Qualifying Companies - Market Values for QCET Purposes

This article sets out Inland Revenue's position on "market value of assets and liabilities" for the purpose of calculating Qualifying Company Election Tax.

We don't expect companies to get formal valuations. Any suitably qualified person (such as a director, the company accountant, or an independent person) can value the assets and liabilities, so long as there is a reasonable estimate of each item's market value. We will accept the book value with any necessary adjustment.

Example

A company owns some land which is valued in the Balance Sheet at $100,000 (as per 1989 Government Valuation). The current market value of the land could be quite different to this figure. Anybody with experience in property sales would be able to give a reasonable estimate of market value.

Private company shares

Shares in a private company could require a different valuation method. The overriding principle in valuing shares is that we are trying to work out a hypothetical price that a willing but not anxious buyer and a willing but not anxious seller would agree on.

There are three well-recognised methods that Inland Revenue will accept to determine the value of shares in private and unlisted companies. In complex cases, you may need to consult text books or previous court cases which deal with the valuation of shares.

1. Notional Liquidation Method

Under this method, the notional liquidation value is "an estimate of the sum which the shareholder could expect to receive if the company assets were liquidated and the company wound up". This is the formula for calculating the value of the shares:

Assets	________
less Liabilities	________
Net Assets	________
less Tax on Profit	________
Sub Total	________
less Tax on shareholder distributions	________
less Liquidation Costs	________
Sub Total	________
Adjustment for Profit on Liquidation	________
Net worth	________

The net worth divided by the number of shares will give the value per share.

When calculating the hypothetical price for shares, you will need to make an appropriate allowance for these items:

(a) Assets should be at estimated market value - book value with a reasonable adjustment will be acceptable (as mentioned above);

(b) Income Tax and GST payable on profit from last balance date to date of valuation of shares;

(c) Dividend tax or imputation credits attached which would be paid on the liquidation of the company;

(d) The costs of a notional liquidation of the company (including cost of selling assets); and

(e) A reasonable profit to the purchaser on the transaction - adjustment in the range of 15 - 33 %

This method is appropriate for valuing all shares in a family company (i.e. where they are not held at arm's length) and majority shareholdings in other companies. Typical companies valued this way would be "farm" and "property" type companies.

2. Capitalisation of Future Maintainable Tax Paid Profits

Under this method, the value of the shares is calculated from Capitalisation of Future Maintainable Tax Paid Profits at the generally accepted rate of return.

The formula is:

Future Maintainable Tax Paid Profit x Capitalisation Rate

The initial guide to Future Maintainable Tax Paid Profit (FMTPP) figure is the past earning capacity plus adjustments for non-recurring excessive or inadequate allowances for expenses such as shareholders salaries and interest paid on advance accounts, with an allowance for tax paid.

Abnormal years should be adjusted, with emphasis given to the most recent years. Other special factors include:

(a) differing amounts of capital employed over the period of examination;

(b) inclusion of income from funds not required for maintenance of normal profits;

(c) change in management;

(d) the case of a new business which had not reached full production capacity;

(e) any other vital or anticipated change affecting past profits.

When considering the rate of return, a satisfactory rate would be that received from a gilt-edged security plus a risk for private investment, range between 10 - 20%. It would be at a rate higher than dividend yield.

This method is appropriate in valuing all shares in a family company (i.e. those not held at arm's length) and majority holdings in other companies. Typical companies are sellers of goods or services in the industrial/wholesale/retail sector.

3. Dividend Yield

Under this method the required dividend yield on both the paid up value of a share and the dividend payable on that share determines the market price of the share. The formula is:

$$\frac{\text{\% dividend yield required}}{\text{\% dividend paid on par value}} \times \frac{\text{par value}}{1} = \text{market value of share}$$

Par value means the nominal value of a share. In most cases this equals the paid-up value of the share. You will need to make an allowance for partly paid-up shares.

You can get an indication of an appropriate dividend by checking listed shares for companies engaged in a similar activity. For example, if you were valuing shares in a private provincial newspaper you might check the dividend yield on Wilson & Horton shares.

This method is appropriate for calculating the value of minority shares in (non-family) private companies and unlisted public companies.

Summary

Valuing shares in a private company is not always an easy task. Court cases have shown that even the experts disagree.

What Inland Revenue is aiming for is a simple calculation to be lodged by the valuers (generally 1-2 pages will be sufficient), showing that they have used one of the accepted valuation methods and used reasonable values, allowances, percentages etc, to arrive at a fair value.

If companies supply this information it will help reduce the amount of checking that we carry out. With more complex valuations, some negotiations with Inland Revenue valuers may be needed. We are happy to discuss any aspect of share valuations with share valuers. The contact person at your local Inland Revenue office is a Senior Investigating Accountant.

Qualifying Companies - Crediting QCET to the ICA

Summary

This item establishes that the Qualifying Company Election Tax (QCET) that a closely held company pays when it elects to become a Qualifying Company is "income tax paid", so it should be credited to the company's Imputation Credit Account (ICA) under section 394D(1) of the Income Tax Act 1976.

Background

QCET is an "entry" tax levied on a company when it enters the Qualifying Company regime. The company must pay QCET on amounts that would be taxable distributions to shareholders if the company was wound up.

Under the Qualifying Company regime, cash dividends that a Qualifying Company pays to its shareholders are either fully imputed or exempt. A dividend is exempt to the extent that it exceeds the amount of imputation and dividend withholding credits attached to it, divided by the company tax rate. Cash dividends and bonus issues will have imputation credits attached to the maximum available from the ICA and dividend withholding payments account.

The amount of income tax that a company pays on income it derives in the imputation year is one of the credits that section 394D (1)(a) requires to be recorded in the ICA. If "income tax paid" includes QCET, this would increase the amount of fully imputed dividends that must be distributed from the ICA before the company can pay exempt dividends under the Qualifying Company regime.

The Law

Section 393K(1) says that a company that elects to become a QC "shall be liable to pay a *special tax by way of an income tax* known as [QCET]".

Section 393L provides for QCET to be paid in the same manner as income tax, and to be included with income tax as a non-deductible item under section 106(1)(f). Further, it says that QCET (and any interest for its late payment) is to be treated *as if it were income tax levied under section 38 of the Income Tax Act 1976*, (except for specified parts of the Act - none of which are relevant to the treatment of ICAs). QCET (and late payment interest) can therefore be treated as "income tax" for the purposes of the ICA provisions, unless those provisions themselves preclude such a treatment.

Section 394D in Part XIIA states which amounts must be credited to the ICA and requires a credit to be recorded in the ICA for any amount of income tax the company pays on income it derives during the imputation year. Nothing in that section or in that Part of the Act prevents QCET from being credited to the ICA.

Thus where section 393M(3)(b) requires "the balance of the company's imputation credit account ...." to be used in the formula for calculating the amount of imputation credit to be attached to a dividend paid by a Qualifying Company, that balance should include QCET that the company pays when it elects to enter the QC regime.

Application of Policy

This policy applies to both "ordinary" QCET (at 33%) and the concessional transitional year QCET (at 7.5%) for those closely held companies that elect to become Qualifying Companies by 31 March 1993.

Reference: Sections 393L, M and U, 394D
Income Tax Act 1976

Policies We're Reviewing

Several people have asked Inland Revenue if we will be changing our policy on:

- Gift Duty on dispositions of property between companies (covered in Public Information Bulletin No.96 of October 1978)
- Deductibility of interest on farm houses (covered in Technical Rulings Chapter 51.5.1).

We are reviewing these policies, and we will ask for comment from interested parties before we finalise any policy changes.

Any policy changes will apply from a future date - either the date we publish the policy or another specified date. The existing policies will continue to apply until we release any policy changes.

Shareholder-Employees and FBT on Company Vehicles

Introduction

This item confirms Inland Revenue's policy and record-keeping requirements for Fringe Benefit Tax when a shareholder-employee has restricted private use of a company vehicle.

Background

The availability of a vehicle for private use is a fringe benefit. That benefit is subject to FBT for the number of days the vehicle is available for private use. Some shareholder-employees have been uncertain what records they must keep when they have chosen to restrict their private use of a company-owned vehicle.

(TIB Vol 1. No 3. Appendix E deals with the situation where an employee owns a vehicle and either leases it to the employer, or is reimbursed for business mileage.)

Policy

- Inland Revenue generally assumes that a shareholder-employee who has access to a company vehicle has unrestricted use of it for private purposes, particularly if s/he has a controlling interest in the company.
- We will assume the vehicle is available for private use unless the company can claim that availability has been restricted, or unless the vehicle is actually unavailable at any time for one or more days, (i.e. due to mechanical breakdown).
- The company may show that a vehicle's availability is partly or completely restricted by:
  - (a) showing details of the restriction,
  - (b) confirming that the shareholder-employee is aware of the restriction,
  - (c) maintaining a vehicle logbook recording both business and private mileage on a daily basis, and
  - (d) producing the vehicle logbook on request as evidence that the restriction has been complied with.
- The company may show that the vehicle was actually unavailable for use for one or more days by:
  - (a) recording in the vehicle logbook the date(s) and reason(s) why the vehicle was unavailable;
  - (b) producing the vehicle logbook on request as evidence that the vehicle was unavailable and that the employee didn't use it during that period.
- When Inland Revenue considers claims that a company vehicle is not available to shareholder-employees for private use, we will particularly look at these factors in the context of the taxpayer's situation:
  - (a) The degree to which the taxpayer's home is connected to the business as a work base, (e.g. areas used for home office or workshop, home as registered office of company, business related telephone usage at home, etc.);
  - (b) The availability and actual use of other transport, including privately owned vehicles and public transport.

Examples

1. Unlimited Private Availability

Mary has a controlling shareholding in Placeville Books Ltd. She is the only employee of the company. The company's registered office is at the bookshop in Placeville, although she has an office in her home where she does the books for the business and keeps the company records. She uses the company vehicle for business related travel. She also uses it without restriction for private purposes.

The GST inclusive cost price of the vehicle was $30,000. The value of the fringe benefit for the income year is 24 % of that price:

$30,000 x 24% = $7200

The vehicle is available every day in the income year, and so the whole amount will be liable for tax. The taxable value of Mary's fringe benefit is $7,200.

2. No Private Availability

Mark has a controlling shareholding in Mark's Catering Company Ltd. He operates his business from home using his kitchen and an office. The registered office of the company is at Mark's home in Placeville. Mark is the only permanent employee of the company. The company has a delivery van which is parked at Mark's home. Mark owns a car in his private capacity.

On behalf of the company, Mark has written a letter to himself (as the employee), which states that the delivery van is not to be used for any private purposes. A copy of this letter is in the company files. In his capacity as employee, Mark received this letter and has retained it for reference. Mark maintains a log book in the van recording the business mileage on a daily basis, so that he can confirm that there has been no private use of the van.

Mark has no FBT liability in relation to the delivery van, since he can show that it is not available for private use, and that it has not been used for private use.

3. Limited Private Availability

May has a controlling shareholding in Placeville Kitchens Ltd. She is the only employee of the company. The company's registered office is at her home in Placeville. She has an office in her home where she does the books for the business and keeps the company records. The company owns a car, which is used primarily for business purposes. May owns a vehicle privately. May's home telephone number is listed on her business cards and she frequently travels directly from her home to visit clients outside normal business hours.

On behalf of the company, May has written a letter to herself (as the employee), which states that the vehicle may only be used for private purposes on weekdays. A copy of this letter is in the company files. In her capacity as employee, May received this letter and has retained it for reference. May maintains a log book in the car recording both the business and private mileage on a daily basis. The logbook helps her to confirm that private use of the vehicle is restricted to the specified times.

The GST inclusive cost price of the vehicle was $30,000. The value of the fringe benefit for the income year is 24 % of that price:

$30,000 x 24% = $7200

The vehicle is available for private use five days in every week throughout the income year. That proportion of the value will be liable for tax. The taxable value of Mary's fringe benefit is 5/7ths of $7,200, or $5142.86

References HO 10.F.15.1
Technical Rulings 67.3.4; 67.12.3

Tax Treatment of Employee Home Telephone Costs

Summary

If an employer pays for an employee's home telephone cost, one of two possible tax liabilities will arise:

- If the employee is liable for the cost of the telephone, but the employer pays it, the employee is liable for income tax on any amount that the employer pays which is not an exempt reimbursing allowance. The employer must deduct PAYE from such amounts.
- If the employer is liable for the cost of the telephone, the proportion of the rental which relates to private use will be subject to Fringe Benefit Tax.

We originally stated Inland Revenue's policy on the income tax treatment of these situations in Public Information Bulletin No.137 (July 1985), and on GST treatment in TIB Volume 2 No.3 (October 1990). The following information summarises and clarifies these earlier statements.

This policy also applies to the cost of mobile telephones, pagers, fax machines and computer connections supplied by employers to their employees at home.

Income Tax - Employee liable for telephone account

This situation will arise where the account and directory listing are in the employee's name. The employee is principally liable for the cost of the telephone (this will still be so even if the number is listed in the directory as part of the employer's listing, or otherwise advertised as an after hours number for the employer). In many cases, the telephone number will be listed in the directory under both the employer's and the employee's name.

Where the employer reimburses the employee for, or otherwise pays the employee's home telephone costs, the payment is monetary remuneration as defined in section 2 of the Income Tax Act 1976, so the employer must deduct PAYE. In this situation, the employer will not be liable for FBT on the payment.

If Inland Revenue is satisfied that all or part of the reimbursement or payment by the employer is justified for business purposes, then that part of the amount will be exempt from income tax in the hands of the employee. Section 73 of the Income Tax Act allows for this exemption.

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Income Tax - Employer liable for telephone account

Where the employer contracts directly with the telephone service provider, payment of the rental and toll accounts is a fringe benefit. Any amount that cannot be justified as an exempt allowance will be subject to FBT. In this situation, the employee will not be liable for income tax on any amount the employer pays.

Income Tax - Exemption

In both situations, whether Inland Revenue is satisfied that the reimbursements or payments are justified will be a question of fact. Factors we will consider are the type of business that the employer is running, the seniority and responsibilities of the employee, and how much the phone is used for business purposes outside normal office hours.

Income Tax records that employer must keep

Employers must keep a schedule of employees for whom they pay the rental of a home telephone. This schedule must be kept with FBT and PAYE records, and it must contain these details:

- employee's name and address
- amount of employer contribution to telephone cost
- statement of the employment-related use of the telephone

GST - Clarification of earlier TIB article

TIB Volume Two, No.3 (October 1990) dealt with the GST treatment of expenditure that employees incur on their employer's behalf. The following information summarises and clarifies this information, especially as it applies to reimbursement of home telephone costs. (See the earlier item for more information.)

- Employers who are registered persons may claim GST input tax credits on rental and toll costs that they pay on employees' home telephones, to the extent that:
  (a) the private phone is used for business purposes, and
  (b) the employee is reimbursed for actual expenditure.
- The employer may not claim an input tax credit if s/he pays the employee a regular allowance, since in this case the employer doesn't incur any GST . There is no direct link between the payment and the actual expenditure.
- The tax invoice requirements of section 24 of the GST Act must be met. Specifically -
  - The employer must hold the original statement
  - Where the employer reimburses only part of the invoice amount, s/he must keep details of the amount of that reimbursement
  - If the invoice from the telephone service provider is for over $200 and is addressed to the employee rather than the employer, Inland Revenue will accept it as long as it meets all the other requirements of section 24(3) of the GST Act.

If an employer pays for the cost of an employee's home telephone, this will normally meet the requirements of section 20 of the GST Act. The employer can claim the input tax credits if s/he is a registered person.

Reference: HO 10.A.8.2; 10.A.8.4; 10.F.15.1; GST A.5.1

Stamp Duty on Forest Sales

Summary

This item confirms Inland Revenue’s policy on the stamp duty treatment of forest sales.

Stamp duty is payable on the capital value of both trees and land when selling and purchasing a forest, whether or not the Agreement for Sale and Purchase expresses the values separately.

Because some agreements for the sale and purchase of forests give separate values for the land and the trees, some taxpayers think that stamp duty should only apply to the land value. They contend that the trees should be treated like an annual crop and not be subject to stamp duty.

Policy

Both land and standing timber are covered by the definition of “land” in the Stamp and Cheque Duties Act 1971. This means that the value of the land and of the standing timber are both subject to Stamp Duty, even if they are specified separately in the Agreement for Sale and Purchase.

Stamp duty and income tax treatments

The stamp duty treatment of forestry differs from the income tax treatment. Stamp duty applies to instruments (documents) dealing with interests in land. These use the common law treatment of land interests, which

treats trees growing on land as part of that land. An exception is where land is sold subject to timber-cutting rights - these rights are then subject to lease duty.

The common and general law distinction between forests and crops applies for stamp duty purposes because the definition of "land" in the Stamp and Cheque Duties Act 1971 ("the Act") does not displace this common/general law treatment - unlike the income tax treatment of forestry operations.

Forestry and Property Law

Common law recognises that forests are typically managed on a long term basis to maximize wood production. Therefore when trees that are sold remain in the ground for the benefit of the purchaser, they are treated as part of the land to which they are attached (*Marshall v Green* (1876) 1 CPD 35 and in *CT v Kauri Timber Co* (1899) 17 NZLR 696 approved in *Kauri Timber Co v CT* (1840-1932) NZPCC 636 [1913] AC 721).

This differs from annual crops and other 'short term' produce (including fruit trees, vines and other plantings cultivated for their crop), which are treated as chattels and are transferable separately from the land.

This distinction is reflected in the stamp duty treatment of instruments evidencing transactions in those property rights.

Stamp and Cheque Duties Act 1971

Section 10(a) in Part II of the Act creates a liability to pay stamp duty to the Crown on conveyances and leases of land.

Section 2 of the Act defines "land" to include buildings, appurtenances and improvements, together with any estate or interest in land (whether legal or equitable, corporeal or incorporeal). Since this is an inclusive definition, the Land Transfer Act 1952 (which regulates the creation and transfer of estates and interests in land) is relevant. It defines land to include "... plantations, ... and all trees and timber thereon or thereunder lying or being, unless specially excepted."

Part III of the Act says how to calculate the stamp duty liability created under Part II, and that for this purpose "land" has the same meaning as in the Valuation of Land Act 1951. That Act defines "land" to mean "all land ... and all trees growing or standing thereon".

Part III of the Act quantifies the same liability that has been created by section 10(a), so the meaning of "land" in the Act must include the meaning given it by the Valuation of Land Act 1951. This means it includes all trees growing or standing on the land in question.

Stamp duty on the sale of a forest is therefore levied on the value of both the land and the trees.

Comparison of Stamp Duty Treatment of Timber-cutting Rights

It is useful to compare the stamp duty treatment of timber-cutting rights with that of forest sales. Timber cutting rights may constitute:

(a) a leasehold interest in the land;

(b) a licence (deemed a lease - section 8(c) of the Act);

(c) a legal or equitable profit a prendre, whether under common law or the Forestry Rights Registration Act 1983.

All such interests are liable to lease duty under the Act, as if they were leasehold interests in land. This is consistent with an acceptance that the forests to which they relate are part of the land.

Conclusion

When land and the forest on it are sold, stamp duty is levied on the value of both the land and the standing timber.

Examples

1. Woodlot Ltd enters into a contract to purchase a forest block planted in three year old pinus radiata. The Agreement for Sale and Purchase itemises the value of the transaction as follows:

Land Value:	$48,000	(plus GST)
Tree Value:	$102,000	(plus GST)
Total Value:	$150,000	(plus GST)
	$168,750	(inc. GST)

   Stamp Duty (Conveyance Duty) of $2,626.00 is levied on the GST inclusive total value at 1% for the first $50,000, 1.5% for the second $50,000, and 2% on the balance.

2. SilviCo Ltd purchases the registered forestry right in a block of land planted in four year old eucalyptus botryoides with the intention of milling them for hardwood in twenty five years. The purchase price is $23,000, (plus GST). The annual payment for the forestry right is $3,000 (plus GST).

   Stamp duty of $230.00 is levied on the purchase price.

References: H.O.9.4.; 9.6.

Taxation of Clubs, Societies, etc

Restatement of Inland Revenue's Policy

Summary

This item reaffirms Inland Revenue's policy on the taxation of clubs, societies, and other similar non-profit organisations.

We have received many enquiries about our policy on taxation of these groups. This is partly because we published a new information booklet - "Clubs and Societies - a tax guide for all clubs, societies, non-profit bodies, associations, and other groups" (IR 254) in July 1992.

Restatement of Policy

Inland Revenue has consistently adopted the policy that clubs and societies are not assessable on member transactions. These are also known as trading "within the circle of membership".

Due to the level of interest in this issue, we are reaffirming this longstanding policy.

Our policy is that clubs and societies are not assessable on member transactions, or on non-member transactions that meet certain criteria. These criteria are that:

a) the transactions are conducted on premises under the control of the particular non-profit organisation; and

b) the non-member transactions are indistinguishable from member transactions; and

c) the relevant activities are conducted substantially for the enjoyment and participation of members.

In practice this policy is limited to non-members who are bona fide guests, members of other clubs enjoying reciprocal rights, and potential members being introduced to the facilities.

The policy recognises the practical problems of differentiating between member and non-member transactions. It also reflects previous advice to non-profit organisations that Inland Revenue would not seek to tax transactions within the "circle of membership", such as bar takings.

Examples of the type of transactions to which the policy applies are bar and kitchen takings, raffles and other fundraising conducted primarily with members, and proceeds from gaming machines after allowing for gaming machine duty. Generally, these transactions meet the criteria listed above.

The policy does not extend to transactions with non-members that can clearly be distinguished. Examples of these include rental of facilities and interest income.

There are specific exemptions within the Income Tax Act 1976 that may apply to clubs and societies. For example, section 61(34) exempts the first $1,000 of income derived by any society, association, or organisation which is a non-profit body. Section 61(30) exempts income derived by an amateur sports promoter. Both sections only apply where members are prohibited from obtaining any private gain.

This item is a reaffirmation of our current policy. All policy statements may be subject to amendment at a later stage. However, we will continue to apply this policy at least until the end of the 1993/94 income year.

Reference: Tech Rulings Ch 13.3.39
HO 10.N.1.5

Entertainment Deductions - IRD Freephone

On 5 April Inland Revenue launched a freephone service to answer questions about the new deduction rules for business entertainment. The freephone is open from Monday 9.00 am to Friday 4.30 pm, on 0800 80 20 22.

We have also posted out information leaflets to nearly 300,000 business people. We'll follow this up with a detailed guide to the new rules as soon as possible.

Questions We've Been Asked

This section of the Tax Information Bulletin sets out the answers to some day-to-day questions that we've received. We've published these as they may be of general interest to readers.

These items are based on letters we've received. A general similarity to items in this package will not necessarily lead to the same tax result. Each case will depend on its own facts.

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Income Tax Act 1976

Self-Employed/Employee Test

A person asked what criteria Inland Revenue used in deciding whether a tax-payer was self-employed or an employee for income tax purposes.

We apply several tests laid down by the general law to work out the correct employment status of staff. They include:

- Control - who controls how and when the work is done, who has the right to suspend or dismiss, and who is responsible for quality and pricing;
- Integration - is the type of work or the way it is done the same as work performed by other staff who are employees? Is the work an integral part of the employer's business?
- Independence - does the worker supply all the necessary tools? Does s/he work from home? Is s/he free to work for other people as well?
- Intention - how are the payments for the work made? Did the worker carry out the same activity as a self-employed person (or an employee) in the past? Is the worker being treated as self-employed?

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- Economic reality - does the type or nature of the business justify employing an independent contractor?

Overall, we look at who has control over the work done, and how and where it is done. If the answer is the employer then the worker is almost certainly an employee. Employers who attempt to opt out of their PAYE obligations by putting staff on contract should ensure that those staff actually meet the tests outlined above and are in fact contractors. Employers may face claims for PAYE not deducted plus additional tax if Inland Revenue considers that the staff are actually employees.

The Tax Education Office Newsletter No.63 (November 1992) reproduces Inland Revenue's checksheets for determining self-employed or employee status. These also appear in our "Self-employed or an employee?" booklet, which will be available shortly.

Reference: HO.TPAH115

Treatment of Income Received by Trade Unions and Employer Organisations

Section 61 - Incomes exempt from tax: A trade unionist asked whether trade unions and employer organisations are liable for tax on income they receive.

Before 1 April 1992 trade unions and employer associations were considered friendly societies, so any income they earned from within the circle of their membership was exempt from tax under section 61(23). At that time the friendly society definition in the Income Tax Act included any society incorporated under any Act relating to industrial unions, industrial associations, or trade unions.

From 15 May 1991 employer associations and trade unions ceased to qualify as friendly societies, since the Employment Contracts Act 1991 repealed the Labour Relations Act 1987 from that date. The Employment Contracts Act provided that any organisation or association that was previously registered under the Labour Relations Act would become an incorporated society registered under the Incorporated Societies Act 1908. Since the Incorporated Societies Act didn't relate specifically to industrial unions or associations, or to trade unions, all of these groups ceased to qualify for the friendly society tax exemption for income derived from within the circle of their membership.

As a transitional measure, section 61(23A) exempted income earned between 15 May 1991 and 31 March 1992 by trade unions, employer organisations, and associations registered (or deemed to be registered) under the Labour Relations Act. This exemption didn't apply to income these groups earned from business carried on outside their circle of membership.

From 1 April 1992 all income of these organisations became assessable. They could qualify as "non-profit bodies", in which case $1,000 of their income is exempt if they meet the requirements of section 61(34). To qualify for this exemption, an organisation would have to establish that:

(a) no proprietor, member or shareholder received any profit or gain from the organisation; and

(b) its governing rules prohibit distribution of money or any property to these people.

Reference: HO.TPPO71

Deductibility of Interest Incurred by a Company

Section 106(1)(h) - Deductibility of Interest: A company in business asked whether it could deduct interest on money it borrowed to repay a loan from a shareholder.

The interest will be deductible under section 106 (1)(h)(ia) if the company uses the loan to replace capital which it used to earn assessable income. The test for deductibility is satisfied if the interest is payable in carrying on a business for the purpose of gaining or producing assessable income.

The article on pages 14 - 18 of TIB Volume Three, No.9 gives full information on this topic.

Reference: HO.TPPO3O

Depreciation on Computer Equipment used on Board Research Vessels

Section 108 - Depreciation Allowance: A taxpayer asked about the correct depreciation rate for computer hardware on board research vessels.

The correct rate for computer hardware is 20% of the diminishing value (“DV”).

On 16 December 1991 the Government announced the introduction of a 25% loading which applies to current depreciation rates. This means that all qualifying assets (including computer hardware) purchased and first used between 16 December 1991 and 31 March 1993 (inclusive) qualifies for the loading. Taxpayers can claim depreciation deductions at one and a quarter times the normal rate for any particular class of asset.

For example -

Computer hardware bought on 1 January 1992 with a depreciation rate of 20% DV would be subject to the loading. This increases the applicable depreciation rate to 25% DV.

We are currently reviewing Inland Revenue's depreciation rates because of the new depreciation regime in the Income Tax Amendment Bill (No.11). We will publicise the results in an upcoming TIB as soon as they are available.

Reference: H.O.TPP042

Income of a Relieving Teacher from the United States

Section 242 - Income Subject to Tax in New Zealand: An American relief teacher who was employed by a school in New Zealand for one year applied for a refund of taxes paid while he was in this country. He based his refund claim on what he called a “mutually reciprocating agreement” between the United States and New Zealand.

Income derived in New Zealand is subject to tax in New Zealand. In some cases there may be relief from tax in New Zealand under a Double Taxation Agreement between New Zealand and the other country in question.

The Double Taxation Relief (United States of America) Order 1983 does not contain any specific reference to the taxation of teachers. However, Article 15 does contemplate the taxation in New Zealand of income earned from dependent personal services (generally meaning income from employment) performed in New Zealand.

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In this case the tax paid will not be refunded as the income is derived from dependent personal services performed in New Zealand. However, if the teacher wanted to check that the correct amount of tax was deducted, he could file a tax return in New Zealand.

Reference: H.O.TPPO17

Non-Resident Receiving Income

Section 316 - Requirement to furnish Statements of Non-Resident Withholding Tax (NRWT) Deducted: A non-resident taxpayer received non resident withholding income. He asked whether Inland Revenue had to send him a NRWT certificate showing the tax deducted.

Inland Revenue's Non-Resident centre in Dunedin verifies NRWT certificates, then returns them to the "payer". That payer should in turn return the certificate to the recipient, although there is no legal requirement for the payer to do so.

Reference: HO.TPPOO3

Resident Withholding Tax on Government Stock

Section 327 - Resident Withholding Tax (RWT) Deductions: An investor asked why the maturity proceeds of his Government Stock investment had withholding tax deducted, and when he could claim the RWT deducted.

The Reserve Bank issued stock at tender in July 1987 for $18,378 with a face value of $19,000. This means the stock was issued at a discount of $622. The taxpayer (investor) acquired the stock at a later stage.

The interest or coupon rate was 14% per annum payable every six months. This amounted to gross interest of $1,330 half-yearly. The net interest paid was $1,010.80 after deducting withholding tax of $319.20 (24 cents in the dollar).

When the stock matured in July 1992, the taxpayer expected to receive the face value of $19,000 plus a half-yearly net interest payment of $1,010.80, making a total of $20,010.80. The amount he received on maturity was $19,861.52, as $149.28 withholding tax was deducted from the discount of $622.00 at the date of issue.

Withholding tax was deducted from both the half yearly interest payment and the discount, as interest for RWT purposes specifically includes a redemption payment (that is, a discount). The investor can claim a credit in his return for the withholding tax deducted from the July 1992 half yearly interest payment and for the withholding tax deducted from the discount on issue of the stock.

Reference: HO.TGC100FF

Qualifying Companies' Imputation Credit Accounts

Section 393M - Dividends from Qualifying Company: An accountant asked whether a credit balance in an Imputation Credit Account ("ICA") is affected when a company elects to become a qualifying company. He also asked whether Inland Revenue would have any objections if a company paid dividends to clear any credit balance in its ICA before electing to become a qualifying company.

The credit balance in the ICA is unaffected by the election to become a qualifying company. In addition, the 66% shareholder continuity requirement to carry forward imputation credits does not apply to qualifying companies.

Inland Revenue has no objections if a company wants to pay dividends to eliminate its credit ICA balance before it elects to become a qualifying company. However, this action is not generally necessary because if dividends are "unpaid" and there are sufficient ICA credits, they will not attract qualifying company election tax ("QCET").

For example:

If the Appropriation account has $67.00 and the ICA has a $33.00 credit, under the QCET formula provided in section 393K, the calculation would be:

($67 + $33 - 0 - 33/.33) x 0.33 = 0

Therefore no QCET would be payable.

In the 1992-93 transitional year any dividends paid to clear the ICA must have been paid, distributed, credited or dealt with in the shareholder's interest or behalf before the start of that income year - that is, before 1 April 1992. When calculating QCET, remember that the ICA will be affected by any tax payable or refundable for a previous year (section 393K(2)(e)). Also, paying QCET will raise a credit in the ICA.

Reference: HO.TPAH127

Unused Dividend Imputation Credits Converted to Loss to Carry Forward

Section 394ZE - Credit of Tax for Imputation Credit: A shareholder in a company asked whether any unused portion of any dividend imputation credit could be refunded to her in cash.

The imputation credit attached to a dividend is available as a tax credit for offset against the shareholder's income tax liability. Section 394ZE(3) specifically prevents excess imputation credits from being refunded to a shareholder. This is because the imputation credit is part of the income tax that the company has paid, so it cannot be directly refunded to the shareholder. This is why any excess in a particular year must be converted into a tax loss and carried forward for offset against future income.

Reference: HO.TPAH128

Election to meet Dividend Withholding Payment Liability by Reducing Loss

Section 394ZN - Election Procedure: A company asked whether the Commissioner could allow an extension of time for it to elect to meet its dividend withholding payment liability by reducing its losses.

Section 394ZN requires an election to be made within 20 days of the end of the quarter in which the company received the dividend. (This is the same time limit that the company has to pay the dividend withholding payment.) The legislation does not allow the Commissioner to give an extension of time, so the company must elect within the 20 days if at all.

If the company does not elect or pay the dividend withholding payment within this time limit, additional tax will be charged under section 394ZN(4).

Reference: HO.TPAH119

Charge of Aiding and Abetting against Practitioners where Taxpayers fail to furnish a Return

Section 416 - Offence not to furnish returns: A practitioner asked whether Inland Revenue would take legal action against practitioners whom taxpayers allege have failed to furnish a return on their behalf.

The offence of failing to furnish a tax return is an absolute liability offence. This means that even if a taxpayer engages a practitioner to file his/her return, the taxpayer remains ultimately responsible for filing the return.

If a taxpayer fails to file a return Inland Revenue may take action against the agent under the aiding and abetting provisions (see *IRD v Thomas* (1990) 12 NZTC 7,005 at p.7,011). However, we will consider each case on its own merits. We cannot use the aiding and abetting provisions against a practitioner merely as a back-up where we have been unsuccessful in gaining a conviction against a defaulting taxpayer.

Reference: HO.TPAH101

Goods and Services Tax Act 1985

Building Permit Fees

Section 10 - Value of Supply of Goods and Services: A taxpayer asked Inland Revenue to confirm that the local City Council was correct in charging GST on their building permit fees.

Section 8 of the GST Act requires registered persons to charge GST on any supply (except exempt supplies) of goods and services in the course or furtherance of their taxable activities in New Zealand. Section 6 includes the activities of a local authority in the definition of taxable activity. This means the Council must register for GST and charge GST on the supply of building permits.

Reference: H.O.TPP025

Stamp and Cheque Duties Act 1968

First Farm Stamp Duty Exemption

Section 22B - No Conveyance Duty Payable on Conveyance of First Farm: A farmer asked whether his wife's interest in their present farm should be combined with his own, for the purpose of working out whether they qualified for the first farm exemption from Conveyance Duty. The value of their combined interest in their present farm exceeded $150,000.

To qualify for the exemption, the person to whom the farm land is conveyed must not hold, or previously have held, any "substantial interest" in farm land (a "substantial interest" is one with a value of over $150,000). A person will not qualify for the exemption if his/her spouse holds or has held any substantial interest in farm land.

Under this Act a husband and wife are treated as one person when determining if they have jointly held a substantial interest in farm land. It is not their single and separate interests that must be considered in determining whether a substantial interest in a first farm applies (see *Case M20* (1990) 12 NZTC 2 129).

In this case the taxpayers cannot claim the conveyance duty exemption for a first farm because they already have a substantial interest in farm land.

Reference: HO.TPAH105F

Legal Decisions - Case Notes

This section of the Tax Information Bulletin sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, the Court of Appeal and the Privy Council.

We have given each case a rating as a reader guide to its potential importance.

- ••••• Important Decision
- •••• Interesting Issues Considered
- ••• Application Of Existing Law
- •• Routine
- • Limited Interest

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision. Where possible, we have indicated if an appeal will be forthcoming.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

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Income Tax Act Cases

Case: TRA No. 92/118

Rating: • • • •

Act: Income Tax Act 1976: sections 67(4)(a) and 104(a)

Keywords: *"expenditure incurred in course of business activities", "preparatory expenditure", "fixed and circulating capital", "purchases on revenue account".*

Summary: This case concerned expenditure on developing farming and rental properties. The taxpayer's development costs were only preparatory to an income earning process; they weren't in the course of the process. Nevertheless, Judge Barber considered the taxpayer had purchased the properties for the purpose of resale, and that they were held on the revenue account. This meant that any expenditure incurred on the properties was deductible.

Facts: A lecturer reduced his teaching position from full time to part time to spend more time developing his farming and rental properties. His primary income over the relevant period was derived from lecturing. There was no farming income other than small amounts from grazing and from the rental of a beach house. The Commissioner only allowed deductions to the extent of that income.

Although the objector spent considerable time and money in developing the 2 farm properties (1.05 and 28.8 Ha respectively), they were never viable economic units. He later sold one of them at minimal profit. The other was on the market at the date of the hearing.

The objector maintained that he undertook all his activities on the properties for business purposes with the intention of making a profit. Since the relevant period, he had moved to another area, bought and sold 20Ha as a potential lifestyle block, and then purchased another 68Ha block. Throughout the relevant period he had appraised other properties for purchase and development but had been unable to obtain finance to purchase them.

Decision: The expenditure on developing the farming and rental properties was only preparatory to an income earning process. Under old principles, it would not have been deductible.

However, since the objector acquired the properties with a purpose of resale, the Authority applied the *Inglis* and *Stockwell* decisions. The Authority held that the objector's expenditure on the farm properties must be regarded as being in respect of circulating capital held on the revenue account. Accordingly, the expenditure on the circulating capital was deductible.

Comments: The Commissioner is appealing this case.

References: Technical Rulings Chapters 12.22, 12.43
CIR v Inglis (1992) 14 NZTC 9,179
CIR v Stockwell (1992) 14 NZTC 9,190

Case: TRA No: 91/160

Rating: •

Act: Income Tax Act 1976: sections 104 and 105

Keywords: *"real estate salespersons", "independent contractor", "employee"*

Summary: The Commissioner was correct in disallowing expenses that a real estate salesman claimed, on the basis that the salesman was an employee.

Facts: The salesman worked for a firm of real estate agents and was paid on a commission only basis. The expenses he claimed were primarily motor vehicle expenses, depreciation, telephone and seminar expenses, and his Real Estate Institute subscription.

Decision: Judge Willy held that the salesman's position with his employer was not materially different from those of the licensed salespersons in the case *Challenge Realty Ltd v CIR* (1990) 12 NZTC 7212. As in that case, the proposition that a licensed real estate salesperson was an independent contractor (as opposed to an employee) was rejected.

Comments: We do not know whether the taxpayer will be appealing this decision.

References: Technical Rulings Chapters 20.8 and 56.9.3

Case: Hadlee and Sydney Bridge Nominees Ltd v CIR, (1993) 15 NZTC 10,107 [PC]

Rating: • • • • •

Act: Income Tax Act 1976: sections 10 and 99
Partnership Act 1908: section 34

Keywords: *"assignment of income", "partnership", "personal services income"*

Summary: This case establishes that income is derived by the person whose personal exertion earns the income.

Facts: This was an appeal by the taxpayers from a judgment of the Court of Appeal.

The taxpayer assigned part of his share of income from a professional partnership to his family trust. The question before the Privy Council was whether the assignment of income was effective to transfer the tax liability from the taxpayer (the partner in the firm) to the trustees of the family trust (the assignee).

Decision: The Privy Council upheld the Court of Appeal's judgment. Their Lordships were in complete agreement with the conclusion that the income is derived by the person whose personal exertion earns it. Therefore, they held the deed of assignment to be ineffective in transferring the tax liability to the assignee.

Note that by implication, their Lordships accepted that there may well be a valid assignment of income and transfer of tax liability to an assignee where a partner's right in a professional partnership depends upon a proprietary interest in the partnership, and not on personal exertion.

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Their Lordships, after reaching the conclusion that the assignment was ineffective, did not find it necessary to deal with arguments on the proper construction of section 10 or the application of section 99.

References: Technical Rulings Chapter 12.38

Case: TRA No. 92/171

Rating: •

Acts: Income Tax Act 1976: section 38
Goods and Services Tax Act 1985: section 8

Keywords: *"taxpayer acting as trustee", "issue of who derived the income", "credibility of witness"*

Summary: The taxpayer successfully objected to income tax and GST assessments that the Commissioner issued. The assessments were based on funds deposited in the taxpayer's bank account by another party.

Facts: P deposited a large sum of money in the taxpayer's personal account over a three year period.

The taxpayer claimed that P had approached him to deposit money in the account for safe keeping. P claimed that he was an employee of the taxpayer and that the money belonged to the taxpayer.

Decision: The issue was who the income belonged to.

In making his decision, Judge Barber had to assess the credibility of the opposing evidence from the taxpayer and P. On the balance of probabilities, the taxpayer was held to have acted as a trustee for P. The deposits had not been derived from his business.

Judgment was fully in favour of the taxpayer.

Comments: Inland Revenue is not appealing this decision.

References: Technical Rulings Chapters 78.5.5.1, 78.5.5.2

Case: TRA 92/59

Rating: •

Keywords: *"penal tax", "withdrawal of case"*

Summary: This case was withdrawn by consent, without any order for costs being made.

Facts: The Commissioner imposed penal tax of 100% for the taxpayer's failure to account for PAYE deductions. The taxpayer was unable to show that the failure to account for the PAYE was due to circumstances outside her control, and withdrew the objection.

Decision: The TRA made a consent order in favour of Inland Revenue.

Reference: Technical Rulings Chapter 56.15.2

Case: TRA No: 92/40

Rating: •

Act: Income Tax Act 1976: sections 104 and 105

Keywords: *"real estate salesperson", "independent contractor", "employee"*

Summary: The Commissioner acted correctly in disallowing the expenses claimed by the objector, a real estate salesman.

Facts: The salesman worked for a firm of real estate agents and was paid on a commission only basis. He claimed tax deductions for various items of expenditure incurred throughout the year.

Decision: The Judge held that the salesman's position with his employer was not materially different from those of the licensed salespersons in the case *Challenge Realty Ltd v CIR* (1990) 12 NZTC 7212. As happened in that case, the proposition that a licensed real estate salesperson was an independent contractor (as opposed to an employee) was rejected.

Comments: We do not know whether the taxpayer will be appealing this decision.

References: Technical Rulings Chapter 20.8 and 56.9.3

Goods and Services Tax Act Cases

Case: L. R. McLean and Company and Others v CIR (1993) 15 NZTC 10,100

Rating: • • • •

Act: Goods and Services Tax Act 1985: section 2

Keywords: *"secondhand goods"*

Summary: This case deals with whether the purchase of wool from unregistered persons falls within the statutory definition of secondhand goods. The High Court concluded that wool is not a secondhand good for the purposes of the GST Act.

Facts: The taxpayers are members of the Federation of New Zealand Wool Merchants Inc. The cases were put forward as test cases to resolve an issue that was common to all members of that Federation.

Private Treaty Wool Merchants purchase wool directly from farmers, both at the farm and at the merchant's store. They purchase all types of wool from farmers, including poorer qualities and small quantities of wool.

The issue in this case was whether wool is a secondhand good for the purposes of the GST Act. If it is, then the wool merchants would be able to claim an input tax credit for all wool they purchase from non-registered persons.

There have been several amendments to the definition of secondhand goods since the GST Act was enacted in 1985. However, the wool merchants claim that wool falls within the present definition of "secondhand goods". They argued that the definition has lost its ordinary meaning and has taken on a technical meaning because of the purpose of the input tax credit mechanism. This argu-

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ment was based on the premise that GST is a neutral tax for business and is only borne by the ultimate consumer.

They also argued that the meaning of the present definition was no different from the meaning of the original definition in the enacting legislation. They considered the amendments to the definition to be merely machinery provisions without substantial effect.

Decision: The High Court confirmed that the taxpayers' claim for an input tax credit should have been disallowed.

Judge Greig rejected the taxpayers' argument that the definition had taken on a technical meaning due to the input tax credit mechanism. Instead, he held that the legislation singled out secondhand goods for special treatment. If the intention had been otherwise, then the phrase secondhand goods would not have been used.

The Judge did not accept that the amendments to the definition were merely machinery provisions without subsequent effect. He concluded that the history of the legislation effectively repealed the original descriptive provision and replaced it with the ordinary meaning of the phrase.

Comments: This case is notable for its interpretation of the term secondhand goods. It also provides a useful discussion of the legislative history of the "secondhand goods" definition in the GST Act.

We do not know whether the taxpayers will be appealing this decision.

References: Technical Rulings Chapters 102.82 and 109.22.2

Inland Revenue Department Act Cases

Case: Green & Waugh v Housden & Simcock (1993) 15 NZTC 10,053

Rating: • • • •

Act: Inland Revenue Department Act 1974: section 17

Keywords: *"production of documents", "scope of demand", "administration and enforcement", "extent of powers"*

Summary: Inland Revenue may issue notices under section 17 to obtain further information after the assessment process or in contemplation of litigation. However, at this stage the notices should not be drawn too widely nor should they seek to obtain tax advisers' advice on the conduct of the investigation or their client's position.

Further, the Commissioner cannot demand the delivery of the documents to the officers of the Inland Revenue Department.

Facts: After investigating a taxpayer, Inland Revenue issued notices under section 17, requesting information from the taxpayer's accountant and solicitor. These notices were sent more than a year after assessments had been made and objected to. The accountant and the solicitor refused to comply with these notices. They sought a judicial review of the Commissioner's decision to issue the notices on the following grounds:

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(a) Whether the Commissioner can use section 17 notices to obtain further information after an assessment or in contemplation of litigation;

(b) Whether the request to produce "all" documents complied with section 17 when only a limited number of documents were being sought;

(c) Whether the notices were outside the scope of the section since they purported to require production of the appellant's documents rather than the company's documents;

(d) Whether the Commissioner can require the documents to be delivered to the Inland Revenue Department.

The High Court decided for the Commissioner on the first three issues, but found in favour of the applicants on the fourth issue. The Applicants appealed this decision on all three points and the Commissioner cross appealed on the fourth point.

Decision: The Court of Appeal allowed the appeal of the Applicants and dismissed the Commissioner's cross appeal. In delivering their judgment, the Court of Appeal concluded:

(a) Notices may be used to acquire further information after the assessment process or in contemplation of litigation.

(b) Depending on the stage of the investigation, the Commissioner must take care not to draw notices too widely. The Court may intervene if the notice is too broad and is established as not relevant to the investigation.

(c) Generally, tax advisers' opinions and advice on the conduct of the investigation and the client's position after the investigation has commenced are not relevant to the Commissioner's inquiries. This information should generally be excluded from section 17 notices.

(d) The Commissioner cannot stipulate a place where the documents should be delivered. It is sufficient for the taxpayer to produce the information at his/her own premises.

Comments: This decision will not be appealed.

References: Technical Rulings Chapter 56.15.3.4

Due Dates Reminder

April

20 PAYE deductions and IR 66N/IR 66W for first 15 days of April 1993 due - "large" employers only. *(Please note that from this payment date onwards, student loan repayment deductions and child support deductions may be due at the same time.)*

PAYE deductions, IR 66N and IR 66ES for March 1993 due - "small" employers only.

Completed Deduction Certificates for year ended 31 March 1993 should have been distributed to all employees.

RWT on Interest deducted during March 1993 due for monthly payers.

RWT on Interest deducted from 1 October 1992 to 31 March 1993 due for six-monthly payers.

RWT on Dividends deducted during March 1993 due.

Non-Resident Withholding Tax (or Approved Issuer Levy) deducted during March 1993 due.

FBT return and payment for quarter ended 31 March 1993 due.

Annual Nil FBT return (1 April 1992 to 31 March 1993) due for employers who pay no fringe benefits.

Gaming Machine Duty return and payment for month ended 31 March 1993 due.

30 GST return and payment for period ended 31 March 1993 due.

May

5 PAYE deductions and IR 66ES for last 15 days of April 1993 due - "large" employers only.

7 First instalment of 1994 Provisional Tax due for taxpayers with January balance dates.

7 Second instalment of 1993 Provisional Tax due for taxpayers with September balance dates.

Third instalment of 1993 Provisional Tax due for taxpayers with May balance dates.

First 1994 Student Loan interim repayment due for periodic payers with January balance dates.

20 PAYE deductions and schedules for first 15 days of May 1993 due - "large" employers

PAYE deductions and schedules for April 1993 due - "small" employers.

Gaming Machine Duty return and payment for month ended 30 April 1993 due.

RWT on Interest deducted during April 1993 due for monthly payers.

RWT on Dividends deducted during April 1993 due.

Non-Resident Withholding Tax (or Approved Issuer Levy) deducted during April 1993 due.

31 Annual Liable FBT return (1 April 1992 to 31 March 1993) and payment due for employers who elected to pay FBT on an annual basis.

GST return and payment for period ended 30 April 1993 due.

Annual Wage Reconciliation and ACC Employer Premium Statement (IR 68A, IR 68P) due to be filed.

1993 Employer Premium due.

Specified Dividend reconciliation IR 17S or IR 17SA due.

Annual Interest Reconciliation Statement (IR 15S) due.

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Questions we've been asked

Answers to enquiries we've received at Inland Revenue, which could have a wider application. See page 8 for a list of topics covered in this bulletin.

Legal Decisions - Case Notes

Notes on recent cases heard by the Taxation Review Authority, the High Court, the Court of Appeal and the Privy Council. See page 14 for a list of cases covered in this bulletin.

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