

INTERPRETATION STATEMENT: IS 16/06

INCOME TAX – TIMING – WHEN IS INCOME FROM PROFESSIONAL SERVICES DERIVED?

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

This Interpretation Statement withdraws and replaces:

- "When to Return Directors' Fees" *Public Information Bulletin* Vol 37 (November 1966): 6;
- "Derivation of Income from Services for Income Tax Purposes" *Public Information Bulletin* Vol 159 (February 1987): 1; and
- "Derivation of Income from Services for Income Tax Purposes" *Public Information Bulletin* Vol 172 (March 1988): 1.

These items discussed when fees from professional services are derived and the rules about changing accounting basis. These items were identified during a review of content published before 1996 in the *Public Information Bulletins* and the *Tax Information Bulletins*. The *Public Information Bulletin* review has now been completed, see "Update on *Public Information Bulletin* Review" *Tax Information Bulletin* Vol 25, No 10 (November 2013): 37.

This Interpretation Statement also withdraws and replaces "Whether Doctor Companies can Return Income Using the Cash Basis" *Tax Information Bulletin* Vol 9, No 6 (June 1997): 19. This is explained in more detail from para 77.

This Interpretation Statement consolidates the general principles discussed in the replaced items, and explains how those principles apply beyond the specific examples discussed in those items.

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Summary

1. The two main methods used to determine **when** an amount of income has been derived are the cash basis and the accrual basis. No general rule of law requires that any particular profession must account for income using one method or the other. However, the correct method is not a matter of choice or practice. Identifying the correct method is a question of fact, having regard to the nature of the business or income-earning activity of any given professional.
2. The courts consider a variety of factors when determining which method is appropriate for a particular business or profession. Not all factors will be relevant in every case and the factors will likely be given different weight. The courts consider these factors:
 - the type of activity carried on by the taxpayer that gave rise to the income;
 - the characteristics of the type of income at issue;
 - the legal and regulatory environment in which the taxpayer operates;
 - the scale of the business or income-earning activity; and
 - the level of sophistication or complexity of the business.
3. In each case, these factors must be weighed against one another to decide which method is appropriate.
4. The courts have held that a cash basis may be appropriate in the following circumstances:
 - an ordinary individual who does not carry on a trade, profession, or business;
 - a business or income earning activity involving a professional person marketing nothing but their own services and receiving nothing but professional fees;
 - a business in which expenditure contributes to income in a subsidiary or minor degree; and
 - a business in which the risk of non-collectable trade debts is unusually high.
5. In most other situations where income is earned from professional services, the accrual basis will be appropriate.
6. When a person accounts **for income on a cash basis, that person's income is derived** when it is received. When a person accounts for income on an accrual **basis, that person's income is derived when it is earned.** The time at which income is earned may be evident from the contract. The cases show that determining when professional fees are earned can be broken down into the following questions:

- First, has the taxpayer performed the services required under the contract and discharged their obligations?
 - Second, is the taxpayer entitled under the contract to demand payment for the services provided?
7. If there is no contract or the terms of a contract do not determine when income is derived, then standard accounting principles and commercial practice may assist in determining when income from professional fees is derived. In particular, it will be necessary to determine whether:
- the income-earning process is complete;
 - the amount of income can be reasonably calculated; and
 - what has taken place satisfies the general understanding among practical business people of what constitutes a derivation of income.
8. In some situations, it may be necessary to change from a cash basis to an accrual basis or from an accrual basis to a cash basis. In these situations, s EG 2 provides rules for transitioning from one method to the other. The effect of applying s EG 2 is that all income is accounted for when a person moves from a cash basis to an accrual basis. When a person moves from an accrual basis to a cash basis, s EG 2 also prevents income from being double counted.

Introduction

9. This Interpretation Statement withdraws and replaces three items about when fees from professional services are derived:
- “When to Return **Directors’ Fees**” *Public Information Bulletin* Vol 37 (November 1966): 6 (PIB 37);
 - “Derivation of Income from Services for Income Tax Purposes” *Public Information Bulletin* Vol 159 (February 1987): 1 (PIB 159); and
 - “Derivation of Income from Services for Income Tax Purposes” *Public Information Bulletin* Vol 172 (March 1988): 1 (PIB 172).
10. PIB 159 and PIB 172 considered the rules for changing between accounting bases in the Income Tax Act 1976. This Interpretation Statement also withdraws and replaces “Whether Doctor Companies can Return Income Using the Cash Basis” *Tax Information Bulletin* Vol 9, No 6 (June 1997): 19 (TIB item on doctor companies).
11. This Interpretation Statement explains when a person derives income from **professional services**. The term “**professional services**” is used to describe someone who earns income from providing services to a third party through the exercise of personal skill and knowledge. Examples of professional services identified in the *Public Information Bulletin* items were accountants, architects, chiropractors, consultants, contractors, engineers, solicitors, surveyors, and veterinarians. The items also address barristers sole, medical practitioners and directors in more detail.

Analysis

12. This Interpretation Statement provides guidance on **when** income from professional services should be returned for tax purposes. This requires **determining when an amount of income has been “derived” for the purposes of the Act**. To determine when a person will be treated as deriving income from

professional services for tax purposes it is necessary to consider the following questions:

- When is the cash basis or the accrual basis appropriate?
 - When is income derived under the cash basis?
 - When is income derived under the accrual basis?
13. This Interpretation Statement then applies the general principles to medical practitioners, barristers sole, and directors (updating the *Public Information Bulletin* items on these professions). This Interpretation Statement also applies the general principles to professionals who operate through companies (updating the *TIB* item on doctor companies).
14. Finally, this Interpretation Statement addresses the consequences of changing between the cash basis and the accrual basis.

When is income from professional services derived?

15. To determine when income from professional services is derived, it is first necessary to consider the legislative requirements.

Derivation of income under the Act

16. Every amount of income must be allocated to an income year: s BD 3(1). The general rule is that an amount of income is allocated to the income year in which the amount is "derived": s BD 3(2). Income that has not previously been derived by a person will be treated as derived when it is credited in their account or dealt with in their interest or on their behalf: s BD 3(4).
17. If a provision in Parts C or E to I of the Act apply, then the income is allocated in accordance with that provision. Depending on the facts of each case, a provision in any of Parts C or E to I may determine when income is derived. This Interpretation Statement provides a general explanation of when income from professional fees is derived. This Interpretation Statement assumes that no provision in Parts C or E to I applies, unless expressly stated. Therefore, it is **necessary to determine when an amount of income has been "derived" according to general principles.**
18. To determine when an amount of income has been derived, s BD 3(3) states that regard must be had to case law, which:
- requires some people to recognise income on an accrual basis; and
 - requires some people to recognise income on a cash basis; and
 - more generally, defines the concept of derivation.
19. **The concepts of "cash basis" and "accrual basis" are explained at para 24.**
20. **The word "derived" is not defined in the Act.** In summary, the courts consider that "derived" means "flowing, springing, or emanating from, and is synonymous with the English tax expression 'arising or accruing': per Richardson J in *Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226 (CA) at [14]. The word "derived" means more than received; it connotes the source or origin, rather than the fund or place, from which the income was taken: *CIR v NV Phillips' Gloielampenfabriken* [1955] NZLR 868 (SC & CA).
21. There are two closely related aspects of the concept of derivation. The first is the source of the income. The source of the income is, for example, the contract or the circumstances from which the income arises. The second aspect is the time

at which the income is derived. It is this second aspect with which this Interpretation Statement is concerned.

Case law on derivation generally

22. The courts are reluctant to formulate a universal test for determining when an amount of income has been derived. Previous cases are helpful signposts, but the time at which income is derived will depend on the facts: *Hawkes Bay*. The aim is to identify the method that provides a substantially correct reflex of income: *Commissioner of Taxes (South Australia) v The Executor, Trustee and Agency Company of South Australia Ltd* [1938] 63 CLR 108 (*Carden's case*). Absolute precision is not required: *CIR v Farmers Trading Co Ltd* (1982) 5 NZTC 61,200 (CA). However, it is necessary to determine which method will produce the more accurate picture of a person's income: *Farmers Trading; Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064.
23. Derivation of income is governed by the principles followed in business and commerce: *Carden's case*. However, business and commercial concepts and principles are persuasive, but not determinative. While accounting standards are not determinative for income tax purposes, they will normally be the first point of inquiry. **Accounting standards tolerate a range of "reasonable" treatments.** However, for the purposes of the Act, only one method will be appropriate: the method that provides a substantially correct reflex of income: *Farmers Trading*.

When is the cash basis or the accrual basis appropriate?

24. As expressly noted in s BD 3(3), there are two main methods of determining when an amount of income has been derived: the cash basis and the accrual **basis (the term "method" is used to refer to both bases)**. The cash basis method of accounting for income is sometimes referred to as the receipts basis. Similarly, the accrual basis is sometimes referred to as the earnings basis. For ease of reference and in accordance with s BD 3(3), this Interpretation Statement will use the terms **"cash basis" and "accrual basis"**.
25. To determine when a person has derived income, it is necessary to identify the appropriate method of income recognition for the particular taxpayer. Under the cash basis, income is recognised only when it is received. Under the accrual basis, an amount of income is derived when it is earned, regardless of when it is actually received. When an amount of income is earned will depend on the particular facts and circumstances of each case.
26. There appear to be no cases that state that, as a matter of general principle, a person in any particular profession must account on a cash basis: *Federal Commissioner of Taxation v Dunn 89 ATC 4141 (FCA)*. The same is true for the accruals basis. Instead, as noted above, the courts will consider which method provides a substantially correct reflex of income: *Carden's case*. This Interpretation Statement discusses the various factors that indicate whether the cash basis or the accrual basis is appropriate.
27. The courts may consider a variety of factors when determining which method is appropriate for a particular business or profession. Not all factors will be relevant in every case. Also, in each case, the factors considered may be accorded differing weights. The factors the courts have considered can be grouped as follows:
 - the type of activity carried on by the taxpayer that gave rise to the income;
 - the characteristics of the type of income at issue;
 - the legal and regulatory environment in which the taxpayer operates;

- the scale of the business or income-earning activity; and
 - the level of sophistication or complexity of the business.
28. In each case, these factors must be weighed against one another to decide which method is appropriate. This Interpretation Statement explains each of these factors in more detail from para 29.

Type of activity carried on by the taxpayer

29. The courts will consider the manner in which the taxpayer carries out their **business that gave rise to the income**. For example, the taxpayer's regular method of contracting and doing business may indicate whether a cash or accrual basis is appropriate: *CIR v National Bank of New Zealand (1976) 2 NZTC 61,150* (CA).
30. The accrual basis will be more appropriate for most businesses, including professions: *Carden's case*. It is generally accepted that a trader or trading entity should account for income on an accrual basis: *Whitworth Park Coal Co. Ltd (in liq) v CIR* [1961] AC 31; *Fincon (Construction) Ltd v CIR* [1970] NZLR 462 (CA); *CIR v Farmers Trading*; *CIR v Morrison (1928-1933) 17 TC 325*; *Carden's case*. However, the courts have noted that there may be exceptions to this principle: *National Bank*; *Morrison*; *Carden's case*.
31. The courts have held that a cash basis may be appropriate in the following circumstances:
- an ordinary individual who does not carry on a trade, profession, or business: *Whitworth Park*; *Case F156* (1984) 6 NZTC 60,343;
 - a business or income earning activity involving a professional person marketing nothing but their own services and receiving nothing but professional fees: *Morrison*; *Carden's case*; *FCT v Firstenberg* 76 ATC 4141;
 - a business in which expenditure contributes to income in a subsidiary or minor degree: *Carden's case*; and
 - a business in which the risk of non-collectable trade debts is unusually high: *National Bank* per Cooke J.

Characteristics of the type of income at issue

32. The courts will also consider the characteristics of the type of income at issue, if it is relevant. For example, the courts have indicated that a cash basis may be appropriate when the:
- level of expectation of payment inherent in the type of income is typically low: *Carden's case*; *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (HCA); *Barratt & Ors v FCT* (1992) 92 ATC 4,275.
 - receipts are governed or affected by legislation such that there are restrictions on when fees can be recovered: *Australian Gas Light*; *Firstenberg*.
 - income represents a reward for professional skill and personal work: *Carden's case*; *Morrison*.

Legal and regulatory environment in which the taxpayer operates

33. For taxpayers in a profession, the legal and regulatory environment in which the taxpayer operates may be relevant. For example, the nature of the taxpayer's business may be shaped by the typical contractual obligations they enter into, or

constraints imposed on the taxpayer by their regular method of contracting and doing business. For example, in *Firstenberg*, McInerney J said at 4149:

Whether the remuneration is to be paid in advance of the performance of the service or from time to time during the performance of the service or only on the completion of the performance of those services is a matter which may be regulated by express or implied agreement between the professional man and the client.

34. In other situations, laws or regulations may affect when income is derived. In *Australian Gas Light* the taxpayer's business was heavily regulated and the circumstances of the taxpayer were described as being "exceptional". In this case the time of derivation was dictated by the statute governing the taxpayer's business.

Scale of the business or income earning activity

35. The scale of the business is relevant to determining the appropriate accounting method for a professional: *Henderson v FCT* 70 ATC 4016; *Firstenberg*; *Dunn*; *Barratt*. At one end of the spectrum is the substantial business operation carried on by a large accounting partnership, such as in *Henderson*. In that case, the accrual basis was the appropriate method for an accounting practice with 19 partners and 295 employees. At the other end of the spectrum, is the solicitor in *Firstenberg* who practised on his own account and employed one secretary. In that case, the cash basis was held to be appropriate.
36. Indicators of the scale of a business include the:
- number of employees and the nature of the work they undertake (that is, whether the employees contribute in only a subsidiary or minor way to the earning of income): *Henderson*; *Firstenberg*; *Dunn*; *Barratt*;
 - general size of the business (in *Henderson* the firm was conducted in various centres, was the largest firm in Western Australia, and one of the largest firms in Australia); and
 - total amount of fees earned and disbursements made: *Henderson*.
37. Where the number of employees is very low or nil, the business is small in size and the total amount of fees earned and disbursements made is low, those factors would indicate that a cash basis might be more appropriate. Otherwise, the accrual basis will be appropriate.
38. In considering the scale of a business, it is necessary to look at the whole of the arrangements. For example, in *Barratt*, the taxpayers were members of a partnership that undertook a pathology practice. Services such as the collection and testing of pathological samples and various nursing, secretarial and courier services were provided to the partnership through a service company that also purchased equipment and was the employer of staff. The shareholders and directors of the service company were the spouses of the partners. The court held that the accruals basis was appropriate. The court based its decision on the following:
- while the partners rendered professional services directly, most of the work from which income was derived was done by nurses and qualified technicians;
 - large and expensive plant was used; and
 - a large number of staff were employed involving significant expenditure.

Level of sophistication or complexity of the business or income-earning activity

39. The level of sophistication or complexity of the **taxpayer's** business or accounts may indicate which method is appropriate. In terms of the complexity of the business, an accrual basis may be more appropriate for a business that involves fixed or circulating capital: *Carden's case*; *Firstenberg*. Another example might be the level of a taxpayer's trade debts: *Whitworth Park*; *Case F156*. The need to account for trade debts often indicates that an accrual basis will be appropriate. However, a cash basis may be appropriate for a business in which the risk of non-collectable trade debts is unusually high (as suggested in an obiter comment by Cooke J in *National Bank*) or where there is little certainty about the payment of fees (as suggested by Dixon J in *Carden's case* in relation to a medical practice).
40. The level of sophistication or complexity of the **taxpayer's accounts** may also indicate which accounting method is appropriate: *Dunn*. However, as previously noted, the **taxpayer's accounting** treatment is not determinative. Nevertheless, the Australian courts have suggested that an accrual basis may be appropriate for a professional when:
- the taxpayer accounts for work in progress and carries the value of that work into a balance sheet at the end of the year: *Dunn*;
 - it is necessary to distinguish between income on capital account or income on revenue account: *Firstenberg*; and
 - it is necessary to ascertain the "capital account" or the "loan account" of the taxpayer: *Firstenberg*.

Summary

41. In summary, the cash basis will be appropriate for very small-scale professions. Some other indications that a cash basis may be appropriate include:
- the income received represents a reward for professional skill and personal work;
 - expenditure contributes to income in a minor way;
 - the level of expectation of payment inherent in the type of income is typically low;
 - there are no employees;
 - if there are employees, they are few and they contribute in only a subsidiary or minor way to the earning of income (an example might be an administrative assistant); and
 - sophisticated or complex financial accounts are not required.
42. It is necessary to weigh up all the factors in any particular case to determine whether the cash basis is appropriate. The ultimate question is whether the cash basis provides a substantially correct reflex of income.
43. The accrual basis will be appropriate in all other circumstances.

When is income derived under the cash basis?

44. **If a person accounts for income on a cash basis, that person's income is derived** when it is received. As stated by Dixon J in *Carden's case* at 155, "the object is to discover what gains have during the period of account come home to the taxpayer in a realized or immediately realizable form".

45. Income that has not previously been derived by a person will be treated as derived when it is credited in their account, or in some other way, dealt with in their interest or on their behalf: s BD 3(4).

Expenditure

46. This Interpretation Statement is concerned with when income is recognised for tax purposes. However, it is important to note that determining when expenditure is recognised for tax purposes is governed by subpart DA. Section DA 1 does not distinguish between the cash basis and the accrual basis for recognition of expenditure. The test is whether the expenditure has been incurred. The courts have defined the term **"incurred"** to mean **"definitively committed to"**: *FCT v James Flood* (1953) 88 CLR 492; *CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351 (PC). As a result, a person accounting on a cash basis may recognise expenditure before it is actually paid.

When is income derived under the accrual basis?

47. Richardson J (who delivered the judgment for the Court of Appeal) explained the accrual basis in *Farmers Trading*. Richardson J said that the essence of the accrual concept is that both revenue and costs are:
- accrued (that is, recognised as they are earned or incurred, not as money is received or paid);
 - matched with one another so far as their relationship can be established or justifiably assumed; and
 - dealt with in the profit and loss account of the period to which they relate.
48. Under the accrual basis income is returned at the point at which revenue is **"earned"**, independently of the date payment is made or becomes due: *Hawke's Bay*.
49. There appear to be no New Zealand cases that consider when a professional earns income. However, this issue has been considered in Australia. In addition, the courts in both Australia and New Zealand have considered when income is **"earned" more generally**.
50. The courts have used various terms to attempt to define the time when income is earned. In Australia, when determining when income from professional services has been derived, the courts have tended to identify the point at which a **"recoverable debt"** arises (*Henderson, Firstenberg, Barratt*). In New Zealand, the courts have referred to a time when there is an **"entitlement to bill"** (*Hawkes Bay, PIB 159*). Ultimately, however, regardless of the terminology that is used, the cases show that **a taxpayer's** earning process is complete when the activity that gives rise to a debt is complete, and no further steps are required to be taken by the taxpayer before being entitled to payment: *Australian Gas Light; Hawke's Bay; Egmont Cooperative Dairies Ltd (In Liq) v CIR* (1996) 17 NZTC 12,536. That is, no contingencies or conditions precedent affect the **taxpayer's** right to demand payment: *Australian Gas Light; Egmont*.
51. Therefore, the cases show that determining when professional fees are earned can be broken down into the following questions:
- First, has the taxpayer performed the services required under the contract and discharged their obligations?
 - Second, is the taxpayer entitled under the contract to demand payment for the services provided?

52. If there is no contract or the terms of a contract do not determine when income is derived, then standard accounting principles and commercial practice may assist in determining when income from professional fees is derived. In particular, it will be necessary to determine whether:
- the income earning process is complete;
 - the amount of income can be reasonably calculated; and
 - what has taken place satisfies the general understanding among practical business people of when income is derived.

53. These tests are discussed in more detail below.

Terms of the contract

54. Generally, the terms of the contract between the professional and the client (where an express contract exists) will determine when an amount of income is derived: *HW Coyle Ltd v CIR* (1980) 4 NZTC 61,558; *Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064.
55. In *Hawkes Bay*, the Court of Appeal held (at 15,232) that the terms of the **contract were a “complete answer” to the question of when the taxpayer derived** income. Under the contract in that case, the consumers used electricity and contractually accepted responsibility to pay for it. **The consumers’ liability to pay** arose when they consumed electricity. For its part, the company supplied and sold that electricity and was contractually entitled to read the meter at any time or estimate the usage and render a bill on balance date. While this was not a case about professional services income, the principles can also be applied to professional services situations.
56. Where a contract expressly provides for payment, a taxpayer can be regarded as having only derived income to which they are contractually entitled: *Horizon, Hawkes Bay*. This means that where the contract provides for progress payments, those amounts will be derived only when they are due under the contract. If no payments are due under the contract until completion, the taxpayer cannot derive income to which they are not yet contractually entitled: *Horizon*.
57. The point at which a professional is entitled to demand payment for their services may be apparent in the terms of an express agreement. If there is no express agreement, the right to demand payment may arise periodically (progress billings) or when the work is completed, depending on the facts. Where the contract expressly provides for the time at which the person is entitled to payment of the amount, that time will generally indicate when the income will be derived. Where there is no express agreement, standard accounting principles and business and commercial practice will be relevant to determining the time of derivation of an amount of income.
58. The legal and regulatory environment may also affect the time that income is derived under the contract: *Australian Gas Light Co; Firstenberg*. For example, in *Australian Gas Light*, **the taxpayer’s business was heavily regulated**. The taxpayer was prohibited from demanding payment before the end of the billing periods imposed by statute. The taxpayer only accounted for amounts relating to gas consumed up to 30 June where the relevant meter had been read and an account based on that reading had been issued. The Federal Commissioner of Taxation argued that amounts relating to the gas consumed up to 30 June, but not yet billed, were amounts of assessable income (that is, an accrual basis). The court held that until the taxpayer was entitled under statute to read meters and render bills for gas consumed, the amounts had not been derived.

Standard accounting principles and commercial practice

59. Although expressed in various ways, the courts in New Zealand and Australia have consistently looked to generally accepted accounting principles and commercial practice in determining when income is derived. However, such concepts and principles are only persuasive and are not determinative: *Horizon; Dunn; Barratt; BHP Billiton Petroleum (Bass Strait) Pty Ltd v FCT* (2002) ATC 5169.
60. In *Farmers Trading* Richardson J noted that generally accepted accounting principles are not a “canonical set of rules”. Instead, they tolerate a variety of reasonable treatments. While accounting standards will be relevant (and often highly persuasive) only one correct time of derivation will be correct for tax purposes.
61. It is important to note that the cases take account of the standard accounting principles that applied at the time of each decision. Standard accounting principles may change and may be different depending on the standards applied by a particular taxpayer (for example, some taxpayers are subject to the International Financial Reporting Standards).

Summary

62. Income from professional services is derived when it is earned. Income from professional services is earned according to the terms of the contract. The cases show that the earning process is complete when the activity that gives rise to a debt is complete and no further steps are required to be taken before being entitled to payment. **Essentially, income is earned (and therefore “derived”) when the taxpayer:**
- has performed the services required under the contract and discharged their obligations; and
 - is entitled under the contract to demand payment for the services provided.
63. If there is no contract, or the terms of a contract do not determine when income is derived, then standard accounting principles and commercial practice may assist in determining when income from professional fees is derived. In particular, it will be necessary to determine whether:
- the income-earning process is complete;
 - the amount of income can be reasonably calculated; and
 - what has taken place satisfies the general understanding among practical business people of when income is derived.
64. Many professionals keep a record of their time as unbilled work in progress (“WIP”). **The total of unbilled WIP will not usually represent income of a taxpayer.** Instead, the principles stated above will need to be applied to determine the extent to which unbilled WIP can be regarded as income derived.

Prepayments

65. In some circumstances, professionals may be paid amounts prior to having performed any services, for example, by way of an advance, or to be held on trust until the services are performed. Where a professional receives payment in advance of services being provided, the income will not be derived until the professional discharges the obligations for which they have received payment (*Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 (HCoA)). The obligations that must be discharged will depend on the

terms of the relevant contract. This principle applies to taxpayers who account on either a cash basis or an accruals basis.

How do the general principles apply to medical practitioners, barristers sole, and directors?

66. *PIB 159* set out general principles of derivation for professionals. The implication from *PIB 159* was that professionals, other than medical practitioners and barristers sole, must account for income on an accrual basis. In addition, *PIB 37* stated that directors generally account for income on a cash basis. *PIB 37* went on to say that a director may account for income on an accrual basis if it had been their practice to do so.
67. However, as discussed, no general rule of law requires any particular profession to account for income using one method or the other. In addition, the correct method is not a matter of choice or practice. Instead, it is a question of fact having regard to the nature of the business or income earning activity of any given professional and the factors outlined in [27].

Medical practitioners

68. Having regard to the factors outlined in this Interpretation Statement, a medical **practitioner's practice may vary in scale**. Such practices range from single doctors practising on their own, to groups of doctors practising together and sharing administration costs, to large corporate groups with many employees. In addition, **the level of sophistication and complexity among medical practitioners' practices varies widely**. Finally, medical practitioners typically contract for their services and there appear to be no legal restrictions on the recovery of fees.
69. Because medical practices vary widely in scale, complexity and sophistication, no particular method will apply to all medical practitioners. Therefore, the Commissioner considers that the principles as outlined above should be applied to **each medical practitioner's circumstances** to determine the correct reflex of their income.
70. Having regard to the general nature of a medical practice, a medical practitioner who practices as a sole practitioner on a small scale, with no employees (other than, for example, an administrative assistant or secretary who does not bring in fee income) can account on the cash basis. This may also be the case where, while the medical practitioner practises with a group of other medical practitioners in shared premises, they still account for their income on an individual, or sole practitioner, basis. Other medical practitioners who operate through a larger structure should, in most cases, account for income on an accrual basis. This is because the accrual basis is generally appropriate for most businesses, including professions.

Barristers sole

71. **A barrister sole's practice is usually small in scale. That is**, they are sole practitioners, who often operate in chambers with other barristers sole to share administration costs. A barrister may also operate through an incorporated law firm. However, the Lawyers Conduct and Client Care Rules state that the barrister must be the sole director and voting shareholder. Therefore, a barrister's practice will generally be small in scale.
72. The income a barrister sole earns is predominantly (if not exclusively) fees from personal services or legal aid payments. In addition, the legal and regulatory environment surrounding a barrister's practice places significant limits on

recovery of fees. Given that payment is sometimes uncertain, these limits mean it is not always prudent to account for fees before they are received.

73. Having regard to the general **nature of a barrister sole's practice**, and to provide a true reflex of their income, it is expected that the cash basis would generally be appropriate. This is because most barristers sole are analogous to the sole-practice taxpayers in *Carden's case* and *Firstenberg*.
74. Some barristers may operate a more sophisticated practice on a larger scale than other barristers. Therefore, it is conceivable that the accrual basis may, in some situations, provide a correct reflex of a **barrister's income**. However, barristers cannot operate through partnerships or companies (unless they are the sole director and voting shareholder), so there are limits on how large in scale a practice can be. A barrister who operates through an incorporated law firm, should also generally account for income on a cash basis. This is because they are still required to operate within the same professional restrictions (ie, they must still operate on their own), whether they are incorporated or not.

Directors

75. **The scale of a director's operations may vary.** The general principles as outlined in this Interpretation Statement should be applied to the particular circumstances of each director. A director generally provides their services personally. The fees directors earn are received in return for providing specialist knowledge and skill. Most directors would hold one or a small number of directorships. This indicates that the cash basis will generally be the appropriate method.
76. However, some directors may be involved in larger scale operations. Alternatively, some directors might operate through a company as a consultant. These directors might be appointed to multiple boards by virtue of their special expertise. In these situations, the accrual basis likely provides the correct reflex of income.

How do the general principles apply to professionals who operate through companies?

77. Many professionals operate through companies. The *TIB* item on doctor companies stated at 19 **that all "doctor companies" must return income on an accrual basis. This is because "the predominant requirement before the cash basis can be used is for the taxpayer's income to be earned as a result of his or her personal exertions"**.
78. The Commissioner considers that there is no general rule of law that prohibits a company run by a professional in sole practice from accounting for its income on a cash basis. This is provided the professional is the only person providing the services and the scale and sophistication of the business otherwise indicated that the cash basis is appropriate. The derivation of income from personal exertion is one indication that a cash basis is appropriate. Although a company does not provide services personally, the cash basis may still be appropriate for one person providing services through a company where the small scale of the operation would otherwise indicate that the cash basis is appropriate. As discussed in this Interpretation Statement, other factors may, on balance, indicate a cash basis is appropriate.
79. The cash basis is still potentially appropriate for barristers in an incorporated law firm. This is because restrictions are imposed on barristers sole, whether they are incorporated or not. This could reasonably be extended to other professionals who operate their sole practice through a company on a small scale and with a low level of complexity. For example, a sole director who operates through a

company is able to account on a cash basis, provided there are no circumstances that indicate that an accrual basis would provide a more correct reflex of income. This is a modification of the view taken in the *TIB* item on doctor companies, which stated that a doctor company must always account on an accrual basis.

What are the consequences of a change in method?

80. In some situations, it may be necessary to change from a cash basis to an accrual basis or from an accrual basis to a cash basis. In these situations, s EG 2 provides rules for transitioning from one method to the other. The effect of applying s EG 2 is that all income is accounted for when a person moves from a cash basis to an accrual basis. When a person moves from an accrual basis to a cash basis, s EG 2 also prevents income from being double counted.
81. When a person moves from a cash basis to an accrual basis, s EG 2(2) requires that amounts owed to the person on the last day of the income year before the year of change is returned as income in the year of change. In addition, an amount owed by the person on the last day of the income year before the year of change is allowed as a deduction in the year of change.
82. When a person moves from an accrual basis to a cash basis, s EG 2(3) provides that the total of all amounts owing by the person in the year of change (that have been allowed as a deduction in earlier income years) is income of the person in the year of change. In addition, the total of all amounts owing to the person in the year of change (that have been treated as income of the person in earlier income years) is allowed as a deduction in the year of change.
83. The amount arising from these adjustment calculations in ss EG 2(2) and (3) is either income under s CH 4 or a deduction under s DB 52.

Meaning of the phrases "amounts owed" and "amounts owing"

84. PIB 172 states that the phrase "amounts owing to", used in a predecessor section to s EG 2, contemplates that a debt has already been established, rather than the "entitlement to bill" concept which is the basis of PIB 159.
85. The precise meaning of the term "owe" (and its derivatives, "owed", "owes", and "owing") will often depend on the context in which the term is used. The words "owed" or "owing" can mean "yet to be paid" or they can mean "due". It is possible for an amount to be owing but not yet due (for example, when the time for payment of a debt has not yet passed): *Bank of New Zealand v Baker* [1926] NZLR 462; *Perrott v Newtown King Ltd* [1933] NZLR 1131.
86. For the purposes of s EG 2, the Commissioner considers that an amount that is "owed" or "owing" is an amount that a person is obligated to pay immediately or in the future to a person who has a right to have it paid to them. An amount "owed" or "owing" to a taxpayer can include amounts for which a person is entitled to demand payment (but for which payment has not yet been demanded, for example, with an invoice). This is consistent with the purpose of s EG 2 to ensure that all income is accounted for, and there is no double counting of income when a person moves from one method to the other. This can also be said to be consistent with the time income is "earned" as discussed above. This position is changed from that stated in PIB 172.

References

Related rulings/statements

- 'Derivation of Income from Services for Income Tax Purposes' *Public Information Bulletin* Vol 159 (February 1987): 1;
- 'Derivation of Income from Services for Income Tax Purposes' *Public Information Bulletin* Vol 172 (March 1988): 1
- 'When to return directors' fees' *Public Information Bulletin* Vol 37 (November 1966): 6;
- 'Whether doctor companies can return income using the cash basis' *TIB* Vol 9, No 6, June 1997: 19

Legislative references

Income Tax Act 2007, ss BD 3, EG 2

Subject references

Barristers sole
Derivation
Directors
Income
Income Tax
Medical practitioners
Professional fees

Case references

- Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (HCA)
- Bank of New Zealand v Baker* [1926] NZLR 462
- Barratt v FCT* (1992) 92 ATC 4,275
- BHP Billiton Petroleum (Bass Strait) Pty Ltd v FCT* 2002 ATC 5169

- CIR v Morrison (1928-1933)* 17 TC 325
- Case F156* (1984) 6 NZTC 60,343
- CIR v Farmers Trading Co Ltd* (1982) 5 NZTC 61,200 (CA)
- CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351 (PC)
- CIR v Morrison* (1928-1933) 17 TC 325
- CIR v National Bank of New Zealand* (1976) 2 NZTC 61,150
- CIR v NV Phillips' Gloielampenfabriken* [1955] NZLR 868 (SC & CA)
- Commissioner of Taxes (South Australia) v The Executor, Trustee and Agency Company of South Australia Ltd* [1938] 63 CLR 108
- Egmont Cooperative Dairies Ltd (in liq) v CIR* (1996) 17 NZTC 12,536
- FCT v Firstenberg* 76 ATC 4141
- FCT v James Flood* (1953) 88 CLR 492
- Federal Commissioner of Taxation v Dunn* 89 ATC 4141 (FCA)
- FCT v Australian Gas Light Co* 83 ATC 4800
- Fincon (Construction) Ltd v CIR* [1970] NZLR 462 (CA)
- Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226 (CA)
- Henderson v FCT* 70 ATC 4016
- Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064 (HC)
- HW Coyle Ltd v CIR* (1980) 4 NZTC 61,558
- Perrott v Newtown King Ltd* [1933] NZLR 1131
- Whitworth Park Coal Co Ltd (In liq) v C of IR* [1961] AC 31

Appendix – Legislation

Income Tax Act 2007

1. Section BD 3 provides:

BD 3 Allocation of income to particular income years

Application

(1) Every amount of income must be allocated to an income year under this section.

General rule

(2) An amount of income is allocated to the income year in which the amount is derived, unless a provision in any of Parts C or E to I provides for allocation on another basis.

Interpretation of derive

(3) When the time of derivation of an amount of income is being determined, regard must be had to case law, which—

- (a) requires some people to recognise income on an accrual basis; and
- (b) requires other people to recognise income on a cash basis; and
- (c) more generally, defines the concept of derivation.

Income credited in account

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

Role of Part E

- (5) Part E (Timing and quantifying rules) contains a number of provisions that—
- (a) specifically modify the allocation of income or have the effect of modifying the allocation of income; or
 - (b) allocate income as part of the process of quantifying it.

Single allocation

(6) An amount of income may be allocated only once.

2. Section EG 2 provides:

EG 2 Adjustment for changes to accounting practice

When this section applies

- (1) This section applies in an income year (the year of change) when a person changes from—
- (a) a cash accounting method to an accrual accounting method of calculating their income tax liability; or
 - (b) an accrual accounting method to a cash accounting method of calculating their income tax liability.

From cash to accrual accounting method

- (2) If subsection (1)(a) applies,—
- (a) an amount owed to the person on the last day of the income year before the year of change is income of the person in the year of change; and
 - (b) an amount owed by the person on the last day of the income year before the year of change is allowed as a deduction in the year of change.

From accrual to cash accounting method

- (3) If subsection (1)(b) applies,—
- (a) an amount equal to the total of all amounts owing by the person in the year of change that have been allowed as a deduction in earlier income years is income of the person in the year of change; and

- (b) an amount equal to the total of all amounts owing to the person in the year of change that have been treated as income of the person in earlier income years is allowed as a deduction in the year of change.

Some definitions

- (4) In this section,—

accrual accounting method means a method of accounting that is regarded as accrual accounting under generally accepted accounting practice

cash accounting method means a method of accounting by which the income tax liability of a person is calculated by reference to cash receipts or outgoings.