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AUSTRALIA

Budget Highlight - A New 'Patent Box' Regime for Australia

Australia is introducing a patent box tax incentive, to encourage investment in Australia's medical and biotechnology manufacturing sectors. The patent box was announced in the Australian Government's Budget 2021–22, which details its economic plan for Australia.

Profits derived from the commercialisation of patented technology developed in Australia and owned in Australia will be subject to a reduced corporate tax rate of 17% (compared with the standard corporate income tax rates of 30% generally and 25% for small to medium enterprises).

Designed to incentivise R&D activities in Australia the regime will encourage companies to retain ownership of patents in Australia. At this stage the incentive is limited to profits from the commercialisation of medical and biotech patents; rather than income from manufacturing, branding and other attributes.

Key features set out in the budget include:

- The research and development (R&D) underpinning the patent must be done in Australia.
- The patent must be applied for after the budget announcement.
- The patent must be granted (ie. not just applied for) for the reduced tax rate to apply.
- The patent must be owned, and the income received, by an Australian company (or permanent establishment).
- The income must be derived directly from the patent (income from manufacturing, branding and other attributes of a patented product or method will not be covered).
- The Government will follow the OECD's guidelines on patent boxes to ensure the patent box meets internationally accepted standards and will consult with the industry on the design.

This new tax incentive raises new issues which may need to be resolved using transfer pricing (TP) principles. The budget indicates that the proportion of the company's income which receives the concession is the amount attributable to Australian R&D, and not foreign R&D. Likely companies will need to identify the pool of R&D expenditure that relates to the patent, and where it was conducted. This could potentially be expenditure in past years, further complicating the process.

Australia has every opportunity to incentivise investment, increase development and drive growth in the region for tech jobs and digital transformation.

While complex, the incentive has the potential to be a significant development for the Australian medical and biotech sectors. Organisations that operate in these fields should keep a close eye on the development of the scheme and take every opportunity to maximise the benefits.

ASHFORDS

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NEW ZEALAND

Bright-line Rule Changes and Proposed Interest Limitation Rules

If you are interested in investing in New Zealand residential land, then you should be aware of the Government's focus on this area over the past few months in response to an out-of-control domestic housing market (particularly in the Auckland region although now apparent in other regions as well), and its attempts to use taxation measures as a cooling tool to a demand that for some time now has clearly exceeded available supply.

Now basic economics at school once taught me, that for as long as demand outstripped available supply, then prices would continue to rise. Consequently you need to focus on fixing the supply side of the equation, however considering that this correlates to building lots more houses which clearly will not happen overnight, the Government has reverted to tinkering with the existing tax rules, to attempt to quash the demand side of the equation instead. I would suggest in this regard, with all due respect to those "powers that be" making these decisions in Wellington, that you just need to look at a number of other countries experiments with these same tools, to appreciate that they just won't work.

So what's recently happened, or is about to, which may certainly have an impact on your investment decision?

Well firstly you may be aware that New Zealand presently does not have a capital gains tax. Historically therefore, as long as you could show that the residential land was bought for investment purposes, any subsequent gain arising upon the disposal of that land, was not subject to income tax. Now the Government first started tinkering with this non-taxed disposal gain in October 2015, when the bright-line rule was introduced – basically sell the land within two years of buying it, and where the land was not occupied mainly as your main home, then income tax was automatically payable on the disposal gain.

However this tinkering clearly didn't work as expected in the Government's eyes, so March 2018 saw the introduction of the 5-year bright-line period.

Still not satisfied with the outcome, within 13 months of the bright-line period change, April 2019 saw the introduction of residential rental deduction ring-fencing rules – to the extent the annual deductions exceeded the rental income, the excess deductions were ring-fenced and required to be carried forward to the next income year, only available for offset against rental income (or land sales income) derived in that future year, and so on. Previously a rental loss could be used to offset any other income derived in that same income year by the taxpayer.

Roll on to 2021, in the midst of a Covid-19 global pandemic (although many would argue New Zealand has done better than most countries) and still rising house prices, and the Government felt the need to intervene yet again. March 2021 consequently saw the increase in the bright-line period again, this time to 10 years.

However not content with both bright-line and deduction ring-fencing rules (because neither were dampening house price growth), the Government also released a discussion document titled "Design of the interest limitation rule and additional bright-line rules".

It's a rather lengthy 144 pages, and as the title suggests, the document not only discusses the proposed "interest limitation rules", but also provide commentary surrounding some proposed additional bright-line rules (further to the 10-year period already legislated for). Accompanying the document release, and fairly typical of any

Government wanting to win favour with their voters, was the political spin that suddenly the ability to claim a deduction for interest incurred on borrowings to fund the acquisition of land to be used to derive residential rental income, was a “tax loophole” in the law which required fixing.

The proposed fix – effective October 1st 2021, interest deductions relating to borrowings which fund residential land acquisitions and associated costs, would no longer qualify for a tax deduction. Now as a concession to the shocked investment community (there having been no prior warning of the proposed legislative change, including the usual consultative process with those affected as historically had occurred), any existing borrowings pre 27th March 2021 would be subject to a four year phase out period.

So basically, if the proposals do proceed to become law, effective 1st April 2025, any interest costs incurred on what I will now refer to as “old builds”, will be non-deductible for New Zealand tax purposes.

I’ve used the term “old builds”, because both the new 10-year bright-line period, and the proposed interest deduction limitation rules, contain a “new build” exclusion. A “new build” will basically be defined as a scenario where either the taxpayer has added a new dwelling to land, or they acquire land containing a new dwelling within 12 months of the code compliance certificate for that dwelling having been issued.

If the “new build” exclusion applies to the taxpayer, then the bright-line period applicable to their residential land will remain at 5-years, and the interest deduction limitation rules will not apply to their borrowings. Additionally the “new build” exclusion could equally apply to subsequent purchasers of the land, for a “new build period” (as yet not defined but could be up to 20 years). However the residential rental deduction ring-fencing rules will continue to apply.

So in essence, I’m seeing a resetting of the residential property investment landscape – buy new and you’ll obtain both a reduced bright-line period and full interest deductions, whereas continue with investing in “old builds”, and it’s the longer bright-line period with no interest deductions. I suspect that the Government’s aim here is to reduce the demand for “old builds”, thereby potentially softening their price, with the consequence that they could become affordable to first-home buyers. My view – with the average Auckland house price having already crossed the $NZ1 million threshold, “old build” prices are going to have to drop significantly to reach the affordability level for most first-home buyers – particularly when you also factor in the deposit requirements for first-home buyers by most New Zealand banks.

Now I expect that most offshore investors also reside in countries which do have a capital gains tax regime, and where the investor is subject to worldwide taxation, then New Zealand’s bright-line rule period really makes no difference to them. However, since a removal of the ability to claim interest deductions has the natural consequence that the investor will be subject to a greater income tax impost in New Zealand, there is certainly a risk of increased tax seepage (foreign taxes paid by the non-resident which they cannot offset against their domestic taxes payable) where the investor’s domestic marginal tax rates imposed on the offshore rental income are less than New Zealand’s rates.

Please do not hesitate to reach out to me, should you have any questions regarding the above narrative, or in fact, in relation to any other New Zealand taxation issue.

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