GST: claims for secondhand goods input tax credits on property transactions between associated persons

Introduction

This policy statement sets out the Commissioner's policy and audit action on claims for secondhand goods input tax credits on property transactions between associated persons. This policy statement refers particularly to land transactions, but it also applies to any other property transactions between associated persons. The focus of the statement is on transactions between associated persons.

Background

In many cases before selling the land, the vendor previously rents the land to a person (often the eventual purchaser) or allows a person (again, often the eventual purchaser) to occupy and use the land without paying rent. The vendor is not registered for GST at the time of the sale and does not pay output tax on the land sale. The purchaser is registered, and claims a secondhand goods input tax credit.

This policy statement explains Inland Revenue's interpretation of the law and how it applies to these transactions. Inland Revenue notes that some of the comments under the heading "Policy" also apply to transactions between non-associated persons.

Policy

Inland Revenue will allow a purchaser to deduct input tax in respect of the supply of secondhand goods acquired for the principal purpose of making taxable supplies where both of these conditions are met:

1. There has been a supply by way of sale of the property to the purchaser.
2. The purchaser has provided "payment" in terms of section 20(3) of the GST Act.

Before 22 March 1989 there was no requirement for the supply to be by way of sale or for payment to have been made if the purchaser was on an invoice basis.

In considering the facts of each case, Inland Revenue will ask the following questions:

Does the transaction constitute a "supply" for the purposes of the GST Act?

The definition of "taxable activity" in section 6 of the GST Act states that a person must supply goods or services to another person in order to carry on a taxable activity. Where the vendor and the purchaser of land are different entities for GST purposes, Inland Revenue accepts that a supply occurs.

Inland Revenue's view is that for the purposes of the definition of "input tax" in section 2 of the Act, there can be a supply by way of sale between the vendor and purchaser of the land providing they are different entities for GST purposes.

Has there been "payment" for the supply?

Section 20(3) provides that in respect of secondhand goods, input tax is deducted from output tax payable by a registered person to the extent that a payment in respect of the supply has been made. Whether or not payment has been made is a question of fact. To determine this, Inland Revenue will look for evidence that satisfaction of the obligation to pay imposed by the agreement for sale and purchase has occurred. Such evidence need not involve a physical transfer of cash. There are other ways to show that payment has been made. The following are some examples of factual situations that suggest payment has been made, unless there is some conflicting evidence:

- ***Journal/accounting entries***

  If the parties agree that a liability may be offset against another liability, there is no legal requirement for money to actually change hands. The crediting of an account, if it is supported by evidence of intention that the entry is to record the satisfaction of the obligation owed to the account holder, may constitute evidence that payment has occurred.

- ***Acknowledgement of debt and mortgage back***

  Inland Revenue will accept as evidence of payment an acknowledgment of debt in the form of a deed which is separate from the sale and purchase agreement. If there is no written acknowledgment of debt and the vendor receives a verbal promise to pay, Inland Revenue will look for supporting evidence to show that the vendor has a legally enforceable promise to pay.

  Factors Inland Revenue will take into account in this situation include:

  - the terms of the sale and purchase agreement
  - the terms of the acknowledgement of debt or mortgage security
  - whether or not the title to the property has been transferred

- ***Cheque swaps***

  Where a cheque is drawn on the vendor's account and credited to the purchaser's account it may be evidence that the vendor has advanced the purchase price to the purchaser. Where a cheque is drawn on the purchaser's account and credited to the vendor's account it may be evidence that the purchaser has used the vendor's advance to pay for the supply. Inland Revenue accepts that payment will occur at the time the cheques are presented and honoured by the bank upon which they are drawn.

  When a cheque is offered as evidence that payment has been made, Inland Revenue will require supporting details of the bank account of the purchaser.

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Is the vendor liable to be registered under section 51?

If the vendor is liable to be registered, the purchaser may still claim an input tax deduction, but the vendor will be required to account for output tax on the sale.

Section 51(4) enables the Commissioner to register a person for the purposes of the GST Act with effect from the date on which that person first became liable to be registered. Inland Revenue will take the following factors into account when determining whether the vendor is liable to register for GST:

- ***Is there a taxable activity?***

  In many land transactions there is a lease in existence between the vendor and the user of the land. Inland Revenue's view is that the leasing and licensing of land are both capable of constituting a taxable activity.

- ***Does the value of the supply exceed the registration threshold?***

  It is common that the user of the land pays rental or outgoings on the land to or on behalf of the owner. Inland Revenue's view is that the payment of rental or outgoings constitutes consideration for the use of the land. Inland Revenue considers that the payment by the lessee or user of the land of mortgage principal, interest, rates or development expenditure constitutes consideration for the supply of the land. As a guideline, Inland Revenue accepts that expenditure capitalised under sections 127 or 128A of the Income Tax Act 1976 constitutes development expenditure.

  Inland Revenue does not consider that repairs and maintenance, insurance, or fertiliser constitute payment of consideration.

  If the total value of supplies in the previous 12 months exceeds the registration threshold, the vendor must register for GST.

- ***What is the value of the supply?***

  Section 10(3) of the GST Act values supplies between associated persons where a supply is made for no consideration, or for consideration in money that is less than the open market value. Section 10(3) deems the value of the supply in these circumstances to be the open market value.

  Sometimes there is reason to believe that the open market value will take the vendor over the registration threshold in section 51. In such circumstances, Inland Revenue will require a valuation of the market rental or market licence by a registered valuer or any other competent person.

  If the market valuation is below the threshold, no registration liability arises. Where the market valuation is above the threshold Inland Revenue requires the vendor to be registered from the date on which the vendor became liable to be registered. If the vendor does not produce a valuation, Inland Revenue will establish a valuation based on all the information available. If registration is required and returns are not furnished there is no statute bar on the issue of the initial assessment.

  If the value of the supply in respect of land leased (or licensed) out before the sale takes the vendor over the registration threshold:

  - The vendor must register for GST and pay GST on supplies made during the period when the vendor should have been registered (including on the renting out the land and on the sale of the land)
  - The purchaser will be allowed an input tax credit for the purchase of the land, providing that the statutory requirements are met.

Audit strategy

Where Inland Revenue has made detailed enquiries which would lead the parties to the transaction to reasonably believe that Inland Revenue has fully considered the transaction, the matter will not be reopened at a later date.

Where Inland Revenue has not made any such enquiries, the transaction will be subject to normal audit review for GST according to this policy -

- immediately upon publication of Inland Revenue's policy if the parties involved have previously received a letter saying that the matter may be revisited, or
- if the matter comes up in the normal course of audit or enquiry in any other case.

Where Inland Revenue has not indicated to taxpayers that we would revisit the transaction, Inland Revenue does not intend to revisit the cases except if the matter comes up in the normal course of audit activity.

Inland Revenue case strategy

There are a number of cases where one or more of the above issues has arisen. These cases have already gone through the assessment and disallowance of objection process, and have reached the stage of having cases stated.

These cases will proceed with a view to having them heard as quickly as possible, unless it would be inconsistent with this policy statement.

Some cases may await the outcome of cases identified as suitable "test cases". This would happen where there is a factual basis making it clear that a decision in the test case will determine the legal principles to be applied to other cases.

The following examples illustrate Inland Revenue's approach.

Example 1

A father, mother and two sons own a farm. They were not registered for GST. In 1991 the father and the sons entered into a partnership to farm the land. The partnership leased the land from the owners for a rental of $28,000 per annum, which was the market rental for the land. In addition, the partnership paid mortgage interest ($10,000) and rates ($5,000) on the land. The owners sold the land to the partnership and the partnership claimed a secondhand goods input tax credit.

Inland Revenue allowed the input tax credit. However, the former owners were required to register for GST under section 51 (as an unincorporated body) and to pay output tax on the sale. This is because the total value of the supplies ($43,000) made by the former owners in the year before the sale exceeded $30,000 (the registration threshold).

Inland Revenue is currently appealing a case on this point.

Example 2

A non-registered individual sells a farm to another individual who is registered. The vendor is not liable to be registered. Possession of the farm is given to the purchaser, but no money changes hands and no promise to pay is given in exchange for the title to the land.

Inland Revenue would not allow the purchaser to claim an input tax deduction as no payment has been made. However, if there was an exchange of cheques or an acknowledgement of debt of the vendor's advance, Inland Revenue would accept that payment has occurred and allow the purchaser the input tax credit.

There are many possible variations on the above scenarios. In some cases more than one issue may arise.

Due dates and penalties

Where the vendor is required to register for GST, output tax is payable by the due date for payment i.e., one month after the assessment is issued. The only circumstance where a new due date will not be set is where Inland Revenue intends to take penal action against a taxpayer for wilfully misleading the Commissioner.

Where the assessment is subject to an objection, 50% of the tax in dispute is payable by the due date. Where the taxpayer(s) does not object to the assessment, 100% of the tax is payable by the due date.

In some cases Inland Revenue has issued assessments, but has agreed not to start recovery action on the unpaid tax until release of this policy statement. In these cases the 10% additional tax and other penalties accrued for late payment will be remitted providing the tax is paid by one month after this statement is published.

Dual assessments

Where Inland Revenue has required the vendor to register because the supply of the property exceeds the registration threshold, the Commissioner will exercise the discretion under section 24(6) of the GST Act and allow the purchaser an input tax credit, even if the purchaser does not hold a tax invoice. This will avoid the situation where Inland Revenue issues "dual assessments".

Summary

Inland Revenue will consider these issues when determining whether a purchaser in an associated person land transaction is entitled to a secondhand input tax deduction:

1. Has there been a supply by way of sale of the land between different entities for GST purposes?
2. Has the purchaser has provided "payment" for the benefit of the vendor?

Inland Revenue will also consider whether the vendor is liable to be registered for GST and pay output tax on the sale. Where the vendor is required to register for GST the Commissioner will exercise the discretion under section 24(6) as it would be impractical to require that a tax invoice be issued. The purchaser will be able to claim an input tax credit on the sale, notwithstanding that no tax invoice has been issued.

Where Inland Revenue has made enquiries which would lead the parties to the transaction to reasonably believe that an Inland Revenue officer with the appropriate authority has fully considered the transaction, no assessment shall be reopened.

Where Inland Revenue has not made such enquiries, assessments may be reopened, and assessments or reassessments may be issued for GST on the transaction. Assessments shall be reopened, and assessments or reassessments shall be issued, for GST according to this policy:

- immediately on publication of Inland Revenue's intentions if the taxpayers involved have previously been warned that the matter might be revisited
- if the matter comes up in the normal course of audit or enquiry in any other case.

$200 limit for writing off assets - is GST included?

Introduction

This article explains when the $200 limit for write-offs in section 108O of the Income Tax Act 1976 ("the Act") is GST inclusive or GST exclusive. Section 108O was introduced with the new depreciation regime by the Income Tax Amendment Act 1993 and was then amended by the Income Tax Amendment Act (No.3) 1993.

Taxpayers can claim a deduction for the cost of assets acquired or created for $200 or less, in the year they acquire such assets. Some taxpayers have asked whether the $200 is GST exclusive or GST inclusive.

In most circumstances, the $200 limit is GST exclusive for a GST registered person and GST inclusive if the person is not registered for GST. The total cost is calculated after deducting any input tax credits which the taxpayer may claim back from Inland Revenue.

Legislation

Section 108O(1) of the Act states that "low value property" means any property of a taxpayer -

"... which is acquired or created by the taxpayer for a total cost not exceeding $200 ...".

The section does not define "cost" or "total cost".

Section 108O(2) provides that the cost of low value property is deductible in calculating a taxpayer's assessable income for any income year where the asset meets both of these conditions:

- it is acquired or created for the purpose of gaining or producing assessable income or of carrying on a business for the purpose of gaining or producing assessable income
- it is primarily and principally used or available for use in that income year for that purpose.

The issue is whether "cost" in section 108O includes or excludes GST.

Section 140B of the Act deals with accounting for GST. Section 140B(6) deals specifically with depreciation and GST. It provides that the cost price is reduced by any amount of "input tax" on an asset. Section 140B(6) states that it applies for the purposes of section 108 of the Act. However, Inland Revenue considers that the approach taken in section 140B should also be applied to section 108O.

Input tax - definition

For the purposes of section 140B "input tax" has the same definition as in section 2 of the Goods and Services Tax Act 1985. Section 2 defines "input tax" as:

> *"Input tax", in relation to a registered person, means -*
>
> *(a) Tax charged under section 8(1) of this Act on the supply of goods and services made to that person:*
>
> *(b) Tax levied under section 12(1) or section 13(1) of this Act on goods entered for home consumption under the Customs Act 1966 by that person:*
>
> *(c) Any amount equal to the tax fraction (being the tax fraction applicable at the time of supply within the meaning of section 9 or any other provision of this Act) of the consideration in money for the supply, being a supply by way of sale that is not a taxable supply, to a registered person of any secondhand goods situated in New Zealand, -*
>
> *being in any case goods and services acquired for the principal purpose of making taxable supplies:*

"Input tax" is limited to GST charged to a **registered person** (including GST on imported goods and the tax fraction for secondhand goods) on goods and services acquired for the **principal purpose of making taxable supplies**. By definition, an unregistered person is not charged input tax even if he or she pays GST when purchasing goods and services.

A registered person only incurs input tax on goods and services acquired for the principal purpose of making taxable supplies.

Policy - GST and depreciation

Inland Revenue's policy on GST and depreciation is based on Section 140B. Paragraph 1.4 of the Appendix to TIB Volume 4 No. 9 (April 1993) states:

> *"If you are not registered for GST, you base your depreciation on the actual price you pay for an asset, including the GST component.*
>
> *If you are registered for GST, you can claim the GST component of an asset's cost price as an input tax deduction. In this case you claim depreciation on the GST-exclusive price that you actually paid for the asset."*

Registered persons - $200 limit excludes GST

GST registered persons who acquire an asset for the principal purpose of making taxable supplies, and who use the asset in producing assessable income as required by section 108O(2), can deduct the GST exclusive cost for an asset costing up to $200 exclusive of GST. Such property would therefore have a maximum price of $225 including GST, although the maximum deduction in calculating assessable income would be $200. The $25 of GST would constitute GST input tax (which is not deductible for income tax purposes), so will not affect the amount of the limitation.

A registered person may acquire an asset with a principal purpose other than making taxable supplies, but still use the asset to gain or produce assessable income (or in a business for that purpose). In this situation, if the GST exclusive cost of the asset was $200 or less, the registered person can claim a deduction for the cost of the asset.

Registered persons who purchase secondhand goods for the principal purpose of making taxable supplies should deduct the tax fraction (one-ninth) to determine whether the cost paid for the asset is $200 or less.

Non-registered persons - $200 limit includes GST

Taxpayers who are not registered for GST can claim a deduction for assets acquired for a GST inclusive cost of $200 or less. This is provided the asset is to be used in gaining or producing assessable income or in carrying on a business for that purpose. Any GST paid would not constitute input tax as the definition specifies that input tax relates only to a registered person.

Summary

The $200 limit in section 108O is calculated on the GST exclusive cost for taxpayers who are registered for GST and who are acquiring the property for the principal purpose of making taxable supplies. If the GST registered person did not acquire the property for making taxable supplies, the $200 limit applies to the GST inclusive cost.

If a taxpayer is not registered for GST, the $200 limit applies to the GST inclusive cost.

Application date

This policy applies to intangible property acquired or created on or after 1 April 1993. In other respects, it applies from the 1993-94 income year onwards.

National standard cost values for livestock - 1994

Under the authority of section 86C(1) of the Income Tax Act 1976, the Governor-General has declared the national standard costs for specified livestock for the year commencing on 1 April 1993.

The costs are listed in the table below.

Kind of Livestock	Category of Livestock	National Standard Cost $
Sheep	Rising 1 year	13.30
	Rising 2 year	7.80
Dairy Cattle	Purchased bobby calves	135.00
	Rising 1 year	268.00
	Rising 2 year	68.20
Beef Cattle	Rising 1 year	116.00
	Rising 2 year	65.50
	Rising 3 year male non-breeding cattle (all breeds)	65.50
Deer	Rising 1 year	35.90
	Rising 2 year	18.60
Meat and Fibre Goats	Rising 1 year	10.10
	Rising 2 year	6.30
Dairy Goats	Rising 1 year	74.00
	Rising 2 year	10.80
Pigs	Weaners to 10 weeks of age	75.70
	Growing pigs 10 to 17 weeks of age	56.70

Income Tax (National Standard Costs for Livestock) Determination 1994

The Income Tax (National Standard Costs for Livestock) Determination which applies for the 1993-94 income year and future income years is printed in Appendix A to this TIB.

This new determination has changed slightly from the determination that applied for 1992-93 transitional year (see the appendix to TIB Volume Five, No.2). The examples in that appendix still apply for the 1994 determination, apart from Example 7 which dealt with the 1992-93 transitional year.

There have been three major changes to the determination:

1. Paragraphs 27 to 31 have been removed, as they related only to the 1992/93 transitional income year. They do not apply to 1993/94 or future income years.
2. the renumbering of paragraph 9A to 10 and the remainder of paragraphs
3. There is a new paragraph 28. This paragraph corrects an oversight with the 1993 determination, which relates to the use of the herd scheme when a farmer wishes to increase livestock numbers and bring those additional numbers to account at cost (national standard cost/self assessed cost). In the former determination the calculation of national standard cost required the opening stock to be an average of herd scheme values and national standard cost.

   This requirement did not reflect the intention of the recommendation of the Livestock Valuation Consultative Committee. The Committee intended that any additional livestock over the herd scheme base number should be valued at cost to remove any impediment to increased production. The averaging method in the former determination inflated the closing values because the market value linked herd scheme figures were included in the calculation.

   The new paragraph simply allows those additional livestock that the farmer wishes to value outside the herd scheme to be valued as though the herd scheme was not being used for that class of livestock.

Example

A farmer retains an extra 100 two tooth ewes in the 1994 income year. All of the two tooth ewes and ewe hoggets were valued under the herd scheme in 1993, and the extra 100 ewes are to be valued under national standard cost. No ewes were purchased (in this example) in the 1994 income year.

The opening value for the 100 ewe hoggets (two tooths at the end of the year) for the 1994 year will be calculated, at the taxpayers' option, for the current or preceding income year. This option of using either the current or preceding national standard cost figures is a simplification issue. The taxpayer can use current year national standard cost figures or use the national standard costs for the appropriate earlier year.

In this case the taxpayer decided to use the current year's figures. The value of the two tooths at the end of the 1994 year will be:

National standard cost for opening livestock *(100 x rising 1 yr NSC figure of $13.30)*	$1330.00
National standard cost for rising 2 year sheep *(100 x $7.80)*	$780.00
	$2110.00

$2110 divided by 100 = **$21.10 a head.**

This standard cost will be retained until these livestock are eliminated from the inventory through sales and deaths.

If they remain on hand after the inventory treatment a new standard cost for a subsequent income year will be calculated on the same basis as if they were a new intake of livestock at the standard cost which would have applied to an intake in that income year.

There have also been some minor changes to the wording of the determination in places.

Making an objection - new procedures

Introduction

From 1 April 1994 there are new procedures for resolving objections to assessments and various decisions and determinations that the Commissioner of Inland Revenue makes. These new procedures apply to income tax and GST requests for cases stated that Inland Revenue receives on or after 1 April 1994. They also apply to any duty objections that are lodged on or after 1 April 1994.

These new procedures were enacted by changes to the Income Tax Act 1976 (section 33), The Goods and Services Tax Act 1985 (section 36), the Estate and Gift Duties Act 1968 (sections 91 and 92), the Stamp and Cheque Duties Act 1971 (sections 73 and 74), and the Taxation Review Authority Regulations 1994.

Background

Before 1 April 1994, when Inland Revenue disallowed an objection the objector had two months in which to require the Commissioner to prepare and state a case to either a Taxation Review Authority or the High Court. After notifying the Commissioner of this requirement, the objector had no further input until the case was heard by either a TRA or the High Court; the Commissioner was responsible for preparing and filing the case.

In many cases this meant that the Commissioner and the objector did not explain their respective views of the facts and analyses of the law to each other. Neither party gained a full understanding of the opposing view until shortly before or even during the hearing.

New procedure

The responsibility for preparing the case is now shared. The requirements for the objector and the Commissioner are fully explained in Inland Revenue's "Objection Procedures" booklet, which we reprinted in March 1994. We've sent a copy of this booklet to everyone who is registered on our agency list, and it is also available from any Inland Revenue office.

Objector's obligations

After requiring the Commissioner to state a case to a TRA or the High Court, an objector has a further three months to supply specific information to the Commissioner. This information then goes to the TRA or High Court as part of the case stated.

The objector must supply the information in a prescribed form, called a points of objection notice. Inland Revenue will send a points of objection notice form to the objector after we receive the request for a case stated. The objector can use this printed form, or type a notice in the same format.

The form is in two parts. The first part is a single page cover/instruction sheet (IR 265A), which the objector must use in all cases. The second part (IR 265B) has spaces for the information that the objector will put before the TRA or High Court. An objector can either use the IR 265B form, or use a separately-typed notice in the same format.

The objector's points of objection notice must contain enough detail to give the Commissioner and the Courts this information:

- the objector's name, and the address for serving documents
- the facts and any propositions of law on which the objector relies to support the objection
- the issues that the objector wants the Court to consider
- a list of documents on which the objector relies to support the objection. (Copies of these documents should be attached to the points of objection notice unless there is a large number of documents.)

The objector must send or deliver this points of objection notice to Inland Revenue's Head Office in Wellington within three months of asking for a case to be stated (unless the Courts allow the objector an extension of time). If this deadline is not met, the objection is deemed to be withdrawn and Inland Revenue does not have to take any further action.

Inland Revenue's obligations

Once Inland Revenue receives this points of objection notice, we have three months to prepare the case and file it with a TRA or the High Court. We will also serve a copy of this case on the objector. The part of the case that Inland Revenue must complete is a prescribed form which sets out these items:

- particulars of the assessment under objection
- the grounds of objection that the objector has given
- the questions to be determined by the Court
- any further facts which the Commissioner considers relevant
- a statement of law
- a list of any further documents
- the issues which the Commissioner claims need to be determined by the Court.

In Appendix D to this TIB there is a sample of the prescribed format in which Inland Revenue must file this information.

If Inland Revenue does not file the case within three months, the Objector can apply to the Courts for an order directing the Commissioner to allow the objection. The Court must make such an order unless it is satisfied that there are reasonable grounds why Inland Revenue has not filed the case.

Taxation Review Authority

There are also new procedures for managing the TRA's fixture list. Before the TRA hears a case, it will hold a preliminary directions hearing. At this hearing, the TRA may do these things:

- obtain estimates of the expected duration of the hearing
- define the issues to be determined
- direct any necessary amendments to the case
- direct the way in which evidence is to be presented.

Both an authorised Inland Revenue officer and the objector must attend this directions hearing. If the objector lives more than 50 km away from the venue, s/he (or his/her legal representative) may attend by way of a telephone conference link-up. If the objector does not attend this hearing, the objection is deemed to be withdrawn unless the TRA gives leave to continue with it.

After the directions hearing, either the objector or Inland Revenue can apply to the TRA to appoint a time for the objection to be heard.

Benefits of the new procedures

When both parties fully understand each other's views, some issues can be agreed and cases may be settled before hearing. The new procedures make sure that these views are exchanged during the preparation of a case, so many cases may be resolved without having to go to Court. This is likely to save time and money for both parties.

In some cases the objector may incur legal costs earlier than under the old procedures. However, if independent legal advice is obtained at this stage, there may be no need to incur the costs involved in a hearing.

More information

If you want more information about these procedures, ask for a copy of the booklet "Objection Procedures" (IR 266) from any Inland Revenue office. This booklet sets out full details of every step in the objection process.

Time share units - when sale profits are assessable

Introduction

This item sets out the Commissioner's current policy on when profits from selling a time share unit are taxable.

A time share purchaser acquires the right to use a unit or apartment and shared use of facilities during a specified period each year. Usually the purchaser buys an interest in the land and leases the unit. Each unit has a composite title which records that each purchaser has a share in the freehold. Cross leases relating to weeks in the year are registered against the title.

Policy

Section 65(2)(f) of the Income Tax Act 1976

Profits or gains derived from the sale or disposition of land within the meaning of section 67 are assessable under section 65(2)(f). A time share purchaser's interest in either the freehold or the leasehold of the property is an interest in "land" as defined in section 67(1) of the Act. Therefore, if an interest in a time share is sold and the circumstances of the sale bring it within section 67, any profit will be assessable.

Profit derived from the sale of a time share will not always be assessable. If a taxpayer acquires a time share only for holiday use, any profit on resale will not be assessable.

However, there will be situations where a profit derived on resale is assessable. These are the most likely situations in which section 67 will apply:

- If the time share unit was acquired for the purpose or intention of selling or otherwise disposing of it (even if this was not the only purpose or intention). This provision will apply even if the purpose of resale was not the taxpayer's main purpose in acquiring the time share.
- If the vendor, or any person associated with the vendor, carried on the business of dealing in land or the business of developing or dividing land at the time the time share unit was acquired, and
    - ***either*** the unit was acquired for the purpose of the business
    - ***or*** the unit is sold within 10 years of acquisition.
- If the time share unit is sold within 10 years of acquisition, and the Commissioner's opinion is that at least 20 percent of the profits or gains derived on sale arise because of one of these factors:
    - the rules of an operative district plan, or any change to those rules after the taxpayer acquired the land
    - consent granted under the Resource Management Act granted after the taxpayer acquired the land
    - a Planning Tribunal decision made after the taxpayer acquired the land
    - the removal of any condition, obligation, restriction, prohibition, or covenant after the taxpayer acquired the land
    - any change or occurrence similar to these factors
    - the likelihood of any of these factors.

Exemptions

There is an exemption in section 67(5) for a house acquired and occupied by the taxpayer primarily and principally as a residence. It will be a question of fact in each situation whether this exemption will apply. Often the taxpayer may only have occupied the time share for a short time each year. By itself, the length of occupation is not a conclusive test of whether the property is primarily and principally used as a residence.

This exemption will not apply if use of the time share as a residence was merely incidental to another purpose such as holding the property pending resale.

The exemption will not apply if the vendor has engaged in a regular pattern of transactions involving acquisition and subsequent sale or disposition of residences.

It will also be a question of fact whether the exemption in section 67(6) (which applies to profits from 'zoning' changes) will apply. The exemption applies to land that the taxpayer acquires and uses (or intends to use) primarily and principally as his or her own residence.

Section 65(2)(a)

A profit derived on sale may be assessable under section 65(2)(a) if the time share is sold in the course of carrying on a business. The business need not solely involve dealing in land. Any profit may be assessable if sale of the time share was a transaction undertaken in the course of a business. An example is a business which trades in a range of property, including land.

Example

Eva works as a consumer adviser. In August 1993 she bought an interest in a time share in Queenstown. She had been keeping an eye on the price of time shares and thought that the market would rise. At the time she bought the unit she told two real estate agents to let her know if they heard of anyone interested in buying a time share unit. She and her family spent a week in November in the unit. In January 1994 one of the agents rang her and said they had a buyer. Eva sold her interest in the time share soon after.

The profit she derived on sale of the time share is assessable under section 67(4)(a). Eva acquired the time share unit for the purpose of resale.

Adjustment to costs when domestic establishment attached to business premises

Introduction

This item sets out the Commissioner's current policy on adjustments to be made to business expenditure to take into account the private use of accommodation attached to a business. It does not deal with the business use of private dwellings, such as the rental of a room in a private house.

Background

It is common for self-employed taxpayers in the motel, hotel, boarding house and similar industries to live on the premises. Section 106(1)(j) of the Income Tax Act 1976 prohibits taxpayers from claiming a deduction for expenditure that is of a private or domestic nature. Therefore, an adjustment must be made to the deductible expenditure of the business to allow for the proprietor's private or domestic use of the business premises or services.

Policy

All deductions of expenditure from assessable income should be made on a factual basis. However, Inland Revenue recognises that in this case the amount of the necessary adjustment can be difficult to quantify, so we are prepared to accept adjustments made using this formula:

$$\frac{a}{b} \times c \times 50\%$$

Here's what the variables stand for:

a is the area of motel, hotel, etc complex which is designated as the proprietor's quarters

b is the total area of the complex

c is the total expenditure on interest, rent, rates, power, telephone rental, insurance, and other costs which cannot be solely attributed either to the proprietor's occupancy or to the carrying on of a business.

The 50 percent adjustment recognises the potential difficulties in apportioning business and private use in some areas. For example, the proprietor's kitchen may be used to prepare meals for guests.

Example

Mr Columbia operates a private boarding house in Wellington, and also lives on the premises. He and his family occupy one floor of the six floor building. Total expenses relating to interest, rent, power, etc, amount to $100,000 for the 1993 income year.

The formula is applied as follows:

$$\frac{1}{6} \times \$100{,}000 \times 50\% = \$8{,}333.33$$

Expenses	$100,000.00
Less cost of domestic establishment	$ 8,333.33
Expenditure claimed in Mr Columbia's 1993 return would be:	$ 91,666.67

Note: A taxpayer does not have to use this formula. Any taxpayer who considers that a more factual adjustment can be calculated by another method can use that other method. In this situation it would pay the taxpayer to discuss the method with the local Inland Revenue office before using it, to avoid any possible disputes at a later date.

Lease duty on assignment of forestry rights - correction

This item corrects an example in the item on stamp duty on forest sales, which appeared on page 6 of TIB Volume Five, No.1 (July 1993). The example incorrectly shows that both lease duty and conveyance duty are payable on an instrument that transfers a registered forestry right. The correct treatment is as follows:

2. MidCo has a registered forestry right in a block of land planted in four year old eucalyptus botroides which was granted by the owner of the land. SilviCo purchases the registered forestry right from MidCo with the intention of milling the trees for hardwood in twenty five years. The purchase price for the forestry right is $23,000 plus GST (i.e. $25,875 including GST). The annual payment for the forestry right is $3,000 (i.e. $3,375 including GST).

   Conveyance duty at $1 per $100 or part thereof is levied on the GST inclusive purchase price ($259). Lease duty is not payable as the instrument did not create a lease, it transferred it. Lease duty would have been paid when the forestry right was first created and granted by the land owner to MidCo.

   The total stamp duty payable is one percent of $25,875, which is $259.

Depreciation - floor mats

There is a new asset class and general depreciation rate for ***Floor Mats***. The depreciation rate is 50% diminishing value, or 40% straight line equivalent. The new rate applies to assets acquired on or after 1 April 1993.

The new rate is set by Determination DEP6: Tax Depreciation Rates General Determination Number 6, which is reproduced below. This determination inserts a new asset class into the Laundry industry category of Determination DEP1 (published on page 40 of the appendix to TIB Volume Four, No. 9 - April 1993).

Determination DEP6

This determination may be cited as "Determination DEP6": Tax Depreciation Rates General Determination Number 6".

1. Application

This determination shall apply to the asset class "Floor Mats" under the "Laundry" industry category where the asset 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) is further amended by inserting the asset class "Floor Mats" into the "Laundry" industry category 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 7th day of April 1994.

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

GST on goods and services acquired in NZ by diplomatic staff

Introduction

This item sets out the Commissioner's current policy on how goods and services tax applies to goods and services acquired in New Zealand by diplomatic and consular staff. This policy is based on the Vienna Conventions on Diplomatic Relations and Consular Relations.

Policy

Article 34(a) of the Vienna Convention on Diplomatic Relations states that "A diplomatic agent shall be exempt from all dues and taxes, personal or real, national, regional or municipal, except indirect taxes of a kind which are normally incorporated in the price of goods or services."

Article 49(1)(a) of the Vienna Convention on Consular Relations states that "Consular officers and consular employees and members of their families forming part of their households shall be exempt from all dues and taxes, personal or real, national, regional or municipal, except indirect taxes of a kind which are normally incorporated in the price of goods or services."

At retail level, GST is incorporated as part of the consideration charged by suppliers, so Inland Revenue considers that diplomatic and consular staff are not exempt from GST.

Example

A foreign consulate wishes to buy land to establish a consular building in New Zealand. The vendor of some suitable land is a GST registered person.

Section 8 of the Goods and Services Tax Act 1985 imposes GST on all supplies of goods and services, except exempt supplies, made by a registered person in the course or furtherance of a taxable activity.

The consulate is liable to pay the GST charged on the purchase price.

Forestry right documents - presentation for stamping

Inland Revenue is concerned that some people are delaying the presentation of forestry right documents for stamping.

Stamp duty is payable on documents relating to forestry rights. The time for paying the duty runs from the date that the documents are executed, not from the date they are presented.

Under section 50 of the Stamp and Cheque Duties Act 1971, documents must be presented for stamping within three months of execution. There is a penalty for late presentation under section 57. This penalty is $0.01 for every dollar of duty payable for each month or part-month that the document is late.

To avoid having this penalty charged, it's important that the documents are presented within three months of when they are executed.

Stamp duty on fruit trees - correction

In TIB Volume Four, No.8, there was an item "Stamp duty on forest sales" on page 6. That article incorrectly stated that forests are part of the land, but fruit trees are chattels because they are crop producers.

Common law treats fruit trees in the same manner as other trees. It does not draw a distinction between trees that produce a crop and trees that do not. In *Windermere Forests Ltd v Commissioner of Inland Revenue* (1993) 15 NZTC 10,267, the High Court recently affirmed the common law position. This case dealt with the purchase of land with trees, and the issue was whether the Commissioner was correct in assessing the consideration for both the land and the trees for stamp duty. The Court held that the Commissioner was correct in assessing the total consideration.

GST - lottery operators and promoters

Introduction

This item sets out the Commissioner's current policy on the GST payable by lottery organisers and promoters.

Background

The running of a lottery is controlled by the Gaming and Lotteries Act 1977. Sections 32 to 35 govern who may conduct a lottery. Under those sections, only a society can legally conduct a lottery. There is one exception to this rule; an individual can conduct a lottery under section 33, provided all the proceeds from ticket sales are used to pay prizes (not exceeding $50 for each prize) and expenses directly incurred in conducting the lottery. In other words, an individual conducting a lottery cannot retain any proceeds for any purpose.

A society is defined as "any corporation sole, association of persons (whether incorporated or not), or local or affiliated branch of any such organisation, that is established and conducted entirely for any purpose other than a commercial one".

When a society conducts a lottery, it is occasionally run by a promoter. The promoter is a person or agency, licensed by the courts, who promotes and runs the lottery for a fee. It is still the society that is conducting the lottery and not the promoter. Although section 5(10) of the Goods and Services Tax Act 1985 refers to licensed promoters, in terms of the Gaming and Lotteries Act 1977 a promoter cannot conduct a lottery.

Legislation

Under section 5(10) of the Goods and Services Tax Act 1985, a supply of services occurs when a person pays an amount of money to participate in a lottery competition. Under section 10(14) the consideration for the supply is the total proceeds, e.g. ticket sales, less any prizes paid in money. This ensures that only the value added content of the proceeds is subject to GST.

GST implications

Society or individual

If the society or individual is registered for GST (or required to be registered), output tax is payable on the receipts from ticket sales less any cash prizes paid out. Input tax credits can be claimed for expenses such as purchases of non-cash prizes, fees paid to a promoter, and other general expenses such as printing of tickets.

Promoter

If the promoter is registered (or required to be registered), output tax is payable on any fees received. Input tax credits can be claimed for expenses connected with the promotion, such as motor vehicle expenses.

Family Support - application date for changes made by Income Tax Amendment Act (No.2) 1993

On page 49 of TIB Volume Four, No 9 (May 1993) there was an item that discussed amendments made to sections 374A to 374N of the Income Tax Act 1976. The final “Application date” paragraph stated that the amendments apply from the income year starting on 1 April 1993, and to subsequent income years. However, two of the amendments have a different application date:

- The amendments to section 374B(1)(e)(vii) state that losses from a qualifying company that are attributed to a shareholder of that company cannot be offset against assessable income for Family Support and GMFI purposes).
- The amendments to paragraph (f) affect the definition of “full time earner” in section 374E(1).

Both of these amendments apply to tax on income derived in the 1992-93 income year and subsequent years.

All the other amendments discussed in the item apply to the income year starting on 1 April 1993, and to subsequent income years.

GST registration of branches and divisions of non-profit bodies

Introduction

This item sets out the Commissioner’s current policy on the ability of non-profit bodies to treat branches and divisions as separate persons for GST registration purposes. This policy is based on section 51(5) of the Goods and Services Tax Act 1985.

Policy

The normal GST rules prevent large organisations from splitting into branches or divisions to circumvent the compulsory registration threshold. By contrast, in certain circumstances non-profit bodies can treat their branches or divisions as separate persons when working out if they must register under section 51. Application for separate registration is made by the registered non-profit body rather than by the branch or division.

A branch or division may be considered to be a separate person for GST registration purposes if it meets both of these conditions:

- It maintains an independent accounting system
- It can be separately identified because of the nature of its activities, or its location.

A branch or division will be regarded as having an independent accounting system if separately records its receipts and payments, and if it produces separate financial statements.

A branch or division will be separately identifiable by reference to the nature of its activities as long as those activities are not just incidental to the body’s main activity. Activities such as administration, fund raising, running raffles, providing refreshments and entertainment are usually associated with the principal activity of the body. A section of an organisation that deals only with one or more of such activities would not normally constitute a separate branch or division for GST purposes.

A branch or division will be separately identifiable by reference to its location if there is a distinct geographical siting. A branch or division does not exist because simply it is located on a separate floor of a building or is in a nearby building which merely houses overflow staff or activities. In these cases the nature of the activity rather than its location would determine whether the branch could be treated as a separate person.

Example 1

A non-profit national body carries on a taxable activity with an expected turnover of $100,000 per year. It is conducted in separate branches, each with its own accounting system. The expected turnovers for the next 12 months are:

Northern Region	$ 40,000
Eastern Region	$ 20,000
Western Region	$ 20,000
Southern Region	$ 20,000
Total	$100,000

The national body could apply to have all its branches treated as separate persons for GST purposes. Only the Northern Region, (whose turnover is over $30,000) would have to register. The remaining three regions would not have to register, but they could do so on a voluntary basis.

Example 2

A golf club which is a non-profit body has an expected turnover of $90,000. Funds are raised as follows:

Green fees, Club hire etc	$70,000
Fund-raising (raffles and gaming machine)	$20,000
Total	$90,000

The golf club could not register the two divisions separately. The fundraising is incidental to and associated with the principal activity of the golf club, so it cannot be separately identified by the nature of its activities or its location.

Policy on changing balance dates - review completed

The Commissioner has recently completed a review of Inland Revenue's balance date policy. This item confirms that the policy announced in TIB Volume 3 No 9 (June 1992) will remain.

Background

Recently many tax practitioners have asked the Commissioner to undertake a review of Inland Revenue's balance date policy. The practitioners are concerned about the effect of the policy on work flow in their practice. They wish to spread the preparation of their clients' accounts and returns more evenly over the year. As most taxpayers have a 31 March balance date, practitioners are busy from the period of May to December but the volume of work diminishes from January to May.

From the perspective of efficient and effective practice management, practitioners have good reason to be concerned. The Commissioner appreciates practitioners drawing this issue to his attention and readily accepts variations do occur in work flow volumes over a year. But after careful consideration he is unable to relax the present balance date policy to remedy the problem because of his assessment of the potential revenue implications.

Revenue implications

The main revenue concern is the potential impact on the timing of Government tax payment receipts. In essence when an entity changes its balance date, its provisional tax (and in some cases its terminal tax) payment dates change. This would have cash flow consequences for the Government.

The following example illustrates this concern.

Example 1

A company has a standard 31 March balance date. The Eighth Schedule to the Income Tax Act sets out the months for payment of terminal and provisional tax. For the 1994-1995 income year, the company is required to make tax payments by the following dates:

1st instalment of provisional tax	7 July 1994
2nd instalment of provisional tax	7 November 1994
3rd instalment of provisional tax	7 March 1995
Payment of terminal tax	7 February 1996

For cash flow and fiscal planning purposes the Government anticipates tax payments by these dates.

If the company had applied for and received a later balance date there is an immediate impact on the timing of tax payment receipts. Suppose the company receives a 30 September balance date. Its payment dates for the 1994-1995 income year would change to the following:

1st instalment of provisional tax	7 January 1995
2nd instalment of provisional tax	7 May 1995
3rd instalment of provisional tax:	7 September 1995
Payment of terminal tax:	7 February 1996

From the Government's perspective the payment of provisional tax is deferred. In the example above, all the provisional tax payments are delayed six months.

If taxpayers were able to easily obtain non-standard balance dates (not 31 March), the Commissioner believes there would be a substantial impact on the timing of revenue flows with the Government likely to incur increased funding costs.

A relaxation of balance date policy would also provide the opportunity for closely related tax entities to enter into arrangements to gain timing advantages. One method is illustrated in Example 2 below:

Example 2

A company with a balance date of 31 March resolves to pay out all of its profit to a major shareholder-employee on 30 March 1995. The company will not have to pay provisional tax for the 1994-1995 income year because it estimates its provisional tax liability to be zero. (If the company had paid provisional tax its payment dates would have been 7 July 1994, 7 November 1994 and 7 March 1995.)

The shareholder-employee, in this example, is not subject to PAYE and applies for a non-standard balance date of 30 August. If this request was granted, the shareholder-employee's payment dates would be as follows:

1st instalment of provisional tax:	7 December 1994
2nd instalment of provisional tax	7 April 1995
3rd instalment of provisional tax	7 August 1995
Payment of terminal tax	7 February 1996

These payment dates are later than those for a shareholder-employee with a standard 31 March balance date. From the Government's perspective the payment of provisional tax has been deferred.

Accordingly, it is the Commissioner's view that the risk to the revenue of relaxing the present balance date policy outweighs the recognised problem tax practitioners have in planning their work flow for a year.

Restated policy

We have reprinted the Commissioner's balance date policy as stated in TIB Volume 3 No 9 (June 1992) in Appendix B to this TIB. This policy sets out the criteria

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the Commissioner considers appropriate for approving a balance date other than 31 March.

The Commissioner will continue to monitor the appropriateness of the standard 31 March balance date for industry sectors. Non-standard balance dates may be granted for industry sectors which are able to demonstrate that the nature of the industry makes a 31 March balance date inappropriate.

Initiatives

There are several other initiatives under way which are designed to ease the problem of tax practitioners' work flows. For example, Inland Revenue has been advised by the New Zealand Society of Accountants that the Society has made certain submissions to the Select Committee considering Company Law Reform. One of those submissions recommended extending the 5 month reporting rule under the Financial Reporting Act 1993 to 9 months in relation to exempt companies. This initiative, if accepted by the Select Committee, will ease some tax practitioners' concerns about increased work flow problems. Also, Inland Revenue does allow certain people who prepare at least 10 returns an extension of time to file. The rules are well known and are set out in Inland Revenue's Tax Practitioner's Handbook.

Motor vehicle log books - a reminder

In TIB Volume Two, No.2 at page 4, and at Appendix C, we provided details of legislation covering the keeping of records where a motor vehicle is used partly for business and partly for other purposes.

Section 106D of the Income Tax Act 1976 provides for a logbook to be kept for a minimum of 90 days in a three-year "logbook application period". If a taxpayer does not maintain a logbook, or complete and accurate details under section 106C, the business use proportion will be calculated on any records that are available, up to a maximum of 25%. Where no records are kept, a deduction for the purposes of section 104 will not be allowed.

Taxpayers are reminded that where 1 April 1991 (the application date of amended section 106B and new sections 106C to 106E) was the effective date, they will need to maintain a logbook for a further period of 90 days or more in order to re-establish a business use proportion of total travel. This process is required to be repeated every three years.

Provisional tax rules from 1994/95 year onwards

Sections 375-391, 398A and 413A, Income Tax Act 1976

Introduction

There is a new Part XII of the Income Tax Act, which applies from the 1994/95 income year onwards. It makes changes to the provisional tax interest rules (to reduce scope for tax deferral), corrects minor problems with the current provisional tax rules, and simplifies the provisional tax legislation.

Appendix C to this TIB contains a section-by section analysis of the new provisional tax rules.

Summary of main changes

Use-of money-interest will apply from the first provisional tax instalment date for taxpayers whose residual income tax (RIT) is over $30,000. This $30,000 threshold recognises that deferral occurs mainly amongst large provisional taxpayers.

The interest rate on overpayments will be different to the rate for underpayments. The Government has decided that provisional tax use-of-money interest will be aligned with market interest rates as far as possible. When one interest rate applies to both under- and overpayments of provisional tax, some taxpayers have incentives to overpay their tax liability and others have incentives to underpay. Separate rates for under- and overpayments will reduce these incentives. The rates are set by Order in Council. For the 1994/95 income year they are 4.5% on overpaid provisional tax, and 9% on underpaid provisional tax.

Use-of-money interest paid to taxpayers will be assessable. Correspondingly, use-of-money interest charged to taxpayers will be deductible, subject to the normal deductibility provisions. Inland Revenue will deduct resident withholding tax from assessable interest under the normal rules.

The legislation increases the grounds for remission of underestimation penalty to include unforeseen fluctuations. The expanded part of the remission provision applies to compulsory estimators (taxpayers whose RIT exceeds $300,000) who have an unforeseen fluctuation of twenty percent or more in their tax liability for an income year, when the fluctuation occurs after the first day of the month immediately before the third instalment date for that year.

Summary of minor changes

The requirement that taxpayers' estimates are "fair and reasonable" has been strengthened. The Commissioner has a new power to amend estimates retrospectively after a taxpayer's income tax liability is assessed. Taxpayers will have a right to object to this and any estimates that the Commissioner makes during the income year.

The legislation provides for a fairer underestimation penalty. The current penalty is a two step process. The first step is to see if the taxpayer's estimate is less than 80% of RIT, and the second step determines the amount of penalty. The penalty is capped by reference to the previous year's RIT, if a taxpayer makes a voluntary estimate. These are the changes to the penalty calculation method:

- Determination of whether a taxpayer has underestimated will be based on the higher of the amount paid and the amount estimated. This prevents the penalty applying to a taxpayer who pays more, but who does not bother to update the estimate.
- Underestimation penalty will only apply to provisional taxpayers who had an obligation to pay provisional tax.

Structure of legislation

A new Part XII was inserted instead of amending the existing Part XII, to give the legislation a simpler and more coherent structure.

The structure of the legislation is embodied in sections 375 to 392. Section 377 sets the total amount of provisional tax payable. This total amount is calculated under section 377 for provisional taxpayers who pay tax on an uplift basis. If a taxpayer estimates or the Commissioner makes a determination, the total provisional tax is still determined under section 377. However, the total provisional tax payable is calculated under section 378 (if the taxpayer makes an estimate) or under section 379 (if the Commissioner makes a determination).

Once the total amount of provisional tax payable is determined, section 380 determines whether it is payable in one, two or three instalments. Provisional tax is normally payable in three instalments. However, it can be payable in one, two or three instalments by new provisional taxpayers, depending on when they start business. It is payable in one instalment for provisional taxpayers with over $300,000 of RIT if they had less than $2,500 of RIT in the previous year. (See below for details.)

Section 381 determines the amount of provisional tax payable on each instalment date. This is calculated using the total provisional tax payable under section 377 and the number of instalments determined under section 380. Section 382 provides that taxpayers can make further payments of provisional tax if they wish.

Sections 384 to 386 apply additional tax when taxpayers underpay an instalment or underestimate their residual income tax at the third instalment date.

Sections 387 to 391 contain offsetting provisions that allow taxpayers to credit provisional tax against their own income tax liability or other taxpayers' provisional tax liability.

Provisional tax payments

Under the new provisional tax rules, any taxpayer whose residual income tax is greater than $2,500 is a provisional taxpayer. Provisional taxpayers must pay tax in one of these ways:

- in three instalments, if their RIT was greater than $2,500 in the previous income year. (A targeted refund provision has been introduced to cover cases where last year's RIT is not known with certainty, causing taxpayers not to know whether they have to pay provisional tax for the current year)
- in one instalment (the third instalment date), if a provisional taxpayer's RIT was less than $2,500 last year but more than $300,000 this year (and the taxpayer is not a new provisional taxpayer)
- in either one, two, or three instalments, if the taxpayer is a new provisional taxpayer (see "New provisional taxpayer provision" below).

If a taxpayer does not estimate, the amount of provisional tax payable on the first and second instalment dates is one of these amounts:

- one third of 105% of last year's RIT
- one third of 110% of the RIT of the year before last, where the taxpayer has an extension of time arrangement and has not furnished last year's return by the instalment date.

At the third instalment date taxpayers who have not furnished the previous year's return must either make an estimate or guess at 105% of last year's RIT (because that tax return has not been filed).

Taxpayers have the right to estimate their liability at any time on or before the third instalment date for an income year. However, they must estimate by the third instalment date if they expect their RIT for an income year to exceed $300,000.

The new payment rules are the same as those of the old system, except that a targeted refund provision and a new provisional taxpayer provision have been introduced.

Targeted refund provision

A new provision provides specifically for a refund of provisional tax paid if it turns out that a provisional taxpayer did not have to pay provisional tax. This provision addresses the problem where provisional taxpayers have not furnished last year's tax return, and so are uncertain whether last year's RIT exceeded $2,500 (and thus whether they have to pay provisional tax). Taxpayers who do pay provisional tax can get that

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money refunded when they file the previous year's return. (Under current rules it is possible that money may not be refunded until the terminal tax date for that income year.) This provision applies from the 1992-93 income year.

Rules for new provisional taxpayers

A new provisional taxpayer provision applies to non-natural persons who start a taxable activity during an income year, and who have not derived assessable income in any of the preceding four years. New provisional taxpayers must pay provisional tax on those instalment dates which occur on or after 30 days after they start their taxable activity. As they can choose to pay on the basis of last year's RIT plus 5%, a payment will normally only be necessary if they have RIT over $300,000 (since these provisional taxpayers must estimate on or before the third instalment date). However, if a new provisional taxpayer's RIT is over $30,000, the interest rules can apply from the first instalment date.

Practical implications of rules for new provisional taxpayers

In most cases, establishing whether provisional tax is payable in one, two or three instalments will not result in a new provisional taxpayer having to pay provisional tax, because such a taxpayer could (at least for two instalments) pay on the basis of last year's residual income tax, which will be nil.

The real impact of establishing instalment dates for new provisional taxpayer is that the use-of-money interest rules will apply to that taxpayer from the relevant instalment dates. For example, suppose a new provisional taxpayer started business 50 days before the second instalment date and had a residual income tax liability of $50,000 for the income year. The taxpayer may choose to pay no provisional tax on the second or third instalment dates (by using the last year's RIT plus 5% option) but would have to pay use-of-money interest from the second instalment date. To avoid interest, a taxpayer in this situation could either estimate or make voluntary provisional tax payments as provided for in section 382.

Provisional tax interest

Non-natural persons

Non-natural persons will be liable for interest if their RIT for the current year is greater than $2,500. If their RIT is $30,000 or less, two way interest will apply from the third instalment date. If their RIT is greater than $30,000, they will be subject to interest from the first instalment date (or possibly the second or third instalment dates if they are new provisional taxpayers - see below).

Natural persons

A natural person whose RIT for the income year is greater than $30,000 will be subject to the new interest rules from the first instalment date. If a natural person's RIT is $30,000 or less, he or she will only be subject to interest if s/he estimates, and then only from the third instalment date. Natural persons who are trustees will be subject to interest and qualify for interest on their trustee income as if they were not natural persons.

An adjustment has been made to the section which pays interest to taxpayers who paid provisional tax because they expected to be provisional taxpayers, but who turn out not to be. These taxpayers must now meet all of these conditions before they can be paid interest:

- they must have reasonably expected to be provisional taxpayers
- they must have estimated their RIT by the third instalment date
- they must have paid an amount of not less than $2,500 as if it were provisional tax
- they would have been provisional taxpayers if their RIT had exceeded $2,500
- they had more than $2,500 of RIT last year.

Interest will be calculated as currently specified except that it will be assessable or deductible (as explained above), and Inland Revenue will deduct RWT from interest on provisional tax overpaid. Taxpayers do not have to deduct RWT from interest paid to Inland Revenue (this requirement has been applied retrospectively). Any interest that taxpayers pay is tax-deductible under the normal rules in the year the tax is assessed or reassessed.

Application date

These rules apply from the 1994/95 income year.

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

Statute barred assessments

Section 25(2) - Fraudulent or wilfully misleading returns: An investigation of a taxpayer's tax affairs uncovered omitted income. The taxpayer asked if Inland Revenue can amend those returns, as they had been assessed years ago and the omission was not deliberate.

Normally, the Commissioner is barred from increasing the amount of tax payable after a period of four years from the end of the year in which the assessment was issued. However, if the taxpayer knowingly or fraudulently failed to make full disclosure, or ignored income derived from a particular source or of a particular nature, the Commissioner can increase the tax assessment for assessments as far back as 1 April 1958.

Before assessing a return that would have been within the barred period, an authorised officer of Inland Revenue must form an opinion as to whether the taxpayer knowingly or fraudulently failed to make full disclosure, etc. When forming an opinion, the authorised officer will review the file, the investigation report, the relevant returns, correspondence and any other relevant facts.

A taxpayer who wishes to dispute the opinion can apply for a Judicial Review through the Courts.

Testamentary gifts

Section 56A - Qualifying gifts: An executor of a deceased person's estate asked Inland Revenue if the estate could claim a rebate for a $1,000 donation it made as a testamentary gift.

Section 56A provides for a tax rebate for cash donations of $5 or more to certain approved donee organisations. However, section 56A(2) states that testamentary gifts do not qualify for the rebate, so the estate in this case would not be entitled to claim for the testamentary gift.

Short term trade credits and the accrual rules

Section 64B - Interpretation: An investor asked how to apply the 63 day rule when determining whether a trade credit is long term or short term (and thus subject or not subject to the accrual rules).

A short term trade credit is any debt for goods or services supplied, when the seller requires payment for the goods or services within 63 days of supplying them. The distinction between short term and long term is not altered by the time taken to actually pay the debt.

For example, often the seller requires payment by the 20th of the month following delivery. Such a debt will not cease to be a short term trade credit simply because the buyer is unable to pay it within 63 days of supply, unless the debt is renegotiated as a long term debt.

Ceasing to be resident and the accrual rules

Section 64F - Income and expenditure where a financial arrangement is redeemed or disposed of: On 1 March 1994, a taxpayer ceased to be a New Zealand resident. She asked how this will affect a financial arrangement.

Section 64F(1)(d) applies where a person ceases to be a New Zealand resident. The effect is that the financial arrangement is deemed to be transferred for its market value at that date. In the 1994 tax return a base price adjustment will be required, using the deemed value at 1 March 1994 as the final consideration. The income or expenditure from the financial arrangement for the 1994 income year will be determined from this base price wrap-up calculation.

Deputy returning officers - deduction for earner premium

Section 105(2) - Deduction for expenditure incurred in production of income from employment: A taxpayer's income consisted of his salary and income received as a deputy returning officer. He asked if he can claim a deduction for the earner premium paid on this income when he files his tax return.

Under section 105(2), a taxpayer cannot make a deduction for expenditure that is incurred in producing "income from employment".

The taxpayer's salary is "income from employment" so no deduction for the earner premium can be made against this amount.

Payments made to a deputy returning officer are "withholding payments" under clause 6 of Part B of the Schedule to the Income Tax (Withholding Payments) Regulations 1979, so they constitute "income from employment" for the purposes of section 105(2) of the Income Tax Act 1976 (under section 105(1)(c)).

The taxpayer must account for the employer and earner premiums on the deputy returning officer income when he files his tax return (sections 102 and 114, Accident Compensation and Rehabilitation Insurance Act 1992). As the withholding payments are "income from employment", the taxpayer cannot claim a deduction for the earner premium paid on them.

Refund of resident withholding tax

Section 327F(2) - Refund of excess tax deductions: A taxpayer who had given his IRD number to his bank found the bank still deducted RWT at 33% instead of 24%. The taxpayer asked whether the bank had to refund the excess amount or whether he should file a tax return to receive a refund of the excess.

If a taxpayer discovers this error and advises the bank before 31 March in the income year in which the deduction is made, the bank may refund the overpayment, provided that the resident withholding tax deduction certificate has not been issued, or if it has been issued, that the certificate is returned to the bank and cancelled (section 327F(2)).

The bank is not liable to refund the excess amount to the taxpayer if the taxpayer's own act or omission caused the excess deduction to be made. (section 327F(4)).

In any case where a person is entitled to a refund, including cases where the error is discovered after 31 March, the person may apply to Inland Revenue for a refund under section 327G.

RWT deducted from a taxpayer's interest is credited against the taxpayer's final income tax liability. Even if the taxpayer does not apply for a refund of the excess amount, or if the bank doesn't refund it, the taxpayer will still receive a credit for the excess amount against that year's final tax liability. The taxpayer should file a tax return for that year to receive the refund.

Goods and Services Tax Act 1985

Superannuation schemes - GST input credits

Section 3 - Meaning of term "financial services": The chairman of a superannuation scheme asked if Inland Revenue would refund GST paid on expenses incurred by the trustees of the scheme.

Section 14 of the Act exempts from GST supplies made in respect of "financial services". Section 3 of the Act defines financial services and includes at section 3(1)(j) the provision or transfer of ownership of an interest in a superannuation scheme, or the management of a superannuation scheme.

Any expenses the trustees incur in relation to superannuation policies cannot be claimed. This is because the provision or transfer of ownership of an interest in a superannuation scheme is an exempt supply.

GST incurred by the trustees can only be claimed back if it is incurred for the principal purpose of making taxable supplies. For example, the trustees may be making taxable supplies if they receive rents from commercial properties. The trustees could claim back GST incurred to the extent that it relates to such taxable supplies.

Gaming Duties Act 1971

Change in return period

Section 12D - Monthly returns to be furnished to Commissioner: A gaming machine operator asked if the return period covered by a return could be to the last Wednesday of each month, to correspond with the business' accounting cutoff date.

Section 12D requires every gaming machine operator to make a return by the 20th day of each month, showing the gaming machine profits for the previous month and the gaming machine duty payable on those profits. All payments of gaming machine duty are due at the time the return is due.

This section was amended from 14 December 1992, to allow gaming machine operators to apply to Inland Revenue to furnish returns for a period ending on any day within 7 days either side of the last day of the month. The time for filing the return and paying the duty remains the same.

If the gaming machine duty isn't paid by the due date, interest will be charged under section 12F(1) at 5% per month or part-month. To avoid being charged this interest, the gaming machine operator must pay the duty for any return period by the 20th of the next month.

The operator in this case is allowed to file returns for the period ending on the last Wednesday of each month.

Assessment of gaming duty

Section 12G - Assessment of duty: A taxpayer asked under what circumstances Inland Revenue would issue an assessment for gaming machine duty.

Generally, the filing of returns together with payment of duty is on a self-assessment basis. However, Inland Revenue can issue an assessment in any of these circumstances:

- a person defaults in furnishing the monthly return
- Inland Revenue is not satisfied with any return
- Inland Revenue is not satisfied that the amount of duty paid is the correct amount
- there is reason to believe that any person is liable to pay gaming machine duty.

Inland Revenue may assess the amount of gaming machine profits on which, in the Commissioner's judgment, gaming machine duty ought to have been paid. This assessment may also include interest, if appropriate. Inland Revenue will give written notice to the person of any assessment. The Commissioner may make additions or alterations to assessments to ensure they are correct, even if the operator has paid the duty assessed.

Payment of gaming duty from third party

Section 12L - Deduction of duty from payments due to defaulters: A gaming machine operator asked if Inland Revenue could collect money that a debtor owed to the operator, to pay the operator's gaming duty arrears.

If an operator does not pay the duty assessed, Inland Revenue can recover the amount outstanding from any third party that owes money to the operator. Inland Revenue issues a written notice to the third party specifying the amount payable, requiring the third party to pay that sum to Inland Revenue to the credit of the defaulter. Inland Revenue also sends a copy of the notice to the defaulter. When the third party makes a deduction from an amount payable, the defaulter is entitled to receive a statement in writing from the person making the deduction, to advise of the deduction and its purpose.

If Inland Revenue asks a third party to make a gaming duty deduction in this way, the third party is required by law to do so. It is an offence to fail to make such a deduction or to fail to pay the sum deducted to Inland Revenue.

Child Support Act 1991

Change in family circumstances

Section 82 - Liable parent to advise Commissioner of certain changes in living circumstances: A custodial parent advised the Child Support Agency that the liable parent had changed his living circumstances. This change resulted in a larger child support liability. The custodial parent's concern was that, had she not been aware of the change, the liable parent may not have advised the agency of the change in circumstances.

Under section 82, liable parents must notify Inland Revenue as soon as practicable of any change in living circumstances that affect their Child Support liability. Failing to notify Inland Revenue of such changes is an offence under section 208(b). The maximum fine for this is $2,000 for a first offence (section 210(3).

In this case, the liable parent had supplied the required information as soon as practicable, so no prosecution was contemplated.

Maximum deduction from wages

Section 165 - Protected net earnings rate: An employer asked if he had deducted the correct amount of PAYE and Child Support. For two months, the employee's earnings were less than they would normally have been. This created the situation where the Child Support deductions became large in comparison to the wages paid.

There is a maximum amount of Child Support that can be deducted. Section 165 of the Act provides that the employer cannot make deductions of Child Support that reduce the employee's wage to less than 60% of the wage remaining after PAYE is deducted. This means the maximum Child Support deduction is 40% of the net wage.

Section 165 only limits the amount of Child Support that an employer can deduct; it does not reduce the liable parent's total liability. This means the liable parent must still pay the assessed amount by another means, (e.g. by cheque) when his or her income becomes sufficient. If the liable parent's income remains low, he or she may elect to have the liability recalculated by completing an "Estimation of income for Child Support assessment" form (CS 107), which is available from the Child Support Agency. However, note that a penalty may apply if the liable parent underestimates his or her actual Child Support liability.

Example

Joe's weekly wage is $151.00. PAYE of $22.65 is deducted from the gross wage, leaving a net wage of $128.35.

60% of 128.35 is $77.01, which is the amount of protected net earnings.

The maximum Child Support deduction is $51.34 for that week (i.e. $128.35 x 40%).

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

Whether “show homes” are trading stock; timing of assessability of income from construction projects

Case: Horizon Homes Limited & others v CIR. HC Wellington AP252/91

Rating: • • •

Act: Income Tax Act 1976 - section 85

Keywords: *Trading stock, fixed capital, profits accounting methods, SSAP-14, construction contracts, derive, progress payments*

Summary: The objectors’ show homes were not trading stock but were fixed capital. The objectors were right to recognise profit on completion because the “percentage of completion” method was not appropriate.

Facts: The objectors were private companies carrying on the business of building domestic dwelling houses. They built houses to order, not “on spec”. The objectors took 10-16 weeks to build each house, and they received progress payments before building was completed. They only recognised profit on completion of each contract, even for contracts spanning two income years. They did not recognise any profit element on progress payment receipts.

Inland Revenue sought to have some profit element recognised from progress payments. This was done by calculating the average gross profit margin on completed contracts, applying this percentage to progress payments received, and adding this amount to increase the closing work in progress figure (which increased the 1987 operating profit). Inland Revenue adjusted the gross profit component in the taxpayer's favour to remove GST.

As part of the building business, the objectors also constructed show homes. These homes were usually sold within two years of construction, so the objector treated them as trading stock. Inland Revenue considered the show homes to be fixed assets.

Decision: Judge McGechan found that, although the show homes were literally within the trading stock definition (section 85(1)(a)), the literal interpretation of that section leads to an absurdity. It cannot be intended to bring fixed assets within the definition. Adopting a common sense approach, His Honour held that to be trading stock the show homes must be built with a 'sufficient accompanying purpose' of sale in the ordinary course of trade. His Honour noted that construction of the show homes had two purposes: to market the objectors' houses and to sell the houses. When applying a dominant purpose test, His Honour found the show homes were built for use as marketing tools and were intended to be fixed capital of the business, not trading stock.

The second point involved the Commissioner's contention that some profit must be recognised on progress payments. SSAP-14 (Accounting for Profit on Construction Contracts) was discussed as the starting point for the tax treatment of progress payments. However, His Honour made it clear that the appropriate accounting treatment was not conclusive for income tax purposes. SSAP-14 requires profit to be recognised on a "percentage of completion" method, where the outcome can be reliably estimated (meaning that revenue, costs, and the amount of the contract performed can be reliably estimated). Where reliable estimates are impractical SSAP-14 provides that no profit should be recognised until completion.

While His Honour believed revenue could be reliably estimated (as the contracts were fixed price), he found that costs could not be. His Honour accepted that the SSAP-14 "percentage of completion" method was not applicable.

His Honour also considered that the Commissioner's method did not provide a better reflection of gross income than SSAP-14 because:

1. It was directly contrary to the general direction of the SSAP, and departures from accepted practice are to be accepted with caution
2. The method relied on estimates, not on actual figures
3. Any mismatch of expenditure and receipts arising from the objectors' accounting methods was of reduced consequence when the business was ongoing
4. Progress payments were less than actual expenditure and there was, in reality, no profit at all.

The final point was explained by discussing and applying *H W Coyle Limited v CIR* (1980) 4 NZTC 61,558. His Honour made it clear that *Coyle's* case was not to be distinguished lightly. The principles from the case regarding the tax treatment of progress payments are valid generally for contracts crossing year-end boundaries. Applying those principles, allowable expenditure should be deducted from progress payments (earned and contractually due) and the balance will be gross profit or loss. For the contracts in question, expenditure exceeded payments and there was no gross profit element until completion of the contract and final payment.

Comment: Inland Revenue has not yet decided whether to appeal this decision. Also, we do not yet know whether the taxpayer will be appealing it

Whether commercial building sold as a going concern

Rating: • • •

Case: TRA 93 / 148, 93 / 149

Act: Goods and Services Tax Act 1985 - section 11(1)(c)

Keywords: *Commercial building, going concern, zero-rating.*

Summary: This case involved the supply of a commercial building with two sitting tenancies. The vendor and the purchasers argued that the supply was of a going concern and could be zero-rated for GST purposes. Inland Revenue argued that the supply of the building and the leases were separate supplies of assets and not that of a going concern. Judge Willy concluded that there was no intention to sell a business as a going concern and therefore the supply was subject to GST at 12.5 percent.

Facts: The purchasers were operating a business, and the lease of the shop they occupied was coming to an end. They sought to find new premises as they considered the terms offered for renewal of the existing lease to be unsatisfactory. They found suitable commercial property and entered into a purchase contract with the vendor. The purchasers specifically wished to acquire the property with vacant possession. The agreement stated that unless particulars of a tenancy were included in the agreement, the property would be sold with vacant possession.

There were two existing tenancies, and due to the nature of the leases with the vendor, these tenancies could not be ceased. As a result, the purchasers did agree to vary the contract and bought the property subject to the tenancies.

Inland Revenue sought to standard-rate this supply on the grounds that the supply was not of a going concern. The taxpayers objected and a case was stated to the Taxation Review Authority.

Decision: Judge Willy reasoned that there had to be an intention to supply a business as a going concern, and that there had to be an intention to acquire that same business as a going concern. In this case, it was concluded that the purchasers had never intended to purchase the building with the aim of receiving rentals from it. They had wanted the whole of that building for themselves. However, this was not possible due to the nature of two existing leases on the property. They nevertheless, agreed to purchase the building subject to the leases.

Judge Willy concluded that there had been no continuity of the business at the time of supply from the vendor to the purchasers. He did not accept the argument that just because the purchasers reluctantly accepted the existence of two tenants in the premises, that it amounted to being a supply of a business by the vendor. What had been supplied were the assets of the vendor's business and not the vendor's business itself. As a result, the supply did not qualify for zero-rating.

Comment: The taxpayer is not appealing this decision.

Deductibility of forestry expenditure

Rating: • • • •

Case: Hill v Commissioner of Inland Revenue CA 94/93

Act: Income Tax Act 1976 - sections 74, 104, 108, 126, and 127

Keywords: *Forestry business, deductions*

Summary: The Court of Appeal ruled that section 74 of the Income Tax Act 1976 is not an exclusive code governing the deduction of forestry expenses; the general deduction provisions also apply. Also, forestry is not "farming" or "agriculture" for the purposes of sections 126 and 127.

Facts: The taxpayer bought a property in 1968 to grow *Pinus radiata* trees. He was carrying on a business as defined in the Income Tax Act 1976. He sought deductions for the income years ended 31 March 1977, 1978, 1979. The taxpayer contended that he could claim deductions under the forestry specific provisions of section 74 and under the general deduction provisions of sections 104 and 108. He also submitted he was entitled to deductions under sections 126 and 127 which are specific to farming and agriculture. Inland Revenue contended that the taxpayer was confined to claiming deductions under section 74 as that section was an exclusive code.

Decision: Judge Richardson delivered the Court of Appeal's judgment, which held that section 74 is not an exclusive code. There is no express provision nor inference in the section which bars a deduction under the other specific deduction provisions of the Act. Therefore, a taxpayer in a forestry business can claim deductions under sections 104 and 108 as well as section 74.

However, the Court also held that in the context of the Income Tax Act 1976, the words "farming" and "agriculture" in sections 126 and 127 do not include forestry. Therefore, a taxpayer in a forestry business cannot claim deductions under these two sections which provide a deduction for capital development expenditure to farmers.

Comment: Inland Revenue 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:

- When Inland Revenue can grant relief from payment of tax in cases of financial hardship
- Telephone rental deductions for businesses based at home
- GST and temporary imports

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

Due dates reminder

May

5 Large employers: PAYE deductions and deduction schedules for period ended 30 April 1994 due.

7 First instalment of 1995 provisional tax and/or Student Loan interim repayment due for taxpayers with January balance dates.

Second instalment of 1994 provisional tax and/or Student Loan interim repayment due for taxpayers with September balance dates.

Third instalment of 1994 provisional tax and/or Student Loan interim repayment due for taxpayers with May balance dates.

20 Large employers: PAYE deductions and deduction schedules for period ended 15 May 1994 due.

Small employers: PAYE deductions and deduction schedules for April 1994 due.

Gaming machine duty return and payment for month ended 30 April 1994 due.

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

RWT on dividends deducted during April 1994 due.

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

31 FBT annual liable return and payment due for employers who elected to pay FBT on an annual basis.

GST return and payment for period ended 30 April 1994 due.

1994 annual PAYE and ACC earner premium reconciliation (IR 68P) due. 1994 ACC employer premium calculation sheet (IR 68A) to be filed. ACC employer premium due to be paid.

RWT on dividends: specified dividend reconciliation (IR 17S or IR 17SA) to be filed.

RWT on interest: annual reconciliation statement (IR 15S) due.

June

5 Large employers: PAYE deductions and deduction schedules for period ended 31 May 1994 due.

7 First instalment of 1995 provisional tax and/or Student Loan interim repayment due for taxpayers with February balance dates.

Second instalment of 1995 provisional tax and/or Student Loan interim repayment due for taxpayers with October balance dates.

Third instalment of 1994 provisional tax and/or Student Loan interim repayment due for taxpayers with June balance dates.

IR 5 taxpayers: annual income tax return to be filed. (SL 9 form to be attached for Student Loan borrowers.)

20 Large employers: PAYE deductions and deduction schedules for period ended 15 June 1994 due.

Small employers: PAYE deductions and deduction schedules for May 1994 due.

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

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

RWT on dividends deducted during May 1994 due.

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

Payment of debit imputation credit account balances as at 31 March 1994 due.

30 Final day for “small” employers to elect to pay FBT annually.

GST return and payment for period ended 31 May 1994 due.

First instalment of 1995 Student Loan non-resident assessment due.

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