Repairs and maintenance

Summary

The new depreciation regime which generally applies from the 1993/94 income year introduces new sections to replace the old section 108 of the Income Tax Act 1976 (the Act). The old section 108 specifically provided for the deduction of amounts spent on repairs and alterations, but the new sections do not. Although this section mentioned repairs and alterations, the deduction available under this section was commonly called "Repairs and Maintenance" or "R & M".

The change resulted from the Government's agreement to the Valabh Committee's recommendation that the deductibility of repairs and maintenance should be considered under the normal deductibility provisions of the Act. In practice what was deductible under the old section 108 and what will be deductible on revenue account under the general provisions of the Act will not differ to any large degree. The only difference is that alterations which do not increase the value of an asset may be on capital account under the general provisions of the Act, whereas they were deductible under the old section 108.

Inland Revenue's policy

Here is Inland Revenue's view of how these provisions apply:

- Expenditure on repairs, maintenance, alterations etc must be on revenue account for it to be deductible. It must be deductible under the normal deductibility provisions of section 104, and avoid the prohibition of capital expenditure in section 106(1)(a).
- Capital expenditure is not deductible, but it will be subject to the normal depreciation rules.
- Expenditure required to maintain an asset in the condition it was when the taxpayer acquired it will be on revenue account, and therefore deductible.
- The replacement of a capital asset will be capital expenditure.
- Inland Revenue regards a distinct physical unit which can function on its own as a unit against which the extent of expenditure will be measured.
- Expenditure on an asset over and above making good wear and tear will be capital expenditure.
- No deduction is available for notional repairs.

Comment

Repairs and maintenance were specifically provided for under the old section 108 of the Act. Once this section was repealed and the new depreciation regime was introduced, the question of the deductibility of "repairs and maintenance" expenditure needed to be considered under the general provisions of the Act. This means the expenditure must now be deductible under the normal deductibility provisions of section 104, and it must avoid the prohibition of deductions for capital expenditure in section 106(1)(a).

Under general case law, whether expenditure is on revenue or capital account depends mainly on the extent of the work undertaken. Case law considers that expenditure on the replacement of an item is essentially the acquisition of a capital asset, so it is capital expenditure. It also considers that categorisation of the work depends on the type and extent of the work done, and of the relevant unit to which the work is being done. Identification of the unit is very important.

Inland Revenue considers that a distinct physical unit which can function on its own is a unit against which the extent of any expenditure will be measured. So, if a building is part of a larger complex, the particular building (and not the wider complex) will be the unit if it is a "stand alone" building. However, each situation will depend on its own facts.

Examples of assets considered to be units are:

- motor vehicles (the unit is not the fleet of vehicles)
- individual buildings (not a complex of attached buildings)
- a boat builder's slipway (not the workshop, slipway and associated plant).

After identifying the individual asset, the next step is to decide whether the expenditure is on capital or revenue account. There is various case law both from New Zealand and from overseas which will help with this decision. The case law that looks at the capital/revenue distinction generally is as important as the case law that relates specifically to expenditure on repairs, maintenance or alterations. At the end of this article there is a section setting out Inland Revenue's interpretation of this case law.

The general case law on the capital/revenue distinction has produced several tests which are useful in deciding whether expenditure is on capital or revenue account. Some of the tests are -

- Does the expenditure increase the useful life of the asset, or its output or efficiency?
- Is the expenditure recurrent?
- Does the expenditure create a new asset that did not exist before?
- Does the expenditure confer an enduring benefit to the taxpayer?
- Does the expenditure relate to the profit-earning process or the profit-earning structure of the business?

None of these tests should be considered in isolation, and it would be unwise to do so. For example, just because an item of expenditure is not recurrent does not in itself mean that the expenditure is on capital account. A lump sum payment representing an aggregation of a recurrent revenue expense is not capital.

examples and case law notes overleaf

Examples: repairs and maintenance - capital or revenue expenditure?

The following examples illustrate Inland Revenue's application of these tests and relevant case law. These examples are intended to be indicative only. A general similarity with them will not necessarily produce the same tax results.

Example 1

Dwayne Lucas, a horse trainer has 20 horse boxes that are in a dilapidated state because of wear and tear over the years. Instead of trying to repair the boxes Dwayne decides that he will completely replace them.

In this case an item has been completely replaced. The expenditure is capital so it is not deductible. *Auckland Trotting Club v CIR* [1968] NZLR 967 is an example where the Court found that because the track had been totally replaced it was on capital account.

Example 2

Joanne Smith owns a three bedroom rental property. She is finding it increasingly difficult to find tenants for the building because of its run-down state. She does some alterations which replace the kitchen and bathroom, and merges two adjoining bedrooms into one.

In this case the expenditure would be regarded as being too extensive to be a revenue expense. A deciding factor in this case would be that the rental property has been substantially improved. *FCT v Western Suburbs Cinemas Ltd* [1952] 86 CLR 102, *Conn v Robins Bros Ltd* [1966] 43 TC 266 are cases which illustrate the often fine line between expenditure which improves the asset, and expenditure which merely restores the asset.

Example 3

Dwayne Lucas's foreman who lives in a house on Dwayne's property is dismissed. Before hiring a new foreman Dwayne decides to do some work on the house. He has the house repainted, the guttering replaced with the same type of material and the front door (which the foreman kicked in as he departed) replaced. Unfortunately Dwayne could not buy a door with frosted glass with swans on it like the old door to replace it, so he settles for the cheapest solid wooden door he can find.

In this case the expenditure would be regarded as being on revenue account. The repainting is recurrent expenditure and along with the reguttering and replacement of the door does not improve the house in any way. Further, this expenditure is not of sufficient magnitude to be on capital account. Cases which illustrate this are as in Example 2 above and also *Vallambrosa Rubber Co Ltd v Farmer* [1910] SC 519.

Example 4

Joanne Smith decides to invest some spare cash she has in the property market. She locates a house in Wadestown with harbour views which she feels has great potential (the real estate agent describes it as a handyman's dream). Because of its particularly run-down state she buys it for $40,000 less than other similar properties in the area. However, before she can rent the property out she embarks on a maintenance programme that includes repainting, wallpapering, and replacing the bath and showers.

Repairs to recently-acquired assets are a special case. Much of the expenditure incurred would normally be deductible, but in this case the expenditure will be on capital account for these reasons:

- the house was recently acquired
- it was purchased for $40,000 less than it normally would have cost, because of its dilapidated state.

Relevant cases are *The Law Shipping Co, Ltd v CIRs* [1923] 22 TC (Court of Session, Scotland), *Collector of Inland Revenue Cook Islands v A B Donald Ltd* [1965] NZLR 679.

Example 5

In the situation outlined in example 1, Dwayne considers that he should get a deduction for the amount that it would have cost him to repair the boxes if he had decided not to replace them.

A claim is not allowable for notional expenses. What must be considered is the actual factual situation that occurred. A relevant case is *FCT v Western Suburbs Cinemas Ltd* [1952] 86 CLR 102.

Example 6

Wade Boggs runs a courier business. The engine in his van seizes, and the van cannot be driven. Wade cannot afford to purchase a new van, so he buys a replacement reconditioned engine of the same make and capacity as the old engine.

In this case the "unit" is the van. The replacement of the engine merely restores the van to a workable state so the expenditure is on revenue account.

Example 7

Laurence Taylor owns a property which he has let for the past 5 years. He lived in it himself for 10 years before he started letting it out. The old concrete tile roof needs repairing, so he replaces it with a new steel-backed tile roof.

Even though the roof has been replaced with different materials the house has not been improved in any way, so the expenditure is on revenue account.

Case law: repairs and maintenance - capital or revenue expenditure?

This section sets out Inland Revenue's interpretation on several leading cases on repairs and maintenance expenditure which form the basis of the statement. It also considers cases which have looked at the capital/revenue distinction.

Cases Concerning Repairs and Maintenance Expenditure

Leading NZ Case - old section 108

The leading New Zealand case on the old section 108 was *Auckland Trotting Club v CIR* [1968] NZLR 967. This case involved the Trotting Club's claim for the cost of demolition of a shell trotting track and the construction of a new limestone track on the same site. The Court of Appeal found that the replacement of the old track with a new track was more than repairs and alterations (the term used in the old section 108), and therefore confirmed Inland Revenue's assessment disallowing this expenditure.

Although the Auckland Trotting Club case focused on the wording of the old section 108 it contains comments which are a useful guide to what will constitute deductible expenditure under the new regime. For example, in determining the unit against which the expenditure must be measured, the Court made these comments:

> "Mr Barker, for the Club, argued before us that the "premises" of the club, with regard to which the work must be evaluated, were constituted by the whole of the Club's complex of buildings and improvements at Alexandra Park: alternatively, if this submission were not accepted, he argued that they were constituted by the track, with its rails, posts, and lighting system, all of which he pointed out, were fixtures. We reject, as Moller J rejected, the first of these contentions. It seems to us to completely to lack reality in the context of the particular statutory provision. It must necessarily involve the proposition that if the total undertaking of a taxpayer is only large enough, the demolition of (e.g.) a single large building forming part of a complex, and the construction of another in its place, is to be classed as "repairs and alterations" to the whole. We agree with, and adopt in this case, the reasoning of Kitto J. in *Lindsay v Federal Commissioner of Taxation* (1961) 106 C.L.R. 377; (1961) A.L.R. 58 at pp. 384, 62 where he says: " In order to determine whether an item of expenditure is to be held on general principles to be chargeable to income or capital account, it is of course necessary to distinguish between the business entity, structure or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns of regular outlay .... But where the question is whether expenditure has been for repairs, and, for the purposes of deciding that question, one asks what the entirety which it is relevant to consider, one is looking not for a profit - earning structure or entity, as such, but for a physical thing which satisfies a particular notion."

Overseas Cases

Lurcott v Wakely & Wheeler

Lurcott v Wakely and Wheeler [1911] 1 KB 905 was a case where a wall was considered to be part of the asset being the premises as a whole. In this case the replacement of the wall was considered to be a repair. This case was not a tax case but was cited in the *Auckland Trotting Club* as it considered the meaning of the word "repair" as used in the old section 108.

Law Shipping

The Law Shipping Co, Ltd v CIRs [1923] 22 TC 621 (Court of Session, Scotland) is a case that contains useful general comment which is specifically directed at a capital/income distinction, rather than interpreting words such as "repairs" and "improvements". The decision itself is concerned with the special situation of a recently-acquired asset.

The *Law Shipping* case was concerned with a company which purchased a ship in poor state of repair for £97,000. The company then used the vessel in its current state of repair for one voyage, and then carried out repairs to the value of £51,558. The company claimed the cost of the repairs as a revenue expense.

The claim was disallowed and this decision was upheld by the Court. The Court indicated that repairs would usually be a revenue outgoing, even if the repairs were delayed for a lengthy period:

> "Repairs may be executed as the occasion for them occurs; or, if they are such as brook delay, they may be postponed to a convenient season: but, in either case, they truly constitute a constantly recurring incident of that continuous employment of the ship which makes them necessary. They are therefore an admissible deduction in computing profits, and, as is admitted in the case, if the ship had not been sold, the purchasers' predecessors would have been entitled to deduct the whole of the £51,558 in returning their profits for Income Tax. Accumulated arrears for repairs are, in short, none the less repairs necessary to earn profits, although they have been allowed to accumulate."

(per Lord President Clyde p 625)

However the Court decided in this case that the repairs were nothing more than part of the expenditure involved in acquiring a capital asset in good working order. It was said:

> "It is obvious that a ship, on which repairs have been allowed to accumulate, is a less valuable asset with which to start business than a ship which has been

continued on page 4

from page 3

regularly kept in repair. And it is a fair inference that the sellers would have demanded and obtained a higher price than they actually did, but for the immediate necessity of repairs to which the ship was subject when they put her in the market."

(per Lord President Clyde p 626)

"[The cost of repairs] is, in substance, the equivalent of an addition to the price. If the ship had not been in need of the repairs in question when bought, the Appellants would, presumably, have had to pay a correspondingly higher price."

(per Lord Cullen p 628)

Odeon Theatres

The limits of the principle in the *Law Shipping* case are illustrated by *Odeon Associated Theatres Ltd v Jones* [1972] 1 All ER 681. In that case the purchaser had bought a cinema, and some repairs had been deferred before the time of purchase. In the ten years after acquiring the cinema alterations were made and they were treated as capital, but in addition repairs were effected and they were held to be on revenue account. In considering the *Law Shipping* case the Court held these distinctions were material:

- The cinema could have continued to be used effectively without the repairs being effected (unlike the necessity for a "survey" of the vessel in the *Law Shipping* case before the vessel could be used in the ordinary course of trade),
- The need for repairs did not alter the cost of acquiring the cinema.
- There was accounting evidence that the repairs to the cinema should be on revenue account.

Western Cinemas and Robins Brothers

It is difficult at times to determine when repairs are of sufficient magnitude to be on capital account. Two cases which illustrate this are *Conn v Robins Bros Ltd* [1966] 43 TC 266 and *FCT v Western Suburbs Cinemas Ltd* [1952] 86 CLR 102. In the *Western Cinemas* case it was decided that a ceiling that was replaced because it was impracticable to repair it was on capital account. The ceiling was replaced with more modern materials than previously.

In contrast, the *Robins Brothers* case involved extensive repairs to leased premises in which a retail business was conducted. In this case extensive alterations were made to a building that was over 400 years old. For example, the roof was stripped, some of the roof timbers were renewed, and the roof was replaced with corrugated asbestos (it had previously been of slate). Some of the walls were removed, so steel girders had to be inserted to support the upper storeys, the joists and the upper walls. These had previously been supported by the walls of the lower floor.

The Court held that although there was extensive replacement of the existing asset, the expenditure was on revenue account. The comment was made -

"No doubt in the course of carrying out these works certain structural alterations were made, as one would expect with any extensive repair of a building over 400 years old, when repairs were being carried out at a time when building techniques have completely altered. But the fact that there were alterations in the structural details of the building does not seem to me to be a good ground for proceeding upon the basis that the work produced something new. On the contrary, I think it is implicit in the Commissioners' finding that the result of this work was not to produce something new but to repair something which had previously existed. Upon that basis it seems to me that there is no ground for regarding this expenditure as capital expenditure."

It is debatable whether the decisions in the *Western Suburbs Cinemas* and *Robins Brothers* cases can be reconciled. Inland Revenue considers that capital/income distinctions often depend on fine factual differences and it would not be wise to simply take the view that the cases are necessarily irreconcilable or that the approach in one case is to be preferred over the other.

What is clear is that when major components of the material unit (e.g. a building) are renewed instead of being simply kept in serviceable condition, a judgment has to be made as to whether the work is of sufficient substance to put the expenditure on capital account. The question of whether the asset is improved in a substantial way will help with that judgment. If the *Western Cinemas* and *Robins Brothers* cases are to be reconciled, that would appear to be the factor which distinguishes the cases. In the *Western Cinemas* case the Court focused on the improvement made by renewing the ceiling. The *Robins Brothers* case took a long term view of maintaining the building (parts of which were 400 years old), and viewed the replacement of major components as a natural process of repair which would be effected and repeated over the centuries, using materials which were appropriate for construction at the time the work was done. The building itself remained the same size, in the same location, and accordingly the work no more than maintained the building's inherent utility. Viewed in that way, the differences between the two cases only involve a different emphasis on facts.

Revenue/Capital Distinction

BP Australia v FCT

One of the leading cases in determining whether an outgoing is of a capital nature is *BP Australia v FC of T* [1965] 3 All ER 209. This case concerned payments that an oil company made to service station proprietors to obtain trade tie agreements by which only the oil company's products were sold from the service station. The Privy Council decided that on balance the expenditure was of a revenue nature. Lord Pearce made the following general observations, which help to determine whether expenditure is of a revenue or capital nature:

> "The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in border-line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree."

British Insulated & Helsby Cables, Ltd v Atherton

The case *British Insulated & Helsby Cables, Ltd v Atherton* [1926] AC 205 the company set aside the sum of £31,784 to form the nucleus of a pension fund for the benefit of its employees. The Court found that the payment was made to secure a substantial and lasting advantage for the company and therefore was on capital account.

Vallambrosa Rubber Co. Ltd

The *Vallambrosa Rubber Co Ltd v Farmer* [1910] SC 519 concerned expenses claimed by the company for weeding and other expenses in relation to trees that could not be productive for another six years. The Court decided that the expenditure was on revenue account, and stated:

> "Now, I don't say that this consideration is absolutely final or determinative, but in a rough way I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year."

Sun Newspapers Ltd

The *Sun Newspapers Ltd v Federal Commissioner of Taxation* [1938] 61 CLR 337, concerned the sum paid by the publisher of a newspaper to another company who were considering publishing a rival newspaper. The Court decided that the payment was capital in nature. Chief Justice Latham made the following comments:

> "As a direct consequence of the agreement, the publication of "The World" ceased immediately, and immunity from a threatened competition within a large area was also obtained for a period of three years. Such a transaction must, in my opinion, be regarded as a transaction which added to the goodwill of the enterprise. In substance it amounted to the addition of a capital asset, immaterial in character but substantial in value and significance, to the general equipment of the business enterprise of the appellant companies."

Determination G5C: Mandatory conversion convertible notes

Determination G5C: Mandatory Conversion Convertible Notes was signed by Peter Barrand, Deputy Commissioner on 18 February 1994. It replaces Determination G5B. The differences between the two determinations are:

1. G5C broadens the scope of the determination so that it applies to a Mandatory Conversion Convertible Note converting into shares in a company other than the company that issued the note. The scope clauses in Determinations G5 and G5A both provided for this.
2. G5C narrows the scope of the determination so that it only applies to a Mandatory Conversion Convertible Note where the interest rate is within a narrower range. For the purposes of the determination this is defined as between 5% p.a. (or half the rate the issuer would have paid on cash repayment borrowings if lower) and 15% p.a. (or double the rate the issuer would have paid on cash repayment borrowings if higher). The change is reflected in the addition of a further example in clause 7.

There are also minor changes in the wording, grammar, and dates used in the examples. These do not alter the intent or application of the determination.

Determination G5C appears in full as an appendix to this TIB.

ACC earner premiums - correction

In TIB Volume Five, No.6 (November 1993), there was an article about income tax deductions and GST input tax credits for ACC premiums. In that article we stated that employers could not claim an income tax deduction for earner premium payments as individual employees bear the cost of this premium.

That statement was not entirely accurate. Employees do bear the cost of the premiums, as the premiums are deducted from gross wages. However, employers can claim an income tax deduction for the gross wages that they pay, including the earner premium deductions. Similarly, a company can claim the gross salaries paid to shareholder-employees.

Depreciation rate for tax software

There is a new provisional depreciation rate of 100% for tax software, applying from 1 April 1993. This is to allow for the fact that tax software only remains up-to-date for one income year - the year for which it was written.

Provisional depreciation rates can apply to all taxpayers in the same way as normal depreciation rates. However, if a provisional depreciation rate is reduced the lower depreciation rate will apply to all existing depreciable property for which a taxpayer used the provisional rate. A reduced general depreciation rate can only apply to assets acquired after the date of the reduction.

This change was introduced in Determination PROV 1. The full text of this determination is printed below.

This determination inserts a new asset class into the Software asset category of Determination DEP 1 (published on page 64 of the appendix to TIB Volume Four, No.9 - April 1993)

Note that Inland Revenue's policy on the tax treatment of computer software changed from 1 July 1993 (see the appendix to TIB Volume 4, No.10). Taxpayers can claim as an expense the cost of any software bought before 1 July 1993.

Determination PROV 1

This determination may be cited as "Determination PROV 1: Tax Depreciation Rates Provisional Determination Number 1"

1. Application

This determination shall apply to software purchased on or after 1 April 1993 that is able to be used in the preparation or filing of income tax returns relating to one particular income year only.

2. Determination

Under the provisions of section 108I of the Income Tax Act 1976 I have determined the following provisional basic economic depreciation rate:

Determination DEP1 (as amended) is amended by inserting in the asset category "Software", the additional asset class "Software able to be used in the preparation or filing of income tax returns relating to one particular income year only" with the following details -

Estimated Useful Life	1 year
DV Banded Depn Rate (%)	100%
SL Equiv Banded Depn Rate (%)	100%

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in section 107A of the Income Tax Act 1976.

This determination is signed by me on the 15th day of February 1994.

Murray McClennan
Manager (Rulings)
Head Office
Inland Revenue Department

Student Loan scheme - interest rates for 1994-95

On 10 January the Ministers of Education and Revenue announced the interest rate which will apply to the Student Loan scheme for the year beginning 1 on April 1994.

The total interest rate will be 7.0 percent. This is made up of the base interest rate of 5.7 percent and the interest adjustment rate of 1.3 percent.

Upcoming TIB articles

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

- When Inland Revenue can grant relief from payment of tax in cases of financial hardship
- Various statements on the qualifying company regime
- GST second-hand goods credit on property transactions
- National standard cost for livestock determination 1994
- Write-off of low value assets - GST inclusive or exclusive.

We'll publish these statements as soon as we've finished consulting with commentators outside Inland Revenue.

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 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.

Income Tax Act 1976

Income from boarders

A home owner asked if rent received from a boarder was taxable.

Inland Revenue's policy is that if a person takes in one boarder, the receipts are not taxable and expenses are not deductible. If a person has two, three or four boarders, 20 percent of the receipts are taxable.

continued on page 8

from page 7

Example:

Three boarders taken in at $100 each per week - total $300
Taxable income to be returned is $60, i.e., 20% of $300.

Anyone who has five or more boarders must calculate profit in the normal manner, i.e., income less deductions. Any profit will then be taxable.

Any board received from relations is not taxable, nor are related expenses deductible.

Sometimes the number of boarders will change during the year. If this occurs, there may be some periods in which the receipts are not taxable (when there is only one boarder) and others when the receipts are taxed at 20 percent.

Example:

One boarder from April to July 1994 -	no tax liability
Three boarders from August to December 1994 -	20% of gross receipts are taxable
Five boarders from January to March 1995 -	gross receipts less expenses are taxable.

The home owner has the option of using this method or calculating actual income and deductions. A home owner who wishes to calculate net profit or loss may find our IR 3R form useful. This is available from any Inland Revenue office.

Balance date change - rate of tax

Section 16(6) - Period other than a year - rate of tax: Inland Revenue granted approval for a farmer to adopt a 30 June balance date. His previous balance date was 31 March. He asked how to calculate the tax for the year ending 30 June 1994, which would involve a 15 month tax return.

When a return period is not for 12 months, taxing the income at normal tax rates may disadvantage the farmer. For example, the increased assessable income derived during the 15 month period may mean that the farmer would be taxed at a higher marginal rate, or more income could be taxed at the higher rate.

Section 16(6) of the Act provides for a pro rata approach. The equivalent yearly income, divided by the tax on that yearly income, gives the rate of tax. This rate is then applied to the extended period's assessable income.

Example

Farming income for 15 months	$35,000
Interest and dividends for 12 months	$ 2,300
Total	$37,300

Calculation of income for 12 months:

Farming income 35000 x $\frac{12}{15}$ =	$28,000
Plus interest and dividends	$ 2,300
Total - income for 12 months	$30,300

Tax calculation:

Tax on $30,300 = $7,272

$37,300 x $\frac{\$7,272}{\$30,300}$ = **$8,952**

Meals provided on aircraft

Section 106G(3)(j) - Not included in entertainment: A businessman travelled on a domestic flight on which a meal was served during the flight. He wanted to know if the cost of the meal was restricted to 50% deductibility under the entertainment regime.

In this case the meal was provided as part of the cost of the business-related flight. The meal was incidental to the flight, so the cost of it is not subject to partial deductibility.

However, if the flight had been for the purposes of enjoyment of entertainment, food or beverages, the full cost of the flight would be subject to the entertainment regime.

Interest payable on qualifying tax in dispute

Section 34A - Interest on certain excess tax: A taxpayer objected to his 1993 income tax assessment. He had omitted to provide receipts for several items of expenditure. Inland Revenue disallowed the claims, thus reducing the refund calculated by the taxpayer. Eventually the taxpayer provided receipts and Inland Revenue issued a further refund. The taxpayer asked if interest is payable by Inland Revenue and if so, what amount.

The interest entitlement applies to competent objections received after 1 April 1985. Under section 34(1) of the Act, a "competent objection" is an objection made in accordance with section 30 of the Act. However, it does not include a "non-qualifying objection". The definition of a "non-qualifying objection" (also contained in section 34(1)) includes an objection where the grounds of objection are that the return or other particulars relating to the return are deficient or insufficient.

In this case the return was deficient because receipts were not supplied. The objection was therefore not competent so no interest was payable to the taxpayer.

Accrual expenditure - local authority rates

Section 104A(4) - Unexpired portion included in assessable income: A shopkeeper decided to pay the local authority rates covering the current year and an estimate of what she thought would be payable in the following year. She asked if the rates paid in advance are deductible in the 1993 income year.

The rates paid in advance are deductible in the 1993 income year under section 104 "except as otherwise provided" in the Act. Section 104A of the Act requires the unexpired portion of expenditure to be added to the assessable income, thereby negating the benefit of an early deduction.

Accrual Determination E8 lists accrual expenditure that is **not** required to be added back to assessable income if certain thresholds and time limits apply. Rates are listed under item "p" in the schedule to the determination. The threshold is limited to the invoiced amount on or before balance date. As the payment made in advance would not have been invoiced, section 104A(4) requires the add-back to assessable income.

Example:

Rates invoiced for 1993	$2,100
Rates paid in advance	$2,500
Total deduction allowed	$4,600

continued on page 10

from page 9

Summary:

A deduction of $4,600 is allowed. The assessable income is increased by $2,500, being the unexpired portion. The amount of the unexpired portion is deductible in the following year (i.e., $2,100 is allowed in 1993 and $2,500 in 1994).

Bad debts subsequently paid

Section 106(1)(b) - Bad debts: A garage owner had written off bad debts and claimed a deduction for them. Almost two years after the write-off, he received a small part of the bad debt. He asked if the money received is assessable and if so, when.

Any amount received as repayment of a bad debt for which a deduction has been claimed is assessable for income tax under section 65(2)(jc) of the Income Tax Act 1976. (This section was inserted by section 15 of the Income Tax Amendment Act (No 3) 1993). The amount will be assessable in the year in which the taxpayer receives it. These amounts were previously assessable under the proviso to section 106(1)(b) (since amended).

In this case, the garage owner was registered for GST. He also had to make an output tax adjustment in the GST period in which he recovered the debt, under section 26(2) of the Goods and Services Tax Act 1985. If the garage owner accounted for GST on a payments basis, output tax is payable in the period the debt is paid by the debtor.

Insurance receipts to be taken into account

Sections 79(2), 106(1)(c) and 117(5): A dairy owner's cooling unit became water damaged. The dairy owner received $3,000 compensation. $1,000 of the compensation was for lost goods, and $2,000 was for repairs to the cooling unit. The dairy owner asked how the insurance payments will affect his 1994 income.

There are two points to consider:

1. Trading stock: The effect of section 79(2) is that the assessable income is increased by $1,000. The dairy owner received no other income from the damaged goods. If he did, that income would be assessable in the ordinary course of business.

In this case the result on the dairy owner's assessable income will be nil as the insurance receipt will offset the original deduction for the damaged goods when they were purchased.

2. Depreciated assets: The dairy owner carried out the repairs to the cooling unit. The expenses incurred were $1,546 for parts and other miscellaneous costs. This expenditure is not deductible under section 106(1)(c).

Section 117(5) of the Act provides that the amount of the excess of the insurance payment over the costs incurred by the dairy owner ($454) is deducted from the adjusted tax value of the cooling unit. If the excess ($454) is greater than the adjusted tax value, that excess over the adjusted book value is also assessable income (section 117(6)).

Goods and Services Tax Act 1985

GST on sale of fishing quota

Section 8(1) - Imposition of tax: A fisherman sold some of his unwanted fishing quota in the course of his taxable activity. He asked if the sale is subject to GST.

Such a sale is subject to GST, as it is not the sale of a going concern. This is because the quota is not capable of separate operation. Therefore, the transaction cannot be zero-rated under section 11(1)(c) of the Act.

Stamp and Cheque Duties Act 1971

Refund of conveyance duty

Section 68 - Refund of duty or penalty on application: The purchaser entered into an agreement for sale and purchase of a property. Stamp duty was correctly paid. The purchaser could not obtain full legal title so the agreement was rescinded, and replaced by a further agreement. The purchaser has asked if the stamp duty paid earlier could be refunded.

Where there is clear evidence that the transaction has been abandoned, duty and any penalty arising on the agreement is refunded. If a verbal agreement to rescind the agreement was made, a letter from the solicitors acting on behalf of the purchasers, setting out the facts is usually acceptable evidence.

In this case, the replacement agreement was acceptable evidence. The original stamped document was noted, advising that the refund had been made. Had the original document been lost or destroyed, the replacement agreement would have been noted with the amount of the refund.

Approved issuer levy

Section 86G - Application to register securities: A non-resident depositor asked a building society to treat his deposit as a registered security. Approved issuer levy would then apply to that contract.

The building society advised Inland Revenue that this depositor is its only non-resident client, and to change its computer system would be costly. It asked if it had to comply with the depositor's request.

Section 86G allows the building society to apply to Inland Revenue for registration of the transaction. The society is not obliged to do so, and in this case it did not.

The depositor has remained a client of the building society, and the correct amount of non-resident withholding tax is being deducted.

Accident Rehabilitation and Compensation Insurance Act 1992

Overseas income liable to premiums

Sections 102 and 114: A New Zealand resident derived income in Singapore as an artist. She asked if this business income earned while overseas is subject to earner and employer premiums.

The artist will pay premiums based on her "earnings" from personal exertion. The Accident Rehabilitation and Compensation Insurance Act 1992 defines "earnings" which includes all assessable income. Therefore, premiums will be payable on overseas income.

Child Support Act 1991

Recovery of Child Support arrears by custodian

Section 180 - Payee may uplift financial support debt: A custodian was concerned that collection of Child Support arrears from an ex-partner was being delayed. She asked whether there was anything she could do to speed matters up.

Under section 180 of the Act, the custodian can apply in writing to have Inland Revenue cease collection of any amount in arrears. The custodian can then personally pursue the debt through the District Court. A custodian who is concerned about the collection of spousal maintenance from a former partner can also use section 180.

Note that a custodian who was a social security beneficiary at the time the financial support was payable cannot use section 180. Further, any election under this section is irrevocable.

Any elections should be in the appropriate approved form - CS 202. You can get this from from any IRD Child Support Agency.

Estate and Gift Duties Act 1968

Value of stamp collection

Section 67 - Valuation of property: A philatelist owned a collection of stamps which she wished to give to a friend. The donor estimates that the collection is worth more than $27,000, but she is unsure as to the exact value. She asked if $27,000 is an appropriate value for gift duty purposes.

Under section 67 of the Act, the Commissioner can value the collection in any manner he thinks fit. Inland Revenue will usually seek advice from experienced people in the appropriate field. In this case, a philatelic society helped to value the stamps. A small amount of gift duty was payable on the valuation made as at the date of the gift.

Gift duty paid by donee

Section 70 - No deduction to be made in respect of benefit to donor: A donor gave $45,000 to each of his three grandchildren, to be held in trust. A condition of the gift was that the trustees would pay any gift duty. The donor did not make any other gifts during the year. The trustees asked how much gift duty is payable. Is duty payable on $135,000?

Donors are liable for any gift duty in the first instance. In this case the donor has effectively passed that liability to the donee (although legally the donor is still liable for the duty). This means the value of the gift is the figure arrived at by calculating the sum that, together with gift duty thereon, would produce $135,000.

This table will help with this calculation:

Known Gross Gift	*Net Gift*
27,000 - 36,450	27,000 + 95.238 cents per $ of gross gift over 27,000
36,451 - 56,250	36,000 + 90.9091 cents per $ of gross gift over 36,450
56,251 - 77,850	54,000 + 83.3334 cents per $ of gross gift over 56,250
Over 77,850	72,000 + 80 cents per $ of gross gift over 77,850

In this case, the dutiable gift is $117,720. Gift duty on that amount is $17,280, giving a total of $135,000. If the donor had gifted $117,720 and paid the duty himself, the result would have been the same.

Gaming Duties Act 1971

Interest payable on unpaid totalisator duty

Section 8(1) - Interest: The secretary of a racing club asked for clarification of late payment penalties.

The club deducts totalisator duty from race day proceeds. It may pay the duty to Inland Revenue immediately or hold it in trust. The due date for payment is within seven days from the day after the race meeting.

There will be no interest charged if the duty is paid within one month of the due date. If the duty is not paid within that time, 5 percent interest will be charged on the outstanding amount for every month or part-month that it remains unpaid.

If a club has a genuine case for remission of interest charged, it may apply for remission under the Public Finance Act 1989. The club's application should state whether the trust account required by section 6(2) of the Act has been used, the reason for non-payment, and details of any benefit derived by the club from retention of the duty.

Student Loan Scheme Act 1992

Credit interest adjustment

Section 42 - Interest adjustment in respect of credit balances: A borrower made payments towards her Student Loan to Inland Revenue. The loan had not been transferred to Inland Revenue by the Loan Manager at the time the payments were made. Inland Revenue must pay credit interest when the Inland Revenue loan account is in credit and the loan has yet to be transferred for that year. The amount of interest is limited to the amount of debit interest transferred to Inland Revenue.

When the Loan Manager transferred the loan to Inland Revenue, a credit interest adjustment was made. The borrower asked if the credit interest should have been more as the payments made exceeded the loan transferred. In this case the borrower was credited with $17.34 - the same amount as the debit interest charged when the loan was transferred.

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.

Contents

Sale of land not a taxable supply

Rating: • •

Case: TRA 93/142

Act: Goods and Services Tax Act 1985 - sections 6, 8, and 57

Keywords: *Supply, taxable activity*

Summary: The sale of a block of land was not a taxable supply made by a farming partnership, but a supply made by a non-registered person who was under no obligation to register. GST is not leviable on that supply.

Facts: Mr and Mrs D were partners in a farming partnership. The farm land consisted of nine separate titles amounting to 290 acres. Mr D was the sole registered proprietor. By 1984, all of the farm land had been sold except for one block of 9.6 hectares. Mr and Mrs D sub-divided the remaining land into two equal blocks in 1991, sold one block and retained the other for themselves. Inland Revenue contended that output tax was payable on the land sold.

Decision: Judge Willy found that the facts of the case showed that although legal title in the land was vested solely in Mr D at all material times, the land was nevertheless partnership property. However, for GST purposes it was Mr D who made the supply of land rather, not the partnership. He was the registered proprietor of the land. Mr D was not a registered person for the purposes of the GST Act (as he was unregistered and not liable to be registered). Therefore, the supply was not subject to GST.

Comment: Inland Revenue is appealing this decision.

Preparatory expenditure in setting up a business

Rating: • • •

Case: TRA 93/183 & 184

Act: Income Tax Act 1976 - sections 104 and 106(1)(j)

Keywords: *New business expenses, in business, gaining or producing assessable income*

Summary: Expenditure is deductible for tax purposes if it is incurred in gaining or producing assessable income or in the carrying on of a business intended to produce assessable income. Expenditure of a preparatory nature in setting up a business is not deductible.

Facts: The objectors purchased a farm in September 1983. They intended to use the site for a mixed venture of deer farming and for running a cat and dog boarding kennel. The objectors and their family spent much time and money bringing the property up to standard for the proposed uses.

In late 1983 the objectors made detailed enquiries concerning the operation of the kennels. In the following year the objectors concluded that they would not be able to satisfy the local authority zoning requirements for the kennels. Another site was purchased a few months later to carry on the kennel business.

The business operations undertaken on this second property were not called into question. The first property was sold in 1987. The objectors sought to deduct farming losses arising in the years 1984 to 1988 inclusive.

Decision: Judge Willy found in evidence that it was always intended to use the first property as a mixed venture. However, from the time the kennel business on that site was abandoned, there was no evidence that the objectors intended operating a business on that site or deriving assessable income from it. Deer farming alone was not a viable business concern on that site. Accordingly, losses on the first property for the years ended March 1985, 1986, 1987, and 1988 were disallowed.

Expenditure and losses incurred on the first property in the first year of operation (year ended March 1984) were held to be of a preparatory nature and disallowed. Considering the dicta of Judge Barker in *Duff v CIR* (1982) 5 NZTC 61,131, Judge Willy looked at whether the expenditure of money was connected with getting the property ready for carrying on the intended business or with actually carrying on the business. The expenditure on fencing, scrub-cutting, and spraying was of a preparatory nature only. The purchase of a few sheep and calves clearly did not form part of the livestock for the intended activity of deer farming and boarding kennels. Hay was produced but not sold commercially.

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

Assessment of accommodation under section 72

Rating: • • •

Case: TRA 93/163

Act: Income Tax Act 1976 - section 72

Keywords: *Residential benefit, monetary remuneration in the form of free accommodation*

Summary: Inland Revenue assessed the objector under section 72 of the Income Tax Act 1976 for the value of residential accommodation situated above the objector's warehouse. During the year in question, the 1989/90 income year, the taxpayer only lived in the accommodation occasionally. It was not until later income years that the accommodation was made suitable for full-time living.

Facts: After investigating the taxpayer's affairs Inland Revenue assessed the taxpayer for the value of an accommodation benefit. The accommodation in question was situated above a warehouse owned by a company in which the taxpayer was a major shareholder. The argument put forward by the taxpayer was that during the 1989/90 income year he only occupied the premises on a very casual basis. It was not properly set up as a residential unit.

Decision: The Authority accepted the taxpayer's position and ruled that there was no residential benefit to be assessed to the taxpayer during the 1989/90 income year.

Comment: Inland Revenue is not appealing this decision.

Sick leave and redundancy

Rating: •

Case: TRA 93/212

Act: Income Tax Act 1976 - section 68

Keywords: *Redundancy entitlements, terms of redundancy agreement*

Summary: The TRA found that a large portion of sick leave entitlement was part of a redundancy payment, as it was covered by the terms of a registered redundancy agreement. Special tax treatment applied to redundancy payments at the time.

Facts: The objector was made redundant, with 267 days of unused sick leave to his credit. The redundancy agreement between the objector and his employer provided that redundant workers were compensated for all unused sick leave. If the objector's employment had been terminated for any other reason, he would have been entitled, after 10 years service, to payment at the rate of 1/5 of accumulated sick leave.

Decision: The TRA found that the terms of the redundancy agreement provided that workers made redundant were entitled to all their sick leave entitlement. However, those leaving for other reasons were entitled to 1/5 entitlement. As 4/5 of the entitlement was payable only on redundancy, it was not excluded by section 68(5) from the concessionary tax treatment for redundancy payments then in force. Therefore, only 5% of the amount of the payment was subject to tax.

Comment: Inland Revenue has not decided whether to appeal this decision.

National superannuation surcharge on income earned before becoming a national superannuitant

Rating: • • •

Case: TRA 93/112

Act: Income Tax Act - section 336

Keywords: *National superannuation surcharge, other income.*

Summary: A superannuitant received interest income after the date on which he qualified to receive national superannuation. Although part of the interest was earned before that date, the full amount must be taken into account for the purposes of the formula used in deciding the amount of the national superannuation surcharge payable. Inland Revenue cannot apportion the interest.

Facts: The taxpayer invested money at interest on 7 September 1990, and became entitled to receive national superannuation on 8 April 1991. The loan matured on 6 September 1991. The taxpayer maintained that the interest should be apportioned, and the amount earned before the date on which he qualified for superannuation ought not to be taken into account when calculating his surcharge.

Decision: The question of whether the interest could be apportioned was to be considered in the light of the common law principles upon which Inland Revenue can apportion interest received by non-business taxpayers. Unlike traders, non-business taxpayers are not assessable for income tax until they get their money. To shift the taxation of such individuals onto a receivables basis would be unfair to most taxpayers and contrary to the clear weight of authority. Inland Revenue was correct in assessing the whole of the income on the basis of its actual receipt in the income year.

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

Whether taxi business purchased as a going concern

Rating: • •

Case: TRA No. 93/136

Act: Goods and Services Tax Act 1985 - sections 2, 11, 20

Keywords: *Taxis, going concern, input tax claim*

Summary: This matter involves the acquisition of a taxi business by the objectors. Inland Revenue disallowed an input tax claim made by the taxpayers on the grounds that the taxpayers were unable to show that GST had been charged to them on the supply. The taxpayers objected and the case proceeded to the Taxation Review Authority (TRA). The TRA upheld Inland Revenue's decision.

Facts: The taxi business was operated in a rural locality. All the taxi proprietors operating in that area belonged to a local taxi association which was a limited liability company. The proprietors owned shares in the Association. The vendor, in this case, owned 600 shares.

Because of past difficulties associated with the GST implications of transferring taxi businesses and accompanying licences, the Association resolved at one of its meetings to establish certain rules for such transfers. The objectors contended that they purchased their taxi business on the basis of these rules. They acquired the business on 13 June 1991 for $18,000. $17,999.90 was appropriated to goodwill and 10 cents to the value of the shares. It was intended that the $18,000 should be inclusive of GST.

continued on page 18

from page 17

Decision: Judge Willy accepted the terms of the arrangement insofar as they represented the general intentions of the company speaking on behalf of its members. However, he pointed out that the intentions of the shareholder members of the association could not bind individual vendors and purchasers. The objectors failed to produce clear evidence of the terms upon which they had contracted with the vendor for the purchase of the taxi business.

Judge Willy also commented that since deregulation, Inland Revenue's policy statement contained in Public Information Bulletin 175 cannot have any relevance to the sale of taxi businesses. This is because the transfer of taxi licences was no longer necessary. He stated that the purchase of a vendor's interest in a taxi co-operative company could of itself constitute a going concern. This was on the basis that the objectors were purchasing the vendor's business. The fact that the purchasers did not buy the vendor's vehicle was considered to be only one element in deciding whether or not the supply was that of a going concern. Judge Willy indicated that if he had to decide on the evidence before him he would have considered the supply to be that of a going concern and therefore zero-rated for GST purposes.

In this case the objectors had failed to show that the $18,000 paid for the purchase of the business was GST inclusive and that the business was not a going concern. As a result the case was decided in Inland Revenue's favour.

Comment: We do not know if the taxpayer will be appealing this decision.

Whether profits from property sales taxable

Rating: • •

Case: TRA Case 83/228: TRA Decision 55/93

Act: Land and Income Tax Act 1954 - sections 88(1)(c) and 88AA(1) & Property Speculation Tax Act 1973

Keywords: *purpose of selling or otherwise disposing of, purpose or intention of selling or otherwise disposing of, work of a minor nature*

Summary: This case dealt primarily with the assessability of profits that the objector derived from certain property transactions under the Land and Income Tax Act 1954 and the Property Speculation Tax Act 1973. The transactions took place in the financial years from 1974 to 1976.

The Authority found that profits arising from some of the transactions were assessable as the properties in question were purchased with the intention of resale. Profits from the remaining transactions were not assessable. The case also addresses the character of several payments made to the objector in these periods which were not "returned". These were found to be not revenue in character and therefore not assessable.

Facts: The objector is a solicitor. During the relevant period he purchased and sold several properties. Inland Revenue assessed the objector on the profits that he derived from these transactions. We considered that the objector bought the properties with the intention of reselling them. The objection followed.

Decision: Judge Barber held that the resulting profits from two of the transactions were assessable because the objector had entered into those transactions with the intention of reselling the properties. Judge Barber also found that the profit on the sale of a flat was subject to property speculation tax at the rate of 90%. However, he held that the profits from a transaction involving the amalgamation of a large block with two smaller sections, the moving of a house onto the site and preparatory subdivision work before its sale, were not assessable. Judge Barber found that the objector had intended to establish a family home and orchard on the property, but then changed his mind. The Authority held that the development and subdivision work carried out on the property was work only of a minor nature.

The Authority also held that the payments in question, that the objector received but did not return, were not revenue in nature and were therefore not assessable.

Comment: We do not yet know whether the objector or Inland Revenue will appeal any aspects of this decision.

Due dates reminder

March

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.

April

5 PAYE deductions and deduction schedules for last 16 days of March 1994 due - "large" employers only.

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

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

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

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

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

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

20 PAYE deductions and deduction schedules for first 15 days of April 1994 due - "large" employers.

PAYE deductions and deduction schedules for March 1994 due - "small" employers.

Completed PAYE deduction certificates for the year ended 31 March 1994 should have been distributed to all employees.

FBT return and payment for quarter ended 31 March 1994 due.

Annual FBT return for period 1/4/93-31/3/94 due for employers who pay no fringe benefits.

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

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

RWT on interest deducted 1/10/93-31/3/94 due for six-monthly payers.

RWT on dividends deducted during March 1994 due.

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

29 GST return and payment for period ended 31 March 1994 due.

Volume Five, No.9 February 1994

Contents