Misappropriation by employees - tax consequences for employers

Introduction

This item states the Commissioner's current policy on the income tax treatment of misappropriation of property by employees or persons rendering services, and the subsequent recoupment of the loss.

Background

The misappropriation of property may occur when staff take cash from the till, steal trading stock, or use cheques for private expenses. Taxpayers who are in business can claim deductions for these losses.

This item sets out the circumstances in which a claim is allowable, and the treatment of recouped losses.

Policy

Section 164 of the Income Tax Act 1976 (the Act) allows the taxpayer to deduct the loss in the year incurred, to the extent that the taxpayer has not already taken the loss into account. This means that if the taxpayer has already made a deduction under section 104 of the Act, no deduction is available under section 164.

The loss can be of property of any kind, e.g. cash, goods, or assets.

Examples

1. For some years, an employee draws a number of cheques for his own benefit, debiting the amount to purchases. Therefore, the money misappropriated under the heading of purchases would have been claimed as a deduction under section 104. The employer is unable to claim a deduction under section 164.
2. An employee has been taking money, and the employer has not taken the loss into account. The employer may claim a deduction under section 164.

When a taxpayer recoups the loss of property by any means, (for example, through an insurance claim or because the employee repays it), the amount recouped is assessable income in the year in which it is recouped.

When a fixed asset is lost, the value of the loss is the lesser of cost or the book value.

Section 164 does not allow a deduction for misappropriation by any of these people:

- a relative of the taxpayer
- an associated person (or a relative of an associated person), if the taxpayer is a company
- a settlor or beneficiary if the taxpayer is a trustee.

GST on payments received from resident and non-resident insurers

Introduction

This item states the Commissioner's current policy on the GST treatment of payments received by registered persons from resident and non-resident insurers.

Registered persons may receive payments under insurance policies as indemnification for assets which are lost or destroyed. The GST liability of the recipient will depend on whether the insurer is resident or non-resident.

Policy

If a registered person receives payment from a **resident** insurer for an asset which formed part of the taxable activity and which is lost or damaged, the registered person must pay GST on the indemnity payment. Section 5(13) of the Goods and Services Tax Act 1985 deems such a payment to be consideration received for a supply of services performed by the registered person.

If a registered person receives payment from a **non-resident** insurer for an asset which formed part of the taxable activity and which is lost or damaged, generally the registered person is not required to return GST on the payment. This is because section 5(13) does not apply when the contract of insurance is not subject to GST. Under section 8 of the GST Act, a contract of insurance supplied by a non-resident is not supplied in New Zealand and so is not subject to GST. The exception is where the non-resident insurer has a registered branch in New Zealand and the branch enters into the insurance contract.

Example

Marion Brown runs a charter boat business in Auckland. One of her boats was destroyed by fire and she received payment from her insurer, a United Kingdom company.

As the payment was received from a non-resident insurer which was not registered for GST, she was not required to return GST on the payment.

Expenditure on land improvements used for farming, agriculture, forestry or aquaculture

Introduction

This item states the Commissioner's current policy on claiming deductions under sections 128A, 128B, and 128C of the Income Tax Act 1976 for expenditure incurred on any of these things:

- land improvements used for farming or agriculture
- land improvements used for forestry
- improvements in relation to aquaculture.

This policy takes into account the effect of the new depreciation rules on these types of expenditure.

Background

Sections 128A, 128B, and 128C apply from the 1988 income year onwards. They provide for a yearly deduction for certain expenditure incurred in relation to land improvements in the agriculture, forestry, or aquaculture industries. The types of expenditure and the rates of deduction are set out in the Thirteenth Schedule to the Act.

For any expenditure incurred in the period from 16 December 1991 to the end of a taxpayer's 1994-95 income year, these rates are increased by 25% on the previous rate (for example, a rate of 20% becomes 25%). For expenditure incurred in the 1995-96 income year or any subsequent year, the rates are increased by 20% (so a 20% rate in the Thirteenth Schedule becomes a 24% rate).

As the new depreciation rules enacted last year also provide deductions for expenditure on land improvements, we have been asked to clarify under what section claims for expenditure incurred on land improvements should be made.

Policy

The definition of depreciable property in section 107A (which is the definition section for the depreciation regime) specifically excludes any property for which a deduction is available under sections 128A, 128B, and 128C. Therefore, if a taxpayer is involved in the agriculture, forestry, or aquaculture industries and is eligible for a deduction under these sections, no deduction is available under the depreciation regime.

Example

Farmer Brown constructed an access track, for use by his stock, which included a culvert under a road. In the past Farmer Brown had claimed a deduction of 5% per year on this expenditure under paragraph (f) of the Thirteenth Schedule. However, after looking through the new depreciation schedule he noticed that this included both roads and culverts. He inquired as to whether he should be claiming a depreciation deduction at the rates specified in that schedule.

Farmer Brown is eligible for a deduction under section 128A for the expenditure specified in the Thirteenth Schedule, so no deduction is allowable under the depreciation rules.

Telephone rental deductions for businesses based at home

Summary

This item states the Commissioner's policy on deductions for the rental of telephone equipment and lines when a business is based at the taxpayer's home.

Inland Revenue will allow deductions for up to 50% of the cost of telephone rental for businesses based at home if the home has only one telephone line. This will apply regardless of whether the rental charged is at the domestic or commercial rate. Inland Revenue will allow a deduction of more than 50% if the taxpayer can show that the actual use of the telephone supports a higher percentage of business use.

If the home has two telephone lines, one charged at the domestic rate and the other at the commercial rate, 100% of the commercial rental is an allowable deduction. In this case, no part of the domestic rental is deductible.

This policy applies to all businesses based from home, except for farmers whose principal or full time occupation is farming.

Background

Under sections 104 and 106(1)(j) of the Income Tax Act 1976, taxpayers who run a business from a home with only one telephone should claim a deduction for telephone rental based on the actual business use of the telephone. Telephone rental should therefore be apportioned according to the actual business and private use of the telephone.

However, telephone rental is a relatively minor deduction item and the Commissioner believes that allowing a deduction up to a set percentage provides certainty, saves time and reduces compliance costs for both taxpayers and Inland Revenue. For most businesses run from a home with only one telephone line there is both significant business and private use of the telephone. In these cases an apportionment to a maximum of 50% of the telephone rental between business and private use is a reasonable approximation of the actual use of the telephone. Inland Revenue will therefore allow a 50% deduction without requiring evidence to support the claim.

In some cases the actual business use of the telephone may support a greater than 50% apportionment. The higher percentage claim is acceptable if supported by the circumstances of each case. In particular, the type of business and the number of people living in the home are likely to be relevant.

If the home has only one telephone the policy will apply regardless of whether rental is charged at domestic or commercial rates. However, if there is a commercial telephone line installed into the home in addition to a domestic line, the commercial line rental will be fully deductible. In this case, no percentage of the domestic line will be deductible.

The 50% apportionment will not apply to farmers who historically claim deductions of 100% of their phone rental. A deduction of the full amount of telephone rental continues to apply to farming businesses. Telephone rental deductions for farmers will be looked at together with other farming deduction issues as part of a wider review; farmers' telephone deductions will not be dealt with in isolation.

Policy

The Commissioner will allow a deduction for up to 50% of telephone rental for businesses based at home if the home has only one telephone line. This will apply whether the phone is rented on a commercial or domestic basis. A taxpayer can claim a higher apportionment percentage if he or she shows that the actual business use of the telephone is greater than 50%.

If the home has two telephone lines, one charged at the domestic rate and the other at the commercial rate, 100% of the commercial rental is an allowable deduction. In this case, no part of the domestic rental is deductible.

Application

This policy applies to all taxpayers who run a business from home except for farmers whose principal or full time occupation is farming. Farmers continue to be allowed 100% of their telephone rental.

This policy only applies to telephone rental deductions for businesses based at home. It does not apply to toll calls or to reimbursement of employee telephone rental by employers.

This policy applies from 1 March 1993, and it applies for both income tax purposes and GST purposes (section 21(5) deductions).

Example

Felix Catt runs a busy dog boarding kennel business from his home. The home has one telephone line rented at the domestic rate. The main business uses of the telephone are:

- receiving bookings and enquiries from customers
- making calls to vets, pet shops and suppliers
- contacting customers.

Felix is divorced and has two young children who live with their mother.

Felix claims that the telephone has about 70% business use.

Inland Revenue would accept a deduction of 50% of telephone rental incurred by Felix without query. As Felix wants to claim a higher proportion of the telephone rental, he must produce some evidence showing a greater than 50% use of the telephone.

It is likely that the particular facts of this case would support a deduction of 70% of the cost of telephone rental. The type of business tends to indicate that there is higher than average business use of the telephone. This could depend on the number of customers the business has. The greater the number of customers, the higher the likelihood that the telephone is used more for business purposes. Further, Felix is the only occupant of the house and is therefore the only person who could be making private use of the telephone. The private use of the telephone is therefore likely to be smaller in relation to the business use.

A high proportion of business toll calls to private toll calls (as evidenced by toll call records) could also support the 70% apportionment. However, a high proportion of business toll calls is not conclusive in itself to show greater than average business use of the telephone. It is merely one factor that indicates the actual business use of the telephone.

Felix should not apportion toll calls on a basis similar to that of the telephone rental. A deduction for toll calls is only available for those calls actually related to the business of running the boarding kennel.

GST: the definition of resident

Introduction

This item states the Commissioner's current policy on the scope of the proviso to the definition of "resident" in the Goods and Services Tax Act 1985 (The Act).

The proviso to the definition of "resident" in the Act deems a person to be a resident for the Act by virtue of having a fixed or permanent place in New Zealand. We have been asked to clarify these two points:

- what constitutes a fixed or permanent place
- whether persons who are resident because of the proviso are resident for all their activities or only for those activities that are connected to the fixed or permanent place.

Policy

A fixed or permanent place

The Act does not define "fixed or permanent place". However, the Commissioner considers that the following characteristics indicate that a fixed or permanent place exists:

- It is a place of business, e.g. a branch, factory, workshop, mine, quarry, oil well
- The place is fixed, having an identifiable place or site
- The person is using the establishment in a productive manner in the course of that person's activity.

The length of time the person has used the place to carry on the activity may also indicate that the place is a fixed and permanent establishment. The longer a person uses the site, the more likely that it is a fixed and permanent establishment. The converse is not necessarily true. The fact that a person has used a place for a short period of time does not necessarily mean that the site is not a fixed or permanent establishment, as there may be an intention to use the site for some time in the future.

Ownership of the premises or space is immaterial. The establishment may be merely a rented space in a market place, or may be part of the premises of another business.

Does residence apply to all activities?

If a person is resident only because of the proviso to the definition of resident, that person is only resident for those activities that relate to a fixed or permanent place.

GST implications of being a non-resident

Section 8 of the Act imposes GST on all supplies (except for exempt supplies) of goods and services made in New Zealand by a registered person in the course or furtherance of a taxable activity.

Section 8(2) sets out the tests for determining when a supply is made in New Zealand. The general rule is that a supply is made in New Zealand if the supplier is resident in New Zealand. If the supplier is not resident in New Zealand, the supply will not be made in New Zealand.

The proviso to section 8(2) provides two exceptions when the supplier is not resident in New Zealand. Supplies made by a non-resident are deemed to be made in New Zealand if either of these conditions applies:

- the goods are in New Zealand at the time of supply
- the services are physically performed in New Zealand by any person who is in New Zealand at the time the services are performed.

If the recipient receives the supplies in the course of a taxable activity, the supplies are deemed to be supplied outside New Zealand unless the supplier and the recipient have agreed otherwise.

Example

An overseas engineering company is not resident in New Zealand under section 241 of the Income Tax Act 1976. The company has two contracts to perform in New Zealand.

The first contract requires the engineering company to design and oversee the construction of an irrigation plant. The engineering company leases office space in a local building from which it designs the irrigation plant and oversees its construction. In this instance, the office space constitutes a fixed or permanent place, and the company is deemed to be resident for GST for the activities it carries out for that contract.

Under the second contract the engineering company provides consultation services to a local engineering company involved in designing and constructing a similar irrigation plant. The engineering company provides these services by seconding staff to the local company. These staff work from the local company's premises. Therefore, the construction company does not have fixed or permanent place in New Zealand and is not resident for GST. There has been no agreement between the local company and the engineering company as to the services being deemed to be supplied in New Zealand.

Under the first contract, the engineering company is liable for GST on the supplies that it makes in relation to those activities.

Under the second contract, the engineering company is not liable for GST on the services it performs, as the services are performed in New Zealand by its staff and there has been no agreement that the services should be considered to be supplied in New Zealand.

Bloodstock breeders - offsetting profits or insurance proceeds against cost of replacement stock

Introduction

If a taxpayer sells breeding bloodstock, or receives an insurance payment for the loss, death, or permanent injury of such bloodstock, then these receipts are assessable for income tax purposes. This item sets out the Commissioner's current policy on offsetting this income against the cost of replacement animals.

Policy

Bloodstock breeders are assessable on amounts received for breeding stock which exceed the book value of the stock.

Section 212B of the Income Tax Act 1976 enables bloodstock breeders to offset against the cost of replacement animals any assessable gains derived from of these sources:

- sale or disposition of breeding bloodstock
- payments of insurance, indemnity, compensation or other damages received as a result of the death of, or permanent injury to, any breeding bloodstock.

The amount offset is not assessable and reduces the cost base of the replacement animal.

"Breeding stock" is defined for the purposes of section 212B. If bloodstock is sold, "breeding stock" means bloodstock that has actually been used for breeding purposes in the bloodstock breeder's business. If an insurance or other indemnity payment is received for bloodstock, "breeding stock" also includes bloodstock that the Commissioner is satisfied was purchased for use in the bloodstock breeder's business (but which may not have been used in the business). Neither definition includes home bred stock which is intended for use in the business but which has not yet been used.

To offset the assessable gain in this way, the taxpayer must apply in writing to the Commissioner. The application must be made within 6 months of the income year in which the breeding stock is sold or disposed of, or within such further period as the Commissioner considers reasonable. The taxpayer must acquire the replacement animal before making the application. The discretion to extend the six-month period is likely to be exercised where, for example, a breeder has sought replacement stock overseas in order to obtain a top line animal.

If the taxpayer receives insurance proceeds or other indemnity payments the Commissioner has a discretion to extend the six-month period. Before this discretion may be exercised, the Commissioner must be satisfied on these two points:

- there are valid commercial reasons for the delay in replacing the breeding stock
- the replacement animal was acquired within two income years following the end of the income year in which the loss, death, or permanent injury occurred.

In these circumstances the application must be made within the two years following the end of the income year in which the loss, death, or permanent injury occurred, or within such further time as the Commissioner allows.

Example 1

Mr Stable is a bloodstock breeder. During the year ended 31 March 1994 he sold one of his broodmares for $100,000. Its book value at 31 March 1993 was $50,000. His assessable gain was therefore $50,000.

In April 1994 he bought a replacement broodmare for $120,000, and then applied to the Commissioner to offset the assessable gain against the cost of the replacement. The Commissioner approved the application. The cost price of the replacement broodmare for tax purposes (e.g. section 86J) was therefore $70,000.

Example 2

A high quality broodmare owned by Ms Bridle, a bloodstock breeder, died in January 1993. A suitable replacement could not be found in New Zealand so she visited stud farms in America. Finally in April 1994 she bought another mare.

Ms Bridle received insurance proceeds of $350,000. The book value of the mare at the time of death was $200,000. Her assessable gain was therefore $150,000. She included the assessable gain in her 1993-1994 income tax return. The cost of the new mare was $500,000.

In June 1994 she applied to the Commissioner to refund the tax paid on the assessable gain and to reduce the cost of the replacement mare.

The application was received within two years of the end of the 1992-1993 year and the Commissioner was satisfied there were valid commercial reasons for the delay. The tax paid on the assessable gain was refunded and the cost of the replacement mare was reduced by $150,000.

Exemption D5: Exemption from the requirements of section 64H(1) of the Income Tax Act 1976

Section 64H(1) of the Act requires people to notify the Commissioner of interrelated financial arrangements. Section 64H(2) permits the Commissioner to exempt certain transactions. The existing Exemption D4 exempts all interrelated financial arrangements from the disclosure provisions, except for those financial arrangements specified in the Schedule to the Exemption.

The only difference between Exemption D5 and Exemption D4 is the application date. Exemption D5 applies from the income year commencing 1 April 1994, and it will remain in force until the Commissioner cancels it.

The full text of Exemption D5 is printed below.

Exemption from the requirements of section 64H(1) of the Income Tax Act 1976

1. Explanation

Section 64H(1) of the Income Tax Act 1976 requires the disclosure of all financial arrangements that are interrelated arrangements.

This exemption removes the disclosure requirement in respect of all interrelated arrangements, the making of which is a generally accepted commercial practice, except for those interrelated arrangements referred to in the Schedule to this exemption.

2. Reference

This exemption is made pursuant to section 64H(2) of the Income Tax Act 1976.

3. Scope of exemption

This exemption shall apply from 1 April 1994 and remain in force until cancelled by the Commissioner.

4. Interpretation

In this exemption, unless the context otherwise requires -

(a) Expressions used have the same meaning as in the Income Tax Act 1976:

(b) Every reference to an income year shall, where a person furnishes a return of income under section 15 of the Income Tax Act 1976 for an accounting year ending with a day other than the 31st day of March, be deemed to be a reference to the accounting year corresponding with that income year:

(c) "Interrelated Arrangement" means a financial arrangement that consists of two or more arrangements, whether or not those arrangements are themselves financial arrangements:

(d) "Liability" includes a contingent liability:

(e) A person shall be deemed not to be a resident of New Zealand in relation to any activity or arrangement carried on through a fixed establishment outside New Zealand:

(f) A person shall be deemed to be a resident of New Zealand in relation to any activity or arrangement carried on through a fixed establishment in New Zealand:

(g) "Value" in relation to any financial arrangement, means -

(i) In relation to any variable principal debt instrument, other than an interrelated arrangement, the amount of money owing to the holder pursuant to the arrangement:

(ii) In relation to any fixed principal debt instrument, other than an interrelated arrangement or an instrument involving a notional principal, the greater of the acquisition price of the arrangement or the nominal or face value of the arrangement:

(iii) In relation to any security arrangement, the greater of -

(A) The amount of the maximum liability of the surety under the security arrangement:

(B) The sum of the values of the financial arrangements wholly or partially secured by the security arrangement:

(iv) In relation to any financial arrangement involving a notional principal (for example, certain types of interest rate or currency swaps, forward rate agreements, certain futures contracts), the amount of the notional principal:

(v) In relation to any arrangement which is not a financial arrangement, the total amount of consideration required to be provided under the arrangement by the person having the greatest liability under the arrangement:

(vi) In relation to any interrelated arrangement, the sum of the values of the arrangements that constitute the interrelated arrangement:

Provided that where, under an interrelated arrangement, consideration is required to be passed between persons more than once and as a consequence an amount would, but for this proviso, be required to be taken into account more than once in calculating the value of an interrelated arrangement, that amount shall not be taken into account more than once in calculating the value of the financial arrangement:

Provided also that where the value can be ascertained pursuant to more than one of the foregoing subparagraphs, the value shall be ascertained pursuant to the subparagraph that provides the greatest value.

5. Exemption

Any person who in an income year is party to an interrelated arrangement shall be exempt from the requirements of section 64H(1) of the Income Tax Act 1976 in respect of the interrelated arrangement and the income year where -

(a) The making of the interrelated arrangement is a generally accepted commercial practice; and

(b) The interrelated arrangement is not of a kind specified in the Schedule hereto.

Schedule

1. Any interrelated arrangement where:
   (a) The parties to one of the arrangements making up the interrelated arrangement include both a resident of New Zealand and a non resident of New Zealand;
   (b) The value of the interrelated arrangements exceeds $2 million at any time in the income year; and
   (c) The interrelated arrangement has a purpose other than only to achieve the exchange of a sum of money in one currency for an equivalent sum of money in another currency, such exchange not being subject to any agreement to reverse the exchange at some future date.
2. Any interrelated arrangement where one of the arrangements making up the interrelated arrangement is a perpetual note and the value of the interrelated arrangement exceeds $2 million at any time in the income year.
3. Any interrelated arrangement where -
   (a) One of the arrangements making up the interrelated arrangement is a share in a company which does not rank equally with the ordinary shares in the company in terms of voting rights or distributions; and
   (b) The value of the interrelated arrangement exceeds $2 million at any time in the income year.
4. Any interrelated arrangement where:
   (a) In respect of one of the arrangements ("the sub-arrangement") making up the interrelated arrangement, the amount of consideration provided or received by one of the parties under the sub-arrangement is influenced by the fact that the sub-arrangement is part of an interrelated arrangement; and
   (b) The value of the interrelated arrangement exceeds $2 million at any time in the income year;

   Provided that this provision shall not apply to an interrelated arrangement where the amount of consideration to be provided or received by one of the parties to the sub-arrangement is influenced only by the existence of a security arrangement as part of the interrelated arrangement.
5. Any interrelated arrangement the value of which exceeds $20 million at any time in the income year.

This determination is signed by me on the 2nd day of May in the year 1994.

P Barrand
Deputy Commissioner of Inland Revenue

1994 International tax disclosure exemption

Introduction

Under section 245W(1) of the Income Tax Act 1976 (the Act), a person who has a control or income interest in a foreign company or an interest in a foreign investment fund at any time during the income year must disclose the interest held. However, section 245W(2) allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of Part IVA (Attributed Foreign Income) of the Act.

The Commissioner has issued an international tax disclosure exemption under section 245W(2), which applies to the income year ending 31 March 1994. The exemption may be cited as "International Tax Disclosure Exemption ITR5" and the full text appears at the end of this item.

Scope of exemption

Exemption from disclosure will be available in the 1994 income year for a person with a control or income interest in a foreign company, if the interest does not constitute an "income interest of 10 percent or greater" (i.e., less than 10 percent). An "income interest of 10 percent or greater" is defined in section 245A(1). For the purposes of determining exemption from disclosure it includes these interests:

- an income interest held directly in a foreign company
- an income interest held indirectly through any interposed foreign company
- an income interest held by an associated person (which is not a controlled foreign company) as defined by section 245B.

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Example

If a husband and wife each hold an income interest of five percent in a Cayman Islands company, the interests would not be exempt from disclosure because the husband and wife are associated persons under section 245B(d). Under the associated persons test they are each deemed to hold each other's interests, so they each hold an "income interest of 10 percent or greater" which requires disclosure. However they are not required to attribute foreign income or loss.

The scope of the 1994 disclosure exemption is not as extensive as in previous income years. In particular, disclosure is required for these interests:

- an interest held in a FIF. The new FIF rules generally apply from 1 April 1993, so disclosure was not necessary in previous income years. (However, transitional provisions required disclosure for the 1993 income year if a FIF interest was acquired or re-acquired in the period from 8 pm on 2 July 1992 to 31 March 1993, or if a person elected to utilise a 1993 loss in the 1993 income year.)
- an "income interest of 10 percent or greater" held in a foreign company. The disclosure obligation applies to all foreign companies regardless of the country of residence.

Foreign company interests

A person who holds a control or income interest in a foreign company must disclose that interest, regardless of the company's country of residence. The 1994 international tax disclosure exemption also makes no distinction about residence, and any interest in a foreign company which is an "income interest of 10 percent or greater" must be disclosed. Disclosure is to be made on form IR 4G "Interest in a Foreign Company Disclosure Schedule".

The disclosure exemption makes no distinction on the residence of a foreign company for these reasons:

- application of attributed (non-dividend) repatriations made on or after 2 July 1992. The rules apply to an "income interest of 10 percent or greater" in a CFC regardless of the CFC's country of residence.
- to identify tax preferences applied by the taxpayer (whether or not specified in Part A of the Sixteenth Schedule) in respect of an interest held in a foreign company which is resident in a Fifteenth Schedule jurisdiction .
- the requirement for a CFC which is resident in a non-list country to attribute foreign income or loss from 1 April 1993.

Foreign investment fund interests

An interest in a foreign entity must be disclosed if it constitutes an "interest in a foreign investment fund" specified within section 245RA(1). These types of interest must be disclosed:

- rights in a foreign company or anything deemed to be a company for the purposes of the Act (e.g., a unit trust)
- an entitlement to benefit from a foreign superannuation scheme
- an entitlement to benefit from a foreign life insurance policy
- an interest in an entity specified in Part B of the Sixteenth Schedule to the Act (no entities were listed when this TIB went to press).

However, any interest that does not fall within the above types or which is specifically excluded as an interest in a FIF under section 245RA(2) does not have to be disclosed. The following are listed in section 245RA(2) as exemptions from what constitutes an interest in a FIF:

- an "income interest of 10 percent or greater" in a controlled foreign company (CFC)
- an interest in a foreign entity that is resident and liable to income tax in a country or territory specified in the Fifteenth Schedule to the Act
- an interest in an employment-related foreign superannuation scheme
- interests in foreign entities held by a natural person, if the aggregate cost or expenditure incurred in acquiring the interests does not exceed $20,000 at any time during the income year
- an interest held by a natural person in a foreign entity located in a country where exchange controls prevent the person deriving any profit or gain or disposing of the interest for New Zealand currency or consideration readily convertible to New Zealand currency
- an interest in a foreign life insurance policy or foreign superannuation scheme acquired by a natural person before he or she became a New Zealand resident for the first time.

There is more information on exemptions from the FIF rules in TIB Volume Four, No.9 (May 1993), and in Inland Revenue's "Foreign Investment Funds" booklet (IR 275B).

A person who holds an interest in a FIF at any time during the 1994 income year must disclose the interest and calculate FIF income or loss on the form "Interest in Foreign Investment Fund Disclosure Schedule and Worksheet". The FIF rules allow a person four options to calculate FIF income or loss (accounting profits method, branch equivalent method, comparative value method and deemed rate of return method), so the Commissioner has accordingly prescribed four forms under the IR 4H series to disclose and calculate FIF income or loss from an interest in a FIF using one of the methods.

Taxpayers had to disclose FIF interests for the 1993 income year if they acquired or reacquired the interest

in the period from 8 pm on 2 July 1992 to 31 March 1993. However, section 245Y(10) deems FIF income or loss from the 1993 and prior income years to be derived or incurred in the 1994 income year. Accordingly, FIF income or loss from an interest in a FIF acquired or reacquired during the period specified above must be calculated and declared in a taxpayer's 1994 tax return.

An interest in a FIF held or acquired on or after 1 April 1993 must be disclosed in a taxpayer's 1994 tax return, regardless of the taxpayer's balance date. The FIF income or loss is ordinarily derived or incurred in the 1994 income year for standard and early balance date taxpayers, and deemed to be derived or incurred in the 1994 income year for taxpayers with late 1993 balance dates.

Overlap of interests

A situation may arise where a person is required to furnish a disclosure for an interest in a foreign company which is also an interest in a FIF. For example, a person with an "income interest of 10 percent or greater" in a foreign company which is not a CFC is strictly required to disclose both an interest held in a foreign company and an interest held in a FIF.

However, in this situation a double disclosure is not necessary and disclosure is only required on the appropriate form IR 4H form to satisfy the disclosure obligations.

A person holding an "income interest of 10 percent or greater" in a foreign company that is not a FIF or CFC is only required to disclose on form IR 4G. An example of such an interest is a 20 percent interest held in a non-CFC Australian company.

Disclosure is not required on either forms IR 4G or IR 4H for an income interest of less than 10 percent in a foreign company (whether a CFC or not) which is also not a FIF interest. An example is an interest which is excluded under the Fifteenth Schedule exemption.

Summary

The 1994 international tax disclosure exemption excludes the requirement to disclose an interest held in a foreign company that does not constitute an "income interest of 10 percent or greater" (i.e., less than 10 percent). The disclosure exemption is not affected by the foreign company's country of residence. Further, an interest in a FIF held or acquired on or after 1 April 1993 must be disclosed.

Persons not required to comply with section 245W of the Income Tax Act 1976

This exemption may be cited as "International Tax Disclosure Exemption ITR5"

1. Reference

This exemption is made pursuant to section 245W(2) of the Income Tax Act 1976. It details interests in foreign companies in relation to which any person is not required to comply with the requirement in section 245W of the Income Tax Act 1976 to make disclosure of their interests, for the income year ending 31 March 1994.

2. Interpretation

In this exemption, unless the context otherwise requires, expressions used have the same meaning as in section 2 or Part IVA of the Income Tax Act 1976.

3. Exemption

Any person who has an income interest or a control interest in a foreign company, in the income year ending 31 March 1994, shall not be required to comply with section 245W(1) of the Income Tax Act 1976 in respect of that foreign company and that income year, except where:

- the interest held by that person during any accounting period of the foreign company (the last day of which falls within that income year of the person), would constitute an "income interest of 10% or greater", as defined by section 245A of the Income Tax Act 1976, as if the foreign company was a controlled foreign company.

This exemption is made by me acting under delegated authority from the Commissioner of Inland Revenue pursuant to section 11 of the Inland Revenue Department Act 1974.

This exemption is signed on the 13th day of May 1994

Tony Bouzaid
Director, Taxpayer Audit

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.

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Income Tax Act 1976

Bloodstock write-downs

Section 2 - Definition of bloodstock : A taxpayer obtained a share in a thoroughbred horse for breeding purposes. He asked whether he can write down the cost of the share in the same way as if he was the outright owner.

Bloodstock means any horse that is a member of the standard breed or thoroughbred breed of horses and includes any share or interest in any such horse. This means that any share or interest is treated in the same way for tax purposes as full ownership of the horse.

The full cost of the share in any breeding stock may be written down over the appropriate term (depending on whether it is a stallion or broodmare) at the same rate as applies for outright owners of breeding stock. Section 86J of the Income Tax Act 1976 provides the rules for the valuation of such bloodstock.

Extension of time to file group returns

Section 17(5) - Professionally prepared returns: The accountant of a group of companies (as defined in section 191(3)) asked for an extension of time to file the group's tax returns. There were 12 companies in the group.

Where there are 10 or more companies in a group, section 17(5)(a)(ii) allows the Commissioner discretion to extend the time for filing the group's annual returns. Once the local Inland Revenue office receives a written application for an extension of time, the group's nominated officer acting as its tax agent, and an officer of Inland Revenue may negotiate a new filing date which will apply to all the members of the group.

Any negotiated date will not be later than the 31 March following the group's standard balance date.

Income derived before receiving NZ Super not liable for surcharge

Section 336D - Determination of "Other Income": A superannuitant asked if all the income she earned during the year was used in calculating the New Zealand Superannuation surcharge. This was the first year that she received New Zealand Superannuation.

Under section 336D(2), if a taxpayer starts receiving New Zealand Superannuation after the beginning of an income year, only the income received during the part of the year where the taxpayer receives New Zealand Superannuation is taken into account in calculating the surcharge.

Spreading income from the sale of standing timber

Section 81A(1) Spreading authorised: A farmer recently made sales from a stand of timber that has just matured. He asked if he is able to spread the income over previous years, and if so, how he should make an application and what details he should supply.

Section 81A(1) allows the Commissioner to spread a taxpayer's assessable income from the sale or other disposition of timber or the right to take timber between the income year of sale and up to three preceding income years. The assessable income that has been spread is then deemed to have been derived in the year(s) to which it has been apportioned, and is liable for income tax accordingly.

For this to occur, the taxpayer or agent must make a written request to the local Inland Revenue office not later than 12 months after the end of the income year in which the income was derived.

Unless the taxpayer specifies how the income is to be apportioned, the Commissioner will make the apportionment so as to give the taxpayer the most advantageous tax position.

Goods and Services Tax Act 1985

Secondhand goods for GST purposes

Section 2 - Definition of secondhand goods: A taxpayer asked whether he could claim an input tax credit for the purchase of pottery and glassware on the basis that they were secondhand goods. The taxpayer carried on the taxable activity of selling pottery and glassware. He was registered for GST. He purchased pottery and glassware from unregistered potters and glassware makers.

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The Commissioner's policy on what constitutes a secondhand good is set out on page 1 of TIB Volume One, No.5 (November 1989). A secondhand good is one that another person has owned for his or her own use. A good that a person manufactures and supplies for the first time cannot be a secondhand good for the person that makes it.

In this case, the potters and the glassware makers had not used their products themselves. They had made the goods and supplied them for the first time. Consequently, the pottery and the glassware are not secondhand goods and the taxpayer cannot claim an input tax credit for the purchase of such goods from non-registered persons.

Child Support Act 1991

Advising Inland Revenue of a change in circumstances

Section 86 - Commissioner to give effect to changed circumstances: A liable parent asked why his assessment for Child Support had not ceased as the eligible child has since left school and been in paid employment for several months.

In this case, Inland Revenue was not made aware of the change. The liable parent has also asked what can be done if the custodian does not advise Inland Revenue of the change.

There will be cases when neither the custodian nor the liable parent has notified the Commissioner of a change in the number of eligible children. The custodian is initially responsible for providing this information, as that person is in the best position to do so. Sometimes, the liable parent may know that a change has occurred. If so, he or she can advise the Commissioner of the change.

If the information doesn't reach Inland Revenue for some months and the assessment is too large, section 86 requires the Commissioner to rectify the position, ensuring that the liable parent has not been over-assessed. Section 87 allows the Commissioner to rectify the position at any time, even if Child Support has already been paid or the child support year has ended.

Estate and Gift Duties Act 1968

Remission of debt not a gift

Section 75B(1) - Forgiveness or remission of liability: A lender asked if the amount of debt remitted under a loan agreement is liable for gift duty.

Sections 64B to 64M of the Income Tax Act 1976 set out the accrual regime. Under section 64F, forgiveness of debt triggers the creation of assessable income, except (since October 1987) when the forgiveness is in consideration of natural love and affection - section 64F(7).

Section 75B of the Estate and Gift Duties Act 1968 provides that where a debt is forgiven and comes under the accrual regime, it is not a gift for the purposes of gift duty.

This means that this kind of debt is not subject to double taxation through being subject to both gift duty and the accrual regime.

Land Tax Act 1976

Land Tax Abolition Act - effect on hardship

Section 56 - Relief in cases of serious hardship: A taxpayer who owed money under the repealed Land Tax Act 1976 believed that she was undergoing serious hardship. The taxpayer asked if the section of the repealed Act which potentially covered this situation still applies.

The Land Tax Abolition Act 1990 that came into force on 31 March 1992 repealed the Land Tax Act 1976. However, the former Act still applies to tax due and payable before that date.

This taxpayer is free to attempt to bring herself within the requirements of the section covering hardship.

Official Information Act 1982

Anonymous information

Section 6 - Conclusive reasons for withholding official information: A concerned citizen wanted to advise Inland Revenue that he knew of someone who was “ripping off the system”. He asked how he could advise Inland Revenue of his concerns without putting himself at risk.

The identity of a person supplying information is not divulged to the taxpayer. That information is protected by section 6(d), i.e., where the safety of any person is at risk.

A person can also give information anonymously. However, often Inland Revenue cannot act on anonymous information, due to the lack of detail. A name or contact point from which further information can be requested is helpful.

Any person who wishes to give information to Inland Revenue should send it in writing to the Senior Technical Officer, Taxpayer Audit, at the local Inland Revenue office. The letter should set out the facts that the person thinks are relevant.

It is Inland Revenue’s policy not to divulge the results of any investigation to the person who initially gave the information.

New Zealand Film Commissions Act 1978

Deduction for New Zealand film

Section 18: A small film company was aware that under section 224D(6) of the Income Tax Act 1976, if a film has been certified as being a New Zealand film, then all film production expenditure may be written off in the later of these two income years:

- The income year in which that New Zealand film is completed
- The income year in which that film production expenditure is completed.

The company asked for details of the certifying criteria used by the New Zealand Film Commission.

In this context, “New Zealand film” means a film which has been certified by the New Zealand Film Commission as being a film which that Commission is satisfied has a significant New Zealand content in accordance with the criteria set out in section 18 of the New Zealand Film Commission Act 1978. Section 18 of the New Zealand Film Commission Act 1978 states that for the purposes of determining whether or not a film has a significant New Zealand content the Commission will have regard to certain factors including the subject of the film, the location of the film, the nationalities and places of residence of the actors, scriptwriters, composers and other people making the film, and the sources from which the money was derived to make the film.

Legal decisions - case notes

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

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

- • • • • • Important decision
- • • • • Interesting issues considered
- • • • Application of existing law
- • • Routine
- • Limited interest

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

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

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Timing of deductibility of warranty costs; derivation of income when warranties not discharged

Rating: • • • • •

Case: The Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited (1994) 16 NZTC 11,099

Act: Income Tax Act 1976 - sections 101, 104(1), 38(2), 64B(1) and 75

Keywords: *Warranty expenses, deductibility of expenses, derivation of income*

Summary: The Court of Appeal held that the provision for anticipated expenses of meeting warranties for defects in motor vehicles sold by the taxpayer was not expenditure incurred in the year of sale. The liability was only a contingent liability which arose if a defect appeared within the warranty period. The taxpayer was not definitively committed to the expenditure at balance date.

However, the Court found that part of the sale price referable to making good any inherent defect was not earned until any warranties were discharged. Consequently, that part of the sale price did not form part of the assessable income in the year of sale.

Facts: Mitsubishi Motors New Zealand Limited (Mitsubishi) assembled new motor vehicles and sold them wholesale to its dealers. The dealers then sold the vehicles to retail customers. Under warranty arrangements the taxpayer reimbursed dealers for liabilities the dealers incurred in giving warranties to purchasers.

Mitsubishi's experience was that despite appropriate quality controls some 63% of all vehicles sold contained inherent defects covered by warranty. It could make reasonable and reliable estimates of the costs of meeting warranty claims as at the end of the tax year. The company sought to offset these costs against the income year in which the vehicles were sold.

Decision: The Court of Appeal rejected the taxpayer's argument that the warranty costs should be deducted in the year of sale. It accepted the taxpayer's alternative submission that the income earned by the giving of the warranty must be spread over the period of the warranty.

Has an expenditure been incurred?

The Court said that the relevant issue was whether the warranty expenditure had the character of an expenditure incurred in the year of sale; whether Mitsubishi was definitively committed to the expenditure at balance date. It held that Mitsubishi did not meet this test because any liability to be discharged under the warranties was only a contingent liability which arose when a defect appeared within the warranty period.

In reaching this conclusion the Court commented that:

(i) accounting principles applicable for financial reporting purposes and good commercial practice could not be substituted for the statutory test of deductibility. However, they may assist in ascertaining the true nature and incidence of the item at issue.

(ii) the true nature of any such transaction could only be ascertained by considering the legal arrangements actually entered into and not on an assessment of the broad substance or overall economic consequences.

When is income derived?

The Court rejected Mitsubishi's argument that section 64B provided for the spreading of income from sales but considered there should be a spread for other reasons.

The issue to be considered was whether the earning process should be considered complete on sale of vehicles, in which case all sums received or receivable would be derived then, or whether the sums received or receivable included unearned amounts. If unearned amounts were included they would not be derived until the warranties were completed or discharged.

The Court held that part of the sale price was not earned until the warranties were discharged, for these reasons:

(i) The facts established that while in a particular case the taxpayer's liability was contingent, collectively the taxpayer was exposed to a certain and measurable risk. It was inherent in the supply of the vehicles that there was a high probability that the taxpayer would be required to perform warranty obligations beyond the year of sale at significant cost.

(ii) The ascertainment of income is firmly grounded in business concepts. Practical business people would conclude that in this case, while technically contingent, services of an identifiable value will have to be performed to complete the transaction. Consequently that part of the receipt which represents a reliable estimate of the costs of performance of those remaining services does not constitute income derived.

The amount relating to warranty services could be reasonably identified and recording part of sales revenue as deferred revenue was in accord with acceptable accounting practice. The fact that Mitsubishi had made a provision for anticipated expenses rather than taking the receipts or receivables to a suspense account was not determinative of the issue.

Comment: Inland Revenue is appealing this decision to the Privy Council

Whether certain charges imposed by airport authority are zero-rated for GST purposes

Rating: • •

Case: Auckland Regional Authority v The Commissioner of Inland Revenue M.1072/91

Act: Goods and Services Tax Act 1985 - former section 11(2)(a)

Keywords: *Airport landing dues, directly in connection with, estoppel*

Summary: International airport dues charged by an airport company for services supplied to an airline were zero-rated as being directly connected with international transportation under a former provision of the Act. Terminal service and international garbage disposal charges made by the airport company could not be zero-rated.

Facts: The ARA was an airport company. It charged overseas airlines:

- airport dues
- terminal services charges
- international garbage disposal charges.

The ARA was assessed for GST from 1 October 1986 to 26 March 1988. It argued that the charges were zero-rated under the (then) section 11(2)(a).

Decision: The ARA's essential argument was that the three types of services were supplied directly in connection with international transportation or the arranging thereof. In the High Court, Justice Barker followed the Taxation Review Authority decision of *Case P78* (1992) 14 NZTC 4,523, where airport dues charged by another international airport were zero-rated. The landing dues were payable according to the gross weight of aircraft. They were payable for the use of aircraft runways, turnoffs, taxiways and holding bays. He held that the service provided by the airport in providing runways and similar was directly in connection with international transport. The Commissioner relied on the Privy Council decision of *Databank Systems Ltd v CIR* [1990] 3 NZLR 385. Justice Barker said the present case could be distinguished from the *Databank* decision.

The international terminal and garbage disposal charges were held not to be zero-rated under the same test. These charges were not considered to be directly in connection with international transport.

Justice Barker noted that the change in wording of section 11(2)(a) after 24 March 1988 would not allow zero-rating for airport landing dues.

The decision also records that in 1986 Inland Revenue advised the ARA that the three charges would not attract GST. Inland Revenue reversed its position in 1988. Justice Barker noted that he was bound by *Brierley Investments Ltd v CIR* (1993) 15 NZTC 10,212 and *CIR v Lemmington Holdings Ltd* [1982] 1 NZLR 517. Estoppel cannot be raised against Inland Revenue in these circumstances.

Comment: Inland Revenue is still considering whether to appeal this decision.

Whether land can be treated as trading stock; whether TRA decision subject to judicial review

Rating: • • •

Case: Murray Darnill Ltd & Darnills Food Market Ltd v Taxation Review Authority & Commissioner of Inland Revenue CP 77/91

Act: Income Tax Act 1976 - sections 27 and 85

Keywords: *Judicial review, trading stock*

Summary: The High Court concluded that section 27 bars an application for judicial review. The Court also concluded that section 85 excludes land from "trading stock" only for the purposes of that section.

Facts: The taxpayer purchased land in 1986 for resale, and sold it in 1990 for a loss. In 1986 the company had claimed as a deduction the expense of purchasing the land. It did not credit the land in its accounts for the year ended 31 March 1987 as trading stock. The taxpayer contended that section 85 required the value of the land to be omitted from the calculation of assessable income.

The Commissioner disallowed the claim for the deduction. The taxpayer objected and the matter was heard by the Taxation Review Authority who upheld the Commissioner's approach. The taxpayer failed to lodge an appeal against the Authority's decision within the statutory time frame given by section 43 of the Inland Revenue Department Act 1974. The taxpayer attempted to challenge the Authority's decision by way of judicial review.

Decision: Justice Tipping held that the taxpayer's application for judicial review was barred by section 27. He added that had it not been strictly barred by section 27 he would have declined relief in the exercise of the Court's discretion.

However, the Court went on to consider whether the Taxation Review Authority was correct in upholding the Commissioner's decision. Justice Tipping held that the Authority was correct in regarding the land as trading stock. Land is excluded from the term "trading stock" only for the purpose of section 85. When land is brought into the revenue account, it should be brought in at cost and remain at cost for tax purposes until disposition.

Comment: We do not know whether the taxpayer will appeal 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
- GST and temporary imports
- Tax treatment of salaries and emoluments received by NZ residents employed by the International Monetary Fund, World Bank and similar entities

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

Due dates reminder

June

5 Large employers: PAYE deductions and deduction schedules for period ended 31 May 1994 due. *(We will accept payments received on Tuesday 7 June as on time.)*

7 Provisional tax and/or Student Loan interim repayments: first 1995 instalment due for taxpayers with February balance dates.
Second 1995 instalment due for taxpayers with October balance dates.
Third 1994 instalment due for taxpayers with June balance dates.

IR 5 taxpayers: annual income tax returns due (SL 9 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 period ended 31 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.

Imputation - payment of debit imputation balances as at 31 March 1994 due.

30 FBT - final day for small employers to elect to pay FBT annually.

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

Non-resident Student Loans - first instalment of 1995 non-resident assessment due.

July

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

7 Provisional tax and/or Student Loan interim repayments: first 1995 instalment due for taxpayers with March balance dates.
Second 1995 instalment due for taxpayers with November balance dates.
Third 1994 instalment due for taxpayers with July balance dates.

Non-IR 5 taxpayers: annual income tax returns due for taxpayers with balance dates from 1 October 1993 to 31 March 1994 (SL 9 to be attached for Student Loan borrowers).

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

Small employers: PAYE deductions and deduction schedules for period ended 30 June 1994 due.

FBT: return and payment for quarter ended 30 June 1994 due.

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

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

RWT on dividends deducted during June 1994 due.

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

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

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Binding rulings - discussion document out soon

A discussion document on Government proposals for the forthcoming system of issuing binding rulings on tax matters is presently being prepared. This document should be available in June.

If you would like to order a copy of this document, please write or send a fax to this address:

Binding Rulings
C/o Legislative Affairs
Inland Revenue Department
P O Box 2198
WELLINGTON Fax (04) 474 7217

There will be no charge for this document.

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Questions we've been asked

Answers to enquiries we've received at Inland Revenue, which could have a wider application. See page 10 or the inside front cover for a list of topics covered in this bulletin.

Legal decisions - case notes

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

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