling his photographs is not taxable business income. The sporadic nature of receipts and lack of profit-making intention also mean the income is not taxable under ordinary concepts or as a profit-making scheme.

Example 2 – income taxable under ordinary concepts

19. Hayden is a solicitor employed full time. He is also an online game enthusiast. He plays the interactive game "CourtCraft" in his spare time. Hayden also likes to makes videos of himself playing CourtCraft, which he posts on his YouTube Channel.
20. Over time, Hayden's online activities result in a substantial following by other online game enthusiasts. Hayden is approached by the developers of CourtCraft and an arrangement is reached under which Hayden monetises his videos and posts a link in them to the developer's online store (a YouTube approved external retail site). Every time someone clicks on the link, they are directed to the store. If this results in the sale of any of the developer's online products, Hayden receives a commission.
21. Hayden's videos are such a success that he ends up earning a few thousand dollars of commission income each month. Hayden retains his day job and continues to play CourtCraft in his spare time. Is he taxable on the commission income?

22. Hayden is employed full time and only plays CourtCraft in his spare time. He consequently devotes little time, money and effort to earning the commission income. Hayden's intention is also not to make a profit from his gaming activities; he simply enjoys playing CourtCraft and the attention he derives from the interest in his videos. Based on these facts, Hayden may not be carrying on a business of earning commission. However, the commission he receives is clearly income within the ordinary concepts definition. It is a regular monthly amount coming in to Hayden, in recognition of a service he provides to CourtCraft's developers. Hayden will therefore be taxable on the commission income.

Example 3 – income taxable from a profit-making scheme

23. Sarah owns an especially cute hamster. She builds a miniature playground, complete with tiny slide and swing, for the hamster and posts a video of it playing on YouTube. She shares the video with her friends on social media. The video is an instant online success and goes viral, quickly amassing millions of views worldwide. Despite the millions of views, Sarah has not made any money from the video. Her friends encourage her to monetise the video and try to make a bit of money.
24. Sarah decides to profit from her cute hamster. She creates a Google AdSense account and monetises the video. Ad clicks by viewers of the video result in Sarah earning a share of advertising revenue. Her hamster video quickly generates $10,000 paid to Sarah in the first month after monetising the video. However, the internet's "cute hamster" phase is short-lived and, after her initial success, viewing of Sarah's video (and resultant AdSense revenue) quickly comes to an end.
25. Although the hamster video going viral appears to be a random event, the money Sarah makes from the video is, on the facts set out, not a windfall gain. This is because Sarah, by choosing to monetise the video and allowing ads to run on the video with the dominant purpose of making a profit, has undertaken a profit-making scheme. The advertising income she receives will be taxable under s CB 3.

Summary

26. If you receive YouTube receipts, they may be assessable income, depending on the circumstances. The assessable income needs to be declared in your tax return.
27. Similarly, if any amount is assessable income, then some of the costs related to gaining or producing that income may be allowable as a deduction (subject to the capital and private limitations).
28. You must retain records sufficient to calculate your income and expenses. Generally, those records should be kept for seven years from the end of the income year to which they relate.

Item provides general guidance only

29. This item provides general guidance only. This item also does not consider any possible goods and services tax consequences of YouTube receipts. Individual circumstances are inevitably different. Inland Revenue suggests that anyone earning significant YouTube receipts may wish to obtain advice from a tax advisor.

References

Related rulings/statements

Tax Information Bulletin Vol 7, No 3 (September 1995): 8
IR1022 – *Online Trading Tax Implications* (October 2013)
IR 320 – *Smart Business: A guide for businesses and non-profit organisations* (March 2016)

Subject references

YouTube receipts
E-commerce
Profit-making undertaking or scheme
Income under ordinary concepts
Record keeping

Legislative references

Income Tax Act 2007, ss CA 1(2), CB 1 and CB 3
Tax Administration Act 1994, s 22

Case references

A Taxpayer v CIR (1997) 18 NZTC 13,350 (CA)
Case S86 (1996) 17 NZTC 7,538
CIR v Walker [1963] NZLR 339 (CA)
FCT v Hyteco Hiring Pty Limited 92 ATC 4,694 (FFC)
Investment & Merchant Finance v FCT (1970) 120 CLR 177 (HCA)
Reid v CIR (1985) 7 NZTC 5,176 (CA)

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.

General Depreciation Determination DEP98: Kiwifruit overhead mesh shelters

Note to Determination DEP98: The Commissioner has issued a depreciation rate determination for kiwifruit overhead mesh shelters.

This asset consists of a self-supporting frame and wires that support an overhead mesh shelter that protects the fruit from weather events (wind, hail, UV) and bird and pests.

Determination DEP98: Tax Depreciation Rates General Determination Number 98

1. Application

This determination applies to taxpayers who own items of depreciable property of the kind listed in the tables below:

This determination applies for the 2017 and subsequent income years.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994 I set in this determination the rate to apply to the kind of items of depreciable property listed in the table below by:

- Adding into the "Buildings and Structures" asset category, the new asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Kiwifruit overhead mesh shelters	12.5	16	10.5

3. Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed on the 11th day of May 2017.

Vanessa Montgomery
Acting Manager, LTS Technical Standards

General Depreciation Determination DEP99: Campervans and Motorhomes

Note to Determination DEP99

This determination corrects the applicable depreciation rate for Campervans and Motorhomes, for the 2010/11 and subsequent income years. The item also clarifies the Commissioner's view that these assets are:

- considered to have a high residual value (20% residual value),
- assets acquired during or after the 2010/11 income year are viewed as having an estimated useful life of 8 years,
- assets acquired prior to the 2010/11 income year were viewed as having an estimated useful life of 10 years.

Taxpayers impacted by the retrospective depreciation rate change can ask for an adjustment to assessments for past years in terms of section 113 of the Tax Administration Act 1994[1], to the extent that legislation permits a refund to be made under Subpart RM of the Income Tax Act 2007. Alternatively, other taxpayers may choose to simply begin to use the new depreciation rate prospectively and make the appropriate depreciation recovery adjustment upon disposal of a campervan or motorhome.

Determination DEP99: Tax Depreciation Rates General Determination Number DEP99

1. Application

This determination applies to taxpayers who own items of depreciable property of the kind listed in the table below:

This determination applies to the 2010/11 and subsequent income years.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994 I set in this determination the rate to apply to the kind of items of depreciable property listed in the table below by:

- Deleting from the "Leisure" industry category and the "Hire equipment" and "Transportation" asset categories, the asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Campervans acquired during or after the 2010/11 income year	8	18	12.5
Motorhomes acquired during or after the 2010/11 income year	8	18	12.5

- Deleting from the "Leisure" industry category, the asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Campervans (including Motorhomes) acquired before 1 April 2005	10	18	12.5
Campervans (including Motorhomes) acquired on or after 1 April 2005 but prior to the 2010/11 income year	10	20	13.5

[1] More information regarding section 113 can be found in Standard Practice Statement SPS 16/01: *Requests to amend assessments*. SPS 16/01 can be found at **www.ird.govt.nz** (search keyword "SPS 16/01").

- Adding into the "Hire equipment" and "Transportation" asset categories, the new asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Campervans acquired between 1 April 2005 and prior to the 2010/11 income year	10	20	13.5
Campervans acquired during or after the 2010/11 income year (residual value estimated at 20%)	8	20	13.5
Motorhomes acquired between 1 April 2005 and prior to the 2010/11 income year	10	20	13.5
Motorhomes acquired during or after the 2010/11 income year (residual value estimated at 20%)	8	20	13.5

3. Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed on the 1st day of June 2017.

Rob Wells
LTS Manager – Technical Standards

Determination CRS 2017/001 – Members' account in a KiwiSaver scheme (excluded account)

Determination CRS 2017/001 – A member's account in a KiwiSaver scheme is an excluded account for the purposes of the CRS applied standard and requirements under Part 11B of the Tax Administration Act 1994

Reference

This determination is made under section 91AAW of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Group Manager, Investigations and Advice, under section 7 of that Act.

Interpretation

In this determination, unless the context otherwise requires:

"AML/CFT" means anti-money laundering and countering the financing of terrorism.

"Crown contribution" means the contribution made by the Crown under section 226 of the KiwiSaver Act 2006, and the amount of tax credit under section MK 1 of the Income Tax Act 2007, that is treated as a Crown contribution for a member under section MK 5 of that Act.

"CRS applied standard" means the CRS standard as modified by section 185O for the determination of requirements under the Tax Administration Act 1994.

"CRS publication" means the *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, published by the Organisation for Economic Co-operation and Development.

"CRS standard" means the *Common Standard on Reporting and Due Diligence for Financial Account Information*, as amended from time to time, which is a standard—

(a) developed by the Organisation for Economic Co-operation and Development and the Group of Twenty countries; and

(b) agreed by the Council for the Organisation for Economic Co-operation and Development on 15 July 2014; and

(c) contained in Part IIB of the CRS publication.

"FMC Act" means the Financial Markets Conduct Act 2013.

"KiwiSaver member" in relation to a KiwiSaver scheme, means a natural person who has been admitted to membership of the scheme and who is, or may become, entitled to benefits under the scheme.

"KiwiSaver member's account" in relation to a member of a KiwiSaver scheme, includes any account held by that member in the KiwiSaver scheme.

"KiwiSaver scheme" is defined in section 6 of the FMC Act, and means a scheme that is registered on the register of managed investment schemes as a KiwiSaver scheme under the FMC Act.

"Permitted withdrawal" means a withdrawal that is permitted under the KiwiSaver scheme rules in Schedule 1 of the KiwiSaver Act 2006.

"Register of managed investment schemes" is defined in section 6 of the FMC Act, and means the register of managed investment schemes kept under Schedule 2 of that Act.

"Retirement or pension account" means an excluded account that satisfies the requirements of subparagraph C(17)(a) of Section VIII of the CRS standard.

Discussion (which does not form part of the determination)

As outlined above, a KiwiSaver scheme is a scheme that is registered on the register of managed investment schemes as a KiwiSaver scheme under the FMC Act. The register is maintained by the Financial Markets Authority. In order to be included on the register, a KiwiSaver scheme must fully meet the registration requirements as set out in sections 126 to 128, and other relevant provisions, of the FMC Act.

Three of the additional registration requirements in section 128 are that a KiwiSaver scheme:

- Is a trust, established and governed by a trust deed, under NZ law;
- Has a purpose of providing retirement benefits directly to individuals; and
- Has a manager who has at least one director who is a New Zealand tax resident.

The policy intent behind KiwiSaver schemes is to encourage long-term savings habits and asset accumulation by individuals principally through the workplace. Only natural persons can become members of a KiwiSaver scheme. A member must meet the New Zealand requirements which include:

- Being a NZ citizen, or being entitled to live in New Zealand indefinitely under NZ law; and
- Living, or normally living, in New Zealand.

KiwiSaver members who are in paid employment have minimum contributions deducted from their earnings and paid to Inland Revenue through the PAYE system along with their employer's contributions. Inland Revenue then distributes the funds to each KiwiSaver member's allocated KiwiSaver scheme which allocates the funds to that member's account. If a person changes employment or leaves the workforce their KiwiSaver member's account goes with them.

KiwiSaver members who are not in paid employment can choose to make contributions directly to their KiwiSaver scheme or to Inland Revenue. All KiwiSaver members can also make voluntary contributions into their own, or into another, KiwiSaver member's account.

All KiwiSaver contributions are locked in until the later of:

- When a member is eligible for New Zealand Superannuation; or
- After five years of membership;

unless a member makes another type of permitted withdrawal in accordance with the requirements of the KiwiSaver Act 2006.

A KiwiSaver member's account:

- Is principally a retirement account;
- Is subject to regulation under the KiwiSaver Act 2006, the FMC Act, the Income Tax Act 2007 and the Tax Administration Act 1994;
- Is subject to AML/CFT procedures under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009;
- Has information reported regularly to Inland Revenue;

- Attracts a Crown contribution by way of an annual limited member tax credit for individual members contributing a minimum amount each year; and
- Only allows members to make permitted withdrawals.

A KiwiSaver member's account has substantially similar characteristics to a retirement or pension account in subparagraph C(17)(a) of Section VIII of the CRS standard, and has other substituting characteristics which indicate that such an account presents a low risk of being used to evade tax.

Determining that a KiwiSaver member's account is an excluded account, and specifying this under NZ law, does not frustrate the purposes of the CRS standard.

Scope of determination

A KiwiSaver member's account does not fully satisfy the requirements for, but has substantially similar characteristics to, a retirement or pension account in subparagraph (C)(17)(a) of Section VIII of the CRS standard.

This determination is issued by the Commissioner of Inland Revenue and applies to a member's account in a KiwiSaver scheme where:

- The KiwiSaver scheme is registered on the register of managed investment schemes as a KiwiSaver scheme, under the FMC Act; and
- The KiwiSaver scheme continues to maintain its registration on the register of managed investment schemes as a KiwiSaver scheme, and its manager complies with the relevant on-going registration requirements under the FMC Act.

Determination

A KiwiSaver member's account in a KiwiSaver scheme, as outlined in the scope of this determination, is an excluded account for the purposes of the CRS applied standard and requirements under Part 11B of the Tax Administration Act 1994.

Application date

This determination applies for the reporting period beginning 1 July 2017, and subsequent reporting periods under the CRS applied standard.

Dated at Wellington this 16th day of May 2017.

Patrick Goggin
Group Manager, Investigations and Advice

Determination CRS 2017/002 – KiwiSaver scheme (non-reporting financial institution)

Determination CRS 2017/002 – A KiwiSaver scheme is a non-reporting financial institution for the purposes of the CRS applied standard and requirements under Part 11B of the Tax Administration Act 1994

Reference

This determination is made under section 91AAW of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Group Manager, Investigations and Advice, under section 7 of the TAA.

Interpretation

In this determination, unless the context otherwise requires:

"AML/CFT" means anti-money laundering and countering the financing of terrorism.

"Broad Participation Retirement Fund" means a fund that is a 'non-reporting financial institution' under subparagraph B(1)(b) of Section VIII of the CRS standard, and that satisfies the requirements of subparagraph B(5) of Section VIII of the CRS standard.

"Crown contribution" means the contribution made by the Crown under section 226 of the KiwiSaver Act 2006, and the amount of tax credit under section MK 1 of the Income Tax Act 2007, that is treated as a Crown contribution for a member under section MK 5 of that Act.

"CRS applied standard" means the CRS standard as modified by section 185O for the determination of requirements under the Tax Administration Act 1994.

"CRS publication" means the *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, published by the Organisation for Economic Co-operation and Development.

"CRS standard" means the *Common Standard on Reporting and Due Diligence for Financial Account Information*, as amended from time to time, which is a standard—

(a) developed by the Organisation for Economic Co-operation and Development and the Group of Twenty countries; and

(b) agreed by the Council for the Organisation for Economic Co-operation and Development on 15 July 2014; and

(c) contained in Part IIB of the CRS publication.

"FMC Act" means the Financial Markets Conduct Act 2013.

"ITA" means the Income Tax Act 2007.

"KiwiSaver member" in relation to a KiwiSaver scheme, means a natural person who has been admitted to membership of the scheme and who is, or may become, entitled to benefits under the scheme.

"KiwiSaver member's account" in relation to a member of a KiwiSaver scheme, includes any account held by that member in the KiwiSaver scheme.

"KiwiSaver scheme" is defined in section 6 of the FMC Act, and means a scheme that is registered on the register of managed investment schemes as a KiwiSaver scheme under the FMC Act.

"NRFI" means a non-reporting financial institution.

"Permitted withdrawal" means a withdrawal that is permitted under the KiwiSaver scheme rules in Schedule 1 of the KiwiSaver Act 2006.

"PIE" means an entity that is defined in section HM 2 of the ITA, which complies with the Portfolio Investment Entity (PIE) rules, as defined in section YA 1 of that Act.

"Register of managed investment schemes" is defined in section 6 of the FMC Act, and means the register of managed investment schemes kept under Schedule 2 of that Act.

"TAA" means the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

A KiwiSaver scheme is a scheme that is registered on the register of managed investment schemes as a KiwiSaver scheme under the FMC Act. The register is maintained by the Financial Markets Authority. In order to be included on the register, a KiwiSaver scheme must fully meet the registration requirements as set out in sections 126 to 128, and other relevant provisions, of the FMC Act.

Three of the additional registration requirements in section 128 are that a KiwiSaver scheme:

- Is a trust, established and governed by a trust deed, under NZ law;
- Has a purpose of providing retirement benefits directly to individuals; and
- Has a manager who has at least one director who is a New Zealand tax resident.

The policy intent behind KiwiSaver schemes is to encourage long-term savings habits and asset accumulation by individuals principally through the workplace. Only natural persons can become members of a KiwiSaver scheme. A member must meet the New Zealand requirements which include:

- Being a NZ citizen, or being entitled to live in New Zealand indefinitely under NZ law; and
- Living, or normally living, in New Zealand.

KiwiSaver members who are in paid employment have minimum contributions deducted from their earnings and paid to Inland Revenue through the PAYE system along with their employer's contributions. Inland Revenue then distributes the funds to each KiwiSaver member's allocated KiwiSaver scheme which allocates the funds to that member's account. If a person changes employment or leaves the workforce their KiwiSaver member's account goes with them.

KiwiSaver members who are not in paid employment can choose to make contributions directly to their KiwiSaver scheme or to Inland Revenue. All KiwiSaver members can also make voluntary contributions into their own, or into another, KiwiSaver member's account.

All KiwiSaver contributions are locked in until the later of:

- When a member is eligible for New Zealand Superannuation; or
- After five years of membership;

unless a member makes another type of permitted withdrawal in accordance with the requirements of the KiwiSaver Act 2006.

A KiwiSaver scheme:

- Is principally a fund to provide retirement benefits to its members;
- Is subject to regulation under the KiwiSaver Act 2006, the FMC Act, the ITA and the TAA;
- Is subject to AML/CFT procedures under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009;
- Has information reporting and disclosure obligations to Inland Revenue;
- Attracts a Crown contribution by way of an annual limited member tax credit for individual members contributing a minimum amount each year;
- Only allows members to make permitted withdrawals; and
- Attracts a lower tax rate for investment income tax, if the scheme is a PIE.

A KiwiSaver scheme has substantially similar characteristics to a Broad Participation Retirement Fund in subparagraphs B(1)(b) and B(5) of Section VIII of the CRS standard, and has other substituting characteristics which indicate that such a scheme presents a low risk of being used to evade tax.

Determining that a KiwiSaver scheme is a NRFI, and specifying this under NZ law, does not frustrate the purposes of the CRS standard.

Scope of determination

A KiwiSaver scheme does not fully satisfy the requirements for, but has substantially similar characteristics to a Broad Participation Retirement Fund outlined in subparagraphs B(1)(b) and defined in B(5) of Section VIII of the CRS standard.

This determination is issued by the Commissioner and applies to a KiwiSaver scheme where:

- The KiwiSaver scheme does not have a single beneficiary with a right to more than 5% of the fund's assets; and
- The KiwiSaver scheme is a scheme that is registered on the register of managed investment schemes as a KiwiSaver scheme, under the FMC Act; and
- The KiwiSaver scheme continues to maintain its registration on the register of managed investment schemes as a KiwiSaver scheme, and its manager complies with the relevant on-going registration requirements under the FMC Act.

Determination

A KiwiSaver scheme, as outlined in the scope of this determination, is a non-reporting financial institution for the purposes of the CRS applied standard and requirements under Part 11B of the Tax Administration Act 1994.

Application date

This determination applies for the reporting period beginning 1 July 2017, and subsequent reporting periods under the CRS applied standard.

Dated at Wellington this 23rd day of May 2017.

Patrick Goggin
Group Manager, Investigations and Advice

ITEMS OF INTEREST

Reportable jurisdictions for the CRS applied standard

These regulations, made under section 226D of the Tax Administration Act 1994 (the Act), come into force on 1 July 2017.

The regulations provide for 58 territories to be reportable jurisdictions for the purposes of the CRS applied standard—the *Common Standard on Reporting and Due Diligence for Financial Account Information (which is part of the Standard for Automatic Exchange of Financial Account Information in Tax Matters*, or AEOI, developed by the OECD) as it is applied in New Zealand. Reportable jurisdictions are territories to which the Inland Revenue Department (IRD) will provide certain information on non-residents that is reported to IRD by financial institutions in accordance with the CRS applied standard (but see also section 91AAV of the Act).

Reportable jurisdictions

Each territory listed in the Schedule is a reportable jurisdiction for the purposes of the CRS applied standard.

Schedule Territories that are reportable jurisdictions

Andorra	Argentina	Australia	Austria
Belgium	Brazil	Bulgaria	Canada
Chile	China	Colombia	Czech Republic
Denmark	Estonia	Faroe Islands	Finland
France	Germany	Gibraltar	Greece
Greenland	Guernsey	Hong Kong (China)	Hungary
Iceland	India	Ireland	Isle of Man
Israel	Italy	Japan	Jersey
Korea	Latvia	Liechtenstein	Lithuania
Luxembourg	Malaysia	Malta	Mauritius
Mexico	Monaco	Netherlands	Norway
Poland	Portugal	Russian Federation	San Marino
Saudi Arabia	Seychelles	Singapore	Slovak Republic
Slovenia	South Africa	Spain	Sweden
United Kingdom	Uruguay		

Participating jurisdictions for the CRS applied standard

Determination

New Zealand's initial list of participating jurisdictions for the purposes of the CRS applied standard and requirements under Part 11B of the Tax Administration Act 1994.

It is anticipated that the list will need to be updated annually, before 1 April each year, primarily to add new jurisdictions to the list, but also if necessary to remove jurisdictions from the list.

Application date

This determination applies for the reporting periods beginning on or after 1 July 2017, and subsequent reporting periods under the CRS applied standard.

Dated at Wellington on the 21st June 2017.

John Nash
Manager, International Revenue Strategy
Inland Revenue

Participating jurisdictions

Anguilla	Antigua and Barbuda	Argentina	Aruba
Australia	Austria	Bahrain	Barbados
Belize	Bermuda	Brazil	British Virgin Islands
Brunei Darussalam	Bulgaria	Canada	Cayman Islands
Chile	China	Colombia	Cook Islands
Costa Rica	Croatia	Curaçao	Cyprus
Denmark	Estonia	Faroe Islands	Finland
France	Germany	Ghana	Gibraltar
Greece	Grenada	Guernsey	Hong Kong (China)
Iceland	India	Ireland	Isle of Man
Israel	Italy	Japan	Jersey
Korea	Kuwait	Latvia	Lebanon
Lithuania	Luxembourg	Macao (China)	Malaysia
Malta	Marshall Islands	Mauritius	Mexico
Monaco	Montserrat	Nauru	Netherlands
New Zealand	Niue	Norway	Panama
Poland	Portugal	Qatar	Russian Federation
Saint Kitts and Nevis	Saint Lucia	Saint Vincent and the Grenadines	Samoa
San Marino	Saudi Arabia	Seychelles	Singapore
Sint Maarten	Slovenia	South Africa	Spain
Sweden	Turks and Caicos Islands	United Arab Emirates	United Kingdom
Uruguay	Vanuatu		

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, 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.

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.

Appeal against partial strike-out dismissed

Case	Chatfield & Co Limited v Commissioner of Inland Revenue [2017] NZCA 148
Decision date	1 May 2017
Act(s)	Section 17 of the Tax Administration Act 1994; Double Taxation Relief (Republic of Korea) Order 1983; Section BH 1 of the Income Tax Act 2007
Keywords	Strike out, legitimate expectation, relevant considerations

Summary

Chatfield & Co Ltd and Chatfield & Co (collectively **Chatfield**) applied to judicially review a decision of the Commissioner of Inland Revenue ("the Commissioner") to issue 15 Notices to Furnish Information under s 17 of the Tax Administration Act 1994 ("the TAA") ("the Notices"). In September 2016 the High Court struck out most of Chatfield's claims (*Chatfield & Co Limited v Commissioner of Inland Revenue* [2016] NZHC 2289, (2016) 27 NZTC 22-072). Chatfield appealed. On 1 May 2017 the Court of Appeal ("the Court") dismissed the appeal.

Impact

The decision applies the standard principles governing strike-out. It also provides some useful comments on the exercise of s 17 of the TAA, operational statements and legitimate expectation.

Facts

The National Tax Service of the Republic of Korea ("the NTS") asked the Commissioner to obtain and provide certain information relating to a number of Companies ("the Companies"), pursuant to a double taxation agreement ("the DTA") between the Republic of Korea ("Korea") and New Zealand. The Commissioner implemented the NTS request by issuing the Notices to Chatfield, the tax agent for the Companies, under s 17 of the TAA.

In May 2015 Chatfield filed a judicial review proceeding alleging the Commissioner acted unlawfully in deciding to issue the Notices, by:

1. breaching a legitimate expectation (based on Operational Statement 13/02 ("OS 13/02")) that she would not issue the Notices to Chatfield without first seeking the requisite information from the Companies themselves ("the first cause of action"); or
2. by failing to take into account certain relevant considerations (being a legitimate expectation the Commissioner would follow OS 13/02; the existence of OS 13/02 and its terms; the limited nature of the tax agent/client relationship and the terms of the DTA) ("the second cause of action").

In September 2016 the High Court granted the Commissioner's application to strike out all except one part of Chatfield's claims, leaving only one part of the second cause of action to go to a substantive hearing. Chatfield appealed.

Decision

The Court agreed with the High Court that the claims in issue were not reasonably arguable and dismissed the appeal.

First cause of action: legitimate expectation

The Court referred to authority supporting the principle that parties seeking to invoke a legitimate expectation claim must satisfy a number of requirements, the first being an unambiguous commitment or promise by a public authority to follow a certain procedure. The interests of good administration requires the implementation of that unambiguous commitment provided that doing so does not interfere with that authority's statutory duty or powers and in the revenue context the Court has previously emphasised that the scope for invoking legitimate expectation is limited by the scheme and purpose of the income tax legislation (citing *Comptroller of Customs v Terminals (New Zealand) Ltd* [2012] NZCA 598, [2014] 2 NZLR 137; *Commissioner of Inland Revenue v New Zealand Wool Board* (1999) 19 NZTC 14,476 (CA)).

The Court referred to previous case law where the Court rejected taxpayer claims of a legitimate expectation that they would not be assessed for income tax purposes on certain transactions based upon operational statements issued by the Commissioner relating to the power to strike down transactions for tax avoidance (*Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC); and *Dandelion Investments Ltd v Commissioner of Inland Revenue* [2003] 1 NZLR 600 (CA)). The Court held the rationale for that approach is beyond challenge – policy statements prepared for the guidance of taxpayers and the general public cannot be elevated to the character of constraints on the Commissioner's statutory duty as only Parliament has that authority (and the same rationale must apply to the exercise of the Commissioner's statutory powers).

The Court noted the power to demand information is necessarily broad given relevant information is normally within the taxpayer's sole possession and control. Section 17 contains the only limitation on that power – the Commissioner must be satisfied the information is necessary or relevant for any purpose relating to the enforcement of the Income Tax Act or any other statutory function (her satisfaction in that respect was not contested here).

The Court found OS 13/02 is simply a comprehensive and correct explanation of the nature and extent of the Commissioner's statutory power to demand information and the circumstances in which she proposes to exercise that power. Parliament vested the Commissioner with this operational discretion to decide what information she considers necessary or relevant and how it is to be obtained but did not vest the discretion for the particular purpose of limiting or impinging upon her otherwise broad statutory power.

The Court rejected Chatfield's attempt to distinguish between information sought under s 17 which is not required for a domestic purpose and information required to satisfy a foreign state's request. The Court did not agree with the submission that exceptions contained in Article 25(2)(a) and (b) of the DTA limit the Commissioner's s 17 power. The Court noted Article 25 has the force of a statutory provision in New Zealand, obliging the Commissioner to exchange such information as is necessary for carrying out the provisions of the DTA or Korea's domestic laws. While forming part of the legal framework within which the Commissioner exercises her powers and applies operational statements, the Court found nothing to suggest Article 25 exceptions limit the Commissioner's s 17 power by obliging her to seek the information from taxpayers before requiring Chatfield's compliance as tax agent.

The Court held that even if OS 13/02 was capable of constituting a binding representation limiting the circumstances in which the Commissioner would exercise her power, Chatfield's argument failed when applied to the plain words of OS 13/02. The Court rejected Chatfield's argument that the word "may" as used in paragraph 71 of OS 13/02 was synonymous with and must read "will only" seek information from tax agents where it relates to an inquiry for a different purpose than satisfying a request under the DTA.

The Court agreed that in paragraphs [71] - [79] of OS 13/02 the Commissioner is referring to a limited category of information relating to tax avoidance or evasion or offences likely to lead to prosecution. The Court was satisfied the word "may" as used here was no more than an expression of how the Commissioner intends to exercise her power in certain circumstances which did not apply in this case. The Court confirmed paragraph [43] of OS 13/02 is a correct legal recital of the Commissioner's power to seek information from multiple sources including those other than the affected tax payer, such as tax agents, whether before or after seeking information directly from that tax payer.

The Court rejected the argument that the claim should not have been struck out as further evidence regarding the meaning of OS 13/02 may be available at trial, holding that the proper construction of OS 13/02 was one of law (not fact as argued by Chatfield) to be determined according to settled principles of interpretation of the document itself.

The Court was satisfied OS 13/02 is not arguably capable of constituting a legitimate expectation by a taxpayer or its agent that the Commissioner will limit the circumstances in which she will exercise her discretionary power under s 17 to demand information, but recorded that even if wrong on that point, it was not satisfied that OS 13/02 could arguably be construed as imposing such a limitation.

Second cause of action: relevant considerations

The Court endorsed the High Court's answer to the allegation that OS 13/02 amounted to a voluntary representation to the world at large regarding the procedures the Commissioner will follow and considerations she will take into account when exercising her power, finding it followed logically from the primary conclusion on legitimate expectation. In finding OS 13/02 could not be construed as limiting the circumstances in which the Commissioner will exercise her s 17 power on receipt of a request under the DTA, it was therefore irrelevant as to whether the Commissioner did or did not take OS 13/02 into account and its consideration would have made no difference to the decision.

The Court held the Commissioner's knowledge of the role actually played by a tax agent in performing its contractual duties is not relevant to a request of an entirely different nature for documents required for the performance of a statutory obligation, the only relevant consideration being (once the Commissioner is satisfied that documents are necessary or relevant), whether in fact the agent is likely to hold them.

The Court also rejected a further proposition that the Commissioner should have taken into account possible reputational damage to Chatfield in complying with the notices.

The Court noted there was no cross-appeal of the decision not to strike out the final claim (that the Commissioner issued the Notices without taking into account the terms of Article 25 and its three exceptions). Assuming the High Court was correct that the Commissioner was required to take Article 25 into account, the Court noted the only evidence before it was that she did in fact do so. The Court however noted it did not have jurisdiction to intervene further.

Court of Appeal finds High Court has no jurisdiction to approve a payment proposal under s 29(1)(b)(iii) of the Insolvency Act 2006

Case	Commissioner of Inland Revenue v Wilson [2017] NZCA 100
Decision date	31 March 2017
Act(s)	Insolvency Act 2006, ss 29, 37 and Part 5 Subpart 2 Tax Administration Act 1994, ss 176, 177, 177A and 177B
Keywords	Payment proposal, inherent jurisdiction, s 29(1)(b)(iii), Insolvency Act 2006

Summary

The Court of Appeal allowed the Commissioner of Inland Revenue's ("Commissioner") appeal, finding that the High Court has no jurisdiction, neither inherent nor express under s 29(1)(iii) of the Insolvency Act 2006 ("the Act") to approve a payment proposal in the context of an application by a judgment debtor to set aside a bankruptcy notice.

Facts

The Commissioner appealed a decision given in the Rotorua High Court, per Christiansen AJ, approving a proposal by Mr Wilson ("the respondent") to pay a debt he owed to the Commissioner (*Wilson v Commissioner of Inland Revenue* [2016] NZHC 87). The Court of Appeal noted that the Commissioner's appeal raised issues of general importance. The respondent cross-appealed the Associate Judge's order for costs to lie as they fall. The respondent claimed that as his application had succeeded, the Associate Judge should have awarded him costs.

On 17 June 2015, prior to the High Court proceeding, the Commissioner obtained a judgment of $137,353.10 against the respondent for unpaid goods and services tax. On 5 November 2015, the Commissioner served a bankruptcy notice on the respondent in relation to the judgment debt.

The respondent then made a payment proposal to the Commissioner. The Commissioner declined that payment proposal initially on 25 November 2015, and by letter dated 8 December 2015.

On 17 November 2015, after making his payment proposal to the Commissioner, but before the Commissioner had responded to it, the respondent applied to the High Court for orders approving the proposal and setting aside the bankruptcy notice. On 21 December 2015, the respondent asked the Commissioner to reconsider his payment proposal. The Commissioner did so, but on 3 February 2016 again declined the proposal.

The High Court heard the respondent's application, and on 22 April 2016, delivered judgment in favour of the respondent.

Following delivery of the High Court judgment, the respondent also applied to the District Court, unsuccessfully, to set aside the judgment debt on which the Commissioner based her bankruptcy notice (*Commissioner of Inland Revenue v Wilson* [2016] NZDC 2012).

Decision

The Court of Appeal noted that, given the Associate Judge had invoked its inherent jurisdiction in approving the respondent's payment proposal; the Commissioner's submissions had focused on the High Court's inherent jurisdiction and had advanced a detailed argument as to why it was not available.

The Court then noted that the respondent had submitted in his written submissions that the High Court had properly exercised its inherent jurisdiction. However, in his oral argument, the respondent changed direction; his primary submission being that s 29 of the Act gave the Associate Judge an express statutory power to approve the respondent's payment proposal.

The statutory provisions – s 29(1)(b)(iii) and part 5 subpart 2 of the Insolvency Act 2006

The respondent submitted that s 29(1)(b)(iii) of the Act gave the Court an express statutory power to approve a payment proposal (whether or not the creditor accepted the proposal). The Court of Appeal did not agree with this argument, stating that it did not accord with the interpretation of s 29 required by s 5 of the Interpretation Act 1999.

The Court of Appeal found that the purpose of s 29 was to set out the requirements for a valid bankruptcy notice. The Court noted that per s 29 the notice must set out the options available to a debtor to avoid bankruptcy (one being set out in s 29(1)(b)(iii) - to compromise the debt).

The Court also held that the purpose of s 29 was not to confer on the High Court a power to approve a compromise, noting that its purpose was confirmed by the context of s 29 and its position in the Act. The Court found s 29 to be merely a process provision. Further, the Court said that the limited purpose and meaning of s 29 was reinforced by the scheme of the Act, stating that the ability of a debtor to make a payment proposal, and the requirements for such a proposal, were dealt with in Subpart 2 of Part 5.

The Court of Appeal then considered the appropriate meaning to be given to s 29(1)(b)(iii), which provides "[t]he bankruptcy notice must … require the debtor … to compromise the amount owing on terms that satisfy the Court or the creditor."

The Court agreed with the Commissioner's submission that "Court" in s 29(1)(b)(iii) should be construed as referring to the Court in its role in approving proposals under Subpart 2 of Part 5, and "creditor" as unrelated to that regime. The Court found support for the Commissioner's interpretation in the prescribed form of the Bankruptcy Notice and in principles of statutory interpretation, noting that the features of Subpart 2 Part 5 achieved results that were sensible, just and workable.

The respondent was constrained to accept that the power in s 29(1)(b)(iii) would not work in circumstances where a debtor had multiple creditors, and sought the Court's approval of a compromise with only the creditor who had served the bankruptcy notice. The Court of Appeal therefore surmised that the respondent was contending for an interpretation of s 29 that would not produce a sensible, just, and workable result.

The Court of Appeal held that the words in s 29(1)(b)(iii) do not confer on the Court the power to approve a compromise and instead the power resided in s 333 of Subpart 2 Part 5.

The statutory provisions – ss 177 to 177B of the Tax Administration Act 1994

The Court of Appeal also significantly held that, where the debtor is a taxpayer seeking to compromise a debt owed to the Commissioner, the debtor must do so by applying for financial relief in terms of ss 177 to 177B of the Tax Administration Act 1994 ("TAA"). The Court listed the following, as reasons for its finding:

1) Unique considerations restrain the Commissioner when deciding whether to accept an instalment arrangement, such as, maximising the recovery of outstanding tax, and the proscription on the Commissioner from entering into an instalment arrangement which would place the taxpayer (if a natural person) into serious hardship.
2) The Commissioner may decline to enter into an instalment arrangement in circumstances set out in s 177B(2) of the TAA, which cannot be reconciled with the creditor voting provisions in s 331 of the Act.
3) The ability of the Commissioner to cancel an instalment arrangement in the circumstances set out in s 177B(6), again cannot be reconciled with Subpart 2 Part 5, where if creditors vote to accept the payments proposal and the Court approves it, it is binding on all creditors.
4) A broad application of the maxim that general provisions must yield to specific provisions.

The respondent submitted that the relevant provisions of the TAA were no longer available to the Commissioner once she had obtained judgment in court. He maintained that a "taxpayer" as defined in s 3 of the TAA ceases to be a taxpayer once that person becomes a judgment debtor. The Court of Appeal rejected this argument and stated that entry of judgment against the respondent did not discharge him from his tax obligations, whether accrued or future.

Section 37 discretion exercisable at the 's 29 stage'

Section 37 of the Act sets out the circumstances in which the Court may, in its discretion, refuse to adjudicate a debtor bankrupt when hearing a creditor's application. The respondent contended that the Court could exercise this discretion earlier, when considering whether to approve a payment proposal by a debtor served with a bankruptcy notice.

The Court of Appeal rejected this argument on a number of grounds. Firstly, on the basis that they had held firmly against the submission that s 29(1)(b)(iii) gave the Court power to approve a payment proposal. Secondly, s 333 of the Act (a provision in Subpart 2 Part 5) contained detailed provisions as to the Court's approval of a payment proposal. Lastly, on the ground that it "mauls" the language of s 37 to suggest that the discretion applies earlier in the bankruptcy process.

Commissioner bound by concession as to jurisdiction

The Court also rejected the respondent's final argument, that the Commissioner was bound by her purported concession before the Associate Judge "that the Court has an inherent jurisdiction to entertain … a payment proposal when considering an application to set aside a bankruptcy notice".

The Court of Appeal did not consider that the Court has an inherent jurisdiction to approve a payment proposal by a debtor, when the creditor or creditors have rejected the proposal. The Court found that such an inherent jurisdiction would cut right across the proposals regime in Subpart 2 Part 5 of the Act. The Court also noted that a party or parties cannot, by consent or by concession, vest in a Court a jurisdiction which it does not have.

The Court agreed with the Commissioner that if the respondent wished to challenge the Commissioner's decision to reject his payment proposal, his remedy was to apply for judicial review of the Commissioner's decision.

The Court of Appeal also explicitly overruled the decision *FM Custodians (FM Custodians Ltd v McNally* [2013] NZHC 34), (which had been relied upon by Christiansen AJ in the High Court judgment) in so far as it held s 29(1)(b)(iii) gave the Court the power to approve a payment proposal.

Cross-appeal

The Court of Appeal provided that, given their finding that the High Court lacked the jurisdiction to approve the respondent's payment proposal, the cross-appeal against the Associate Judge's costs order went away.

Result

The Court of Appeal allowed the Commissioner's appeal and dismissed the cross-appeal of the respondent.

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