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<u>Draft Interpretation Statement PUB00262: Income Tax – Treatment of New Zealand Patents</u>

Introduction

1. The Law Society welcomes the opportunity to comment on Exposure Draft *PUB00262: Income Tax – Treatment of New Zealand Patents* (Exposure Draft), and has identified some gaps and inconsistencies (and some minor errors) in it that have potential consequences for taxpayers. These are explained below.

Comments

Patent Applications

2. Paragraph 25 of the Exposure Draft discusses patent applications, but does not refer to two additional routes for filing patent applications with complete specifications in New Zealand: convention applications[1] and treaty applications.[2] Treaty applications make up the vast majority of patent applications filed in New Zealand.[3] New Zealand residents file on average only around 10% of patent applications in New Zealand.

3. A convention application is one filed in New Zealand claiming priority[4] from an overseas patent application in a country belonging to a relevant patent convention. A convention application is relevant where a New Zealand business exploits the patented invention in New Zealand as a New Zealand subsidiary, agent, independent licensee of the overseas owner, or occasionally as the assignee of the overseas owner. An overseas patent applicant does not have any rights in New Zealand apart from a potential right to claim priority if a convention application is filed.

4. On the other hand a treaty application[5] is treated as a patent application accompanied by a complete specification in New Zealand from the time that it is filed internationally.[6] However, if an international application does not enter the national phase in New Zealand,[7] it is to be treated as void for the purposes of the Patents Act.[8] The consequences of this for the

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1 Patents Act 2013, sections 53 to 56
2 Patents Act 2013, sections 46 to 52
3 IPONZ charts at the link: https://www.iponz.govt.nz/about-iponz/facts-and-figures/
4 A priority claim establishes a starting date after which publication or use of the invention does not affect its novelty.
5 An international patent application filed under the Patent Cooperation Treaty.
6 Patents Act 2013, section 46
7 A treaty application has an "international phase" from when it is filed, and a "national phase" from when it is filed in New Zealand.
8 Patents Act 2013, section 51

purposes of income tax is that an international patent application could be considered to be a patent application with a complete specification in New Zealand even before it has, in effect, been filed in New Zealand.

5. This will not be of any consequence for taxpayers who are not resident in New Zealand. But New Zealand taxpayers who have filed an application with a provisional specification and then filed a treaty application (internationally) instead of a complete specification (in New Zealand), it means that they should be entitled to treat expenses incurred overseas on a treaty application as patent application expenses in New Zealand.

6. A treaty application may remain in the international phase for as long as 31 months[9] after it has been filed before it either is entered into the national phase in New Zealand or it becomes void. This means that a taxpayer may delay the actual filing of a complete patent specification[10] for up to 43 months from the date of filing of a provisional specification. However, the complete specification of a treaty application is given an effective filing date of the date of filing of the complete specification[11] for the purposes of the Patents Act.

Effect of a Patent

7. The first sentence of paragraph 29 of the Exposure Draft is correct in stating that the patentee has the exclusive right to exploit a patent. However, subsequent references to what a patentee may do are potentially misleading because the activities set out are narrower than the definition of "exploit"[12] which is new to the Patents Act 2013. The Law Society recommends that the paragraph be amended to refer consistently to exploiting a patent, with a footnote referring to the definition of "exploit" in the Patents Act. The description of rights given by patents in other countries should also be changed to say that a patent right is a right to "exploit" an invention.

Incorrect use of "Specification"

8. In the first sentence of the last sub-paragraph of paragraph 29, reference is made to the "particular patented specification". It should read "particular patented invention". A patent specification is the document that describes and defines an invention. But it is the invention that a patent establishes right in. The same correction needs to be made in the second sentence of paragraph 69.

Patents outside New Zealand

9. The absence of any statement in the Exposure Draft of the tax treatment of patents outside New Zealand leaves a large gap. Taxpayers' purpose in filing applications for patents outside New Zealand is to generate income to be returned to New Zealand. Because of the larger size of overseas markets, that income is potentially much larger than that generated by exploiting the invention in New Zealand.

10. Items 12 and 13 of Schedule 14 of the Income Tax Act 2007 provide that overseas rights similar to those provided under the Plant Variety Rights Act 1987 are depreciable intangible property. While the subject matter and the breadth of the rights protected under plant variety rights legislation are different from those protected by patents, there is no apparent difference in their nature to explain why one set is intangible property while the other is not.

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9 Patents regulations 2014, regulation 62

10 The date that it enters the national phase in New Zealand.

11 Patents Act 2013, section 48

12 Patents Act 2013, section 18(2)

Items 3 and 4 of Schedule 14 should be amended to be consistent with items 12 and 13 and treat overseas patents and patent applications in the same way as New Zealand ones.

Devisor of an invention

11. Paragraphs 99 and 182 of the Exposure Draft use the phrase "a taxpayer who devises an invention" in relation to who is entitled to a deduction. This usage is inconsistent with the definition of "inventor'" in section 5 of the Patents Act 2013, which defines the inventor as "the actual devisor of the invention". An inventor (devisor) is a physical person and cannot be a legal entity such as a company. In the majority of cases it is the business that employs or has commissioned an inventor that has incurred the expense, but the business is not the devisor of the invention. The inventor is the devisor. It is possible for an inventor who is also an applicant to have incurred the expenses, but it occurs in practice in only a minority of cases.

Maintenance or renewal fees

12. Paragraphs 7, 105 and 185 explain that annual maintenance and renewal fees are revenue in nature. Most businesses use either specialist renewal services or patent attorney services to docket when the fees are due and to pay them on time. These renewal services incur administration fees that should also be deductible. This possibility should be included in these paragraphs.

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

13. The corollary of the statement in paragraph 135 (and section CB 30) is that the sale of a patent application with a provisional specification is capital in nature. This distinction is arbitrary. A patent application filed with a provisional specification does not have all of the rights of an application with a complete specification, but it must describe the invention in the complete specification to "support" the invention claimed in the complete specification.[13] If there is to be an arbitrary line it should be drawn between treatment of an invention before and after the filing of any patent application regardless of whether or not it is accompanied by a provisional or complete specification.

14. The statement also raises the question of the status of a treaty application[14] that is sold before it enters the national phase in New Zealand. If the treaty application is subsequently entered into the national phase it is not clear whether it is treated as a patent application with a complete specification[15] for the purposes of the Income Tax Act. It is also unclear whether, in the event that a treaty application is not subsequently entered into the national phase in New Zealand, the sale is to be considered the sale of a patent application with a provisional specification.[16] (Failure to enter a treaty application into the national phase in New Zealand renders that application void for the purposes of the Patents Act 2013.[17])

Relationship of amount of deduction or depreciation to invention

15. The first statement in paragraph 195 appears to be at odds with the principle set out in paragraph 19 that an invention is not the physical manifestation of that invention. The light bulb example in paragraph 195 may not be the physical manifestation of the invention protected by the patent. The invention protected by the patent may be one component of a

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13 Patents Act 2013, sections 58 and 59
14 Refer to paragraphs 3 to 5 above.
15 And therefore income in nature.
16 And therefore capital in nature.
17 Patents Act 2013, section 51

light bulb, but the expenditure may be for refining components of the light bulb other than those protected by the patent.

16. The analogous situation arises when it has been found that company B has infringed Company A's patent for a component of a light bulb. Company A seeks damages calculated on the costs of a light bulb as a whole, but the patent only covers a single component.

Expenditure of a taxpayer attacking a patent

17. The summary in both the Exposure Draft (ED) (at paragraph 8) and the current Interpretation Statement (IS2215) (at paragraph 1.5) states that:

> *"Legal expenses incurred in either defending or attacking a patent are generally revenue in nature" (and therefore deductible)*
>
> (underlining added).

18. However, in the substantive discussion of legal expenses in IS2215 (at paragraphs 5.1 – 5.13), the word "generally" is not used and there is no qualification to the statement that such legal expenses are revenue:

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

19. By contrast, paragraph 131 repeats the above statement but includes the word "generally" before "revenue in nature", and paragraph 132 of the Exposure Draft states that:

> *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.*
>
> (underlining added)

20. The only justification provided for the apparent change of view is at paragraphs 129 – 130 of the Exposure Draft, where it is noted that:

> *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. … [130] 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 deals 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.*

21. In *Ward* the Privy Council held that a brewery company was unable to deduct the expenses incurred in a publicity campaign designed to influence voters against supporting the introduction of prohibition. However, *Ward* is of little assistance in the circumstances given that:

(a) it concerned a deductibility provision requiring that the expenditure was "exclusively" incurred in the production of assessable income; and

(b) has been discredited in England (in *Morgan (I of T) v Tate & Lyle Ltd* (1954) 35 TC 367 the House of Lords reached the opposite conclusion on similar facts).

22. Paragraph 132 of the ED can also be criticised on the ground that there is no principled basis for distinguishing the position in *CIR v Murray Equipment Ltd*, which is cited in the ED as supporting deductibility in the normal course. In *Murray* the action was instigated opposing a patent application out of a concern that if the patent sought had been granted, it would seriously affect the taxpayer's business, preventing or seriously risking sales of its machines. Therefore the action was undertaken "to safeguard or protect its existing business and investment" (see also *Kellogg Company of Canada Ltd. v Minister of National Revenue* [1942] *C.T.C. 5*). The legal expenses in a case such as *Murray* were incurred to protect a significant part of an advantage for the enduring benefit of the taxpayer's trade that was already in existence. If that does not disqualify the expenditure from being revenue, it is difficult to understand why protecting a single patented asset on which the existing business operation depends should be treated as a capital expense. Whether the business is seriously endangered or threatened with extinction does not seem to be a valid point of distinction, and one that may in practice be difficult to draw as a factual matter in any event.

23. The Law Society therefore submits there is an insufficient basis for the apparent change of view underlying the statement in paragraph 132, and therefore in Example 8 the penultimate sentence of paragraph 202 ("Both companies held numerous patents") should be deleted.

Minor errors

24. The Law Society notes the following minor errors:

- Paragraph 85: the cross-reference at the end of the paragraph is incorrect and should be to [89] – [98] (and not [82] – [98]).

- Paragraph 111 – the second bullet point does not seem relevant to the discussion at paragraphs 106 – 112.

- Appendix, Paragraph 12 – the definitions of "development" and "research" should refer to the "<u>new</u> reporting standard".

Conclusion

25. This submission has been prepared with the assistance of the Law Society's Tax Law and Intellectual Property Law committees. If you wish to discuss this further please contact the committees' secretary Jo Holland (04 463 2967), jo.holland@lawsociety.org.nz.

Yours sincerely

Kathryn Beck
President