

QUESTION WE'VE BEEN ASKED

QB 19/04

Income tax – provisional tax and use of money interest implications for a person in their first year of business

This Question We've Been Asked (QWBA) has arisen because the provisional tax rules in the Income Tax Act 2007 apply to a "taxable activity". Taxable activity is a term borrowed from the Goods and Services Tax Act 1985.

Question

When should a person pay tax in their first year of business to prevent use-of-money interest charges?

Answer

A person who starts a business and has residual income tax of \$60,000 or more should pay provisional tax in one to three equal instalments (dependent on the start date) to prevent use-of-money interest charges.

A person who starts a business and has residual income tax of less than \$60,000 must pay the residual income tax for their first year of business by the terminal tax date to prevent use-of-money interest charges.

Key provisions

Goods and Services Tax Act 1985, s 6
Income Tax Act 2007, ss RC 3(3), RC 9(9), YA 1 ("initial provisional tax liability" and "taxable activity")
Tax Administration Act 1994, ss 3(1) ("new provisional taxpayer"), 120KC

Key terms

Provisional tax: income tax paid as instalments
Residual income tax: income tax liability minus tax credits
Terminal tax date: the date terminal tax is due
Use-of-money interest: money charged on late or underpaid tax or paid for overpaid tax

Explanation

1. The provisional tax rules apply to a person who is required or chooses to pay provisional tax. A person has no obligation to pay provisional tax for a tax year, if their residual income tax for the preceding tax year is \$2,500 or less. But when a person starts a taxable activity that results in residual income tax of \$60,000 or more in their first year they become a new provisional taxpayer and need to pay provisional tax instalments, or they will be exposed to use-of-money interest. The number of instalments required depends on when the business commenced. Use-of-money interest under s 120KC of the Tax Administration Act 1994 (TAA), is charged on any instalment shortfalls or paid on any instalment overpayments.

2. Originally, a “new provisional taxpayer” was a person who was GST registered and starting a taxable activity. However, this first requirement was removed in 2007 to ensure that someone who was not GST registered could also be treated as a new **provisional taxpayer**. But the requirement to “start a taxable activity” was left in.
3. The same term is also used in the resident withholding tax rules where it was thought **necessary to use the GST definition of “taxable activity” with its inclusion of the phrase “whether or not for pecuniary profit” to capture the activity of the not-for-profit sector** that is liable for income tax when income exceeds \$1,000. The same approach applies to the provisional tax rules.
4. **The GST concept of “taxable activity” is used for determining liability to pay provisional tax** when starting a business. It includes anything done in connection with the beginning or ending of a taxable activity as well as any activity carried on continuously or regularly, irrespective of profit, involving or intended to involve the supply of goods and services.
5. However, unlike for GST, taxable activity also applies to the making of exempt GST supplies, such as financial services or providing residential accommodation. This is because income tax is payable on income arising from such activities but not GST.
6. The sort of questions that can arise include the following:
 - What sort of preliminary activities might, or might not, be treated as taxable activities?
 - What happens if an intention exists to carry on a business that then comes to a premature end?
 - If a start-up business has been running at a loss for several years and finally comes into profit will they be treated as starting a taxable activity in that profit year?
7. Numerous court decisions have explored **what is meant by “taxable activity”** in the GST context. These decisions can be equally applied to determine whether a person is starting a taxable activity for the purposes of s RC 9(9) of the Income Tax Act 2007 (ITA). That section applies to a **person with an “initial provisional tax liability”**, an expression defined in s YA 1 of the ITA that also **means a “new provisional taxpayer”** in the TAA.

Meaning of initial provisional tax liability

8. **A person with an “initial provisional tax liability” under s RC 9(9) of the ITA is also described as a “new provisional taxpayer” in s 3(1) of the TAA.** Section YA 1 defines the term:

initial provisional tax liability, means—

 - (a) for a person who is not a natural person, a provisional tax liability for a tax year in which the person starts to derive income from a taxable activity when—
 - (i) they did not derive income from a taxable activity in any of the 4 previous tax years; and
 - (ii) they have residual income tax of \$60,000 or more in the tax year; and
 - (b) for a person who is a natural person, a provisional tax liability for a tax year when—
 - (i) they did not have residual income tax of more than \$2,500 in any of the 4 previous tax years; and
 - (ii) they have residual income tax of \$60,000 or more in the tax year; and

- (iii) in the tax year, they stopped deriving income from employment and then started to derive income from a taxable activity

9. This **Question We've Been Asked** focuses on the meaning of taxable activity and the residual income tax threshold for exposure to use-of-money interest. It, therefore, assumes the remaining requirements for having an initial provisional tax liability, as defined above, have been met. For example, it only applies to an individual who has stopped deriving income from employment and to taxpayers with residual income tax of \$60,000 or more.
10. Section RC 9(9) of the ITA exposes new provisional taxpayers to use-of-money interest if they do not pay provisional tax on the number of provisional tax instalment dates determined by the start date of the taxable activity:

Persons with initial provisional tax liability

- (9) A person with a new provisional tax liability who starts a taxable activity in a tax year is liable to pay interest calculated under section 120KC of the Tax Administration Act 1994 as if they were liable to pay provisional tax for the tax year—
 - (a) in 3 instalments under subsection (3) if they start a taxable activity at some time in the period that starts at the beginning of the corresponding income year and ends 30 days before the date of instalment B:
 - (b) in 2 instalments—
 - (i) in a case to which section RC 13 applies; or
 - (ii) if they pay GST on a 6-monthly basis and start a taxable activity at some time in the period that starts at the beginning of the corresponding income year and ends 30 days before the date of instalment C:
 - (c) in 1 instalment in a case to which section RC 14 applies. [Emphasis added]
11. For taxpayers with a standard 31 March balance date, provisional tax instalments are on 28 August (P1), 15 January (P2) and 7 May (P3). The instalments referred to in s RC 9(9)(a) will be on these dates for such a taxpayer.
12. The expression “[a] **person with a new provisional tax liability**” is not defined in the ITA. However, the heading of s RC 9(9), “**Person with initial provisional tax liability**”, is an aide to the interpretation of this phrase. Section 5 of the Interpretation Act 1999 indicates that the meaning of an enactment must be ascertained from its text and in the light of its purpose. Headings may be considered as an indicator to the meaning of the provision.
13. The TAA defines a “new provisional taxpayer” in s 3(1) as a person who has an initial provisional tax liability as described in s YA 1 of the ITA. A person with an initial provisional tax liability is identified in s RC 9(9) as a person with a new provisional tax liability. Consequently, all three terms have the same meaning.
14. Section RC 9(9), from the 2018 tax year, treats both individuals and non-natural persons (such as companies) as new provisional taxpayers when they start a new taxable activity and have residual income tax of \$60,000 or more. They usually will have no obligation to pay provisional tax under s RC 3(3), because **their prior year's** residual income tax was \$2,500 or less. But if they do not make one to three equal instalments of provisional tax (depending on the start date of the taxable activity) as set out in s 120KC of the TAA, they will be exposed to use-of-money interest on any shortfall. Overpayments at these instalment dates will entitle new provisional taxpayers to receive interest.

Meaning of taxable activity

15. In the provisional tax rules, “taxable activity” is defined as having the same meaning as it has in s 6 of the Goods and Services Tax Act 1985 (GSTA) except that the exclusion in s 6(3)(d) (the making of exempt supplies) does not apply. GST exempt supplies such as financial services are subject to income tax, so the GST exclusion for these supplies is not relevant for provisional tax purposes.
16. Section 6(1)–(3)(d) of the GSTA defines “taxable activity”:
- (1) For the purposes of this Act, the term taxable activity means—
 - (a) any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club;
 - (b) without limiting the generality of paragraph (a), the activities of any public authority or any local authority.
 - (2) Anything done in connection with the beginning or ending, including a premature ending, of a taxable activity is treated as being carried out in the course or furtherance of the taxable activity.
 - (3) Notwithstanding anything in subsections (1) and (2), for the purposes of this Act the term taxable activity shall not include, in relation to any person, —
 - (a) being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or
 - (aa) not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby; or
 - (b) any engagement, occupation, or employment under any contract of service or as a director of a company, subject to subsection (4); or
 - (c) any engagement, occupation, or employment—
 - (i) pursuant to the Members of Parliament (Remuneration and Services) Act 2013 or the Governor-General Act 2010;
 - (ii) as a Judge, Solicitor-General, Controller and Auditor-General, or Ombudsman;
 - (ia) pursuant to an appointment made by the Governor-General or the Governor-General in Council and evidenced by a warrant or by an Order in Council or by a notice published in the *Gazette* in accordance with section 2(2) of the Official Appointments and Documents Act 1919;
 - (iii) as a Chairman or member of any local authority or any statutory board, council, committee, or other body, subject to subsection (4); or
 - (d) any activity to the extent to which the activity involves the making of exempt supplies.

[Emphasis added]

17. The words in bold text are particularly relevant to the question asked. To be a “taxable activity”, the activity is described as:
- being carried on continuously or regularly;
 - whether or not for pecuniary profit;
 - involving or intended to involve, in whole or part, the supply of goods and services; and

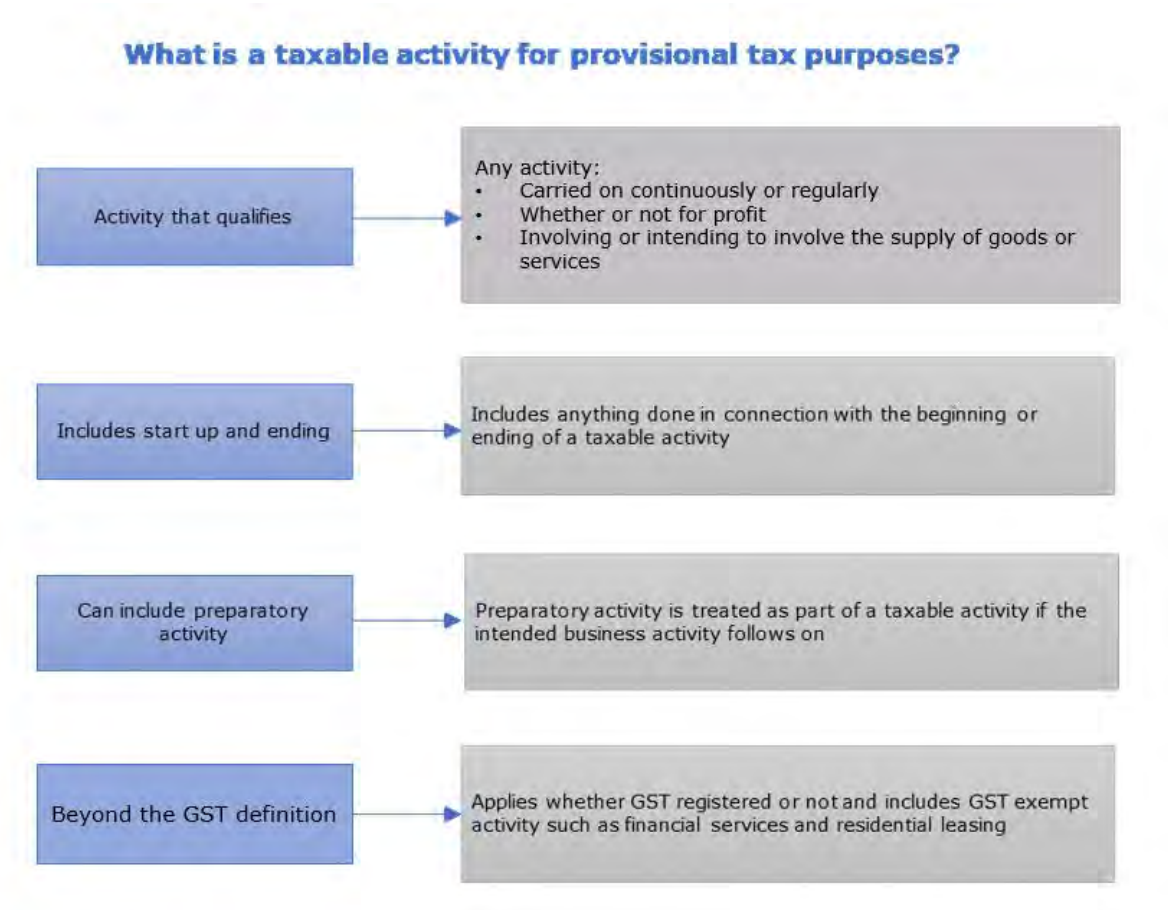
- includes anything done in connection with the beginning or ending (including a premature ending) of the taxable activity.
18. The courts have clarified the meaning of “**activity**” and what is meant by the phrase “**carried on continuously or regularly**”, and these are now well understood. Activity is a broad concept involving a combination of tasks undertaken, or a course of conduct pursued by, the taxpayer: *CIR v Newman* (1995) 17 NZTC 12,097 (CA), per Gault J at [32] and *CIR v Bayly* (1998) 18 NZTC 14,073 (CA), per Richardson P at [23].
 19. To be carried on “continuously or regularly”, the activity must not have ceased in a permanent sense or have been interrupted in a significant way. It must be carried on at reasonably short intervals with a steadiness or uniformity of action so that it recurs or is repeated at fairly fixed times or at generally uniform intervals to be of a habitual nature and character: *Newman* per Richardson J at [20]; *Case N27* (1991) 13 NZTC 3,229 (TRA), Judge Bathgate at [26] and [27]; *Allen Yacht Charters Ltd v CIR* (1994) 16 NZTC 11,270 (HC).
 20. The activity must involve, or be intended to involve, the supply of goods or services for consideration.
 21. Judge Bathgate in *Case N27* at [28] noted the actual supply of goods and services is not necessary so long as there is an intention to be involved in that supply. He considered this introduced a subjective element to an otherwise objective provision. It would then be “**a matter of fact and degree to be ascertained from all the evidence in a particular case**”. If no actual supplies are made, there may still be a taxable activity if there is an intention that the activity will involve the making of supplies.
 22. Judge Barber considered the application of s 6(2) of the GSTA in *Case P73* (1992) 14 NZTC 4,489 (TRA), concluding that commencement work can be only added under that provision to the establishment of a taxable activity. Commencement work cannot by itself amount to a taxable activity. Therefore, if something is done in connection with the beginning of a taxable activity, that beginning activity is treated as part of that taxable activity. However, if no taxable activity is subsequently commenced, the commencement actions are not sufficient on their own to be treated as a taxable activity.

Summary

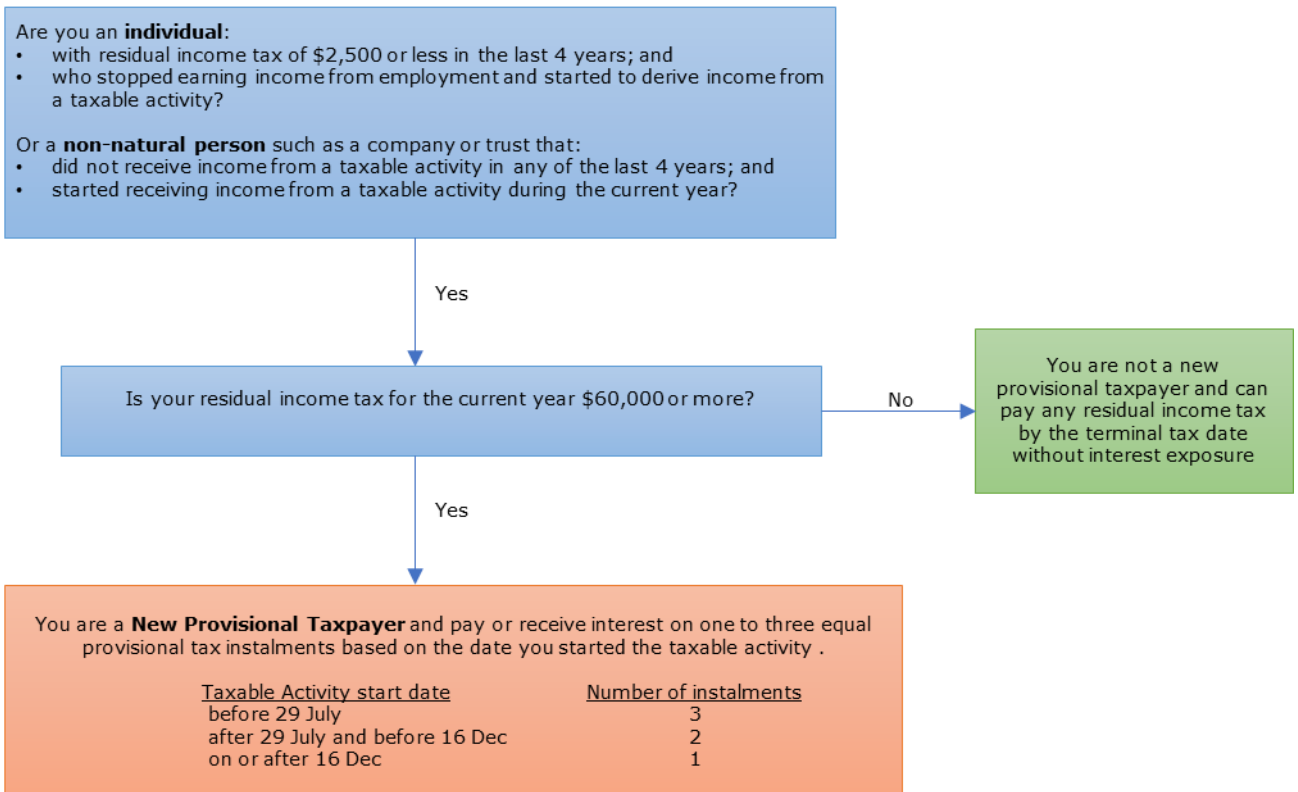
23. The start of a taxable activity is a concept well understood in the GST context and it also applies to the provisional tax rules. It includes anything done in connection with the beginning or ending of a taxable activity as well as any activity carried on continuously or regularly, irrespective of profit, involving or intended to involve the supply of goods and services. Under the provisional tax rules, a taxable activity includes GST-exempt supplies and applies to persons who are not GST registered.
24. When a new provisional taxpayer starts a taxable activity, they will have an exposure to use-of-money interest where their residual income tax in that year is \$60,000 or more if they do not pay one to three instalments on the provisional tax instalment dates as set out in s RC 9(9) of the ITA in conjunction with s 120KC of the TAA. Where two or three instalments are required, each payment must be of equal amounts. Where only one payment is required, it must be a lump sum payment on or before the third instalment date. This is despite a new provisional taxpayer not having an obligation to pay provisional tax under s RC 3(3) **where their prior year’s** residual income tax was \$2,500 or less.
25. A new provisional taxpayer starting a taxable activity with residual income tax in that first year below \$60,000 will, because of s 120KE of the TAA, be exposed to use-of-money interest only if they do not pay the residual income tax by the terminal tax date.

The terminal tax date is on 7 February of the following year for taxpayers with a 31 March balance date whose tax account is not linked to an agent with an extension of time arrangement.

26. The following flowcharts and examples illustrate these points:



Exposure to use-of-money interest when starting a new business?



Examples

Example 1 – New business deriving only passive income with residual income tax of \$60,000 or more

Facts: Marnie Oil Ltd is established on 1 April 2018 and crowd-funds to grow plantation mānuka on the East Cape for mānuka oil production. It raises capital of \$6 million that it invests at 4%, resulting in income of \$240,000 and \$67,200 residual income tax by 31 March 2019 (it holds a resident withholding tax exemption certificate). In the next tax year, it secures a forestry right over a block of land and begins planting with a view to harvesting and pressing leaves in years 4–10. It will also earn a share of income from bee-hives placed on the property by a mānuka honey producer.

Question: Did Marnie Oil have an “initial provisional tax liability” for the 2019 tax year?

Answer: Yes. Marnie Oil has residual income tax exceeding \$60,000 at 31 March 2019. It has not at that date commenced a taxable activity, but it has raised capital and earned passive income on that capital while preparing to commence the mānuka plantation. This preparatory work in year 1 is treated as being the start of the taxable activity subsequently commenced in year 2, and Marnie Oil also had a firm intention in year 1 to be involved in the mānuka oil business when it sought and raised capital for this purpose.

This is the impact of the meaning of “taxable activity” for the provisional tax rules in the ITA that references to s 6 of the GSTA. Section 6(2) of the GSTA states, “[a]nything done in connection with the beginning or ending of a taxable activity is **treated as being carried out in the furtherance of the taxable activity**”. This approach was confirmed in *Case P73*.

Furthermore, s 6(1)(a) of the GSTA states that a taxable activity can be an activity that **“involves or is intended to involve” the making of taxable supplies**. The plain meaning of the provision is that a taxpayer may have a taxable activity before any supplies are ever made. Consistent with this, Judge Bathgate in *Case N27* held that the supply of goods and services is not necessary, provided an intention exists to be involved in that supply. Numerous examples of this occur in primary products industries such as establishing kiwifruit orchards, vineyards and forestry ventures where expenses are incurred for long periods before income is derived.

Marnie Oil will have an initial provisional tax liability as it did not have residual income tax of more than \$2,500 in any of the four prior years and it will have residual income tax of \$60,000 or more in the 2019 tax year. Consequently, if it does not voluntarily pay provisional tax in three equal instalments (that is, on P1, P2 and P3) of \$22,400 under s RC 9(9)(a) of the ITA and s 120KC of the TAA, use-of-money interest will be charged on any shortfall from the date of the shortfall until the amount is paid.

Example 2 – New business deriving only passive income with residual income tax less than \$60,000

Facts: The same facts as in example 1 apply but the income is invested at 3% so residual income tax is only \$50,400 for the 2019 tax year.

Question: Did Marnie Oil have an initial provisional tax liability for the 2019 tax year?

Answer: No. Marnie Oil has residual income tax that is under \$60,000 for the 2019 tax year and no residual income tax in the four prior tax years. Consequently, it does not have an “initial provisional tax liability” in that tax year and is not exposed to use of money interest. It will have an obligation to pay the residual income tax on the terminal tax date of 7 February 2020.

Example 3 – New business with residual income tax of \$60,000 or more ends prematurely

Facts: An Australian tea tree oil producer, TTO Pty decides to expand into New Zealand mānuka oil production as it has greater therapeutic benefits than tea tree oil against certain types of bacteria and only small quantities are being produced. It makes an application for Overseas Investment Office approval on 30 September 2018 to buy a large block of land covered in mānuka on the East Cape and has plans to augment this with additional planting of mānuka seedlings. While the application is being processed, TTO hires staff, incurs legal fees and receives a \$2.4 million capital contribution from a mānuka honey producer who wants to have an exclusive right to place hives on the property. The capital contribution is taxable under s CG 8 of the ITA and must be spread equally over 10 years. Consequently, \$240,000 is allocated to the 2019 tax year, and residual income tax exceeds \$60,000.

On 1 October 2019, the Overseas Investment Office turns down the application because **all the mānuka leaf is going to be processed in Australia at the company’s existing tea tree facilities** and there is not enough benefit flowing to New Zealand. TTO is forced to repay the \$2.4 million and abandon its business plans.

Question: What are **TTO's provisional tax obligations** and use-of-money interest exposure for the 2019 and 2020 tax years?

Answer: TTO has carried on an activity in the 2019 tax year that is intended to involve the supply of goods. The work undertaken is beyond mere preparation as it has received a significant contractual payment, incurred expenditure and followed up on a detailed land acquisition and harvesting plan. TTO, therefore, **had a "taxable activity"** in the 2019 tax year in terms of s 6(1)(a) of the GSTA despite the land purchase being subsequently thwarted on 1 October 2019 and the business being terminated in the 2020 tax year. Consequently, TTO has an initial provisional tax liability in the 2019 tax year and is exposed to use-of-money interest if it does not voluntarily make the payments determined under s 120KC of the TAA.

As a new provisional taxpayer commencing a taxable activity on 30 September 2018 (being after 29 July but before 16 December) the number of provisional tax instalments required under s 120KC of the TAA is two in the 2019 tax year, assuming a balance date of 31 March. Anything done in connection with the premature ending of a taxable activity is expressly treated as being carried out in the course of the taxable activity under s 6(2) of the GSTA.

In the 2020 tax year, TTO has only expenditure and deductions to claim and no income, as it has repaid the entire capital contribution made by the honey producer. However, because its residual income tax exceeded \$2,500 in the 2019 tax year it is a provisional taxpayer for the 2020 tax year and opts to use the standard option to pay provisional tax of 105% of 2019 residual income tax divided by three at P1 on 28 August 2019.

Having learnt of the Overseas Investment Office decision on 1 October 2019, TTO decides to swap to the estimation method. It sends a secure email to Inland Revenue advising of this using myIR and estimates zero for P2 on 15 January 2020. The nil estimate is still reasonable at P3 and no revised estimate is required to be filed. **TTO also files an IR348 showing each employee's finish date**, then it files a final tax return in July 2020 seeking a refund of tax paid on 28 August 2019 and includes a letter to Inland Revenue advising the date it ceased to carry on business and the reason why. TTO also confirms it no longer has any assets and encloses a balance sheet and profit and loss account up to the date it ceased to carry on business.

Example 4 – Start up business with losses comes into profit

Facts: Sateconnect Ltd is a start-up firm and has incurred tax losses for 5 years while it develops intellectual property that is based on the provision of satellite internet cover to support the Internet of Things connectivity. Following the successful launch of the first satellite it is able to quickly monetarise its IP and in year 6 the residual income tax is over \$60,000 and all carried forward tax losses are used up.

Question: Is Sateconnect a new provisional taxpayer starting a taxable activity in year 6?

Answer: No. Sateconnect incurred tax losses testing and developing its IP with the full intention of monetarising this when satellite internet became a reality. As a result, it commenced a taxable activity when it was first set up in year 1. As the residual income tax in year 5 was less than \$2,500, Sateconnect has no obligation to pay provisional tax in year 6 under s RC 3(3) of the ITA.

However, because the residual income tax in year 6 exceeds the use-of-money interest terminal tax safe harbour of less than \$60,000, the residual income tax will need to be voluntarily paid by the last instalment date for provisional tax for year 6 if use-of-money interest is to be avoided. If Sateconnect makes no payments on the first and second instalment dates for provisional tax for year 6 this will correctly reflect its default status of adopting the standard method which requires 3 instalment payments of one third of the **5th year's residual income tax multiplied by 105% (or if that year has yet to be filed, the 4th year's residual income tax multiplied by 110%)**. Both those amounts are nil.

Sateconnect will be a provisional taxpayer in year 7 and needs to choose what method it wishes to adopt for that year or default to the standard method.

References

Subject references

Initial provisional tax liability
New provisional taxpayer
Provisional tax rules
Residual income tax
Starting a taxable activity
Taxable activity, meaning in the GST context
Use-of-money interest

Legislative references

Goods and Services Tax Act 1985, s 6
Income Tax Act 2007, ss CG 8, RC 3(3),
RC 9(9), YA 1 ("initial provisional tax liability"
and "taxable activity")
Interpretation Act 1999, s 5
Tax Administration Act 1994, ss 3(1) ("new
provisional taxpayer"), 120KC

Case references

Allen Yacht Charters Ltd v CIR (1994) 16 NZTC
11,270 (HC)
Case N27 (1991) 13 NZTC 3,229 (TRA)
Case P73 (1992) 14 NZTC 4,489 (TRA)
CIR v Bayly (1998) 18 NZTC 14,073 (CA)
CIR v Newman (1995) 17 NZTC 12,097 (CA)

Other references

Inland Revenue Department NZ, *Provisional Tax*
IR289