GST on supply of goods after a change in use

Summary

This item states the Commissioner's policy on how GST applies to supplies of goods after a change in use of the goods.

It applies when GST registered persons acquire goods, apply those goods in a manner requiring adjustments under section 21 of the GST Act, and later sell or otherwise supply those goods to another person. This includes the situation when goods are deemed supplies upon de-registration under section 5(3).

The GST on the subsequent supply depends only on whether the registered person initially acquired the goods for the principal purpose of making taxable supplies. If the goods were so acquired, and the registered person claimed a GST input tax deduction, the subsequent supply will be subject to GST, regardless of any section 21 adjustments. If the goods were not acquired for the principal purpose of making taxable supplies, and no input tax deduction was claimed, the subsequent supply will not be subject to GST, again regardless of any section 21 adjustments.

In either case, the only exception is if the registered person has made a one-off, 100 percent change in use adjustment under section 21. In this situation the GST treatment of the subsequent supply will reflect the adjustment.

All legislative references in this item are to the Goods and Services Tax Act 1985.

Background

This policy updates and expands on the Commissioner's policy as set out in on page 4 of Public Information Bulletin No.169 (February 1988).

Broadly, under section 20(3) and the "input tax" definition in section 2(1), a GST registered person who acquires goods for the principal purpose of making taxable supplies may claim an input tax deduction on those goods. The person can claim a full input tax deduction for all GST paid, even if either of these circumstances applies:

- The making of taxable supplies is not the sole purpose of acquiring the goods.
- The person's actual application of those goods in the making of taxable supplies is different from what was originally intended. For example, the registered person acquires goods principally to make taxable supplies but subsequently applies them for private purposes.

Section 21(1) adjustments are required in either of these circumstances. Under section 21(1), GST output tax must be paid to reflect the manner in which the registered person subsequently applies the goods.

For example, a registered person that is a finance company may buy a computer and apply it 55 percent for taxable purposes and 45 percent for exempt purposes (such as supplying financial services within section 3). This indicates that the person's principal purpose in acquiring the computer was to make taxable supplies. If it was, the finance company would be entitled to a full (100 percent) input tax deduction for the computer.

However, the finance company must make section 21(1) adjustments in a manner which would broadly have the effect of recapturing the 45 percent of this deduction over time. These period-by-period adjustments would be required during the full period of ownership of the computer. Accordingly, the total adjustments might be less or more than 45 percent of the original deduction.

Section 10(8) places a value on the deemed supply under section 21(1).

An example of how this policy applies is set out in the item "GST - section 21 and property developers who rent out property for residential purposes" on page 1 of TIB Volume Five, No.8 (January 1994).

Section 21(1)

There are two classes of adjustments under section 21(1) for subsequent exempt or private supplies:

- Goods acquired for the principal purpose of making taxable supplies may, in fact, be subsequently applied wholly (100 percent) for non-taxable purposes. In this situation, the GST registered person must make a one-off section 21(1) adjustment to effectively wholly reverse the input tax deduction (dependent on the value of supply under section 10(8)).
- Goods may be applied principally for taxable and partly for non-taxable purposes. In this situation period by period adjustments will usually be made over time. However, under the second proviso to section 21(1), a registered person may make a one-off adjustment of less than 100 percent if the relevant goods form part of the capital assets of a taxable activity and have a cost of less than $10,000 (GST inclusive).

Section 21(5)

A GST registered person or partnership may acquire goods after 1 October 1986 for a principal purpose other than making taxable supplies. No deduction will initially be available for such a supply. The person may be entitled to input tax deductions under section 21(5) if the goods are subsequently wholly or partly applied for taxable purposes. Again, the adjustments may be either a one-off 100 percent adjustment or less than 100 percent adjustments (usually period by period adjustments).

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from page 1

Also, under the second proviso to section 21(5), a GST registered person or partnership may make a one-off adjustment of less than 100 percent for capital assets which cost less than $10,000 (GST inclusive).

Subsequent supply

A registered person may subsequently supply the goods that have been subject to section 21 adjustments to another person. For example, the finance company mentioned above may sell or lease the computer to another company.

Under section 5(3) there is a deemed supply when a person ceases to be GST registered. Any goods and services forming part of the assets of a taxable activity previously carried on by that person are deemed to be supplied.

This item states the Commissioner's policy on the GST treatment of a subsequent supply.

Policy

The Commissioner considers that:

1. The subsequent supply ends the requirement to make any ongoing section 21(1) or section 21(5) adjustments for the goods, from the taxable period of the subsequent supply onwards.
2. The subsequent supply is not itself a subsequent application of those goods requiring further section 21(1) or 21(5) adjustments. The supply of a good is distinguished from how it is "subsequently applied" within those provisions. The Commissioner considers that goods can only be subsequently applied within a taxable activity, not when they are supplied to another person.
3. Under section 8(1), the test for determining the GST treatment of the subsequent supply is whether the supplier supplies the goods in the course or furtherance of a taxable activity.

This leads to the following four treatments:

- If the registered person claimed an input tax deduction but made a one-off, 100 percent adjustment under section 21(1) for a change to non-taxable use, the Commissioner accepts that the subsequent supply is not in the course or furtherance of the GST registered person's taxable activity. Accordingly, the subsequent supply is not subject to GST.
- If the registered person claimed an input tax deduction but makes less than 100 percent adjustments (period by period or one-off) under section 21(1), the Commissioner considers that the asset is a taxable activity asset, supplied in the course or furtherance of that taxable activity. The subsequent supply is subject to GST.
- In the reverse situation in which the registered person acquired goods for a non-taxable principal purpose, but made a one-off, 100 percent adjustment under section 21(5) for a change to taxable use, the Commissioner considers that the subsequent supply is in the course or furtherance of the GST registered person's taxable activity. The subsequent supply is subject to GST.
- If the registered person acquired goods for a non-taxable principal purpose but makes less than 100 percent adjustments (period-by-period or one-off) under section 21(5), the Commissioner considers the asset is not a taxable activity asset. It is supplied outside the course or furtherance of that taxable activity. The subsequent supply is not subject to GST.

The Commissioner's policy on such supplies is summarised in the flow chart on page 3.

Alternative view

The Commissioner notes that some tax practitioners hold another view. These practitioners have argued that the subsequent supply of a taxable activity asset, subject to section 21(1) adjustments for non-taxable use, should give rise to a one-off, "wash up" adjustment under section 21(1). After this adjustment, the asset should not be a taxable activity asset. Its supply should then not be subject to GST under section 8(1).

The Commissioner does not accept this approach. The Commissioner considers that such a wash up section 21(1) adjustment is not possible under the legislation.

Examples

Example 1

A GST registered company supplying both taxable and exempt services buys a car for the principal purpose of making taxable supplies. The car costs more than $10,000. During the first two taxable periods the company uses the car 90 percent for making taxable supplies and 10 percent for making exempt supplies. In the following two taxable periods the company uses the car 80 percent for making exempt supplies and 20 percent for making taxable supplies. The company sells the car at the end of the fourth taxable period.

GST treatment

The company acquired the car for the principal purpose of making taxable supplies, so a full input tax deduction is permitted in the taxable period in which the car was acquired. In all taxable periods in which the company applies the car for an exempt purpose, there is a deemed supply under section 21(1) to the extent of the exempt usage. Period-by-period adjustments are made.

When the car is sold there is a supply, and that supply is in the course or furtherance of a taxable activity. The supply is taxable and the company must charge GST on the sale.

Example 2

A GST registered sole trader buys a car for her private use. The car costs more than $10,000. In the first two taxable periods she uses the car 80 percent for private purposes and 20 percent in her taxable activity. In the following two taxable periods the trader uses the car 80 percent in her taxable activity and 20 percent for private purposes. The trader sells the car at the end of the fourth taxable period.

GST treatment

As the sole trader did not acquire the car for the principal purpose of making taxable supplies, no input tax deduction is allowed on acquisition. In each taxable period when she applies the car for the purpose of making taxable supplies, she will make period-by-period adjustments under section 21(5) to the extent the asset is applied for that purpose. The sale of the car is not subject to GST.

Example 3

A GST registered sole trader buys a car costing more than $10,000 solely for business purposes. After five taxable periods he decides that the car is not suitable for use in his business and thereafter he uses it solely for private purposes. After five years of private use the trader sells the car to trade up to a newer model.

GST treatment

The sole trader acquired the car for the principal purpose of making taxable supplies, so he will have been entitled to an input tax deduction. As he subsequently applied the car 100 percent for private purposes, he will be required in the sixth taxable period to make a one-off 100 percent adjustment under section 21(1). The subsequent sale of the car after five years will not be subject to GST.

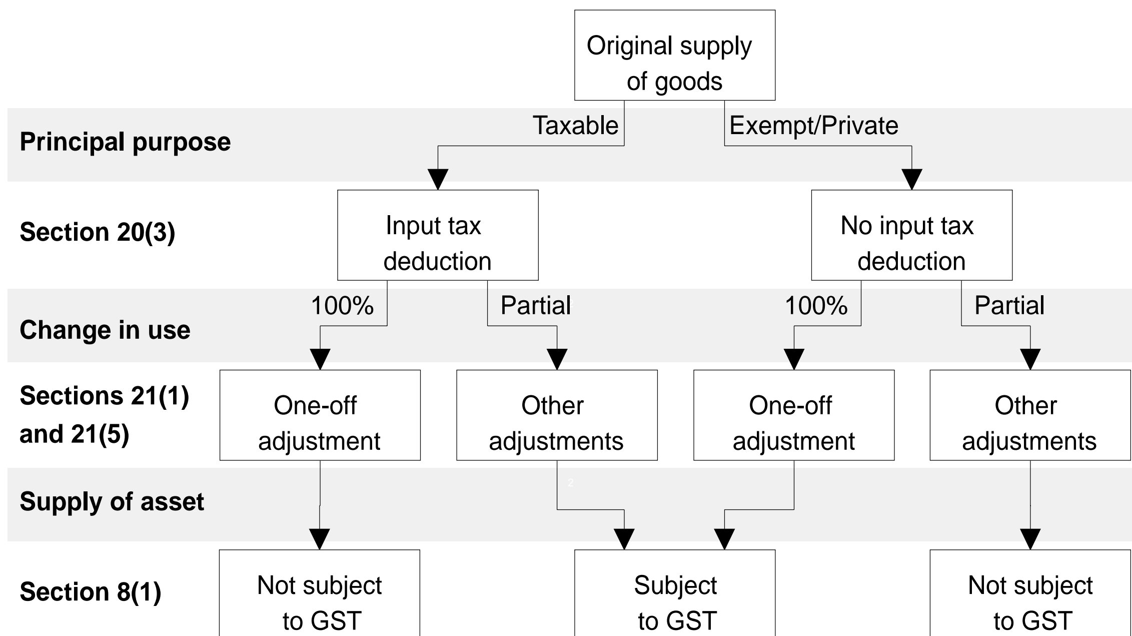
Example 4

XCo is a GST registered company. It buys a computer for $40,000 for the principal purpose of making taxable supplies. The computer is used 80 percent in XCo's taxable activity and 20 percent for exempt uses (providing financial services within section 3). After ten taxable periods, XCo's total annual value of taxable supplies falls below the GST registration threshold in section 51(1). XCo de-registers for GST purposes.

GST treatment

XCo acquired the computer for the principal purpose of making taxable supplies, so it will have been entitled to a GST input tax deduction. It will make period by period adjustments under section 21(1) to the extent of exempt usage. Upon de-registration, the computer is deemed to be supplied by XCo under section 5(3). This deemed supply is in the course or furtherance of a taxable activity. The deemed supply is subject to GST.

Summary flowchart - GST on supply of goods after a change in use



Allocation of imputation credits to dividends when company liquidated

Summary

This item sets out the rules in the income tax legislation on allocating imputation credits to dividends when a company is in liquidation.

Company law requires the liquidator to pay out all distributions before the company ceases to be incorporated on the New Zealand companies register. The company is still incorporated when the liquidator pays out the final dividend distributions, so it is still a New Zealand tax resident and an imputation credit account (ICA) company. Because the company is still an ICA company, the liquidator may attach imputation credits to the final dividend distributions of the company.

In addition, the liquidator must attach the imputation credits to the dividends so that they comply with two rules:

- The maximum imputation ratio rule: The imputation ratio of an imputation credit attached to any dividend must be less than or equal to the maximum imputation ratio of 33/67.
- The benchmark dividend imputation ratio rule: The imputation ratio of all dividends paid after the benchmark dividend must be the same as the imputation ratio of the benchmark dividend. The benchmark dividend is the first dividend paid after 1 April each year.

A company may vary the imputation ratio of a dividend paid after the benchmark dividend if the company files a ratio change declaration form.

All legislative references in this item are to the Income Tax Act 1994 unless otherwise indicated.

Background

When a liquidator is liquidating a solvent company, usually there will be distributions made to the shareholders. Liquidators and shareholders will need to know which distributions come within the definition of "dividends" and are therefore assessable income, and what imputation credits they can attach to the dividends. When a solvent company is being liquidated, it is likely that the liquidator will distribute some of the dividend types in section CF 2 (1) to the shareholders.

An imputation credit account is often referred to as an ICA.

When a company is being liquidated and a share of the company is redeemed or cancelled, certain amounts (set out in section CF 3 (1)(b)) are not included as dividends. The Income Tax Amendment Act 1994 made some changes to sections 4(1) and 4A(1) of the Income Tax Act 1976, (now sections CF 2 (1) and CF 3 (1)). In particular it inserted a new paragraph (c) into section 4A(1) of the Income Tax Act 1976 (now section CF 3 (1)(b)). These amendments took effect from 1 July 1994.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
CF 2 (1)	4(1)
CF 3 (1)	4A(1)
CF 3 (1)(b)	4A(1)(c)
CF 6 (1)	4B(1)
FZ 1	194
GD 3	97
GD 5	190
HF 1 (5)	199(6)
ME 1 (1),(2)	394B(1),(2)
ME 4 (1),(2)	394D(1),(2)
ME 5 (1)(a)	394E(1)(a)
ME 5 (2)(a)	394E(2)(a)
ME 6	394F(1)
ME 8 (1),(2),(3)	394G(1),(2),(3)
OB 1 - "Dividends"	394A(1)
OB 1 - "Imputation credit account company"	394A(1)
OB 1 - "Imputation ratio"	394A(1)
OB 1 - "Imputation year"	394A(1)

The definition of dividends for the Act includes the items listed under section CF 2 (1), but excludes the items listed under section CF 3 (1).

The definition of dividends for the imputation rules is the general definition of dividends used in the Act, apart from the following two exclusions.

Section OB 1 defines dividends for imputation purposes. It excludes these two types of dividends:

- a dividend paid on a specified preference share to which section FZ 1 applies
- an amount deemed to be a dividend under sections GD 3, GD 5, or the proviso to section HF 1 (5).

Section CF 6 (1) states:

> ... for the purposes of determining the amount of income derived by a person, but subject to section LB 1, the term "dividends" includes -
>
> (a) The amount of any imputation credit attached to the dividends; and
>
> (b) The amount of any dividend withholding payment credit attached to the dividends.

An "imputation credit account company" is defined in section OB 1 as a company that must maintain an ICA. Almost all New Zealand resident companies have to maintain an ICA, under section ME 1 (1) and (2). An "imputation year" is defined in section OB 1 as a period of 12 months from 1 April to the following 31 March.

Under section ME 4 (1), generally any amount of income tax paid by an ICA company during the imputation year is an imputation credit. Section ME 4 (2) says that these credits arise in the ICA on the date the relevant tax is paid.

When an ICA company pays a dividend (as defined in the imputation rules), section ME 6 allows the company to attach an imputation credit to that dividend. Section ME 5 (1)(a) requires a debit to be recorded in the ICA for the amount of the imputation credit attached to the dividend paid. Section ME 5 (2)(a) says that the debit arises on the date the company pays the dividend.

Allocation rules

The liquidator must attach the imputation credits so that they comply with the two allocation rules.

- **Maximum imputation ratio rule:** Under section ME 8 (1), the imputation credit attached to any dividend must be less than or equal to the maximum imputation ratio.

  The maximum imputation ratio is:

  $$\frac{\text{company tax rate}}{1 - \text{company tax rate}}$$

  The current ratio is: 33/67

- **Benchmark dividend imputation ratio rule:** Under section ME 8 (2), the imputation ratio of all dividends paid after the benchmark dividend in that imputation year must be the same as the ratio of the benchmark dividend.

  The benchmark dividend is the first dividend paid in an imputation year. So, the imputation ratio of the benchmark dividend is the imputation ratio of the first dividend paid on or after 1 April in each year.

The imputation ratio is defined in section OB 1 as:

$$\frac{\text{Imputation credit attached to the dividend}}{\text{Dividend paid (excluding the imputation credit)}}$$

Section ME 8 (2) also says that any benchmark dividend with an imputation ratio greater than the maximum imputation ratio is deemed to have the maximum imputation ratio.

Section ME 8 (3) states:

The **imputation ratio** of a **subsequent dividend may differ** from that of a benchmark dividend if-

(a) An officer of the company declares, in a **ratio change declaration** in the prescribed form, that the subsequent dividend is not being paid as part of an arrangement to obtain a tax advantage, and provides such further information as may be prescribed; and

(b) The ratio change declaration is **delivered** to the Commissioner **before the date of payment** of the **subsequent dividend**, or before such later date as the Commissioner may allow in any case or class of cases; and

(c) The subsequent dividend is not paid as part of an arrangement to obtain a tax advantage. (Emphasis added)

Application

The liquidator may attach imputation credits to all distributions that he or she makes.

Company law requires the liquidator to pay out all distributions before the company ceases to be incorporated on the New Zealand companies register. As the company is still incorporated when the liquidator pays out the final dividend distributions, for tax purposes the company is still a resident of New Zealand and an ICA company. As the company is still an ICA company the liquidator may attach imputation credits to the final dividend distributions of the company.

The liquidator will need to file a ratio change declaration if all of the following events occur in the process of winding up the company:

- The liquidator decides to pay a final dividend to the shareholders.
- The company has paid the benchmark dividend for that imputation year
- The imputation ratio of the distribution on winding up is different to the imputation ratio of the benchmark dividend.

Example

X Ltd has a 31 March balance date. X Ltd made losses in the 1991-92 and 1992-93 income years of $21,000 and $32,500 respectively. X Ltd has a credit balance in its ICA as at 1 April 1993 of $3,455. X Ltd has a nil liability for provisional tax for the 1993-94 income year.

On 15 May 1993 X Ltd pays a dividend of $6,000 and attaches maximum imputation credits of $2,955. (i.e. 33/67 x $6,000 = $2,955)

On 25 July 1993 X Ltd goes into liquidation.

On 3 October 1993 the liquidator pays a final dividend distribution to the shareholders of $7,800. There are imputation credits of $500 remaining in the ICA, which are insufficient for the company to meet the benchmark ratio rule. The liquidator files a ratio change declaration (IR 4R) before the date of payment of the final dividend. On the ratio change declaration the liquidator advises the following:

- The imputation ratio of the benchmark dividend is 33/67
- The imputation ratio of the final dividend is 500/7800.

The liquidator attaches the remaining imputation credits of $500. The allocation of imputation credits is recorded in X Ltd's ICA as follows:

Imputation Credit Account
for imputation year ended 31/3/94

15.05.93	allocation	2,955	01.04.93	balance b/fwd	3,455
03.10.93	allocation	500			
		$3,455			$3,455

Imputation returns when company liquidated

Summary

When a company incorporated in New Zealand is being liquidated, the liquidator must prepare and file the final imputation return.

This item sets out:

- the period covered by the final imputation return
- the date by which the final imputation return is to be filed
- the information that the final imputation return must contain.

Every company incorporated in New Zealand is resident in New Zealand for tax purposes. Every company that is resident in New Zealand (with some exceptions, as set out in section ME 1 (2)) must keep an imputation credit account (ICA) and file an imputation return up to the date it is removed from the New Zealand companies register.

When a company ceases to be an ICA company, it must file an imputation return to the last day on which it is an ICA company. This return must be filed within two calendar months from the date the company ceased to be an ICA company, and it must cover the period the company is an ICA company. It has to contain the same type of information as an annual imputation return.

The annual imputation return must show the opening and closing balances of the ICA, a summary of all the debits and credits to the account, and declarations on these subjects, if they have changed by more than 20% from the equivalent ratio in the previous year:

- the imputation ratio of all dividends paid in the imputation year
- the imputation ratio of all debits to all credits in the imputation year

All legislative references in this item are to the Income Tax Act 1994 unless otherwise indicated. The Tax Administration Act 1994 is abbreviated to TAA.

Background

The Companies Acts 1955 and 1993 govern the incorporation and termination of companies in New Zealand.

"Company" is defined in section 2(1) of the Companies Act 1993 as:

(a) A company registered under Part II of this Act.

(b) A company registered under this Act in accordance with the Companies Reregistration Act 1993.

A certificate of incorporation issued under section 13 of the Companies Act 1993 is evidence that a company is incorporated under that Act.

After a company (as defined in the Companies Act 1955 or 1993) has been liquidated, it ceases to exist for company law purposes when it is removed from the register of companies incorporated in New Zealand.

The removal of a company from the New Zealand companies register does not affect the liability of any former director, shareholder or any other person for any act or omission that took place before the company was removed. This liability continues and may be enforced as if the company had not been removed from the register.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
ME 1 (1),(2)	394B(1),(2)
OB 1 - "Company"	2
OB 1 - "Imputation credit account company"	394A(1)
OE 2 (1)	241(6)
Tax Admin. Act 1994	**Income Tax Act 1976**
69(1),(2),(3)	394J(1),(2),(3)
70(2)	394K(2)
70(4)(b)	394K(3)(b)

Section OB 1 states that an imputation credit account company is a company that is required by section ME 1 to maintain an imputation credit account.

Section ME 1 (1) says that every company (as defined in the Income Tax Act) that is resident in New Zealand must establish and maintain an imputation credit account, unless it is prohibited from maintaining one under section ME 1 (2).

"Company" is defined in section OB 1 to mean:

... any body corporate or other entity which has a legal personality or existence distinct from those of its members, whether that body corporate or other entity is incorporated or created in New Zealand or elsewhere: ... .

Section OE 2 (1) states:

A company is **resident in New Zealand** within the meaning of this Act if -

(a) It is **incorporated in New Zealand**; or

(b) It has its head office in New Zealand; or

(c) It has its centre of management in New Zealand; or

(d) Control of the company by its directors, acting in their capacity as directors, is exercised in New Zealand, whether or not decision making by directors is confined to New Zealand. (Emphasis added)

Imputation returns to date of ceasing to be an ICA company

When a company ceases to be an ICA company during any imputation year, it must file an imputation return

for the period from 1 April to the last day on which the company is an ICA company. This return must be filed within two calendar months from the last day the company is an ICA company. These requirements are contained in section 70(2) of the TAA.

Section 70(4)(b) of the TAA says that this imputation return must contain the same type of information as an annual imputation return (described in section 69 of the TAA), except that the information must relate to the period of this return, rather than to the imputation year.

Contents of the annual imputation return

Under section 69(1) of the TAA, the annual imputation return must contain a summary of the entries in the imputation credit account. That is:

- the opening and closing balances for the imputation year
- the source and amount of all debits and credits that have arisen during the imputation year
- the amount of any further income tax payable for the imputation year
- the amount of any imputation penalty tax payable for that imputation year.

When a company is also a branch equivalent tax account company or a policyholder credit account company, further opening and closing balances and credits and debits must be shown in the imputation return, in accordance with section 69(1)(e) and (f) of the TAA.

Sections 69(2) and (3) of the TAA state that when either of the following ratios have increased or decreased by more than 20% from the equivalent ratio for the previous imputation year, the company must disclose this in the annual imputation return and explain why the ratio(s) have changed:

- the imputation ratio of all dividends paid in the imputation year
- the imputation ratio of all debits to all credits in the imputation year.

The imputation ratio of all dividends paid in the imputation year is:

$$\frac{a}{b}$$

In this formula:

a is the total amount of imputation credits and dividend withholding payment credits attached to all dividends paid by the company during the imputation year.

b is the total amount of all dividends paid by the company during the imputation year (excluding the imputation credit).

The imputation ratio of all debits to all credits in the imputation year is:

$$\frac{c}{d}$$

In this formula:

c is the aggregate amount of all debits arising in the company's ICA during the imputation year.

d is the aggregate amount of all credits arising in the company's ICA during the imputation year.

Application

A company that is incorporated in New Zealand is an ICA company, and must maintain an imputation credit account.

When a company ceases to exist under company law, it will no longer be a company which is resident in New Zealand for income tax purposes.

When a company ceases to be a company which is resident in New Zealand, it also ceases to be an ICA company.

When a company ceases to be an ICA company, its ICA is adjusted to bring the balance to nil.

Example 1

Y Ltd goes into liquidation. Y Ltd is removed from the New Zealand companies register, and ceases to be an ICA company on 25 June 1993. Y Ltd must file an imputation return for the period 1 April 1993 to 25 June 1993. This final imputation return must be filed with Inland Revenue by 25 August 1993.

Example 2

Z Ltd goes into liquidation on 4 February 1994. Z Ltd is still in the process of liquidation on 31 March 1994. The liquidator completes and files the final accounts of Z Ltd, and the company is struck off the companies register on 20 May 1994.

The liquidator must file an annual imputation return for the imputation year ended 31 March 1994, and an imputation return for the period 1 April 1994 to 20 May 1994.

Transferring credit DWPA balance to ICA when company liquidated

Summary

This item explains how section MG 11 (1) of the Income Tax Act 1994 applies. When a New Zealand company is liquidated under the Companies Act 1955 or 1993, section MG 11 (1) allows the company to transfer all or any part of a credit balance in its dividend withholding payment account (DWPA) to its imputation credit account (ICA).

If a credit balance remains in the DWPA immediately before the company being liquidated ceases to be incorporated, the liquidator must record a debit in the account equal to that credit balance to bring the account to nil. This means any credit DWPA balance is lost.

However, when a liquidator is liquidating a New Zealand company under the Companies Act 1955 or 1993, and the company has a credit balance in its DWPA, immediately before a debit arises in the account to bring it to nil, the liquidator may elect to transfer all or any part of that credit balance to the company's ICA.

The liquidator may do this for either or both of two reasons:

- to clear or reduce a debit balance in the ICA, and thereby lessen or eliminate the company's liability for further income tax on a debit balance in the ICA
- to increase the credit balance in the ICA, and so increase the maximum level the Commissioner is able to refund for income tax purposes when the company is due for an income tax refund.

All legislative references in this item are to the Income Tax Act 1994 unless otherwise indicated. All references to the words "company", "liquidator", "liquidated", or "liquidating" are to the Companies Act 1955 or 1993.

Background

A company may elect to transfer all or any part of a credit balance in its DWPA to its ICA in either of these situations:

- when it elects to cease being a DWPA company
- when it ceases to be resident in New Zealand.

When a liquidator is liquidating a company, and the company ceases to exist (i.e., it is removed from the New Zealand companies register), then the company ceases to be resident in New Zealand.

When a company is being liquidated, the liquidator may clear any credits in the DWPA by attaching them to any dividends that the company is able to pay, or by transferring them to the ICA. If a credit balance remains in the DWPA immediately before the company ceases to be incorporated, these credits are lost.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
MD 2 (2)	394M(2)
ME 9 (3)	394L(3)
MG 5 (1),(2)	394ZW(1),(2)
MG 11 (1),(2)	394ZZE(1),(2)

Section MG 11 (1) states:

A company that has a credit balance in its dividend withholding payment account -

(a) At the end of any imputation year; or

(b) Immediately before the arising of the debit referred to in section MG 5 (1)(j), where the company ceases to be resident in New Zealand -

may elect that all or any part of that credit balance shall be a credit to the company's imputation credit account and a debit to its dividend withholding payment account for the imputation year in which the credit balance occurred.

Section MG 11 (2) states:

A company shall make an election under this section by recording the amount in respect of which it makes the election -

(a) As a debit in the company's dividend withholding payment account; and

(b) As a credit in its imputation credit account.

Section MG 5 (1) states:

There shall arise as debits to be recorded in a company's dividend withholding payment account for any imputation year the following amounts:

...

(c) Any amount forming all or part of an end of year credit balance in the account that the company elects in accordance with section MG 11 to be a credit to the company's imputation credit account:

...

(j) The amount of the credit balance, if any, of the dividend withholding payment account where, during the imputation year, the company ceases to be a dividend withholding payment account company.

Section MG 5 (2) states:

The debits referred to in subsection (1) shall arise -

...

(c) In the case of a debit referred to in paragraph (c) of that subsection, at the end of the imputation year in which there was the credit balance:

...

(h) In the case of a debit referred to in paragraph (j) of that subsection, immediately before the company ceases to be a dividend withholding payment account company.

Section ME 9 (3) states:

Where there is a debit balance in a company's imputation credit account immediately before the company ceases to be an imputation credit account company, then the company is liable to pay to the Commissioner an amount of tax by way of further income tax of an amount equal to that debit balance.

Section MD 2 (2) states:

Where a company that has ceased to be an imputation credit account company becomes entitled to a refund of income tax in accordance with section MD 1 in respect of any income year during which it was an imputation credit account company, the refund to be paid to the company shall not exceed the credit balance (if any) of the company's imputation credit account that arose as a debit under section ME 5 (1)(k) immediately before the company ceased to be an imputation credit account company.

Application

A company maintaining DWPA, including a company in the process of being liquidated, that pays out a dividend may attach a DWP credit to that dividend.

When a New Zealand company that maintains a DWPA is being liquidated, and has a credit balance remaining immediately before it ceases to be incorporated in New Zealand, the liquidator must record a debit in the company's DWPA equal to the amount of the credit balance. The liquidator must record the debit as arising immediately before the company ceases to be incorporated. Effectively, the credit balance in the DWPA is lost.

If a New Zealand company that is being liquidated has a credit balance in its DWPA, immediately before a debit arises in the account to bring it to nil, the liquidator may elect to transfer all or any part of that credit balance to the company's ICA. Two reasons why a liquidator may elect to transfer all or part of this credit balance are:

- To clear or reduce a debit balance in the ICA, and thereby lessen or eliminate the company's liability for further income tax on a debit balance in the ICA.

  A company that is being liquidated may have a credit balance in its DWPA and a debit balance in its ICA. If the liquidator does not wish to incur further income tax, he or she must clear the debit balance in the ICA before the date the company ceases. The liquidator may clear or reduce the debit balance in the ICA by transferring all or any part of the credit balance from the DWPA.

- If the company is due for an income tax refund, to increase the credit balance in the ICA so as to increase the maximum level the Commissioner is able to refund.

  The Commissioner is not able to refund an amount which exceeds the credit balance in the ICA.

  When there is a debit in the ICA or a credit balance less than the amount of the income tax refund which is due, the liquidator may transfer all or part of the credit balance in the DWPA to the ICA. This may reduce the debit balance, and/or increase the credit balance, and so increase the maximum level of income tax which the Commissioner is able to refund.

Example 1

Reddy Spray Limited is a New Zealand company that is in the process of being liquidated. The liquidator determines that the company is due for an income tax refund of $4,500. Reddy Spray Limited has a credit balance in its DWPA of $6,000 and a debit balance in its ICA of $2,000. The liquidator transfers all of the $6,000 credit balance from the DWPA to the ICA. This brings the DWPA to nil, and creates a credit balance in the ICA of $4,000. Reddy Spray Limited is not liable for any further income tax on its ICA as it is not in debit. The Commissioner is able to refund income tax of $4,000 as this is the credit balance in the ICA immediately before the company ceases to be incorporated.

Example 2

Penny's Fashion Limited, incorporated in New Zealand, is being liquidated. The liquidator has paid all creditors. Its DWPA has a credit balance of $3,812.68, and its ICA has a debit balance of $950.

The liquidator pays out a final dividend of $5,000 and attaches the maximum DWP credits of $2,462.68. The liquidator transfers the excess DWP credits of $1,350 to the ICA. This clears the debit balance in the ICA and creates a credit balance of $400. Section MG 5 (1)(j) requires the liquidator to record a debit in the ICA, as arising immediately before the company ceases to be incorporated, equal to this credit balance so as to bring the account to nil. That is, the company loses the imputation credits of $400.

Further income tax, imputation penalty tax, and additional tax when company liquidated

Summary

This item sets out the circumstances in which a company in the process of liquidation is liable to the following taxes:

- **Further income tax** - the amount of tax a company must pay to bring its imputation credit account (ICA) to nil at 31 March, i.e. to clear the account
- **Imputation penalty tax** - a penalty for having a debit balance in the ICA on 31 March
- **Additional tax** - a penalty for not paying tax (including further income tax and imputation penalty tax) by the due date.

A company is liable for further income tax under section ME 9 (1) if it meets both of these conditions on 31 March:

- It has a debit balance in its ICA.
- The liquidator is *in the process* of liquidating the company (i.e. the liquidator has not completed his or her liquidation duties and the company has not been removed from the companies register).

The company is also liable for imputation penalty tax, because this further income tax arose on a debit ICA balance at 31 March. The imputation penalty tax is 10% on this further income tax.

A company that is being liquidated ceases to be an ICA company when the Registrar removes it from the New Zealand companies register.

When the liquidator has completed his or her liquidation duties and the company has a debit balance in its ICA *immediately before* it is removed from the New Zealand companies register, it is liable for further income tax under section ME 9 (3). The company is *not* liable for imputation penalty tax on this further income tax. This is because this further income tax arose on a debit balance in the ICA immediately before the company was removed from the New Zealand companies register.

A company liable for further income tax or imputation penalty tax that fails to pay the tax by the due date is liable for additional tax. Additional tax is 10% of the amount in default. When any tax in default, or additional tax, remains unpaid after a six-month period, the company is liable for another amount of additional tax of 10% of the unpaid amount.

All legislative references in this item are to the Income Tax Act 1994 unless otherwise indicated. Legislative references to the Tax Administration Act 1994 are indicated as TAA.

Background

To determine when a company ceases to be an ICA company, it is necessary to know what an ICA company is. An ICA company is a company that must keep an ICA. Every company (as defined for income tax purposes) that is resident in New Zealand has to establish and maintain an ICA. The company must meet these two criteria:

- It is a company as defined in section OB 1.
- It is “Resident in New Zealand” as defined in section OE 2 (1).

For income tax purposes, “company” generally means any body corporate or other entity which has a legal personality or existence distinct from those of its members. The definition of company in income tax law is broader than that in the Companies Acts 1955 and 1993.

A company is “resident in New Zealand” if it meets any of these criteria:

- It is incorporated in New Zealand.
- Its head office is in New Zealand.
- It has its centre of management in New Zealand.
- The directors exercise control of the company in New Zealand.

A company only ceases to be resident in New Zealand when it no longer meets any of these criteria.

There are situations when a company may cease to be incorporated in New Zealand (i.e. cease to meet the first criterion), but continue to be resident in New Zealand. For example:

- A company is an amalgamating company.
- A company transfers its company registration to a foreign country, but continues to be controlled from New Zealand.
- A company ceases to be incorporated, but continues to trade in and be controlled from New Zealand as a trust (i.e. a separate legal entity).

When a company is liquidated it will cease to be a company as defined for income tax purposes, and will cease to meet all four of the residence criteria. So, when a company is liquidated it ceases to be an ICA company.

After the liquidator has completed the liquidation duties, he or she will file the final report and statement of realisation and distribution in accordance with section 257 of the Companies Act 1993. The liquidator will then apply to have the company removed from the New Zealand companies register. A company ceases to be an ICA company when the Registrar removes it from the New Zealand companies register.

When a company is being liquidated, it is the liquidator's duty to pay any outstanding tax liabilities of the company, including any further income tax, imputation penalty tax, and additional tax.

Under the Companies Act 1993, the liquidator has control of the assets and affairs as follows:

Section 248(1)(a) of the Companies Act 1993 states:

With effect from the commencement of the liquidation of a company, -

(a) The liquidator has custody and control of the company's assets:

Section 253(a) of the Companies Act 1993 states:

... the principal duty of a liquidator of a company is -

(a) To take possession of, protect, realise, and distribute the assets, or the proceeds of the realisation of the assets, of the company to its creditors in accordance with this Act: and

(b) ...

in a reasonable and efficient manner.

During the period a company is being liquidated, the liquidator is required to do all of the following:

- determine the company's final tax liability up to the date of liquidation
- file the final income tax return(s)
- pay any tax currently outstanding
- pay any additional tax arising during the liquidation period.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
ME 1 (1)	394B(1)
ME 9 (1)-(4)	394L(1)-(4)
OB 1 - "company"	2
OB 1 - "imputation credit account company"	394A(1)

Tax Administration Act 1994	Income Tax Act 1976
148	394L(6)
149	394N(4)
153(1)-(3)	394N(1)-(3)

Section OB 1 states:

"Imputation credit account company" means a company that is required by section ME 1 to maintain an imputation credit account:

Section ME 1 (1) states:

Except as provided in subsection (2), every company that is resident in New Zealand shall establish and maintain an imputation credit account for each imputation year.

The definition of "company" in section OB 1 is:

"Company" -

(a) Means any body corporate or other entity which has a legal personality or existence distinct from those of its members, ..."

Section OE 2 (1) states:

A company is resident in New Zealand within the meaning of this Act if -

(a) It is incorporated in New Zealand; or

(b) It has its head office in New Zealand; or

(c) It has its centre of management in New Zealand; or

(d) Control of the company by its directors, acting in their capacity as directors, is exercised in New Zealand, whether or not decision making by directors is confined to New Zealand.

Section ME 9 (1) - (4) states:

(1) Where there is a debit balance in a company's imputation credit account at the end of any imputation year, and the company is not a company that is liable to pay further income tax under subsection (3), then the company is liable to pay to the Commissioner an amount of tax by way of further income tax of an amount equal to that debit balance.

(2) A company shall pay any further income tax for which it is liable under subsection (1) not later than the 20 June following the end of the imputation year for which there was the debit balance.

(3) Where there is a debit balance in a company's imputation credit account immediately before the company ceases to be an imputation credit account company, then the company is liable to pay to the Commissioner an amount of tax by way of further income tax of an amount equal to that debit balance.

(4) A company shall pay any further income tax to which it is liable under subsection (3) not later than the last day on which it is still an imputation credit account company.

In relation to additional tax, section 148 of the TAA states:

Where a company liable to pay further income tax under section ME 9 of the Income Tax Act 1994 fails to pay the tax within the time for payment ..., the company is liable for a penalty by way of additional tax equal to -

(a) 10% of the amount in respect of which default has been made (in this subsection referred to as the "amount in default"); and

(b) 10% of so much of the amount in default and the amount of any penalty added in accordance with paragraph (a) as remains unpaid at the end of the day on which there expires the period of 6 months immediately following the day on which the failure to pay occurred; and

(c) 10% of so much of -

(i) The amount in default; and

(ii) The amount of any penalty added in accordance with paragraph (a) or paragraph (b); and

(iii)The amount of any penalty previously added in accordance with this paragraph,-

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as remains unpaid at the expiry of any of the periods of 6 months that, consecutively, succeed the 6-month period referred to in paragraph (b);-

...

Section 153 of the TAA states:

(1) Every company that is liable to pay further income tax under section ME 9 (1) of the Income Tax Act 1994 in respect of an end of year debit balance is also liable to pay a special tax by way of an income tax known as imputation penalty tax.

(2) The amount of the imputation penalty tax payable by a company shall be 10% of the amount of further income tax that gives rise to the liability for the imputation penalty tax.

(3) A company that is liable to pay imputation penalty tax shall pay the tax not later than the 20 June that follows the end of the imputation year in which occurred the end of year debit balance giving rise to the liability for the further income tax and the imputation penalty tax.

In relation to additional tax, section 149 of the TAA states:

Where a company that is liable to pay imputation penalty tax fails to pay the tax on or before the relevant 20 June, the company is liable for a penalty by way of additional tax equal to -

(a) 10% of the amount of imputation penalty tax in respect of which default has been made (in this subsection referred to as the "tax in default"); and

(b) 10% of so much of -

(i) The tax in default; and

(ii) The amount of any penalty added in accordance with paragraph (a), -

as remains unpaid at the end of the day on which there expires the period of 6 months immediately following the day on which the failure to pay occurred; and

(c) 10% of so much of -

(i) The tax in default; and

(ii) The amount of any penalty added in accordance with paragraph (a) or paragraph (b); and

(iii)The amount of any penalty previously added in accordance with this paragraph,-

as remains unpaid at the expiry of any of the periods of 6 months that, consecutively, succeed the 6-month period referred to in paragraph (b);-

...

Application

Further income tax

A company may be liable for further income tax under either section ME 9 (1) or section ME 9 (3).

If both of these conditions apply on 31 March, a company will be liable for further income tax under section ME 9 (1):

- The company has a debit balance in its imputation credit account (ICA).
- The liquidator is *in the process* of liquidating the company (i.e., the liquidator has not completed his or her liquidation duties and the company has not been removed from the New Zealand companies register),

The amount of the further income tax equals the amount of the debit balance in the ICA. Under section ME 9 (2), this further income tax is due on 20 June following the end of the imputation year (31 March) which has a debit balance.

A company that is being liquidated ceases to be an ICA company when the Registrar removes it from the New Zealand companies register. When the liquidator has completed his or her liquidation duties and the company has a debit balance in its ICA immediately before it is removed from the New Zealand companies register, it is liable for further income tax under section ME 9 (3). The amount of the further income tax equals the amount of the debit balance in the ICA. Under section ME 9 (4), this further income tax is due on the last day that the company is still an ICA company.

Imputation penalty tax

Under section 153(1) of the TAA, a company is liable for imputation penalty tax when it is liable for further income tax under section ME 9 (1). If a company that is being liquidated meets both of these conditions, it is liable for imputation penalty tax:

- It is in the process of being liquidated (but the liquidator has not completed his or her liquidation duties and the company has not been removed from the New Zealand companies register).
- It has a debit balance in its ICA on 31 March.

Under section 153(2) of the TAA, the amount of the imputation penalty tax is 10% of the amount of further income tax. Under section 153(3) of the TAA, the imputation penalty tax is due by 20 June following the end of the imputation year (31 March) in which the debit balance arose in the ICA.

If the liquidator does not want to incur imputation penalty tax, he or she can make a payment of income tax equal to the amount of the debit balance in the ICA before the end of that imputation year (i.e., 31 March).

A company is *not* liable for imputation penalty tax when it is liable for further income tax under section ME 9 (3). In other words, when a company is being liquidated and it is liable for further income tax under section ME 9 (3) (because it had a debit balance in its ICA immediately before it was removed from the New Zealand companies register), it is not liable for imputation penalty tax.

Additional tax

When a company that is liable to pay further income tax (under section ME 9 (1) or (3)) fails to pay the tax within the time it is due, it is liable for additional tax, under section 148 of the TAA.

When a company that is liable to pay imputation penalty tax (under section 153(1) of the TAA) fails to pay the tax within the time it is due, it is liable for additional tax, under section 149 of the TAA.

Under sections 148 and 149 of the TAA, the amount of the additional tax, in both cases, is 10% of the amount of any unpaid further income tax or imputation penalty tax. Additional tax is added at the end of every six-month period in the same manner on any unpaid further income tax, imputation penalty tax, or additional tax.

Timing of income tax payments

If there is any remaining income tax to pay (including further income tax), to enable the imputation credits resulting from the payment of this tax to be attached to the final distribution, this tax must be paid before both of these dates:

- the date of any distributions are made to the shareholders
- the date the company ceases to be an ICA company.

When any tax is paid after a distribution is made to shareholders which could have had an imputation credit attached, the liquidator cannot retrospectively attach any credits arising in the ICA to that distribution.

Example 1

On 20 February 1994 a liquidator starts liquidating ABC Ltd. On 31 March 1994 the company is still in the process of being liquidated (i.e. the liquidator has not completed his liquidation duties and the company has not been removed from the register).

On 31 March 1994 ABC Ltd has a debit balance in its ICA of $5,800. ABC Ltd is liable to pay the following amounts:

Tax due	$	Due date
Further income tax	5,800	20/6/94
Imputation penalty tax	580	20/6/94
Additional tax (if the further income tax and imputation penalty tax are not paid by the due date of 20/6/94)	638	
Additional tax (if the further income tax, imputation penalty tax, and additional tax are not paid by 20/12/94)	702	

ABC Ltd is liable for further income tax under section ME 9 (1) for both of these reasons:

- It has a debit balance in its ICA on 31 March.
- Section ME 9 (3) does not apply.

ABC Ltd is liable for imputation penalty tax because it is liable for further income tax under section ME 9 (1).

The liquidator completes his duties, files the final report and statement of realisation and distribution, and applies to have ABC Ltd removed from the companies register. The Registrar removes ABC Ltd from the companies register on 5 July 1994 (i.e. ABC Ltd ceases to be an ICA company on that date). Immediately before ABC Ltd was removed from the register it had a debit balance in its ICA of $3,500.

ABC Ltd is liable to pay:

Tax due	$	Due date
Further income tax	3,500	5/7/94
Additional tax (if the further income tax is not paid by the due date of 5/7/94)	350	
Additional tax (if the further income tax and additional tax are not paid by 5/1/95)	385	

ABC Ltd is liable for further income tax because it has a debit balance in its ICA immediately before it ceases to be an ICA company. ABC Ltd is not liable for imputation penalty tax because it is liable for the further income tax under section ME 9 (3), not section ME 9 (1).

Example 2

DEF Ltd is being liquidated. The Registrar removes the company from the register on 31 March 1995 (i.e. the company ceases to be an ICA company on that date). Immediately before 31 March 1995 the company has a debit balance in its ICA of $6,200. DEF Ltd is liable to pay the following amounts:

Tax due	$	Due date
Further income tax	6,200	31/3/95
Additional tax (if the further income tax is not paid by the due date of 31/3/95)	620	
Additional tax (if the further income tax and additional tax are not paid by 30/9/95)	682	

DEF Ltd ceased to be an ICA company at the end of the imputation year (i.e. 31 March), but is not liable for further income tax under section ME 9 (1). DEF Ltd is liable for further income tax under to section ME 9 (3) because it had a debit in its ICA immediately before it ceased to be an ICA company. DEF Ltd is not liable for imputation penalty tax because it is liable for further income tax under section ME 9 (3), not section ME 9 (1).

Resident withholding tax and certain back-to-back loans

Summary

The Tax Simplification Consultative Committee recommended that resident withholding tax exemption certificates be available on a limited basis for back-to-back loans. After carefully considering the Committee's recommendation, the Government, on Inland Revenue advice, has decided not to amend the legislation to allow such certificates. This item sets out the reasons for the decision.

The legislation currently contains remedies to prevent cash-flow difficulties arising from certain back-to-back loan situations. This item also discusses the application of those provisions.

All legislative references in this item are to the Income Tax Act 1976 unless otherwise stated. The following table gives the equivalent sections in the Income Tax Act 1994.

Cross-reference table

Income Tax Act 1976	Income Tax Act 1994
327C	NF 2
327M	NF 9

Background

In its final report of September 1990, the Tax Simplification Consultative Committee recommended that resident withholding tax (RWT) exemption certificates (CoEs) be available on a limited basis for back-to-back loans.

The Committee was addressing the following type of situation:

A taxpayer may borrow funds from a financial institution to on-lend to his or her business or another related entity. A common example is when an individual shareholder borrows funds to on-lend to his or her company, intending a small or nil margin on the interest rate. The shareholder may borrow funds because the financial institution prefers to lend to the individual for reasons of credit risk. For example, the financial institution might take a security over the individual's private assets.

In this type of back-to-back loan situation, the RWT legislation may create a cash-flow disadvantage for the shareholder or other person borrowing from the financial institution. The following example illustrates this:

Example 1

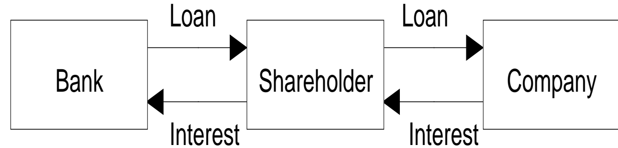
Bank is a registered bank that holds a CoE under section 327M(1)(a). Shareholder is the majority shareholder and proprietor of a business run through a company with $100 share capital (Company).

Shareholder arranges a $500,000 loan for Company, with a mortgage over his house as security for Bank. Bank specifies that it will only lend to Shareholder personally, not to Company.

Interest of $50,000 is payable by Shareholder to Bank each year on 31 March, Company's and Shareholder's balance date for income tax purposes.

Shareholder enters into a back-to-back loan arrangement with Company on identical terms. Neither Shareholder nor Company holds a CoE.

The arrangement can be expressed as follows:



The legislation requires Company to deduct $12,000 of RWT (at the 24 percent rate). Company will pay Shareholder $38,000 (i.e. $50,000 less $12,000). Shareholder does not have to deduct RWT from interest paid to Bank because Bank holds a CoE. However, shareholder must pay Bank interest of $50,000 and will, therefore, have a cash-flow disadvantage of $12,000.

The RWT deduction of $12,000 will give rise to a tax credit for Shareholder that he can apply (successively) against income tax for the present, past, or future income years, or claim a credit from Inland Revenue for the excess (under section 327K(2)).

The RWT rules can apply in this manner because they treat the three parties in the above example as follows:

Shareholder

The shareholder or other borrower from the financial institution will not typically hold a CoE (unless he or she is in a tax loss position).

Section 327M sets out the categories of CoE holders. Very broadly, they are limited to persons whose main activity is borrowing and lending money, taxpayers with income of more than $2 million, and certain non-profit organisations. TIB Volume Six, No.8 (January 1995) at page 11 lists the persons who may apply for CoEs.

Also exempted under section 327M(12)(a) and (b) are persons with tax losses and persons with $500 or more of excess RWT credits. Section 327M(12)(b) was enacted specifically to deal with back-to-back loans and is discussed later in this item.

Broadly, section 327M(12)(a) allows a CoE to a lender if the lender will or is likely to incur a loss, or will or is likely to be entitled to claim aggregate deductions under the Act of not less than the aggregate of any assessable income derived by that person.

Company or ultimate borrower

Sections 327C(4) and (5) require the company or other ultimate borrower, if resident, to deduct RWT from its interest payments to the shareholder or other lender. The only practical exception under subsection (5) is if it has not made interest payments of $5,000 or more in the immediately preceding year.

Bank

The shareholder or other lender will not typically have to deduct RWT from interest payments to the financial institution because of section 327M(1). As the taxpayer will receive its interest payments net of RWT, it may not be able to meet its interest obligations to the financial institution from those payments.

Government decision

The Government has carefully considered the Committee's recommendation and, on Inland Revenue advice, has decided that the legislation should not be amended to allow limited CoEs for back-to-back loans.

The reasons for this decision include the following:

- Section 327M(12)(b) prevents these consequences in certain cases (discussed under "Section 327M(12)(b)" opposite).
- During the development stages of the RWT rules, financial institutions made it clear that they did not want CoEs that applied to some accounts and not to others. They did not want CoEs that were only valid to a particular date, except for those issued under section 327M(12).
- If the legislation allowed CoEs for certain lenders of back-to-back loans, those taxpayers could use them for all their bank accounts. For example, the shareholder in Example 1 could use the CoE to avoid RWT on interest on his personal bank term investments. This would compromise the RWT rules and provide opportunities for tax evasion.
- Any "excess" RWT credits that arise for the shareholder or other lender will affect it, if it is a provisional taxpayer, less after the first income year of the back-to-back loan. After the first year, provisional taxpayers' excess RWT credits will be reflected in a lower residual income tax liability for subsequent years. Similarly, a lender that is a PAYE or other taxpayer can apply to Inland Revenue for a special tax code for his or her other income.

Section 327M(12)(b)

The Government specifically inserted section 327M(12)(b) into the RWT legislation to solve the cash-flow problems for certain back-to-back loans.

In summary, section 327M(12)(b) gives the Commissioner the discretion to issue a CoE for a period specified in the certificate in the following circumstances. The Commissioner can issue such a certificate to a lender if the lender would be (or be likely to be) entitled to claim aggregate RWT credits exceeding his or her income tax liability for any year during the validity of the CoE by $500 or more, but for the application of the section.

Section 327M(12) requires a person seeking a CoE to give all of the following to Inland Revenue:

- an application on Inland Revenue form IR15E
- a set of budgeted accounts detailing the person's projected income, deductions, RWT credits, and income tax liability for the proposed period of validity of the CoE
- such further information about the person or the budgeted accounts as the Commissioner may require.

Example 2

Under Example 1 above, Shareholder was to receive annual interest income of $38,000 with a RWT credit of $12,000. Assume also that he was, or was likely, to have a total income tax liability of $11,410 (from say salary from Company of $42,875) in the 1994/1995 income year.

In this situation Shareholder's income tax liability for the income year would be:

From back-to-back loans:	nil
From salary:	$11,410
Total:	$11,410
RWT credits:	$12,000
Excess credits:	$ 590

The excess of RWT credits over income tax liability is more than $500, so shareholder could apply for a CoE under section 327M(12)(b).

Adverse events scheme - interest rate increased

The interest rate paid on deposits in the adverse events income equalisation scheme has been increased to 6.5%. The increase is effective from 21 April 1995. The rate was previously 4.7%.

Under the scheme, farmers forced to sell livestock because of an adverse event can deposit assessable income arising from these stock sales into the adverse event scheme. These deposits will not be taxable until the year in which they are withdrawn. Interest is paid on the deposit for as long as it remains in the scheme.

The new interest rate is set by the Income Tax (Adverse Event Income Equalisation Scheme Rate of Interest) Regulations 1995.

Depreciation - Static Delimbers (timber industry)

The Commissioner has issued Determination DEP 9: Tax Depreciation Rates General Determination 9, which applies to static delimbers. It is reproduced below.

Determination DEP 9: Tax Depreciation Rates General Determination Number 9

This determination may be cited as "Determination DEP 9: Tax Depreciation Rates General Determination Number 9".

1. Application

This determination shall apply for the 1994/95 and subsequent income years to the industry category listed below.

2. Determination

Pursuant to section EG 4 of the Income Tax Act 1994 I have amended the general basic economic depreciation in Determination DEP 1 (as previously amended by DEP 2 to DEP 8):

Determination DEP 1 is further amended by inserting the industry category "Delimber, Static" into the "Timber and Joinery Industries" industry category with the following details:

Estimated Useful Life (years)	5
DV Banded Depn Rate (%)	33
SL Equiv Banded Depn Rate (%)	24

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 1994.

This determination is signed by me on the 22nd day of March 1995.

Virginia Flaus
Manager (Rulings - Tax Policy)
Head Office
Inland Revenue Department

Tax Administration (Form of Warrant) Regulations 1995

The Governor General recently signed an Order in Council making the Tax Administration (Form of Warrant) Regulations 1995.

These regulations prescribe the form of warrant which may be required for an Inland Revenue investigating officer to gain access to a private dwelling when the occupier has refused entry. The warrant enables the officer to exercise the inspection functions contained in section 16 of the Tax Administration Act 1994 (TAA).

To get the access warrant, the Commissioner or an authorised officer will need to prepare an application and have it considered by a District Court Judge, Justice of the Peace, or Registrar. This person will consider the application, and issue the warrant if appropriate.

The warrant will not authorise the use of force to obtain entry, nor is it Inland Revenue's policy to use force to gain entry.

These regulations came into force on 1 April 1995, the day the TAA takes effect.

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 1994

Assessability of cash payment received by widow from late husband's employer

Section BB 4 (section 65, Income Tax Act 1976) - Items included in assessable income: A widow received a cash payment from her husband's former employer. The widow was a friend of the employer, and he gave the money out of friendship to help pay for funeral costs. The employer has asked if the widow must return this payment in her income tax return.

When any taxpayer receives a cash payment, that payment could potentially be included in the recipient's assessable income as one or more of the following:

- monetary remuneration under section BB 4 (b)
- a pension under section CH 1 (section 65(2)(j), Income Tax Act 1976)
- "other" income under section BB 4 (d).

The payment in this case is not monetary remuneration as it was not made to the widow in respect of, or in relation to, the employment or service with the person who gave the payment.

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The payment was not a pension. Any payment received by a taxpayer in these circumstances is excluded from the definition of "pension" if both of these conditions are met:

- The employer made the payment as a consequence of the employee's death, and within 12 months immediately succeeding the date of death.
- The employer made the payment voluntarily.

The payment can only be included as assessable income under any of the above provisions if it has the characteristics of income. The three main characteristics of income are:

- It comes in.
- It is periodic, recurring, or regular.
- Its quality in the hands of the recipient.

Although the widow received the payment, it does not have the characteristics of income. Money was received, but it was not usual for the widow to receive payments from her late husband's employer, and the payment in question was only made to help her with funeral costs.

As the payment was made voluntarily, and neither the former employer nor the widow received a benefit from the payment, it was not assessable to the widow.

The gift duty implications of this transaction are set out in TIB Volume Five, No.13 (June 1994) at page 15.

The following item explains the tax implications of the payment for the employer.

Deductibility of gift made by employer to former employee's widow

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: This item follows on from the previous item. It explains the tax consequences for an employer who made a cash payment to the widow and small children of a former employee. The payment was exempt from gift duty under section 75(1)(c) of the Estate and Gift Duties Act 1968. The employer has asked if he may claim an income tax deduction for the payment.

Under section BB 7, expenditure incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income, is tax deductible. Consequently, if the payment to the former employee's widow and children is incurred in the course of producing assessable income, it is tax deductible.

In this case the payment by the employer was made at his discretion to acknowledge his personal friendship for the grieving family. The payment was made in the private capacity of the employer and is therefore not deductible.

In some cases this type of expenditure may be viewed as a necessary business expense to promote general staff welfare and the need to be seen as a good employer. Each case needs to be considered on the facts, to establish any connection with gaining or producing assessable income.

Promotional cash prizes

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: ABC Limited is in the business of marketing interior kitchen designs. ABC recently presented a $20,000 cash prize for a Best Kitchen Interior Design Competition, which was free for anyone to enter. The competition attracted entries worldwide, and was successful in promoting the company's products. ABC's manager asked whether the prize money paid under the promotion was tax deductible to the company, and the GST implications of the payment. The competition was won by an Australian designer.

All expenditure incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for that purpose, is deductible under section BB 7. Therefore, the cost of a promotional prize incurred in the course of carrying on a business is generally included as a deduction against assessable income.

In this case, the cash prize is deductible as a business expense to the company.

Although ABC Limited is registered for GST, no GST implications arise as a result of the company conducting the competition. A supply is made by a person conducting a prize competition if money is paid to participate in the competition (see section 5(10) of the Goods and Services Tax Act 1985). In this case there was no entry fee and therefore no supply by ABC Limited. ABC Limited cannot claim an input tax deduction for the $20,000 prize.

Payments to non-profit bodies for voluntary labour

Section CB 4 (h) (section 61(30), Income Tax Act 1976) - Non-profit bodies' and charities' exempt income: The manager of a large business approached the treasurer of a sports club (a non-profit body that is registered for GST), and asked if the club could supply a number of people to assist with the firm's stocktake, for an agreed $12 per hour, per person. The treasurer has identified ten members willing to donate their services as a means of boosting club funds. She wishes to know the income tax and GST implications for the club.

Section CB 4 (h) exempts from income tax the income of any society or association which, in the opinion of the Commissioner, has been established substantially or primarily to promote any amateur game or sport, for the recreation or entertainment of the general public.

Alternatively, section CB 4 (k) (section 61(34) of the Income Tax Act 1976), exempts up to $1,000 per year of the net income of a non-profit body from income tax.

A non-profit body is any society, association, or organisation that meets both of these conditions:

- It is not carried on for the profit or gain of any member or shareholder.
- Its rules or constitution prevent it from distributing any property or money to any member or shareholder.

Organisations wishing to be considered for the above exemptions should apply to their local Inland Revenue office. They will need to include these items with the application:

- an up-to-date copy of the organisation's constitution, rules, or founding documents

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- a copy of the certificate of incorporation (if incorporated)
- details of how the organisation has been or will be operating.

The application should also state whether the organisation is seeking an exemption from resident withholding tax on interest.

Inland Revenue will consider the application, and advise the organisation in writing if we approve it. We will also advise the organisation if we can't approve the application, and give the reasons for this.

An approved organisation does not have to file income tax returns, unless the approval is subsequently revoked.

An organisation that does not have rules or a constitution cannot qualify for any exemption. This is because there will be nothing in writing to bind members to a particular course of action, or to prevent them from using the organisation's funds for themselves.

The above exemptions are for income tax only. For more information on the tax obligations of clubs, societies, or non-profit bodies, see our booklet "Clubs and Societies" (IR 254). You can get a copy from any Inland Revenue office.

Section 14(b) of the Goods and Services Tax Act 1985 exempts from GST "the supply by any non-profit body of any donated goods or services". The members in this case are donating their time to the club, so the money the club receives from the business for the stock-take will not be subject to GST.

If the club is approved under section CB 4 (h) of the Income Tax Act 1994, the money received will not be liable for income tax. If the club does not have approval under section CB 4 (h), but has approval under section CB 4 (k), the income will not be liable for income tax to the extent that the club's income does not exceed the $1,000 threshold.

Note that the income tax exemption only applies if the business pays the money directly to the club. If the business pays the money to the club members who perform the stock-take work, the money will be taxable income in the hands of these members, even if they donate it to the club.

Fringe benefit tax on leased motor vehicle provided to employee

Section CI 3 (section 336O, Income Tax Act 1976) - Value of fringe benefit: A taxpayer is considering leasing a motor vehicle for the personal use of one of her employees (not a shareholder-employee). She asked for details of FBT costs that could be incurred. The vehicle would be leased at market rates from a firm that was not an associated person. The employer files FBT returns quarterly.

FBT is charged under section CI 3 and paragraph 1(c) of Schedule 2 to the Income Tax Act 1994 (Tenth Schedule to the Income Tax Act 1976). The value of the vehicle on which FBT is calculated is the GST-inclusive market value on the day the lease began, multiplied by 6% per quarter.

For a quarterly FBT return, this is the formula for calculating the value of a fringe benefit resulting from the use of the leased motor vehicle:

$$\frac{\text{No. of days available for private use}}{\text{90 days}} \times \text{6\% of the vehicle's market value}$$

If an employee pays any amount in return for having the use of the motor vehicle, that payment is deducted from the above calculation when working out

the taxable value of the benefit. FBT is then charged on the resulting value at 49 cents in the dollar.

The motor vehicle that this employer was considering leasing for her employee had a market value of $30,000 (GST inclusive). It would be available for the employee's use every day during the lease period, and the employee would make no monetary contribution.

If the lease started on 1 April 1995, the value of the fringe benefit for the following quarter would be:

$$\frac{90}{90} \times \$30{,}000 \times 6\% = \$1{,}800$$

The aggregate of four such quarters ending on 31 March 1996 would be $7,200. Accordingly, FBT for the year ending 31 March 1996 would be 49% of $7,200, i.e. $3,528.

Deductibility of costs of replacing a farm drainage system

Section DO 4 (section 128A, Income Tax Act 1976) - Expenditure on land improvements used for farming or agriculture: A taxpayer asked if he could claim a deduction for the cost of replacing the tile drainage system in a low-lying part of his farm. The existing tile drainage system is no longer effective and will be left in the ground. He is considering re-laying part of the drainage system each year.

Section BB 7 (section 104 of the Income Tax Act 1976) allows a deduction for expenditure or loss that meets either of these conditions:

- It is incurred in gaining or producing assessable income in any income year.
- It is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income in any income year.

Section BB 8 (section 106 of the Income Tax Act 1976) restricts the provisions of section BB 7 by disallowing a deduction for expenses of a capital nature (amongst other items).

Although draining farmland is an expense incurred in producing assessable income, an expense cannot be claimed as a deduction under section BB 7 when it is for the replacement of an asset, as this is a capital expense. However, a deduction for land improvement expenditure may be available under section DO 4.

Section DO 4 and Schedule 7 (Thirteenth Schedule to the Income Tax Act 1976) allow a deduction for expenditure on land improvements. For draining swamps or low-lying lands, the deduction is limited to 5 percent of the expenditure, on a diminishing value basis. If the expenditure is incurred in the 1995 income year, the Schedule 7 deduction rate is increased by 25 percent. For expenditure incurred in the 1996 income year, the deduction rate is increased by 20 percent.

If the taxpayer was claiming a deduction for the cost of the old drain, he cannot claim a loss when it is scrapped. Nor can he continue to claim a deduction as the asset is not a benefit to the business in that income year, as required by section DO 4 (1).

Re-laying the tile drainage over a period longer than one year does not affect the deduction that can be claimed.

Depreciation rates for rental appliances

Section EG 4 (4) (section 108C, Income Tax Act 1976) - Depreciation rates: The representative of a company that is in the business of renting whiteware assets to consumers has asked if the company can use the economic depreciation rates for residential rental property chattels listed in Determination DEP4 to depreciate its whiteware rental assets acquired on or after 1 April 1993.

There are no specific rates for rental whiteware assets. However, following the instructions on page 24 of Inland Revenue's IR 260 Depreciation Guide (April 1994), the taxpayer is entitled to use the rates for residential rental property chattels listed in DEP4 (on page 42 of the Depreciation Guide). The Commissioner considers that the type of usage and environment that the whiteware assets are used in is very similar to that of the assets listed in DEP4, so a separate depreciation determination is not required.

Trustee's liability on taxable distributions derived by non-NZ beneficiaries of foreign trusts

Section HH 3 (2) (section 227(2), Income Tax Act 1976) - Income assessable to beneficiaries
Section BB 3 (section 242, Income Tax Act 1976) - Liability of income derived from New Zealand and abroad: A taxpayer has asked if a trustee is liable for tax as agent on taxable distributions earned by non-New Zealand resident beneficiaries of "foreign trusts".

Section OB 1 (section 226(1) of the Income Tax Act 1976) gives this definition of a "foreign trust":

"... any trust where at all times from the later of 17 day of December 1987 or the date upon which a settlement was first made on the terms of that trust until the date of the distribution, no settlor of that trust was resident in New Zealand".

A New Zealand resident trustee is liable for income tax on taxable distributions to beneficiaries of foreign trusts as agent of the beneficiary under section HH 3 (2). However, section BB 3 (c) says that:

"No income which is neither derived from New Zealand nor derived by a person then resident in New Zealand shall be assessable for income tax".

The Commissioner considers that taxable distributions are not assessable to the trustee as agent of the beneficiary, as long as the distributions meet both of these conditions:

- They do not emanate from trust fund income earned in New Zealand.
- They are distributed to a person who is not a New Zealand resident.

If a non-resident receives a taxable distribution and the trust's income was not earned in New Zealand, that distribution cannot be subject to income tax in New Zealand. Non-residents are only subject to income tax on income with a New Zealand source.

Unclaimed tax deduction certificates

Section NC 15 (1)(e) (section 353(1)(c), Income Tax Act 1976) - Payment of tax deductions to Commissioner: As required by section NC 15 (1)(e), an employer posted an IR 12 tax deduction certificate to an employee who had left her employment. The certificate was returned in the mail, endorsed "Gone Away". The

employer asked what she should do with the returned form, as she had no idea where to find the former employee.

Under section NC 15 (1)(e), when an employee ceases employment with an employer, the employer must deliver the tax deduction certificate to the employee within seven days.

If the tax deduction certificate is returned unclaimed, Inland Revenue's policy is that the employer should keep it for a reasonable time in case the ex-employee requests it. What is reasonable for this purpose will depend on the circumstances. If the certificate is not claimed, the employer should send it to Inland Revenue with a letter explaining the position, and refer any subsequent enquiries from the ex-employee to Inland Revenue.

Including a loss clause in a contract to ensure non-employee status

Section OB 1 (section 2, Income Tax Act 1976) - Definition of "employee": A forestry worker has asked whether the contract under which he is engaged must contain a loss clause before he will be considered to be self-employed.

Tests have evolved from court decisions to determine whether a person is an employee or self-employed. These tests are set out in TIB Volume Four, No.7 (March 1993) and No. 8 (April 1993). One factor to be considered in a work contract is whether the contract contains a clause setting out who is liable for any loss that may occur.

It is not necessary for the forestry worker to have a loss clause in his contract to be considered self-employed, but the presence of one may be an indicator in determining his employment status.

Whether or not a contract contains a loss clause does not, on its own, determine a person's employment status. Each particular situation will depend on its own facts, and the status of a taxpayer will be determined by assessing that taxpayer's situation against the tests developed by the courts.

Residence status of public servant and family while overseas

Section OE 1 (section 241, Income Tax Act 1976) - Determination of person other than a company: A public servant went overseas to work for four years in the service of the New Zealand Government, accompanied by his wife and children. He is employed by a "Public authority" as defined by section OB 1 (section 2 of the Income Tax Act 1976).

The family sold their house in New Zealand, closed all their bank accounts here, and took with them, or disposed of, their personal property. They have no intention of returning to New Zealand when the public servant's term of employment has ceased, and have decided to purchase a home in the overseas country. The majority of their social and economic ties with New Zealand have been cut. They have asked whether they are classed as residents of New Zealand for tax purposes while they are overseas.

Section BB 3 (section 242 of the Income Tax Act 1976) provides that income which meets either of the following conditions is assessable for income tax in New Zealand:

- It is derived by a person who is a resident in New Zealand at the time it was derived, whether it is derived in New Zealand or elsewhere.

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- It is derived from New Zealand, whether the person deriving that income is resident in New Zealand or elsewhere.

Section OE 1 determines a person's place of residence for tax purposes. Under section OE 1 (1) and (2), a person who meets either of these conditions is a resident:

- The person has a permanent place of abode in New Zealand, whether or not a permanent place of abode exists elsewhere.
- The person has been personally present in New Zealand for more than 183 days in any 12 month period.

However, under section OE 1 (3), if a person is personally absent from New Zealand for more than 325 days in any 12-month period, and has no permanent place of abode here, that person is deemed not to be resident from the first day of absence.

Section OE 1 (5) provides that regardless of the above rules, a person who is personally absent from New Zealand in the service of the New Zealand Government is deemed to be a New Zealand resident during that absence.

This means that the public servant is a New Zealand tax resident whilst he is employed by the New Zealand Government, subject to the articles of any relevant double tax agreement.

The spouse and the rest of the family are not personally absent on government service so section OE 1 (5) does not apply to them. In this particular case, the spouse and family do not appear to have an enduring relationship with New Zealand and have no permanent place of abode here. They do not intend to return to New Zealand. They became non-resident from the first day in the 12-month period in which they were personally absent and without a permanent place of abode. This was the day after their departure, as section OE 1 (4) deems a person who is present in New Zealand for any part of a day to be present for the whole of that day.

Goods and Services Tax Act 1985

Whether a mortgagee sale can be the supply of a going concern

Section 11 - Zero-rating: A fully tenanted commercial property is to be the subject of a mortgagee sale. The mortgagor and the proposed purchaser of the property are both GST registered persons. The proposed purchaser has asked if the mortgagee sale can be a zero-rated supply under section 11(1)(c).

Section 11(1)(c) provides for the zero-rating of goods when the supply is made to a registered person, and is of a taxable activity as a going concern, or of a part of a taxable activity as a going concern if that part is capable of separate operation.

This transaction is the result of a mortgagee sale, and the property is being sold in satisfaction of a debt under section 5(2). However, the property is deemed to be supplied in the course or furtherance of a taxable activity carried on by the mortgagor unless either of these conditions apply:

- The mortgagor has given a written statement to the mortgagee stating that the supply would not be a taxable supply if the goods were sold by the mortgagor, and stating fully the reasons.
- The mortgagee determines that the supply of the goods would not have been a taxable supply if those goods had been sold by the mortgagor.

For a sale of a taxable activity to be considered to be a sale of a going concern, the tenanted commercial property activity must be capable of being continued by the purchaser after the transfer.

Although this transaction results from a mortgagee sale, the transaction can still be considered to be the supply of a going concern. Accordingly, the sale of the fully tenanted commercial property to the proposed purchaser will be the sale of a going concern. GST is payable at zero percent.

Insurance proceeds from a farm house

Section 14 - Exempt supplies: A farmer received an indemnity payment from her insurance company for the loss by fire of a cottage used to accommodate farm employees. As a GST registered person, she has asked if she must account for GST on this payment.

Section 5(13) deems indemnity payments received to be consideration for a taxable supply made, to the extent that the payment relates to a loss incurred in a registered person's taxable activity.

Section 14(c) exempts from GST:

"The supply of accommodation in any dwelling by way of -

(i) Hire; or

(ii) A service occupancy agreement; or

(iii) A licence to occupy."

Section 6(3)(d) excludes from the definition of taxable activity, "Any activity to the extent to which the activity involves the making of exempt supplies."

The provisions of section 5(13) do not apply in this instance, because under section 6(3)(d) the payment does not relate to the registered person's taxable activity, i.e., it is for the supply of domestic accommodation which is an exempt supply. The farmer does not have to account for GST on the payment

Student Loan Scheme Act 1992

Student Loan repayments when student going overseas for a short time

Section 37 - Borrower to advise Commissioner of absence from New Zealand: A student who has a Student Loan is planning an overseas trip that will take her out of New Zealand for between 6 and 10 months. While she is away, she will continue to receive wages from New Zealand employment. She has asked about her loan responsibilities whilst she is out of New Zealand.

Under the residence rules, the student will remain a resident of New Zealand for tax purposes because she will not be absent for more than 325 days in a 12-month period.

A student who is going to be absent overseas for more than three months must give Inland Revenue a contact address so that statements and notices can be forwarded. However, when a student continues to have repayment deductions made, or makes payment of any instalments or interim repayments, he or she does not need to give Inland Revenue a contact address.

The student in this case is continuing to receive wages from a New Zealand employer, so she must continue having deductions made from her wages. Any interim or end of year payments must be paid by the due date.

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This student must also file a tax return at the end of the year, and declare her worldwide income. Her repayment liability will be based on the assessable income shown in that return. Any resulting overpayment or underpayment will respectively either be refunded or must be paid by 7 February the following year.

Insolvency Act 1967

Lotto winnings received after bankruptcy - payment to Official Assignee

Section 42 - Property passing to Assignee and commencement of bankruptcy: A taxpayer has been declared bankrupt and his affairs are being handled by the Official Assignee. He has asked whether the Official Assignee has access to Lotto winnings received after bankruptcy for the payment of debts owed to Inland Revenue and other creditors.

Under section 42, all property acquired by or devolving upon the bankrupt before his discharge is to pass to the Official Assignee, up to a maximum of the amount of debt owing.

The Official Assignee does have access to the Lotto winnings. The taxpayer is responsible for contacting the Official Assignee to advise details of the win.

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.

Case	Rating	Subject	Page
Newman v CIR CA 150/94	• • • • •	Subdivision and sale of own land by builder - not a taxable activity for GST	27
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Subdivision and sale of own land by builder - not a taxable activity for GST

Rating: • • • • •

Case: Newman v Commissioner of Inland Revenue, CA 150/94

Act: Goods and Services Tax Act 1985 - section 6

Keywords: *taxable activity, continuously, regularly*

Summary: The Court of Appeal held that the “one-off” property subdivision carried out by the appellant did not constitute a “taxable activity” for GST purposes.

Facts: The appellant was a builder who purchased a block of land in Queenstown on which he intended to build a family home for himself. During the construction of the house, he subdivided the property to fund its completion. The appellant did not carry out the subdivision in the course or furtherance of his taxable activity as a builder. The Commissioner assessed output tax on the sale of the subdivided property. The builder objected to the assessment. The TRA agreed with the Commissioner and decided that an isolated subdivision transaction could constitute a “taxable activity”.

On appeal to the High Court, the Court upheld the TRA decision. The High Court held that the subdivision process involved a series of sequential steps carried out with a common purpose without interruption. The Court concluded that these steps constituted an activity carried out "continuously" and therefore fell within the definition of "taxable activity".

Decision: The Court of Appeal held that the subdivision activity of the appellant did not constitute a taxable activity. In reaching this decision, the Court examined the activity of the appellant as a whole. It noted that the activity was a straightforward subdivision which did not involve development work on the property. The activity involved neither repetition over time nor repeated acts. The Court agreed with the judgment in *Tout v Cook* (1991) 13 NZTC 8053 that the "one-off" development involved in that case was not a continuous or regular activity.

The Court of Appeal did not consider that it was relevant to dissect an activity into a series of sequential steps to determine whether the activity was carried on "continuously". On this basis, the Court considered that the activity of shopping or selling a car could arguably be taxable activities. However, Justice Gault agreed with the High Court that the construction and sale of a commercial building could be a continuous activity.

The Court of Appeal also made the general comment that the determination of whether or not a particular subdivision activity was a taxable activity would depend on the facts of each case.

Comment: Inland Revenue is not appealing this decision.

Payment on involuntary termination of employment not a retiring allowance

Rating: •

Case: TRA No 94/35

Act: Income Tax Act 1976 - section 68(2) (repealed)

Keywords: *retiring allowance*

Summary: Judge Willy found that payments made to the taxpayer, on the termination of employment, were not retiring allowances for the purposes of section 68(2).

Facts: The taxpayer refused to return to work at the end of a period of annual leave, as she felt that the employer should have granted her further leave. The employer terminated the taxpayer's employment, paid her all of the money due under her collective employment contract, and deducted tax at her marginal tax rate. The taxpayer objected on the grounds that the payments were retiring allowances and that tax was deductible at a concessionary rate under section 68(2).

Decision: Judge Willy found that "retirement" ordinarily meant the voluntary act of surrendering a position and that it had this ordinary meaning in section 68(2). He did not accept that "retirement" included the involuntary termination of employment.

As the taxpayer did not voluntarily surrender her employment, the payments were not retiring allowances for the purposes of section 68(2).

Comment: The taxpayer is not appealing this decision.

Whether penal tax charged was excessive

Rating: • •

Case: TRA No. 92/20

Act: Goods and Services Tax Act 1985 - sections 67, 68, 69 and 70

Keywords: *penal tax, excessive*

Summary: The TRA confirmed the Commissioner's assessment of penal tax at 100% of the deficient tax.

Facts: This case involves a husband and wife partnership of sharemilkers registered for GST on a payments basis. The partnership filed the return for the period ended 30 April 1988 on 30 May 1988. It involved a false claim for stock purchases. At no time had stock under any of the contracts been invoiced or paid for before 30 April 1988.

An audit of the partnership revealed that an input claim had been made for stock purchases not actually made during the return period ended 30 April 1988. The Commissioner imposed penal tax of 100% of the deficient tax.

Decision: Judge Barber held that the Commissioner took a fair and balanced approach towards the manner of assessing penal tax. He considered the reasons for the imposition of the penal tax and concluded that the amount of penal tax was not excessive.

Those reasons included that the taxpayer deliberately prepared and furnished a false return, that the false claim was made to finance future purchases and that the taxpayer did not make disclosure when notified of the audit. Inland Revenue viewed the offence as a serious one against Government funds.

Other factors taken into account were:

- that penal tax can be imposed at up to 300% of the wilful deficient tax
- the relatively short time before the offence was detected by Inland Revenue
- the taxpayer's admission once the offence was detected
- the "one-off" nature of the offence
- the taxpayer's attitude towards future compliance
- the need to provide a deterrent to other taxpayers.

In recognition of the fact that it had been nearly three years since the filing of the case stated the Commissioner undertook a partial waiver of interest otherwise payable on the penal tax.

Comment: The taxpayers are not appealing this decision.

Interest deductibility and apportionment

Rating: • •

Case: TRA 93/88

Act: Income Tax Act 1976 - section 106(1)(h) (Income Tax Act 1994 - DD 1 (b))

Keywords: *interest deductibility, apportionment*

Summary: The taxpayer was allowed to deduct part of the interest paid on a loan that allowed him to rent out a cottage and to complete a townhouse in which he and his family lived. The TRA found that some of the interest was deductible as it

related to renting out the cottage. The rest of the interest deduction was denied to reflect the private use of the funds in completing the townhouse.

Facts: The taxpayer bought a cottage in 1972 as a family home. In 1987 he decided to redevelop the property by building two townhouses on the section. Unfortunately the market for townhouses collapsed before completion of the first townhouse. To complete the townhouse, the taxpayer borrowed money, using the entire property as security for the loan. The taxpayer and his family moved into the incomplete townhouse and rented out the cottage. The taxpayer sought an interest deduction for that part of the interest on the borrowed money that related to the renting of the cottage. The Commissioner denied the deduction, claiming the interest was not connected to an income-earning process.

Decision: Judge Willy allowed the taxpayer an interest deduction, but preferred the Commissioner's apportionment method.

The TRA found that the facts established that part of the loan was used solely to finance the cottage as a commercial letting proposition. The TRA distinguished *Case N63* (1991) 13 NZTC 3483.

It was clear to the TRA that the proportion of interest claimed was payable in gaining or producing rental income from the cottage, and was an outgoing necessarily payable in carrying on the business of letting the property for rental income. Therefore, it was deductible under both section 106(1)(h)(i) and section 106(1)(h)(ia).

The TRA allowed an apportionment of interest using the Commissioner's suggested method. This involved dividing the value of the rented property by the total value of the property, and applying this percentage to the interest amount for the relevant income year. This was the deductible amount of interest.

Comment: Inland Revenue is not appealing this decision.

Whether interest income received was derived from a specified activity

Rating: • • •

Case: TRA 94/45

Act: Income Tax Act 1976 - section 188A (IE 2 and OB 1 - Income Tax Act 1994)

Keywords: *interest, specified activity*

Summary: The taxpayer owned and leased motels. The case concerned whether interest he received was derived from specified activities. The Taxation Review Authority considered that the interest received from the taxpayer's bank accounts was not derived from a specified activity. It decided however that interest received from a debenture held by the taxpayer was derived from a specified activity.

Facts: The taxpayer owned and leased motels. The case concerned whether the interest earned from various investments was derived from his "specified activity" under section 188A of the Income Tax Act 1976 (now repealed). The Taxation Review Authority considered this question under three categories, interest from a sinking fund, interest from other accounts and interest from a debenture.

Sinking fund

The "sinking fund" was related to an amount the taxpayer borrowed in Swiss francs for general business purposes. One of the conditions on which the New Zealand bank arranged the loan was that the taxpayer would pay the sum of $16,000 per annum into a "sinking fund" with the payments to be made

monthly. The bank insisted on the sinking fund to protect its exposure in the event of default by the borrower caused by exchange fluctuations. The bank paid the taxpayer interest on the balance held in the account from time to time.

Interest from other accounts

The taxpayer also derived interest from various deposits in ordinary accounts.

Debenture

The taxpayer also earned interest on a debenture. The taxpayer owned a motel property and had sold the lease and the right to carry on a business from those premises. The purchaser did not honour the terms of the agreement for sale and purchase or lease, and also defaulted on its mortgage obligations. The mortgagee took possession of the motel chattels, and the taxpayer reoccupied the premises. The taxpayer then found a new purchaser but one of the terms of the sale was that the taxpayer left in the sum of $250,000 secured by way of debenture over the purchaser's assets. The purchaser paid interest to the taxpayer in terms of the security documents.

Decision: The TRA found that the first two amounts of interest did not relate to the taxpayer's specified activity. For the sinking fund the TRA found that the loan agreement related to the land, and that the sinking fund requirement (which was necessarily part of that agreement) also related to the land. However, the TRA found that it was illogical and a misuse of language to argue that the borrowing of money on that land was done with a view to deriving revenue from it. The TRA stated that what section 188A encompassed was agreements which relate to the revenue to be derived from land, or losses made in respect of it. The TRA found borrowing money on the security of land was not the earning of revenue, it was the raising of capital. The loan transaction therefore did not come within the subsection.

The TRA found that the interest derived from investments in other accounts were the fruits of quite distinct investment decisions taken by the taxpayer and did not satisfy the test of being a "specified activity".

For the interest received from the debenture the TRA stated that the true inquiry was whether or not the interest received satisfied the requirements of section 188A in the sense that it was, or was not, revenue from an agreement relating to land. The TRA found that it did meet the requirements because the debenture clearly related to the land in the sense that the business whose assets it secured was carried on from the land. The receipt was therefore within the provisions of section 188A and formed part of the "specified activity" of leasing motels from that land.

Comment: Inland Revenue is appealing this decision.

GST input credits on property used for business and accommodation

Rating: • • • •

Case: TRA No. 93/135

Act: Goods and Services Tax Act 1985 - section 2(1) definition of "input tax" paragraph (c)

Keywords: *secondhand goods, principal purpose of making taxable supplies*

Summary: The proprietor of a saddlery business was entitled to a full GST input tax credit on premises purchased both to live in and operate his business from. The TRA

found that the premises were acquired for the principal purpose of making taxable supplies.

Facts: The proprietor of a small saddlery business purchased a half share in a house from his father to operate the business and for his own accommodation. The objector occupies the house by himself.

The basic working area for the business was the basement and garage, and much of the house was used for storage purposes. Materials were stored in many places through the house. Common areas such as the kitchen, toilet facilities, eating areas and passages are used as much for business as for private residential purposes.

The objector had over the years claimed 50% of the property expenses as business expenses for income tax purposes, and claimed 50% of the GST on property expenses as business input tax deductions. He believed that these were the maximum amounts to which he was entitled.

The Commissioner argued that the objector was not entitled to claim the GST input tax credit because the property was not acquired for the principal purpose of making taxable supplies.

Decision: Judge Barber agreed that the objector could claim a full GST input tax deduction, if it was established that the objector acquired the property for the principal purpose of making taxable supplies.

Judge Barber found that the objector used more than 50% of the property for his business. He found that on the balance of probability, the objector's predominant or principal use of the property was for his business.

Judge Barber held that the objector acquired the half share in the land and buildings for the principal purpose of making taxable supplies. As a result, the taxpayer was entitled to claim GST input tax in full.

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

Compensation payments by company on shareholders' behalf not deductible

Rating: • •

Case: TRA No 94/97

Act: Income Tax Act 1976 - section 104 (Income Tax Act 1994 - BB 7)

Keywords: *capital payment, source of payment*

Summary: Payments made by a company to meet its shareholders' obligations are not payments made by the company in the course of its business.

Facts: The shareholders in a pharmacy ("the vendors") sold the shares. The agreement provided that if the vendors opened another pharmacy which supplied any medical practitioners who were customers of the original pharmacy, the vendors would pay compensation to the purchaser of the shares in the original pharmacy.

The vendors set up another company (the objector) and used that to operate a new pharmacy which supplied customers of the original pharmacy.

The objector made the payments that the vendors were required to make under the agreement to the original pharmacy. The objector sought to deduct the payments.

Decision: It was not part of the objector's pharmacy business to make the compensation payments. The fact that the payments were sourced from the objector did not make them part of the objector's business. The vendors were a separate entity from the objector and the vendors were responsible for making the compensation payments to the purchasers of the shares. The payments to the original pharmacy were capital in nature because they were either an adjustment to the capital purchase price, or a reimbursement for a loss of goodwill.

Comment: The taxpayer is not appealing this decision.

Upcoming TIB articles

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

- Successive supplies in the building and engineering industries under section 9(3)(aa)(ii) of the GST Act 1985
- GST and the de minimis rule
- Value of pooled vehicles for FBT purposes
- Deductibility of fines and levies paid by hotel licensees
- GST tax invoice requirements - expense incurred by employee on employer's behalf
- Time limits for new companies to make QC elections
- Non-residents registering for GST
- 1996 IR 6 return - error regarding LAQC losses
- Deductibility of FBT when FBT period spans employer's balance date
- Remitted specified suspensory loans - income tax treatment

List of Inland Revenue booklets

This list shows all of Inland Revenue's information booklets as at the date of this Tax Information Bulletin. There is also a brief explanation of what each booklet is about.

Some booklets could fall into more than one category, so you may wish to skim through the entire list and pick out the booklets that you need. You can get these booklets from any IRD office.

For production reasons, the TIB is always printed in a multiple of eight pages. We will include an update of this list at the back of the TIB whenever we have enough free pages.

For people in business

A guide to Inland Revenue audits (IR 297) March 1994
For business people and investors. It explains what is involved if you are audited by Inland Revenue; who is likely to be audited; your rights during and after the audit, and what happens once an audit is completed.

ACC premium rates March 1995
There are two separate booklets, one for employer premium rates and one for self-employed premium rates. Each booklet covers the year ended 31 March 1995.

Approved issuer levy (IR 291A) May 1994
For taxpayers who pay interest to overseas lenders. Explains how you can pay interest to overseas lenders without having to deduct NRWT.

Consolidation (IR 4E) March 1993
An explanation of the consolidation regime, which allows a group of companies to be treated as a single entity for tax purposes.

Controlled foreign companies (IR 275) November 1994
Information for NZ residents with interests in overseas companies. (more for larger investors, rather than those with minimal overseas investments).

Depreciation (IR 260) April 1994
Explains how to calculate tax deductions for depreciation on assets used to earn assessable income.

Employers' guide (IR 184) 1995
Explains the tax obligations of anyone who is employing staff, and explains how to meet these obligations. Anyone who registers as an employer with Inland Revenue will receive a copy of this booklet.

Foreign dividend withholding payments (IR 274A) Mar 1995
Information for NZ residents with interests in overseas companies. This booklet also deals with the attributed repatriation and underlying foreign tax credit rules. (more for larger investors, rather than those with minimal overseas investments).

Foreign investment funds (IR 275B) Oct 1984
Information for taxpayers who have overseas investments. (more for larger investors, rather than those with minimal overseas investments).

Fringe benefit tax guide (IR 409) June 1992
Explains fringe benefit tax obligations of anyone who is employing staff, or companies which have shareholder-employees. Anyone who registers as an employer with Inland Revenue will receive a copy of this booklet.

GST - do you need to register? (GST 605) May 1994
A basic introduction to goods and services tax, which will also tell you if you have to register for GST.

GST guide (GST 600) 1994 Edition
An in-depth guide which covers almost every aspect of GST. Everyone who registers for GST gets a copy of this booklet. It is quite expensive for us to print, so we ask that if you are only considering GST registration, you get the booklet "GST - do you need to register?" instead.

Imputation (IR 274) February 1990
A guide to dividend imputation for New Zealand companies.

Non-resident withholding tax payers' guide (IR 291)Jul 1994
A guide for people or institutions who pay interest, dividends or royalties to people who are not resident in New Zealand.

PAYE deduction tables
- Four-weekly and monthly (IR 184Y) 1996
- Weekly and fortnightly (IR 184X) 1996

Tables that tell employers the correct amount of PAYE to deduct from their employees' wages.

Qualifying companies (IR 4PB) October 1992
An explanation of the qualifying company regime, under which a small company with few shareholders can have special tax treatment of dividends, losses and capital gains.

Record keeping (IR 263) March 1995
A guide to record-keeping methods and requirements for anyone who has just started a business.

Re-ordered tax Acts (IR 299) April 1995
Explains the reorganisation of the Income Tax Act 1976 and the Inland Revenue Department 1974 into the Income Tax Act 1994, the Tax Administration Act 1994 and the Taxation Review Authorities Act 1994.

Resident withholding tax on dividends (IR 284) Oct 1993
A guide for companies, telling them how to deduct RWT from the dividends that they pay to their shareholders.

Resident withholding tax on interest (IR 283) March 1993
A guide to RWT for people and institutions which pay interest.

Running a small business? (IR 257) Jan 1994
An introduction to the tax obligations involved in running your own business.

Surcharge deduction tables (IR 184NS) 1994
PAYE deduction tables for employers whose employees are having national super surcharge deducted from their wages.

Taxpayer Audit (IR 298)
An outline of Inland Revenue's Taxpayer Audit programme. It explains the units that make up this programme, and what type of work each of these units does.

For non-profit groups

Charitable organisations (IR 255) May 1993
Explains what tax exemptions are available to approved charities and donee organisations, and the criteria which an organisation must meet to get an exemption.

Clubs and societies (IR 254) June 1993
Explains the tax obligations which a club, society or other non-profit group must meet.

Education centres (IR 253) June 1994
Explains the tax obligations of schools and other education centres. Covers everything from kindergartens and kohanga reo to universities and polytechnics.

Gaming machine duty (IR 680A) February 1992
An explanation of the duty which must be paid by groups which operate gaming machines.

Grants and subsidies (IR 249) June 1994
An guide to the tax obligations of groups which receive a subsidy, either to help pay staff wages, or for some other purpose.

For individual taxpayers

Dealing with Inland Revenue (IR 256) April 1993
Introduction to Inland Revenue, written mainly for individual taxpayers. It sets out who to ask for in some common situations, and lists taxpayers' basic rights and obligations when dealing with Inland Revenue.

Interest earnings and your IRD number (IR 283L) September 1991
Explains the requirement for giving to your IRD number to your bank or anyone else who pays you interest.

IR 56 taxpayer handbook (IR 56B) April 1995
A booklet for part-time private domestic workers, embassy staff, nannies, overseas company reps and Deep Freeze base workers who make their own PAYE payments.

Koha (IR 278) August 1991
A guide to payments in the Maori community - income tax and GST consequences.

New Zealand tax residence (IR 292) April 1994
An explanation of who is a New Zealand resident for tax purposes.

Objection procedures (IR 266) March 1994
Explains how to make a formal objection to a tax assessment, and what further options are available if you disagree with Inland Revenue.

Provisional tax (IR 289) March 1994
People whose end-of-year tax bill is over $2,500 must generally pay provisional tax for the following year. This booklet explains what provisional tax is, and how and when it must be paid.

Putting your tax affairs right (IR 282) May 1994
Explains the advantages of telling Inland Revenue if your tax affairs are not in order, before we find out in some other way. This book also sets out what will happen if someone knowingly evades tax, and gets caught.

Resident withholding tax on investments (IR 279) April 1993
An explanation of RWT for people who receive interest or dividends.

Retiring allowances and redundancy payments (IR 277) June 1994
An explanation of the tax treatment of these types of payments.

Self-employed or an employee? (IR 186) April 1993
Sets out Inland Revenue's tests for determining whether a person is a self-employed contractor or an employee. This determines what expenses the person can claim, and whether s/he must pay ACC premiums.

Special tax codes (IR 23G) January 1995
Information about getting a special "flat rate" of tax deducted from your income, if the regular deduction rates don't suit your particular circumstances.

Stamp duty and gift duty (IR 665) March 1995
Explains what duty is payable on transfers of real estate and some other transactions, and on gifts. Written for individual people rather than solicitors and legal firms.

Student Loan repayments (SL 2) January 1995
A guide to making student loan repayments.

Superannuitants and surcharge (IR 259) January 1995
A guide to the surcharge for national superannuitants who also have other income.

Tax facts for income-tested beneficiaries (IR 40C) September 1992
Vital information for anyone who receives an income-tested benefit and also has some other income.

Problem Resolution Service (IR 287) November 1993
An introduction to Inland Revenue's Problem Resolution Service. You can use this service if you've already used Inland Revenue's usual services to sort out a problem, without success.

Child Support booklets

Child Support - a guide for bankers (CS 66) August 1992
An explanation of the obligations that banks may have to deal with for Child Support.

Child Support - a parent's guide (CS 1) March 1992
An in-depth explanation of Child Support, both for custodial parents and parents who don't have custody of their children.

Child Support - an introduction (CS 3) March 1992
A brief introduction to Child Support.

Child Support - does it affect you? (CS 50)
A brief introduction to Child Support in Maori, Cook Island Maori, Samoan, Tongan and Chinese.

Child Support - how to approach the Family Court (CS 51) July 1994
Explains what steps people need to take if they want to go to the Family Court about their Child Support.

Child Support - the basics - a guide for students
A basic explanation of how Child Support works, written for mainly for students. This is part of the school resource kit "What about the kids?"

Your guide to the Child Support formula (CS 68)
Explains the components of the formula and gives up-to-date rates.

Child Support administrative reviews (CS 69A)
Explains how the administrative review process works, and contains an application form.

Due dates reminder

May

5 Large employers: PAYE deductions and deduction schedules for period ended 30 April 1995 due.

7 Provisional tax and/or Student Loan interim repayments: first 1996 instalment due for taxpayers with January balance dates.
Second 1995 instalment due for taxpayers with September balance dates.
Third 1995 instalment due for taxpayers with May balance dates.

(We will accept payments received on Monday 8 May as on time for 7 May.)

20 Large employers: PAYE deductions and deduction schedules for period ended 15 May 1995 due.

Small employers: PAYE deductions and deduction schedules for period ended 30 April 1995 due.

Gaming machine duty return and payment for month ended 30 April 1995 due.

RWT on interest deducted during April 1995 due for monthly payers.

RWT on dividends deducted during April 1995 due.

Non-resident withholding tax (or approved issuer levy) deducted during April 1995 due.

(We will accept payments received on Monday 22 May as on time for 20 May.)

31 GST return and payment for period ended 30 April 1995 due.

FBT annual liable return (1 April 1994 to 31 March 1995) and payment due - employers who elected to pay FBT on an annual basis.

PAYE/ACC annual reconciliations (IR 68P and IR 68A) and 1995 ACC employer premium due.

RWT annual reconciliation (IR 15S) due.

Specified dividend reconciliation (IR 17S or IR 17SA) due.

June

5 Large employers: PAYE deductions and deduction schedules for period ended 31 May 1995 due.
(we will accept any payments received on Tuesday 6 June as on time.)

7 Provisional tax and/or Student Loan interim repayments: first 1996 instalment due for taxpayers with February balance dates.
Second 1996 instalment due for taxpayers with October balance dates.
Third 1995 instalment due for taxpayers with June balance dates.

IR 5 tax returns due to be filed.

20 Large employers: PAYE deductions and deduction schedules for period ended 15 June 1995 due.

Small employers: PAYE deductions and deduction schedules for period ended 31 May 1995 due.

Gaming machine duty return and payment for month ended 31 May 1995 due.

RWT on interest deducted during May 1995 due for monthly payers.

RWT on dividends deducted during May 1995 due.

Non-resident withholding tax (or approved issuer levy) deducted during May 1995 due.

Imputation: payment of debit balances as at 31 March 1995 due.

30 GST return and payment for period ended 31 May 1995 due.

FBT: final day for "small" employers to elect to pay FBT annually.

Non-resident Student Loan repayments: first instalment of 1996 Student Loan non-resident assessment due.

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Questions we've been asked

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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 27 or the inside front cover for a list of cases covered in this bulletin.

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