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Prizes won in Competitions run by Banks

Introduction

Prizes won in competitions run by banks were discussed in a ruling in TIB Volume Two, No 3. The ruling was that such prizes are not generally subject to income tax. We have recently been asked if the entitlement to a cash prize or an advance from a ballot by a building society would also be exempt from tax.

Ruling

The assessability of building society prizes is specifically dealt with by section 65(1A) of the Income Tax Act 1976.

The section provides that a cash ballot prize, or an advance taken instead of the cash prize, received pursuant to section 31A of the Building Societies Act 1965 is included in the term "interest". Therefore, these building society "ballot" prizes are still subject to income tax.

If a building society holds a competition for depositors similar to those mentioned in the earlier TIB item, which does not come within the provisions of section 65(1A) of the tax act, the prizes would not be "interest" and would be exempt from tax

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GST - School Fees Payments to State Schools - IRD's Position on Refunds on GST Overpaid

Summary

This item states Inland Revenue's position on the re-opening of assessments, or where late objections are lodged as a result of our change in policy that payments of certain school fees are not subject to GST.

Background

We reviewed our interpretation of "unconditional gift" in TIB Volume Two, No 4 (November 1990).

As a result of the review, we have determined that payment of school fees (as defined in that TIB) to state schools are unconditional gifts and not subject to GST.

We have been asked to apply the new policy retrospectively, which would enable schools to seek a refund of any GST overpaid.

Inland Revenue's Position

Our general position on handling such changes is that where a change of policy results in a change to the interpretation of the law as previously understood, the new policy will not apply retrospectively unless there is a live objection.

However, where a request is made for an assessment to be re-opened or where a late objection is lodged, the general position of not applying policy changes retrospectively is subject to the requirement that each case will be considered on its own merit to see if it would be unfair for us to decline to re-open the assessment or to disallow the late objection.

Reference: GST O.1.1.1

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Section 17, Inland Revenue Department Act 1974

Court of Appeal Decision - CIR v The National Bank of New Zealand Limited - CIR v New Zealand Stock Exchange

Introduction

This item has been written in light of the recent Court of Appeal decision in the cases CIR v The National Bank of New Zealand Limited and CIR v New Zealand Stock Exchange. These cases were heard together, and tested and confirmed Inland Revenue's powers to collect information about unnamed taxpayers from third party sources.

Background

In March 1990 the High Court decided that the Commissioner could only request information from a third party source when the request related to a specific named taxpayer. The Commissioner appealed this decision.

The Court of Appeal overturned that decision in July 1990 and confirmed the Commissioner's powers. The Court took the view that the Commissioner has a statutory duty to determine the amount of tax payable for every taxpayer and that he "cannot be totally reliant on a taxpayer's willingness to comply honestly and accurately with the reporting requirements of the legislation and will often have regard to 'other information' obtained from third parties".

The National Bank and the Stock Exchange sought leave to appeal the Court of Appeal's decision. This leave was granted and the case will be considered by the Privy Council in due course.

Inland Revenue's Policy for the Use of Section 17

The purpose of the section is to give the Commissioner power to obtain information which is not otherwise readily available to him. Where the information is available publicly for a fee, it is usual for Inland Revenue not to use Section 17 to obtain this information but rather to go through the normal public channels and pay the charges.

Inland Revenue will continue its audit strategy which includes the collection of third party information. There will not, however, be an increase in the level of this activity, but a continuation of the level of activity prior to the cases being heard.

We are aware that it can be time-consuming and costly for organisations to comply with such requests, so we will offer to extract the information ourselves, or provide assistance if required.

The decision has confirmed that the Department has been acting correctly in the collection of third party information.

FBT and the Cost Price of Motor Vehicles

GST to be included in Cost Price - Taxation Reform Bill (No.3) 1990

The Minister of Revenue made this press release on 20 December 1990:

The Minister of Revenue confirmed today that 1 October 1990 would be the start date for the change to the FBT regime requiring that the "cost price" of a motor vehicle will include GST.

"Concern has been raised that employers who have been calculating FBT without including GST will not have time to change their 1 October quarter return by 20 January when they must be sent to Inland Revenue", the Minister said.

The Minister said that employers who have been calculating FBT without including GST could file their 1 October quarter return on a GST exclusive basis.

"Any shortfall can be paid with the 1 January quarter return without penalty", Mr Creech said.

The Minister of Revenue emphasises that the Bill* will be carefully considered by the Finance and Expenditure Select Committee.

The Government will consider any recommendation from the Committee which will achieve the Government's goal of a simple and certain rule for the valuation of motor vehicle use for FBT purposes.

* Taxation Reform Bill (No 3) 1990.

Bloodstock and GST

Introduction

With the annual yearling sales taking place, The Minister of Racing asked Inland Revenue to outline the correct GST treatment of export yearlings.

Bloodstock is classified as goods for GST purposes. This means that any sale of bloodstock by a person registered for GST is normally liable for GST at the standard rate of 12.5%. However, the sale of bloodstock to an overseas purchaser may be zero-rated subject to certain qualifications.

Determination of Time of Supply

To determine the correct GST treatment of an animal it is necessary to determine the "time of supply" for the purposes of the Goods and Services Tax Act. A supply of goods and services takes place -

> "At the earlier of the time an invoice is issued .... or the time any payment is received by the supplier, in respect of that supply".

It is important to note that any invoice or payment, even if it does not represent the full price of the horse, triggers the time of supply.

Bloodstock has been Exported by Supplier

For goods to be zero-rated when supplied the *supplier* must -

a) Enter the goods for export, or alternatively, they must have been deemed to be entered for export under the Customs Act; and

b) The goods must have been actually exported by the supplier.

For example, if a horse is sold in New Zealand and exported by the purchaser, it is the purchaser and not the supplier who is the exporter. As a result this supply could *not* be zero-rated.

Bloodstock will be Exported as a Condition of Supply

Where goods will be exported as a condition of the sale contract, the supply of those goods may be zero-rated if exported within 28 days of the time of supply.

What happens if a Horse is not Exported Immediately due to Circumstances Beyond Control?

The Commissioner has discretion to allow zero-rating for goods with export documentation that are not physically removed from New Zealand within 28 days of the time of supply where the delay is caused by such events as shipping strikes and the like.

This discretion cannot apply where the purchaser has simply decided to retain the animal in the country. It must be a circumstance "beyond the control of the supplier and the recipient".

Any request for this discretion to apply must be made in writing to your local District Office of Inland Revenue.

When Goods are Not Exported Immediately as a Result of the Nature of Supply:

When a horse is not exported within 28 days of the time of supply zero-rating may still occur. This is possible where due to the nature of the supply it is not practical for the supplier to export those goods.

For example, a supplier contracts to export a horse subject to certain conditions in the contract, such as a period of time to allow the animal to develop in order to withstand the rigors of travel. In that case the Commissioner's discretion would apply as the "nature of the supply" means that the horse cannot be exported within 28 days of the time of supply.

As a practical guideline this extension for zero-rating will only be given for yearling horses, and will not be extended beyond 183 days after the time of supply. The 183 days includes the current time limit of 28 days.

Any application for the extension of time must be made to your local District Office of Inland Revenue.

Where 28-Day Rule has been Exceeded and Commissioner's Discretion Does Not Apply:

Where an animal has been sold but the supplier has failed to export the animal within 28 days as specified in the contract of sale then GST at the standard rate is payable to Inland Revenue by the supplier. Where at some later date the horse has been exported as per the contract it is considered that the nature of the original supply has been changed and accordingly an adjustment to the output tax on the original supply may be made.

Example

A registered person sells a horse to an overseas purchaser, and one of the requirements of the sale is that the seller exports the horse. The seller has a taxable period of March / April, and the date of sale is 15 March.

By 12 April the horse has not been exported. This gives rise to an output tax liability in the March / April return.

On 15 June the horse is exported as per the contract.

As the horse has now been exported an adjustment of the March / April return is available to reflect that the supply of that horse should be zero-rated.

Liability if Animal is Zero-rated but Not Exported or is On Sold

If the supply of an animal is zero-rated, as it is intended to be exported, but that animal is not exported, or is sold by the purchaser to another party (whether that party is in New Zealand or overseas) the supply of that horse cannot be zero-rated. The original supplier would be liable for the GST that would have been chargeable if GST had been levied at 12.5%.

Buyers of Bloodstock

Buyers need to enquire as to the terms of sale prior to purchasing, whether the sale is at auction or privately. If the sales basis is GST exclusive and the seller is registered for GST, the purchaser must pay the GST. If the sales basis is GST inclusive or the vendor is not registered, the purchase is not increased by GST.

An auctioneer may declare that an auction shall take place on a GST inclusive basis. While this does not affect the sale of animals on behalf of registered persons, the auctioneer is required to account for any GST charged on animals sold on behalf of non-registered persons.

Interest on Shareholder Advances to a Company

Introduction

This matter has arisen because of the resident withholding tax on interest.

When a shareholder makes an advance to a proprietary company (including an advance on current account), the interest payable by the company on the advance is often determined annually after the company's profit for the income year is known. This article specifically addresses this situation.

Income and expenditure recognition

When interest is -

- predetermined at a particular rate, or
- determinable by reference to a commercial indicator, or
- determined by reference to something other than the company's profits or dividend paid,

shareholder advances will be subject to the accrual rules for post implementation date advances. Guidelines for income and expenditure recognition on such advances under the accrual rules are set out below, preceded by a short analysis of pre-accrual rules treatment.

Pre-Accrual Rules

(a) Assessability

Interest on financial arrangements preceding the relevant implementation date under the accrual rules is assessable under section 65(2)(j). Inland Revenue's policy on recognition of pre-accrual rules interest is stated in PIB 96. In summary, taxpayers not in the business of lending money should return interest when it is received, credited to account or capitalised. Taxpayers in the business of lending money should return interest on a receivable basis. This view is supported by case law - *Leigh* v *IRC* {1928} 1 KB 73 and F156 (1984) 6 NZTC 60,343. It is possible that a shareholder in a proprietary company which is otherwise in the business of lending money will not make the shareholder advance as part of that business, and in such circumstances it may be appropriate for the shareholder to return interest on a receipts basis.

Section 75 of the Act deems every person to have derived income although it has not been actually paid to or received or reinvested or accumulated, or capitalised, or carried to any reserve, sinking, or insurance fund, or otherwise dealt with in the person's interest or behalf. The purpose of Section 75 is to bring the interest into assessable income where it has been channeled elsewhere than directly to the taxpayer and thus some equivalent to receipt has occurred (Case F156 at page 60,347). This point is discussed further below in relation to RWT and NRWT.

(b) Deductibility

Deductibility of interest paid on financial arrangements preceding the relevant accrual rules implementation date is governed by Section 106(1)(h) i.e., following the amendments applicable from 1 April 1985, the interest must be:

i) payable in gaining or producing assessable income for any income year, or

ii) necessarily payable in carrying on a business for such purposes, or

iii) payable by one company included in a group of companies in respect of money borrowed to acquire shares in another company included in that group of companies. Previously, instead of the first two limbs there was a requirement for deductibility of interest that it be payable on capital employed in the production of assessable income.

The test of whether interest is "payable" under Section 106(1)(h) is similar (although not identical) to the general test under Section 104 of whether expenditure is "incurred" - paid to be deductible - it is sufficient that the liability to pay the money has come into existence (*W. Nevill and Co Ltd* v *C of T* 1 AITR 67; 73).

Accrual Rules - Implementation Date

The general implementation date for the application of the accrual rules to shareholder advances is 31 July 1986. However, where a shareholder advance constitutes a variable principal debt instrument ("VPDI") which was in existence at 1 April 1987, the implementation date will be 1 April 1987. A shareholder advance will constitute a VPDI only if it is contemplated that the shareholder may advance further sums at the demand or call of the company or, where the advance is denominated in a foreign currency, the shareholder may require repayment from the company upon demand or call.

Application of the Accrual Rules - Income Recognition

(a) Cash Basis Holder

Shareholders who are natural people will be cash basis holders if they fulfil both of these criteria:

a) They have either:

   i) less than $50,000 of income as calculated under the accrual rules; or

   ii) total financial arrangements in the relevant income year of less than $400,000 in value;

and

b) the difference between their income calculated under the accrual rules and under ordinary taxation principles does not exceed $15,000.

In each year of the advance a shareholder who is a cash basis holder may return the interest in the manner outlined in PIB 96. However, in the income year of remission or maturity of the advance a cash base price adjustment under Section 64F(3) must be performed to ensure that all interest received under the advance has been returned without allowing a deduction to the shareholder for any amounts remitted.

> Note: Changes announced in the Government's Economic Statement of 19 December 1990 will change some of the thresholds for cash basis holders. These changes were summarised in TIB Vol 2 No 6.

(b) Non-Cash Basis Holder

Non-corporate shareholders who are not cash basis holders and corporate shareholders must apply a basis provided under the accrual rules for returning income. For this purpose Section 64C provides that:

- The yield to maturity ("YTM") method or some equivalent method must be used (section 64C(2)).
- Where the YTM method cannot be applied, a method contained in a determination of the Commissioner or some equivalent method must be used (section 64C(3)(a)).
- Where the YTM method cannot be applied and there is no other prescribed method, a method which meets the criteria of being consistently applied by the taxpayer for financial reporting purposes and being fair and reasonable must be adopted (section 64C (3)(b)).
- A market method may be used, subject to certain conditions including that the holder and the issuer are not associated persons and the holder is in the business of dealing in the type of financial arrangement in question (section 64C(4)).

The YTM method cannot be used for a shareholder advance unless there is a fixed interest rate and a fixed term as this method requires.

The market method cannot be applied because proprietary companies and their shareholders will usually be associated persons and/or the shareholder will not be in the business of dealing in such financial arrangements. Therefore, in the absence of a determination on a reviewable rate a method must be adopted which meets the section 64C(3)(b) criteria as noted above.

In this respect Determination G12 will be of relevance, as in many circumstances the shareholder involved would not prepare financial accounts and therefore could not comply with one of the necessary criteria for the application of section 64C(3)(b) where there is no specific determination. The determination provides that, where there is no specific determination, a method must be used that meets three criteria. It must:

a) have regard to the principles of accrual accounting;

b) conform with commercially acceptable practice; and

c) result in the allocation to each income year of an amount that is fair and reasonable, having regard to the tenor of section 64C(2) [i.e. a spreading provision].

The example in the Determination indicates that a method of accounting for a reviewable rate mortgage which apportions interest receivable at a payment date to the appropriate accounting periods on a straight line daily basis over the days in the period to which the payment relates is acceptable. This would thus be an acceptable method of dealing with loans from shareholders where the interest rate is determined by a commercial indicator.

Expenditure Recognition under the Accrual Rules

Companies must use methods similar to those described above for income calculation of non-cash basis holders for returning interest expenditure under the accrual rules. Expenditure arising under the accrual rules will generally be deductible under section 106(1)(h)(i) and (ia) as payable in the company's business or otherwise in deriving assessable income, or possibly under section 106(1)(h)(ii), as the proviso to section 106(1)(h) deems such expenditure to be interest payable.

Resident Withholding Tax

A proprietary company will prima facie be required to deduct RWT from interest paid on shareholder advances if the company:

a) Is resident or has a fixed establishment in New Zealand; and

b) Makes the payment wholly or partly in the course or furtherance of a taxable activity or as the holder of a valid certificate of exemption.

However, no RWT deductions will be required from interest paid on shareholder advances in the following circumstances:

a) If less than $5,000 resident withholding income is paid in the immediately preceding year (i.e. 1 April to the following 31 March) AND a certificate of exemption is not held by the company (or is held on grounds that the company derives exempt income, will or is likely to incur a loss, has nil assessable income or can claim aggregate RWT credits in an income year exceeding the income tax liability for that year by $500 or more).

b) The payment is attributable to or effectively connected with a fixed establishment of the company outside New Zealand.

c) The shareholder is a company in the same group as the proprietary company for tax purposes (i.e. a two-thirds or more common shareholding)

d) The interest constitutes non-resident withholding income, i.e. the shareholder is a non-resident without a New Zealand fixed establishment.

e) The shareholder holds a valid certificate of exemption.

RWT is required to be deducted at the time the interest is "paid", defined in 327A (1) as including:

> ".... distributed to, credited to, applied on account of, or dealt with in the interest of, any person;...."

These words are similar to those in section 75 which (as noted above), in relation to taxpayers returning interest on a receipts basis is concerned with ensuring that where there is an equivalent to a receipt but no receipt as such, the interest is still deemed to be received for tax purposes.

Based on the definition of "paid", RWT in respect of interest on shareholder advances must be deducted by the company at the time the amount of interest is quantified and either paid, credited into account or otherwise dealt with in the interests of the shareholder. This will generally be in the period in which the accounts are actually ratified. The RWT is allowable as a tax credit to the recipient in the income year that interest income is derived.

Resident withholding tax in relation to interest must be deducted in accordance with this formula:

$$(a \times (b + c)) - c$$

where -

a is the rate of resident withholding tax (presently 24%)

b is the amount of interest paid (before the deduction of resident withholding tax), and

c is the amount of foreign withholding tax paid or payable in respect of that amount of interest paid.

Non-Resident Withholding Tax

Interest constitutes non-resident withholding income and is liable to NRWT if derived by a non-resident shareholder of the company (other than a shareholder with a fixed establishment in New Zealand). This is subject to certain limited exceptions, such as when the interest is exempt from income tax.

The rate of NRWT on interest is 15%, reducible to 10% under some double tax agreements. Where the proprietary company and the shareholder are associated persons the NRWT will generally be a minimum tax and hence will also be subject to income tax rates applicable to non-residents (sections 317 and 318), with a credit allowed for the NRWT. The NRWT will however be a final tax where it exceeds the income tax so calculated or if total non-resident withholding income and other taxable income derived by the shareholder is less than $1,000.

Some double tax agreements will override sections 317 and 318 so that the maximum tax charged is (depending on the agreement) 15% or 10%. However, other double tax agreements contain associated persons provisions which allow the New Zealand domestic rules to apply in associated person situations, and thus the full rate of tax is imposed. Such agreements include those with Australia, Singapore, Malaysia and Fiji.

Most New Zealand double tax agreements provide that if, by reason of special relationship between a payer or payee of interest, the interest paid exceeds that which would have been paid but for the special relationship, only the amount which would have been paid receives the benefit of rate reductions under the agreement. The remaining excess amount of interest must be dealt with under domestic law.

Regarding the issue of when the liability to deduct NRWT from the interest paid to non-resident shareholders arises, the definition of "paid" for NRWT purposes is similar to that for RWT purposes. This means the liability will arise when the interest is quantified and either paid, credited to or otherwise dealt with in the interests of the shareholder.

Section 192 and 195 of the Income Tax Act

As well as the above, there may be circumstances where a shareholder advance constitutes a debenture in terms of section 192 and 195 of the Income Tax Act.

A TIB article on this subject will be issued at a later date.

Reference: 10.I.6.9

Due Dates Reminder

March

5 PAYE Deductions for last 13 days of February due - "Large" employers only.

7 First instalment of 1992 Provisional Tax due for taxpayers with November balance dates.

Second instalment of 1991 Provisional Tax due for taxpayers with July balance dates.

Third instalment of 1991 Provisional Tax due for taxpayers with March balance dates.

14 Interest PAYE deducted during February due - monthly payers.

14 Dividend PAYE deducted during February due.

Non-Resident Withholding Tax deducted during February due.

20 PAYE Deductions for first 15 days of March due - "Large" employers.

Tax Deductions for February due - "Small" employers.

28 GST return and payment due for period ending 28 February.

TAX INFORMATION BULLETIN

INLAND REVENUE

TE TARI TAAKE

THIS IS AN INLAND REVENUE DEPARTMENT SERVICE
TO PEOPLE WITH AN INTEREST IN NEW ZEALAND TAXATION.

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