GST - section 21 and property developers who rent out property for residential purposes

Background

When a registered person acquires an asset, the Goods and Services Tax 1985 ("the Act") applies an all-or-nothing approach to determine whether that person can claim an input tax deduction for the GST paid on the asset. If the asset is "acquired for the principal purpose of making taxable supplies", the person can claim a full input tax deduction. The person can't claim an input tax deduction if the asset is not acquired for the principal purpose of making taxable supplies.

If a person acquires an asset for the principal purpose of making taxable supplies, but subsequently uses it for a non-taxable purpose, section 21(1) of the Act creates a "deemed supply" and the registered person will have an output tax liability. The value of the deemed supply (and the corresponding output tax liability) is determined by section 10(8).

There have been three recent cases concerning GST and property developers. One of these cases (a decision of Judge Bathgate) is reported as two separate cases - *Case N13* (1991) 13 NZTC 3,105 and *Case N31* (1991) 13 NZTC 3,277. The other two cases are *Case N19*(1991) 13 NZTC 3,158 (Judge Barber) and *Case N22 (*1991) 13 NZTC 3,187 (Judge Bathgate). There are difficulties in reconciling the approaches taken by the TRA in these cases. Inland Revenue has not appealed these cases because our main concern was that the registered person did not in fact acquire the property for the principal purpose of making taxable supplies. After hearing the evidence in those cases, the TRA held in favour of the taxpayers. The Commissioner accepts those decisions, as they were made on the relevant facts.

The problem that has arisen is a consequential flow-on effect from how the TRA has applied section 21. Inland Revenue considers that the TRA has not applied section 21 correctly, and we will not follow the decisions in applying section 21.

Policy

This article sets out Inland Revenue's interpretation on applying section 21(1) to property developers who rent out property for residential purposes before selling it. It does not apply to property developers who rent out property for commercial purposes.

This article sets out:

- When a property developer can claim a full input tax deduction
- The section 21(1) adjustment
  1. The TRA approach
  2. Inland Revenue's view
  3. The value of the supply
- The application of the de minimus rule
- Whether the developer can claim an input tax deduction for ongoing expenses
- Treatment upon disposal of the property
- The application of section 14(d)

Input tax deduction

If a property developer acquires a property for the principal purpose of making taxable supplies a full input tax deduction is permitted.

Whether a property is acquired for the principal purpose of making taxable supplies is a question of fact, and all the circumstances surrounding the acquisition must be considered.

A developer who has acquired a property for the principal purpose of making taxable supplies (and has received a full input tax deduction), may then rent out the property for residential purposes. This may occur if the developer is unable to sell the property. Such a supply is an exempt supply under section 14(c) of the Act.

The recent cases, especially Cases *N13, N31* and *N22,* have held that even though the property has been rented, the developer can still apply the property for the principal purpose of making taxable supplies. The renting-out of the property is a separate and subsidiary purpose. This means that a developer who acquires a property for the principal purpose of making taxable supplies, but who rents it out, may have two separate and distinct purposes:

- making taxable supplies; and
- making exempt supplies.

Although each case must be determined on its own facts, Inland Revenue accepts that the developer can still apply the property for the principal purpose of making taxable supplies, even when it is rented out. In this case the exempt application would be a subsidiary purpose.

The section 21(1) adjustment

Where goods acquired for the principal purpose of making taxable supplies are subsequently applied for a purpose other than making taxable supplies, section 21(1) deems a supply of those goods to occur to the extent of the subsequent application. In other words, section 21(1) deems the supply of rental accommodation (ordinarily an exempt supply) to be a taxable supply, on which the supplier must account for output tax.

TRA approach to the section 21(1) adjust-

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ment

In *Case N19*, Judge Barber held that section 21(1) applies only where the principal purpose for acquiring a property changes. If the principal purpose remains unchanged but the property is still applied for an exempt purpose such as a residential tenancy, then *Case N19* holds that section 21(1) does not apply.

In *Cases N13, N31* and *N22*, Judge Bathgate held that section 21(1) did apply where there was a subsidiary exempt purpose, and held that the words "to the extent that" in section 21(1) indicated that there was an apportionment of the input tax credit originally allowed. *CIR* v *Banks* [1978] 2 NZLR 472 was cited in support of this approach.

In *Case N22,* Judge Bathgate held that the property was applied 51% for a taxable purpose, and 49% for a non-taxable purpose. The value of the supply was, presumably, determined by section 10(8) and was the original cost of the property. This meant the developer made a deemed supply of 49% of the cost of the property.

The TRA indicated that the section 21(1) adjustment is a one-off adjustment. It further suggested that when the rental activity ends, (and the property is again applied 100% for the purpose of making taxable supplies), there is a deemed supply under section 21(5). The developer would then be entitled to the remaining 51% of the input tax credit.

The result is that when the property is rented, 49% of the input tax credit originally allowed is effectively "clawed back" by Inland Revenue. When the property is no longer rented, there is a deemed supply under section 21(5), and the developer is entitled to the remaining input tax credit.

Inland Revenue's View

Contrary to *Case N19*, Inland Revenue considers that section 21(1) is not limited to cases where there is a change in the registered person's principal purpose in acquiring the goods. We consider that section 21(1) applies to every supply of goods or services that is an exempt supply, if the person originally acquired those goods or services for the principal purpose of making taxable supplies.

Further, we consider that the problem with the TRA approach in Cases *N13, N31* and *N22* is that it joins the supply of land to the property developer (for which the developer is allowed a full input credit) to the developer's subsequent supply of residential accommodation (which section 21(1) deems to be a taxable supply). Section 21 does not provide for any such joining of supplies.

Inland Revenue's view is that section 21(1) does not affect the GST treatment of the supply of property made by the vendor of the property. If the property developer's principal purpose in acquiring the property is to use it to make taxable supplies, then the developer is entitled to a full input credit on the acquisition. Section 21(1) is not relevant to that supply.

Section 21(1) becomes relevant when analysing the property developer's subsequent supplies relating to the property. In letting the property on a residential tenancy, the property developer is supplying land by way of lease. Section 14(c) provides that those supplies are exempt from GST. However section 21(1) overrides that exemption, and deems a supply of property under a residential lease to be a taxable supply for which the property developer must return GST output tax. These "deemed" supplies will be subject to output tax under section 8, therefore they are taxable supplies. The value of those taxable supplies is determined by section 10(8).

Under section 21(2), the deemed supply is made at the time the goods are applied for a purpose other than that of making taxable supplies (i.e., for residential accommodation). There will be an output tax liability in every taxable period in which the property is applied for the residential purpose. This means the deemed supply under section 21(1) must be considered on a period by period basis. Output tax must be returned from the first period of the deemed taxable supply.

The value of the supply

Section 10(8) of the Act states that where a person is deemed to supply goods and services under section 21(1) of the Act, the consideration in money for that supply is the lesser of;

(a) The cost of the goods and services to the supplier; or

(b) The open market value of the supply.

The value of the "deemed supply" of residential accommodation under section 21(1) will be the lesser of the cost of the goods or the open market value.

(a) "Cost of Goods"

Inland Revenue does not view the cost of the goods (property) to be the original cost of the property to the developer. Rather, "cost of the goods" will be the cost to the developer of making the "deemed supply of residential accommodation". The "cost of goods" will usually include items such as depreciation of the property, upkeep of the property, rent collection costs, interest etc.

(b) Open Market Value of the Supply

Open market value of the supply in this context is the open market value of the "deemed supply of residential accommodation", i.e., the comparative market rental for the property.

Usually the property will be rented at open market value. In this case, if the open market value is less than the cost of goods (explained above), the value of the "deemed supply of residential accommodation" will be the rent charged. If the open market value is the value of the deemed supply, the developer should return one-ninth of the rent charged as output tax in each taxable period in which the deemed supply of residential accommodation takes place.

Where the property is not supplied at open market

value, the open market value of the property should be determined. The developer should return one-ninth of the open market value determined as output tax in the taxable period which the deemed supply takes place. This does not mean that the property developer should charge GST on the rent. Rather, the rental charged is a means of valuing the deemed taxable supply of rental accommodation.

Summary of the section 21(1) adjustment

Inland Revenue's view is that there is no apportionment of the property developer's input tax deduction on the acquisition of the property. The words "to the extent that" in section 21(1) merely indicate that it is only the application for the non-taxable purpose (the residential accommodation) that is deemed to be a taxable supply. The value of the deemed supply must be determined under section 10(8).

The de minimus proviso

The first proviso to section 21(1) applies where the estimated value of all the developer's exempt supplies is less than $48,000 per annum, and less than 5% of all the developer's supplies. If the first proviso to section 21(1) applies, there is no deemed supply under section 21(1), and the developer should make no output tax adjustment.

"On-going" expenses

The developer may incur "on-going" expenses while the property is being rented. For example, the developer may pay rates and insurance, or purchase building materials. The following rules apply to on-going expenses:

1. If the developer makes an output tax adjustment under section 21(1)

If the developer makes an output tax adjustment under section 21(1), there will be two taxable supplies. The first is the intended sale of the property, and the second is the deemed taxable supply of residential accommodation. The developer is entitled to an input tax credit on all supplies received for the principal purpose of either the sale of the property, or the rental of the property;

2. If the developer makes no output tax adjustment under section 21(1)

When the first proviso to section 21(1) applies, there is no deemed supply under section 21(1). This means the developer will be making a taxable supply (the intended sale of the property) and an exempt supply (supplying residential accommodation). The supply of residential accommodation is exempt under section 14(c).

The developer is only entitled to claim input credits on supplies received for the purpose of making taxable supplies (the sale of the property). No input tax can be claimed on supplies made to the developer for the principal purpose of making exempt supplies (the renting of the property).

Expenses such as rates do not relate to the exempt supply as they are payable regardless of the tenancy situation. The developer can claim input tax credits for such expenses.

Disposal of the Property

When the developer sells the property, the sale will be subject to GST since it is made in the course of the property developer's taxable activity. If the property developer has completely abandoned the property development purpose the sale will not be in the course of a taxable activity, so it won't be subject to GST.

If the property is rented for five years or longer - application of section 14(d)

(a) If the property was applied for taxable and exempt purposes

Inland Revenue is aware that some property developers are claiming that no GST is payable on the sale of a building which has been used exclusively for rental purposes for five years before the sale, on the basis of section 14(d). Our view is that a property developer can only take advantage of the exemption in section 14(d) if the property has been used *exclusively* for rental purposes. When the property has been used for two purposes, one a taxable supply (property development) and one an exempt supply (rental accommodation), we consider that the property has not been used exclusively for the exempt purpose, so section 14(d) cannot apply.

Any subsequent sale of the property will be a supply in the course of the property developer's taxable activity, and GST will be payable.

(b) If the property was applied for exempt purposes only

If the property owner has abandoned the property development purposes and has instead adopted residential letting as his or her only purpose, Inland Revenue considers that a one-off adjustment is required. A one-off adjustment will be required under section 21(1) as there has been a complete (100%) change in the application of the asset from a taxable to a non-taxable activity.

The supply is valued under section 10(8). For one-off adjustments the two limbs of section 10(8) are given a different interpretation. In this context the "cost of goods and services" in section 10(a) means the acquisition cost of the goods, and "open market value" in section 10(8) means the amount the asset would fetch if sold on the open market. Because land usually appreciates the value of the supply will usually be the acquisition cost of the property. This means the developer will effectively pay back the amount of input tax originally allowed on acquisition of the property (by virtue of an output tax liability) in the taxable period in which the property is applied for the non taxable purpose.

This effectively claws back the original input tax allowed on the property. When the property is subse-

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quently sold, no GST is payable as the sale is not a supply in the course of a taxable activity of property development.

Conclusions

- Where a property developer acquires a property for the principal purpose of making taxable supplies, a full input tax credit is allowed.
- If the developer subsequently applies the property for an exempt purpose (e.g., residential accommodation) that application is a deemed supply. The deemed supply is valued under section 10(8) and the developer must return one-ninth of that value as output tax.
- If the first proviso to section 21(1) applies there is no deemed supply under section 21(1), and the developer should make no output tax adjustment.
- Where section 21(1) applies, both the intended sale of the property and the deemed supply of residential accommodation are taxable supplies. In this case the property developer's expenses relate to goods and services acquired for the principal purpose of making taxable supplies. A full deduction of input tax incurred on expenses is allowed.
- Where section 21(1) does not apply because of the first proviso to section 21(1), the property developer makes both taxable and exempt supplies. An input tax credit is only allowed for those expenses incurred for the purpose of making taxable supplies. The property developer must account for GST on the sale of the property unless the property development purpose is completely abandoned.
- A property developer can only take advantage of the exemption in section 14(d) if the property has been used exclusively for rental purposes. Where the property developer has abandoned the property developing purpose a one off adjustment is required. Any subsequent sale will be exempt from GST under section 14(d).

Examples

Period by period adjustment required

A property developer is registered for GST.

- On 3 August 1992 she buys land and an exterior timbered domestic residence from an unregistered person. The principal purpose for buying property is to renovate it and sell it at a profit.
- The price paid for both the land and buildings is $120,000. The land has a value of $70,000 and the buildings are worth $50,000.
- The property is not tenanted at the time of acquisition. The developer is a category A registered person with return periods ending on the last day of the odd numbered months of the year.
- The property is put up for sale on 29 September 1992. As at the end of November there is no prospect of sale and tenants are installed on 1 December 1992. The developer rents the property out at $600 per month. This interim measure is to defray expenses pending an upturn in the housing market.
- The developer sells the property on 1 February 1993 for $141,000.

Because the developer bought the property for the principal purpose of making taxable supplies, she is permitted a full secondhand goods input tax credit on the purchase price of $120,000 ($13,333.33) in the return period ended 30 September 1992.

On 1 December 1992 a supply is deemed to occur under section 21(1). At that time, property which was acquired for the principal purpose of making taxable supplies is applied for a non-taxable purpose. As there is a deemed supply the property developer must account for output tax. The following must be determined to calculate that liability:

1. The extent to which the property is applied for the exempt purpose; and
2. The value of the deemed supply.

At the time the property is rented, all of it is applied for the non-taxable purpose of residential rental. There is no part of the property that is not applied for the non-taxable purpose.

Under section 10(8), it is necessary to establish the lesser of “cost of those goods and services” or “open market value” to value the deemed supply.

Cost of goods or services (section 10(8)(a))

Depreciation - straight line at 2.5%

$\frac{\$50{,}000 \times 2.5\%}{6} \times 100\% = \$208.33$

Cost of goods and services = $208.33

(Because land has no depreciation rate, the depreciation adjustment only applies to the building.)

Open market value (section 10(8)(b))

Rent for the two month period is $1,200

Cost is the lesser amount. Therefore, under section 10(8) the value of the supply is $208.33. The adjustment to be included in box 6 of the return for the period ended 31 January 1992 is:

$\frac{\$208.33}{9} = \$23.15$

The developer must make this adjustment in every taxable period in which she is renting out the property.

When the developer disposes of the property it will be a taxable supply, and she must charge GST on the supply.

Application of section 14(d)

Assuming the same fact scenario as above, but at 1 December the property developer decides to discon-

tinue developing the property for resale and to become a full time residential lessor. Because there has been a complete change of purpose, she must make a one-off adjustment under section 21(1).

Under section 10(8) it is necessary to establish the lesser of "cost of those goods and services" or "open market value".

Cost of the goods and services (section 10(8)(a)).

Acquisition cost of the property = $120,000

Cost = $120,000

Open market value (section 10(8)(b))

What the property would sell for on the open market = $141,000.

Cost is the lesser amount. Therefore under section 10(8) the value of the supply is $120,000. The adjustment to be included in box 6 of the return for the period ending 31 January is:

$$\frac{\$120{,}000}{9} = \$13{,}333.33$$

$13,333.33 would be returned in the first period in which the property was first applied for the non-taxable purpose.

Any subsequent sale of the property would be an exempt supply and not liable for GST.

Surgical implant instrument sets - depreciation

There is a new asset class and general depreciation rate for ***surgical implant instrument sets (orthopaedic)***. The depreciation rate is 50% diminishing value, or 40% straight line equivalent. The new rate applies to equipment acquired on or after 1 April 1993.

The new rate is set by Determination DEP3: Tax Depreciation Rates General Determination Number 3, which is reproduced below. This determination inserts a new asset class into the Scientific, Medical and Laboratory Equipment asset category of Determination DEP1 (published on page 54 of the appendix to TIB Volume Four, No.9 - April 1993).

Determination DEP3

This determination may be cited as "Determination DEP3: Tax Depreciation General Determination Number 3".

1. Application

This determination shall apply to the asset class "Surgical Implant Instrument Sets (Orthopaedic)" under the "Scientific, Medical and Laboratory Equipment" asset category where the equipment is acquired on or after 1 April 1993.

2. Determination

Pursuant to section 108C of the Income Tax Act 1976 I have determined the following basic economic depreciation rate:

Determination DEP1 (as amended by Determination DEP2 dated 2 November 1993) is amended by inserting in the asset category "Scientific, Medical and Laboratory Equipment" an additional asset class "Surgical Implant Instrument Sets (Orthopaedic)" with the following details -

Estimated Useful Life (years)	3
DV Banded Depn Rate (%)	50
SL Equiv Banded Depn Rate (%)	40

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 1976.

This determination is signed by me on the 12th day of January 1994.

Murray McClennan
Acting Manager (Rulings)
Head Office
Inland Revenue Department

Student Loan Scheme - repayment threshold raised

The Government has reviewed the repayment threshold for the Student Loan Scheme, and raised it to $13,520 for the 1994-95 income year.

Residential rental property chattels - depreciation

There is a new industry category ***"Residential Rental Property Chattels"*** which sets new general depreciation rates. The new depreciation rates apply to assets acquired on or after 1 April 1993.

The new rates are set by Determination DEP4: Tax Depreciation Rates General Determination Number 4, which is reproduced below. This determination inserts the new industry category "Residential Rental Property Chattels" into Determination DEP1 (published in the appendix to TIB Volume Four, No. 9 - April 1993).

Determination DEP4

This determination may be cited as "Determination DEP4: Tax Depreciation Rates General Determination Number 4".

1. Application

This determination shall apply to the asset classes listed under the industry category "Residential Rental Property Chattels" where the assets are acquired on or after 1 April 1993.

2. Determination

Pursuant to section 108C of the Income Tax Act 1976 I have determined the following basic economic depreciation rates:

Determination DEP1 (as amended by Determination DEP2 and Determination DEP3) is further amended by inserting the industry category "Residential Rental Property Chattels" with the following asset classes, estimated useful lives, diminishing value depreciation rates and straight line equivalent depreciation rates:

Residential Rental Property Chattels

Asset Class	Estimated Useful Life (years)	DV Banded Depn Rate (%)	SL Equiv Depn Rate (%)
Residential Rental Property Chattels (not elsewhere specified)	5	33	24
Blinds	8	22	15.5
Carpets	5	33	24
Curtains	8	22	15.5
Drapes	8	22	15.5
Dryers (clothes, domestic type)	6.66	26	18
Freezers (domestic type)	8	22	15.5
Furniture (loose)	10	18	12.5
Microwave Ovens (domestic type)	6.66	26	18
Ovens (domestic type)	8	22	15.5
Refrigerators (domestic type)	8	22	15.5
Stoves (domestic type)	8	22	15.5
Vinyl flooring	10	18	12.5
Washing machines (domestic type)	6.66	26	18
Appliances (small)	4	40	30
Light fittings	10	18	12.5
Furniture (fitted)	15.5	12	8
Vacuum cleaners (domestic type)	3	50	40
Televisions	5	33	24
Video recorders	5	33	24
Stereos	5	33	24
Heaters (electric)	3	50	40
Heaters (gas, fitted)	8	22	15.5
Heaters (gas, portable)	5	33	24
Dishwashers	6.66	26	18
Linen	3	50	40
Lawn mowers	4	40	30
Water heaters	12.5	15	10

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 1976.

This determination is signed by me on the 19th day of January 1994.

Murray McClennan

Acting Manager (Rulings)
Head Office
Inland Revenue Department

Tax system advances

Inland Revenue's annual report, which was tabled in Parliament in late December, shows unprecedented success in reducing the number of outstanding returns in the last year. Approximately 880,000 1992 returns were overdue at the beginning of the year, but by June this had been reduced by nearly 87% to only 116,000.

There were also major improvements in the collection of overdue tax, with net collectable debt dropping by 25% during the year, from $829 million to $621 million. Inland Revenue's new computer systems and structures enable us to quickly identify those people whose tax was overdue, and begin collecting the money owed.

Inland Revenue's audit activities also achieved good results, with back taxes of $604 million assessed during the 1993 year. Our Investigations and International Audit section collected $18.16 for every dollar spent in that area, significantly over the budgeted collection figure of $13 for every dollar spent.

Many people have incorrectly assumed that Inland Revenue's actions against them will be slow, but our new structures and systems are changing those assumptions. We will take swift and firm action against those taxpayers who put costs on the rest of the community by not fulfilling their basic tax obligations.

On the service side, Inland Revenue staff had more than four million contacts with taxpayers last year, including a growing number of phone enquiries. Our market research shows that most customers like Inland Revenue's computerised phone system, but some do find it irritating. To alleviate this, by April 1994 the larger Inland Revenue offices will be re-equipped with systems that allow people to direct dial individual numbers according to their particular requirements.

Whitebait buyers and withholding tax

Recently Inland Revenue took steps to remind people who work in the West Coast whitebait industry of their tax obligations. This was part of our increased attention to tax evasion in all areas. Early reports show that withholding tax collected from whitebait sales has nearly doubled this year on the West Coast. Last year $116,000 was collected, compared with $204,000 for the season so far.

As well as the extra tax assessed, we achieved our other goal of educating and reminding people about their tax obligations. In particular, all buyers are legally required to deduct withholding tax.

Receiving the TIB - have you replied?

With the November 1993 Tax Information Bulletin we sent out a reply portion for people who want to keep on receiving the TIB.

We will start using the new mailing list from next month. If you want to receive the TIB from February onwards, please make sure you've sent the reply sheet back to us. The address is:

TIB Mailing List
P O Box 2546
WELLINGTON

It's faster for us to process your response if you send back the original bar-coded reply page, but if you've misplaced that page then please write to us anyway so we know to keep you on our mailing list.

Questions we've been asked

This section of the Tax Information Bulletin sets out the answers to some day-to-day questions that people have asked. We have published these answers 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 section 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

Objection to assessment made by facsimile

Section 30(1) - Notice of objection: A taxpayer objected to an income tax assessment by way of a fax. The question that arose was whether an objection to an assessment transmitted by fax satisfies the requirements of the Act.

A fax meets the requirement of "delivery" under section 30 of the Act. The taxpayer's objection was received in time.

Payment of tax deductions by employee

Section 342 - Payment to be made by employee where tax deduction exceeds source deduction payment: An employee received no cash earnings for a pay period. He lives in a house supplied by his employer. The benefit of living in the house has been assessed at $120 per fortnight. The employer asked whether tax deductions must be made and if so, how they can be made as there was no cash from which to make the deduction.

Tax deductions must be made. Section 72 includes the value of any board or lodging, or use of a house or quarters as being within the definition of the term "monetary remuneration". All "monetary remuneration" is assessable under section 65(2)(b). The value of such section 72 benefits are specifically included within the section 2 definition of "salary or wages" and are therefore subject to tax deductions under Part XI of the Act.

Section 342 provides that where either insufficient cash is received to pay the required tax deduction or no cash is received, the employee must pay the employer the amount required to meet the tax deduction. The employer must then pass the payment on to Inland Revenue.

If the employee fails to make the payment to the employer, section 355 of the Income Tax Act requires the employee to pay the amount to Inland Revenue by the 20th day of the month following the pay period.

Losses brought forward - income under $9,880 rebate

Section 50C - Transitional tax allowance: A taxpayer incurred a rental loss in the 1992 income year. Part of that loss was offset against the taxpayer's 1993 assessable income. When Inland Revenue calculated the taxpayer's transitional tax allowance (income under $9,880 rebate), the loss brought forward to the 1993 income year was excluded from the calculation. The taxpayer asked why the loss was excluded.

When calculating this rebate, only the assessable income for the 1993 income year was taken into account. That was because section 50C(2) of the Act specifies that the calculation is based on the *"assessable income derived in the income year"*. The losses carried forward were not derived in the 1993 income year, so they were correctly excluded from the calculation.

For the purposes of calculating the amount of income tax owing for the 1993 income year, the loss can be carried forward and offset against the taxpayer's 1993 assessable income under section 188 of the Act.

Approved donee organisation

Section 56A - Qualifying gifts: A taxpayer has asked how she would know if a donation made to a charity would qualify for the donation rebate under section 56A(2).

Donations made to donee organisations qualify for a tax rebate. The amount of the rebate is 33⅓% of the total qualifying donations paid by a taxpayer, up to a maximum of $500. This means that the maximum amount of total qualifying donations eligible for the rebate is $1500.

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Taxpayers thinking of making a donation who are unsure whether it will qualify for the donation rebate should contact their local Inland Revenue office, where there is a list of approved organisations available.

Organisations may apply to Inland Revenue to obtain donee status. Inland Revenue advises such organisations if their donee status is approved. When an approved donee organisation issues a receipt for a donation, the receipt should meet these conditions:

- It must be officially stamped with the name of the organisation.
- It must show the date on which the donation or gift was made.
- It must be signed by a person authorised by the organisation.

Inland Revenue must be satisfied that the donation was made either as a gift or as a payment of fees. Any taxpayer who claims a rebate for donations must have a receipt for each donation, and each receipt must be for $5 or more.

List of organisations with "donee" status

The secretary of a charitable organisation has asked if Inland Revenue would release the names of other organisations that are exempt from income tax.

Inland Revenue does not release specific details about taxpayers, but we do publish a list of organisations that have been granted "donee" status under section 56A(2) of the Income Tax Act 1976. Only the name of each organisation appears on the list.

Copies of the list are available from Taxpayer Services, Inland Revenue Head Office, PO Box 2198, Wellington at a cost of $31.50, Alternatively, you can view this list at the counter of any Inland Revenue office.

Family Support - effect of 1993 livestock revaluation

Section 86L - Spreading of income arising in 1992-93 income year from re-valuation of specified livestock: A farmer wanted to know how the livestock revaluation income affected his Family Support calculation.

Some farmers had additional income from livestock revaluation in the 1993 year. Section 86L of the Income Tax Act enables them to spread that income over the succeeding four years. For Family Support purposes, section 374B(1)(e)(iii) of the Income Tax Act excludes the revaluation income when determining the Family Support tax credit, regardless of the year in which the income is assessed (and that includes the 1993 income year).

This treatment differs from earlier years when livestock revaluation income was included in the calculation for Family Support purposes.

However, if the farmer concerned was eligible for a "section 86L spread" but had not utilised that spread, then the farmer would still be entitled to reduce his or her income for Family Support purposes by the section 86L amount.

Overseas tax paid and dividend imputation credit

Sections 293(2) - Credit for tax paid overseas, and 394ZE - Credit of tax for imputation credit: A taxpayer had both overseas tax credits and dividend imputation credits to offset against his assessable income. He has asked which credit should be offset first.

The overseas tax paid can be used as a credit against tax payable. Any excess is not refundable. Imputation credits in excess of tax payable are also not refundable, although the excess can be converted to a deemed loss and carried forward and offset in succeeding income years.

Inland Revenue's practice is to offset the overseas tax credit first. This gives the taxpayer the greatest advantage through the ability to carry forward any unused dividend imputation credits by way of a deemed loss.

Example One - if the overseas tax credit is deducted first:

Tax payable	$120
Less overseas tax credit	$90
	$30
Less imputation credit	$50
Tax to refund	NIL

Deemed loss to carry forward ($ 20.00 divided by .28) = **$ 71.43**

Example Two - if the dividend imputation tax credit is deducted first:

Tax payable	$120
Less imputation credit	$ 50
	$ 70
Less overseas tax credit	$ 90
Tax to refund	NIL

No deemed loss to carry forward

The correct treatment is illustrated in Example One.

Nominee company and imputation credit account

Section 394B - Companies required to maintain imputation credit account: A taxpayer asked if a nominee company is required to maintain an imputation credit account.

A nominee company is a company which holds assets in the company's name as a bare nominee or trustee for the asset's beneficial owners. The powers of nominee companies are restricted and they do not carry on business in the normal sense. They are perhaps most commonly used by legal and accounting firms.

Generally, companies are required to maintain imputation credit accounts. However, sections 394B(2)(b) & (c) of the Income Tax Act provide an exception to this where the company is acting only as trustee or where the constitution prohibits the distribution of profits or income. A nominee company is therefore not required to maintain an imputation credit account.

Goods and Services Tax Act 1985

Keeping assets when ceasing to be registered

Section 5(3) - Cessation of registration: A businessman asked what the GST implications are when he ceases business. He will be keeping assets that were previously used in the business.

When the businessman completes his final GST return, he must make an adjustment for the value of assets that he will retain. His GST payable will be calculated on the value of the assets on the day that he ceases to be registered. Section 10(8) deems the value of supply to be the lesser of cost (including any GST) or

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market value of the retained assets. The businessman must pay GST on all the assets that he retains regardless of whether or not he received an input tax credit when he acquired them.

The businessman must notify Inland Revenue of the cessation of his business, in writing and within 21 days of when it ceases. That notice must also contain a statement as to whether he intends to carry on any taxable activity within 12 months of cessation.

Under section 75(3) the businessman must keep his GST records for at least 7 years after the end of the taxable period to which they relate.

Financial services - GST charged on local authority rates

Section 5(7) - Supply by local authority: A city council asked whether local authority rates that it charged are subject to GST, if part of them are used to make loan and interest repayments. The council suggested that the part of the rates attributable to the loan repayments may constitute a "financial service" and be exempt from GST under section 14(a).

In this case the financial service is the loan from the lender to the council, not the payment of the rates. Therefore, as rates are not included in the definition of "financial services" and are deemed to be a supply of goods and services by section 5(7)(a), GST applies to local authority rates.

Local authorities should be aware that certain "rates" imposed under sections 384, 463, 466, 514, 533, 644E, 674 and 675 of the Local Government Act 1974 are deemed by the proviso to section 5(7)(a) not to be supplies of goods and services.

Secondhand goods subsequently used overseas

Section 11(1)(d) - Zero-rated goods: A GST-registered person purchased an aircraft from a non-registered person. No GST was therefore charged on the purchase price. However the registered person was able to obtain a notional secondhand goods input tax credit on the purchase price. The aircraft was subsequently leased overseas and the registered person asked if lease payments are zero-rated.

As a general rule, goods supplied that are not situated in New Zealand at the time of that supply are zero-rated (section 11(1)(b)). However, in this case, section 11(1)(d) precludes the zero-rating of the supply of the aircraft because the registered person had previously been able to claim the notional secondhand input tax credit on the purchase price.

GST calculated to less than a cent

Section 24(8) - Fractions of a cent: A taxpayer asked if the calculation of GST on an invoice should have fractions of a cent rounded down to the nearest cent.

Section 24(8) of the GST Act specifies that where a calculation results in a fraction of half a cent or less, it can be disregarded. However if the fraction is greater than half a cent, it is to be rounded up to a whole cent.

Accident Rehabilitation and Compensation Insurance Act 1992

Allowances to be included in liable earnings

Section 115 - Deduction on account of earner premiums: An employer has asked if earner premium is to be paid on the value of the use of a house supplied to an employee.

Section 115 of the Act specifies that earner premium deductions are imposed on earnings of an employee to which Part XI of the Income Tax Act 1976 applies. Part XI of the Income Tax Act 1976 applies to salary or wages, and to other source deduction payments.

Paragraph (a) of the definition of "salary or wages" specifically includes within the meaning of that term the value of the benefits to which section 72 of the Income Tax Act 1976 applies. Section 72 applies to the value of board, lodging and house allowances. Such benefits are therefore within the meaning of the term "salary or wages" and Part XI applies to them. This means they are subject to the imposition of earner premiums under section 115.

Child Support Act 1991

Application for Child Support

Section 18 - Liability arises on acceptance of application: A custodial parent requested a formula assessment to be undertaken as the previous voluntary agreement had been abandoned. The parent asked if the application date of the formula assessment could be backdated.

The request for a formula assessment incurs a liability for the non-custodial parent to pay Child Support on the later of;

- The day on which the application is received, or;
- If the application was not properly made, the date on which the application becomes properly made.

Section 18 of the Child Support Act does not provide for an earlier date to be used. Therefore, the formula assessment cannot be backdated to prior to the application date.

Student Loan Scheme Act 1992

Interest Capitalisation on Loan

A student asked if the interest paid on his student loan is compounded.

The loan agreement signed by the borrower at the time of requesting the loan provides for the interest charged during the year to be capitalised on 31 March.

If a loan is transferred to Inland Revenue as at 28 February, the loan account will attract interest at a daily rate on the principal amount transferred. The interest transferred and the interest calculated by Inland Revenue for March is capitalised on 31 March. On 1 April, interest will be charged on the new loan balance, which will include interest charged previously. Accordingly, the interest will compound on an annual basis.

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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Case	Rating	Subject	Page
Finnigan v CIR HC New Plymouth M 52/91	• •	Partner not entitled to deduct advance to partnership	15
TRA No. 93/56	• • •	Purchase of secondhand asset outside NZ by bare trustee	15
TRA 93/141	• •	Use of assets accretion method upheld	17
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Previously-published cases - appeal notes

TIB Volume Four, No.11

Alcan New Zealand Ltd v CIR: Inland Revenue is appealing this decision to the Court of Appeal.

TIB Volume Five, No.1

AA Finance v CIR: The taxpayer is appealing this decision to the Court of Appeal.

TIB Volume Five, No.2

Mitsubishi Motors NZ Ltd v CIR AP 165/92: Inland Revenue is appealing this decision to the Court of Appeal.

TIB Volume Five, No.7

CIR v Henwood AP 117/92: The taxpayer is appealing this decision to the Court of Appeal.

Shell New Zealand Ltd v CIR AP 153/92: The taxpayer is appealing this decision to the Court of Appeal.

Partner not entitled to deduct advance to partnership

Rating: • •

Case: Finnigan v CIR. HC New Plymouth M 52/91

Act: Income Tax Act 1976, section 106(1)(h)(i)

Keywords: *interest, deductibility*

Summary: A taxpayer participated in a company restructuring transaction. The transaction involved the formation of a partnership which borrowed a sum of money. The taxpayer co-guaranteed the loan and advanced money to the partnership to pay part of the interest on the loan.

The High Court held that the payments to the partnership by the taxpayer were not deductible under section 106(1)(h)(i) as they were not payments of interest.

Facts: The taxpayer held shares in a public company which went heavily into debt when one of its subsidiaries went into receivership. At this time the public company owed $1 million to a major creditor. The shareholders of the public company devised a financial restructuring scheme to assist the company to meet its debt obligations. The scheme involved the formation of a group partnership which borrowed $1,070,000 from the major creditor. The effect of this transaction was to extinguish the public company's debt to the creditor.

The taxpayer participated in the scheme. He was one of the guarantors of the loan to the partnership. In addition, as interest fell due on the loan, the taxpayer and the other loan guarantors also advanced money to the partnership to pay the interest. The taxpayer sought to deduct the payments made to the partnership under section 106(1)(h)(i) of the Income Tax Act 1976.

Decision: The taxpayer contended that he had borrowed money from the partnership and used the money to acquire capital. He claimed that the payments were deductible as interest payable in gaining or producing assessable income.

Inland Revenue asserted that the interest was not deductible as the taxpayer was not liable to pay the interest on the loan to the partnership. In the High Court, Judge Anderson agreed with Inland Revenue. His Honour concluded that the real nature of the restructuring transaction did not obligate the taxpayer to make interest payments. The payments made by him were capital advances to the group partnership enabling the partnership to meet its interest obligations. As the payments were not interest, they were not deductible under section 106(1)(h)(i).

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

Purchase of secondhand asset outside New Zealand by bare trustee

Rating: • • •

Case: TRA No. 93/56

Act: Goods and Services Tax Act 1985, section 8(1), 8(2), 20(3)(a), paragraph (c) of the definition of "input tax" in section 2(1).

Keywords: *Secondhand goods; bare trustee; taxable activity inside/outside New Zealand*

Summary: Judge Willy held that an Isle of Man company (C Limited - which was owned by the objector) held a ship as bare trustee for the New Zealand objector. The New Zealand objector company purchased the secondhand ship outside

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New Zealand from a non-registered supplier and was not entitled to a secondhand goods input tax credit for the purchase of the ship.

Facts: The objector, a New Zealand company, entered into an agreement on 3 November 1990 to purchase a roll-on roll-off ship for US$18 million from an Isle of Man company. The ship was second-hand and was in need of repair.

The objector had intended to use the ship for trans-Tasman work. At the time of purchase trans-Tasman work was depressed so the objector looked for alternative work for the vessel. The objector had discussions with the US military and the UK Ministry of Defence about the possibility of obtaining charter work to convey military personnel and equipment to the Middle East during the Gulf War. The objector decided that if the ship was to be engaged in this type of work it would be unsuitable to employ a New Zealand crew. The vessel would also need to sail under a foreign flag, i.e., be registered under a foreign shipping registry, to avoid adverse publicity for the company in New Zealand.

To facilitate the vessel being retained on the Isle of Man shipping registry, the objector acquired an Isle of Man company, C Limited, and arranged for C Limited to be the registered owner of the vessel. On 30 January 1991 the objector on behalf of C Limited paid approximately US$30 million and accepted delivery of the ship at Rotterdam. The objector did not obtain a contract with the military as the conflict in the Middle East had ended.

The objector decided to sail the ship to New Zealand under a bareboat charter to a company in which the objector's parent company had a substantial interest. The charter was a non-commercial arrangement because the charter rate was US$1 per day. The ship arrived in Auckland on 24 March 1991 where the objector arranged the completion of the repairs that were begun in Rotterdam. The objector also made a series of book transactions to buy the vessel from its wholly owned subsidiary, C Limited. The objector claimed an input deduction for the vessel on the basis that the vessel was in New Zealand when C Limited sold it.

Decision: Judge Willy decided that C Limited held the vessel as a bare trustee for the objector as beneficial owner because:

1. It was originally intended that the vessel would be purchased by the objector.
2. The objector had exclusive control over the disposition of the vessel.
3. The circumstances of the alleged loan lacked all commercial reality.
4. C Limited had no legal or equitable right to dispose of the vessel contrary to the wishes of the objector.

The objector first acquired the legal and the equitable title to the vessel from its previous owners before it set up C Limited (who acquired the legal title only). The supply took place when the objector first contracted to purchase the vessel and that supply took place outside New Zealand. Judge Willy concluded that it follows that under paragraph (c) of the definition of 'input' tax in section 2(1) there was no supply in New Zealand of secondhand goods. Inland Revenue acted correctly in disallowing the input tax deduction.

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

Use of assets accretion method upheld

Rating: • •

Case: TRA No. 93/141

Act: Income Tax Act 1976

Keywords: *Assets accretion method, onus of proof*

Summary: The case concerned a taxpayer's objection to an assessment made by Inland Revenue using the assets accretion method to determine the taxpayer's income. The TRA found that the taxpayer failed to discharge the evidential burden of showing that the assets accretion exercise and result was wrong and therefore the assessment was confirmed.

Facts: Following an investigation into the taxpayer's affairs Inland Revenue issued an assessment for the 1984 year. In arriving at the assessment for the 1984 year Inland Revenue relied upon the assets accretion method. The taxpayer objected to this assessment.

Decision: Judge Willy found that there was an obligation on the taxpayer to demonstrate by the production of acceptable evidence on the balance of probabilities, that the result of the assets accretion method in this case was wrong and by how much it was wrong. The Judge found that the objector had failed to do this and therefore the assessment was confirmed.

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

Investment allowances not available on equipment hired out

Case: James Bull Ltd v CIR. C.A. 37/93

Rating: • • •

Act: Income Tax Act 1976, section 122

Keywords: *Statutory interpretation, use, performing services, directly*

Summary: Investment allowances under section 122 are not available to a taxpayer whose business is hiring out equipment to other taxpayers who are in the business is farming or agriculture.

Facts: James Bull Ltd purchased, paid for and owned farm machinery. It hired the machinery to James Bull and a farming partnership. The partners were James Bull, a family trust and another family company. The operators of the farms used the machinery for farming purposes. The High Court judgment, reported at (1993) 15 NZTC 10,001, held that the farm machinery failed to qualify for investment allowances under either paragraph (a) or (b) of section 122(1).

Decision: The taxpayer argued that the High Court had taken a too restrictive approach to the interpretation of the relevant economic incentives. The taxpayer accepted that the owner of the machinery had to satisfy the statutory criteria. However, the taxpayer emphasised that the High Court had accepted that the acquisition and the use of the machinery had the result desired by Parliament of increasing farm output.

Section 5(j) of the Acts Interpretation Act 1924 requires consideration of the scheme and language of the legislative provisions and the relevant objectives of those provisions. In this case the legal answer turned on a consideration of section 122 in its statutory context giving full weight to the statutory purpose. The Court analysed the scheme and language of the section to determine the line between qualifying and non-qualifying farming-related activities.

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The Court found that the true object of section 122 is identifiable without going outside the Act. The activities of the taxpayer and the operators of the farm properties, when taken together, meet the objectives of the incentive provisions. However, it is the taxpayer's activities that are relevant.

Section 122 focuses on plant and machinery for use by the taxpayer. The taxpayer's business was hiring out farm machinery. The taxpayer did not use the farm machinery directly for any farming business as required under paragraph (a). Supplying machinery by the taxpayer to the operators did not satisfy the requirement to perform services on the farmers' land as required under paragraph (b).

The Court of Appeal unanimously dismissed the appeal.

Comments: The taxpayer is not appealing this decision.

Upcoming TIB Articles

In the next few months we'll be releasing policy statements on these topics in the Tax Information Bulletin:

- Repairs and maintenance policy resulting from the new depreciation regime
- When Inland Revenue can grant relief from payment of tax in cases of financial hardship
- Various qualifying company statements
- GST - secondhand goods credit on property transactions
- National standard cost for livestock determination 1994

We'll publish these statements as soon as we've finished consulting with external commentators.

Due dates reminder

February 1994

5 PAYE deductions and deduction schedules for last 16 days of January 1994 due - “large” employers only.

7 First instalment of 1994 provisional tax due for taxpayers with October balance dates.

Second instalment of 1994 provisional tax due for taxpayers with June balance dates.

Third instalment of 1994 provisional tax due for taxpayers with February balance dates.

1993 end-of-year tax due for taxpayers with balance dates from March-September inclusive.

Annual income tax return due for non-IR 5 taxpayers with balance dates from 1-31 October 1993. (Remember to attach SL 9 form for Student Loan borrowers.)

First instalment of 1994 Student Loan interim repayment due for taxpayers with October balance dates.

Second instalment of 1994 Student Loan interim repayment due for taxpayers with June balance dates.

Third instalment of 1994 Student Loan interim repayment due for taxpayers with February balance dates.

1993 residual Student Loan repayment due.

Earner and employer premium payments due for self-employed people.

20 PAYE deductions and deduction schedules for first 15 days of February 1994 due - “large” employers.

PAYE deductions and deduction schedules for January 1994 due - “small” employers.

Gaming machine duty return and payment for month ended 31 January 1994 due.

RWT on interest deducted during January 1994 due for monthly payers.

RWT on dividends deducted during January 1994 due.

Non-resident withholding tax (or approved issuer levy) deducted during January 1994 due.

28 GST return and payment for period ended 31 January 1994 due.

March 1994

5 PAYE deductions and deduction schedules for last 13 days of February 1994 due - “large” employers only.

7 First instalment of 1995 provisional tax due for taxpayers with November balance dates.

Second instalment of 1994 provisional tax due for taxpayers with July balance dates.

Third instalment of 1994 provisional tax due for taxpayers with March balance dates.

Annual income tax return due for non-IR 5 taxpayers with balance dates from 1-30 November 1993. (Remember to attach SL 9 form for Student Loan borrowers.)

First instalment of 1995 Student Loan interim repayment due for taxpayers with November balance dates.

Second instalment of 1994 Student Loan interim repayment due for taxpayers with July balance dates.

Third instalment of 1994 Student Loan interim repayment due for taxpayers with March balance dates.

20 PAYE deductions and deduction schedules for first 15 days of March 1994 due - “large” employers.

PAYE deductions and deduction schedules for February 1994 due - “small” employers.

Gaming machine duty return and payment for month ended 28 February 1994 due.

RWT on interest deducted during February 1994 due for monthly payers.

RWT on dividends deducted during February 1994 due.

Non-resident withholding tax (or approved issuer levy) deducted during February 1994 due.

31 GST return and payment for period ended 28 February 1994 due.

Fourth instalment of 1994 Student Loan non-resident assessment 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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