Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT: 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.

Contents

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).

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 x value or cost x 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 x value or cost x 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.

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**	**x**	**value or cost**	**x**	**months ÷ 12**
	=	0.05	x	$10,250	x	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 deduction (s EE 16)	**= annual rate**	**x**	**value or cost**	**x**	**months ÷ 12**
	= 0.05	x	$10,250	x	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 deduction (s EE 16)	**= annual rate**	**x value or cost**	**x months ÷ 12**
	= 0.05	x $9,694	x 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 deduction (s EE 16)	**= annual rate**	**x value or cost**	**x months ÷ 12**
	0.05	x $9,694	x 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 deduction (s EE 16)	**=**	**annual rate**	**x**	**value or cost**	**x**	**months ÷ 12**
	=	0.22	x	$240,000	x	11/12
	=	$48,400				

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

Depreciation deduction (s EE 16)	**=**	**annual rate**	**x**	**value or cost**	**x**	**months ÷ 12**
	=	0.22	x	$240,000	x	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 deduction (s EE 16)	**=**	**annual rate**	**x**	**value or cost**	**x**	**months ÷ 12**
	=	0.05	x	$54,694	x	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 deduction (s EE 16)	**=**	**annual rate**	**x**	**value or cost**	**x**	**months ÷ 12**
	=	0.05	x	$115,000	x	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 deduction (s EE 16)	**=**	**annual rate**	**x**	**value or cost**	**x**	**months ÷ 12**
	=	0.05	x	$114,042	x	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.

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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

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Appendix – Legislation and reporting standards

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) x 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.

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 x 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*
>
> **5.1 Research costs shall be recognised as an expense in the period in which they are incurred.**
>
> **RECOGNITION OF DEVELOPMENT COSTS**
>
> *STANDARD*
>
> 5.2 The development costs of a project shall be recognised as an expense in the period in which they are incurred unless the criteria for asset recognition identified in 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).