Public binding rulings - have your say

Binding rulings

Since 1 April 1995 Part VA of the Tax Administration Act 1994 has allowed the Commissioner to issue binding rulings. The two main benefits of these rulings are:

- certainty for taxpayers about the tax implications of business decisions (transaction certainty)
- help for taxpayers in complying with tax law (compliance certainty).

For a full explanation of the binding rulings system, see TIB Volume Six, No. 12 (May 1995).

Public binding rulings

This item deals particularly with public binding rulings ("public rulings"). A public ruling will bind the Commissioner for as long as it remains in force, for all taxpayers who calculate their tax liability in accordance with the public ruling. In practice, this means the Commissioner will be bound if the taxpayer's return follows the tax treatment set out in the ruling, or otherwise relies on the ruling.

The Commissioner will initiate all public rulings. Taxpayers cannot require the Commissioner to make a public ruling on any particular subject, but they can suggest to the Commissioner topics which they think are suitable for public rulings.

Planned rulings for 1995-96 year

In the year to 30 June 1996 we plan to publish approximately 70 public rulings. When we prepare any public ruling, we will consult with any representative bodies we know will be interested in the topic of the ruling. We would also like comments from other people, so we will make the draft ruling available to anyone who asks for a copy.

In July, the first of our public rulings will be available to TIB readers for comment. Their titles are listed on page 44.

In each month's TIB from now on we'll list the titles that will be available for comment during the next month. The deadline for comments will generally be 21 days from availability.

We seek any comments that will help us to improve the rulings from a technical or practical standpoint. When we've received and evaluated all comments on a ruling, we'll also write to people who have commented, acknowledging the value of their contributions.

Ordering a draft ruling

To order a copy of a draft ruling for comment, fill in the details on page 44 and send the whole page back to us. We'll post you the draft rulings on the day they are available.

From July onwards, each TIB will include a similar order page. Because of the short time we have to deal with your comments, please send them directly to the address on the order page - don't send them with other returns or letters.

Loss attributing qualifying companies with shares carrying the right to appoint representative directors

Summary

This item states the Commissioner's policy on when certain companies can become loss attributing qualifying companies (LAQCs). These are companies with shares which carry the right to elect or appoint different directors but otherwise have identical rights.

LAQCs are qualifying companies which pass through or attribute their losses to their shareholders in proportion to the shareholders' effective interests in the company. Provided that each share carries the same rights (albeit in relation to different directors) then the Commissioner accepts that such companies can become LAQCs, providing they are otherwise eligible.

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

Background

Several professional advisers have asked whether a company with shares which carry a right to appoint different directors can qualify to be an LAQC. Minority shareholders or shareholders who do not control at least 51% of the voting rights may want their shares to carry the right to appoint a director. They may not wish to be in the position where a majority shareholder or other minority shareholders voting together may appoint the directors of their choice, leaving them without representation on the board of directors. However, the LAQC rules require shares in LAQCs to have the same rights to prevent the streaming of losses to shareholders who can best use them. This is because the shareholders' share in the losses is based on their voting interests.

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Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
HG 2	393A(2)
HG 14	393N
HG 16	393P
OB 1	393A(1) definition of "effective interest"
OB 1	8B defn. - "shareholder decision making rights"
OD 2 to OD 4	8A to 8D
OB 1 and OD 5 (10)	8B definitions
OD 3	8C

Section HG 14 contains certain requirements for a company that wishes to be an LAQC in any income year. The relevant requirements in this case are contained in section HG 14 (b), which states:

Each share in the company carries at all times in the income year the **same** -

(i) Right to exercise voting power and participate in any decision-making **at any time** concerning-

(A) The distributions to be made by the company; and

(B) The constitution of the company; and

(C) Any variation in the capital of the company; and

(D) The appointment or election of directors of the company...

(Emphasis added)

Application

The reason for the requirement that each share carry the same rights is the operation of the loss attribution mechanism for shareholders. Section HG 16 deems a shareholder in an LAQC which incurs a loss in any income year to incur a loss equal to that loss multiplied by the shareholder's "effective interest" in the company. Section OB 1 defines "effective interest", except in the case of a market value circumstance, as the person's voting interest. Section HG 2 states that the person's voting interest and market value interest in the company must be determined according to sections OD 2 to OD 5

Section OD 3 provides that, subject to the succeeding provisions of the section, a person's voting interest is the percentage of the total shareholder decision-making rights that his or her shares in the company carry at that time. Section OD 3 (2) provides that, when the percentage of shareholder decision-making rights carried by shares differs as between the types of decision-making listed in the definition of shareholder-decision making rights, the person's voting interest must equal the average at that time of the differing percentages.

Section OB 1 defines "shareholder decision-making rights" as:

"Shareholder decision-making rights" means, in respect of any company, rights (carried by shares issued by the company or options over shares issued by the company) to vote or participate in any decision-making concerning -

(a) The dividends or other distributions to be paid or made by the company, whether on a liquidation of the company or otherwise (not being decision-making undertaken by directors acting only in their capacity as directors); or

(b) The constitution of the company; or

(c) Any variation in the capital of the company; or

(d) The appointment or election of directors of the company: (emphasis added)

The various rights specified in the section OB 1 definition of "shareholder decision-making rights" for loss attribution are almost identical to the rights which section HG 14 (b) requires to be the same for LAQC shares. The more rights that a shareholder has, the greater that person's share of the company's losses. If all LAQC shares have the same rights to participate in decision-making about distributions, the constitution and so on, this means that the voting interests of each share are the same. Because the allocation of losses to shareholders depends on the rights of the shareholders, each share will get the same proportion of the loss (assuming no market value circumstance exists). There is no possibility of streaming losses to specific shareholders.

Policy

The Commissioner's view is that when the only distinction between the classes of shares is the right to appoint separate directors, the shares do have the same rights to elect or appoint directors. If one director has to be replaced, the affected shareholders are merely exercising their right to choose a director. The other shareholders have already done this. The right always exists whether or not a director is actually being replaced. The shareholders' rights are the same, although the different classes of shareholders may have the opportunity to exercise those rights at different times.

It follows that if the Commissioner accepts that these shares have the same voting rights to elect directors, each share's percentage of the total shareholder decision-making rights to appoint or elect company directors will be equal for loss attribution purposes.

Section HG 14 (b) imposes the requirements for the same rights in respect of "each share". This requires equal numbers of shares to exercise equal voting rights. Different classes of shares - when the only difference in those classes is the right to elect different representative directors - are permissible for an LAQC, provided that the shares have equal rights in this respect. In other words, the Commissioner requires that the voting rights attached to each share for the election or appointment of directors are equal rights, e.g. if there are 20 "A" shares with voting rights to elect or appoint a director, then equally 20 "B" shares must give the same right to elect or appoint a director. This prevents any loss streaming as discussed above.

If for any reason it was discovered that the shares were subject to an arrangement to defeat the purposes of section HG 14, it would be possible to rely on section HG 14 (d). Section HG 14 (d) requires that no share in the company may, in the opinion of the Commissioner, be subject to any arrangement or series of arrangements for the purpose of defeating the intent and application of the section.

Example 1

XYZ Ltd is a qualifying company with a share capital of 50 "A" shares, 50 "B" shares, and 50 "C" shares. It has the following five shareholders:

Wilfred owns 20 "A" shares

Bertie owns 30 "A" shares

Daniel owns 50 "B" shares

Mary owns 25 "C" shares

Bertha owns 25 "C" shares

Each class of shares is identical, apart from the right of each class of share to elect a representative director or directors. In this case it requires 50 shares of each class to appoint a director. Each share of each class has equal voting rights. Wilfred and Bertie elect Director "A". Daniel elects Director "B". Mary and Bertha elect Director "C".

The Commissioner accepts that the company may become an LAQC, providing it fulfils the other requirements of section HG 14.

Example 2

Alphabet Co Ltd is a qualifying company with a share capital of 100 "A" shares which carry the right to elect two directors, and one "B" share which carries the right to elect one director.

Georgie owns 50 "A" shares

Ann owns 50 "A" shares

Rangi owns the 1 "B" share

In this case it requires 50 "A" shares to elect a director, but it only requires 1 "B" share to elect a director. The shares do not have equal voting rights. The company is not eligible to become an LAQC.

GST status of cash dividends

Summary

This item states the Commissioner's current policy on the GST status of cash dividends that a company pays to its shareholders.

The Commissioner considers that the actual cash amount paid as a dividend is a supply of money, not a supply of goods and services. However, the activity of paying a dividend is an exempt supply of financial services.

The receipt of a dividend by a shareholder is not a supply of services by the shareholder to the company. However, a third party who collects dividends for a shareholder makes an exempt supply to that shareholder.

Any GST on supplies the company acquires for the activity of paying a dividend will not satisfy the definition of "input tax" under section 2(1). This is because these supplies are not acquired for the principal purpose of making taxable supplies.

Any section 21 adjustment a company must make to reflect the activity of paying dividends should not include the total cash amount paid as dividends.

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

Background

There is some uncertainty about the correct GST treatment of cash dividends that a company pays to its shareholders. One argument is that the actual cash amount paid as a dividend is a supply of money, rather than a supply of goods and services. Therefore, the actual cash amount paid as a dividend is neither a taxable nor an exempt supply.

The other view is that the actual cash amount paid as a dividend is part of the exempt supply of paying a dividend under sections 3(1)(ka) and 14(a).

This item does not discuss the GST treatment of supplies made by or acquired from a share registry company.

Legislation

Section 8(1) imposes GST on the supply (other than an exempt supply) of goods and services, in New Zealand, by a registered person in the course or furtherance of a taxable activity carried on by that person. The definitions of "goods" and "services" exclude money, so supplies of money are outside the scope of the Act. Section 14 exempts certain supplies from GST. In particular, section 14(a) exempts the supply of financial services from GST. When tax is imposed on a supply, a registered person who receives the supply may be able to deduct input tax under section 20(3).

Section 2(1) defines "goods", "input tax", "money", and "services":

"Goods" means all kinds of personal or real property; but does not include choses in action or money.

"Input tax", in relation to a registered person means-

(a) Tax charged under section 8(1) of this Act on the supply of goods and services made to that person:...

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being in any case goods and services acquired for the principal purpose of making taxable supplies...

"Money" includes-

(a) Bank notes and other currency, being any negotiable instruments used or circulated, or intended for use or circulation, as currency; and

(b) Postal notes and money orders; and

(c) Promissory notes and bills of exchange,-

whether of New Zealand or any other country, but does not include a collector's piece, investment article, or item of numismatic interest.

"Services" means anything which is not goods or money.

Section 3(1) defines "financial services":

For the purposes of this Act, the term "financial services" means any one or more of the following activities:...

(f) The provision of credit under a credit contract:

(ka) The payment or collection of any amount of interest, principal, dividend, or other amount whatever in respect of any debt security, equity security, participatory security, credit contract, contract of life insurance, superannuation scheme, or futures contract.

Section 10(8) states:

Where goods and services are deemed to be supplied by a person under section 5(3) or section 21(1) of this Act, the consideration in money for that supply shall be deemed to be the lesser of-

(a) The cost of those goods and services to the supplier, including any tax charged in respect of the supply of those goods and services to that supplier:

(b) The open market value of that supply.

Section 21(1) states:

Subject to section 5(3) of this Act, to the extent that goods and services applied by a registered person for the principal purpose of making taxable supplies are subsequently applied by that registered person for a purpose other than that of making taxable supplies, they shall be deemed to be supplied by that registered person in the course of that taxable activity to the extent that they are so applied:

Provided that this subsection shall not apply to any goods and services to the extent that they are applied for the purpose of making exempt supplies where at the commencement of any taxable period there are reasonable grounds for believing that the total value of all exempt supplies to be made by that registered person in that month then commencing and the 11 months immediately following that month will not exceed the lesser of-

(a) The amount of $48, 000:

(b) An amount equal to 5 percent of the total consideration in respect of all taxable and exempt supplies to be made during that 12 month period.

Policy

Nature of supply when cash dividend paid

GST is a tax charged on supplies of goods and services. The definitions of "goods" and "services" exclude money, so supplies of money are not subject to GST.

The actual cash amount paid as a dividend is a supply of money that is outside the scope of the Act. However, the actual activity of paying a dividend is an exempt supply under sections 3(1)(ka) and 14(a). Therefore, the goods and services involved in the activity of paying a dividend (for example, goods and services used in updating the register of shareholders, making announcements to the Stock Exchange, writing cheques, posting dividend cheques to shareholders, etc) are used in making exempt supplies of financial services under sections 3(1)(ka) and 14(a).

Exclusion of money from GST

The exclusion of money from the definitions of "goods" and "services" illustrates an important concept underlying GST. Every provision of goods and services involves at least two persons and at least two supplies. One person supplies goods and services to another. That other person usually supplies money in return. This second supply (the supply of money) is not subject to GST. The direction of the cash flow when a dividend is paid, from company to shareholder, supports the view that the actual cash amount paid as a dividend is not a supply of goods and services.

Ignoring cash flows in this context is consistent with the GST treatment of other financial services under section 3, for example, the provision of credit under a credit contract (section 3(1)(f)). The actual cash amount of credit provided under a credit contract is not included within the exempt supply of a financial service.

Collection of dividends may be exempt under section 3(1)(ka)

A third party who receives a dividend (for example, an investment manager) makes an exempt supply if he or she supplies the service of collecting dividends under section 3(1)(ka). Such a supply by the recipient of the dividend is to the person entitled to the dividend, not to the company paying the dividend. The value of the supply is the fee charged for collection, not the amount of the dividend collected. A shareholder's receipt of a dividend on his or her own behalf does not fall within section 3(1)(ka). In this situation the receipt of the dividend is ignored for GST purposes.

Input tax

GST on supplies a company acquires for the activity of paying a cash dividend (including the costs of calculating and declaring a dividend) will not satisfy the definition of "input tax" under section 2(1). This is because these supplies are not acquired for the principal purpose of making taxable supplies. The Commissioner's view is that these supplies are acquired for the principal purpose of making exempt supplies (the financial service of the activity of paying a dividend). There are no inputs relating to the supply of money (the cash amounts of dividends), which do not also relate to the exempt supply (the activity of paying dividends).

Application of section 21

Some supplies acquired for the principal purpose of making taxable supplies by a company may also partly be used for paying a dividend. For example, a company may use its computer mainly for the taxable supplies of the business, but also partly for paying dividends. In such a case, section 21(1) output tax adjustments are necessary. When costs can be directly attributed to exempt or taxable supplies, no section 21(1) adjustment is necessary.

(In many cases, the de minimis rule in the first proviso to section 21(1) will apply to exclude the need for a section 21(1) adjustment. The de minimis rule provides that section 21(1) does not apply if the value of a company's exempt supplies does not exceed the lesser of $48,000 or 5% of the its total taxable and exempt supplies over the next year.)

Appropriate section 21 method

When a section 21(1) adjustment is necessary, the company may want to use the turnover method or a special method (for example, time and effort). The most appropriate method will be the method which most accurately measures the mixed use of inputs in making both taxable and exempt supplies. The value of the exempt supplies should not include the total cash amounts paid as dividends, for the reason above that supplies of money are not relevant for GST purposes.

Section 21(1) output tax adjustments create a deemed taxable supply to the extent of the exempt supplies. These deemed supplies create an output tax liability.

Value of section 21(1) adjustments

Section 10(8) values deemed supplies under a section 21(1) adjustment. Section 10(8) deems the consideration for a deemed supply to be the lesser of the cost of the goods and services and the open market value of those goods and services.

Example

Sports Limited (SL), a sportswear manufacturer, is a publicly listed company with a widely spread shareholding. Each year SL pays an interim and a final dividend. SL's financial division administers and pays the dividends. SL's financial division has a budget of $75,000. In the 1994-95 year the amount SL pays as cash dividends is $2,000,000.

SL will have to calculate the costs of its financial division that relate to paying a dividend, either by directly attributing the costs or using a section 21 adjustment method. For costs that cannot be directly attributed, SL must make a section 21(1) adjustment to reflect the financial division's exempt supplies of paying dividends. This adjustment would not take into account the cash amounts of dividends paid. (An adjustment is only necessary if SL's exempt supplies exceed the lesser of $48,000 or 5% of total taxable and exempt supplies.)

Investor Limited (IL) is a registered person and a shareholder in SL. SL pays a dividend of $5,000 to IL. IL is not supplying a service of collecting dividends within section 3(1)(ka) and can ignore receipt of the dividend for GST purposes.

Whether an activity is a GST taxable activity or a hobby

Summary

A hobby is not a taxable activity for the purposes of the Goods and Services Tax Act 1985. This item explains the factors that the Commissioner considers when deciding whether an activity is a taxable activity or a hobby.

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

Background

A taxable activity does not include an activity that is essentially a private recreational pursuit or hobby. A person participating in such an activity cannot register for GST nor claim or charge GST.

Legislation

Section 6(3) states:

> Notwithstanding anything in subsections (1) and (2) of this section, for the purposes of this Act the term "taxable activity" shall not include, in relation to any person,-
>
> (a) Being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or
>
> (aa) Not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby; or...

Application

There are a number of relevant factors that the Commissioner takes into account when determining whether an activity is a hobby or a taxable activity.

In Judge Bathgate's judgment in *Case N27* (1991) 13 NZTC, he says:

> I do not attempt to give an all-embracing or exclusive definition of the phrase ... "essentially as a private recreational pursuit or hobby", but observe that would seem to require, in essence, a private pastime carried on for the personal refreshment, pleasure or recreation of the person (or persons) concerned.

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No one factor by itself is conclusive. The weight given to each factor depends on the facts of the particular situation.

Factors considered include:

- The reasons for conducting the activity - the intention of a hobbyist is quite different to that of a person carrying on a taxable activity. A hobbyist carries on an activity predominantly for pleasure or enjoyment. A person carrying on a taxable activity may derive pleasure or enjoyment from the activity, but this is a secondary factor.

  For example, in *Case M131* (1990) 12 NZTC 2,850, a building company claimed a deduction for promotional expenses connected with racing and depreciation on a racehorse. It also claimed an input tax deduction for the purchase price of the horse, which the Commissioner disallowed. The TRA held that the predominant objective and purpose of the expenditure was to promote and advertise the company. Any private enjoyment gained was merely a result of the predominant purpose, and quite incidental to it.

  The intention to make a profit is not a necessary ingredient of a taxable activity. In *Case N27*, Judge Bathgate noted that the definition of "taxable activity" is not the same as a "business" in the Income Tax Act. A business involves the intention to make a pecuniary profit, but such a prerequisite is expressly excluded from the definition of a taxable activity for GST purposes.

- Duration of the activity - if the activity is taxable, it will usually possess a certain degree of continuity.

- Regularity - an activity that is only undertaken from time to time is more likely to be a hobby.

  For example, in *Case P73* (1992) 14 NZTC 4,489, a company bought a yacht in October 1986, with the intention of setting up a chartering business. The taxpayer was advised to race the yacht for publicity for the proposed charter venture. The taxpayer claimed input tax deductions up until October 1989. The Commissioner disallowed the claims, considering that the taxpayer was not carrying on a taxable activity.

  The TRA held that no chartering activity was ever achieved on a regular or continuous basis. The dominant reason for the racing was as a private recreational pursuit or hobby and not for the promotion of the proposed chartering activity.

- Frequency of supply - if infrequent, this may indicate that the activity is a hobby.
- Business-like nature of operations - are the methods and actions consistent with those of carrying on a taxable activity?
- Structure and organisation - a taxable activity usually exhibits some form of structure and organisation.
- Level of financial investment - the hobbyist is less likely to tie up large amounts of money in an activity, compared to a person carrying on a similar, but taxable, activity.
- The time available to devote to the activity - a hobby is usually pursued on a part-time basis, because it is carried on as an interest or leisure activity. It is not a major source of income for the hobbyist. The amount of time the hobbyist spends in pursuing the activity is therefore restricted to the amount of spare time available.

Example 1

Jenny works full-time as a receptionist for a large medical practice in the city. She finds that spending some of her free time making scented beeswax candles relaxes her. She gives candles to her friends and family as gifts. Once or twice a year, she has enough candles to sell from a friend's stall in the Harbourlight City markets. The money she makes from the sales covers most of the cost of the raw materials she has to buy.

Example 2

John works 15 hours a week as a waiter in a Mexican restaurant. Every day, from mid-morning until just before he leaves for work at around 5 pm, he makes children's wooden toys in a large garage he leases for this purpose. He has a monthly account at the local timber merchants. He has outlaid a considerable sum of money on installing modern woodworking machinery, a new lighting system, and burglar alarms. Every Saturday he sells the toys from a stall at the Harbourlight City markets. For each of the last ten years, in late October, he has published and distributed a mail order catalogue to toyshops, kindergartens, child care organisations, parent groups and similar organisations, to advertise the toys.

The Commissioner would accept that for Jenny, the candle-making is a hobby. However, John's woodwork would be considered a taxable activity.

GST - The meaning of "open market value"

Summary

This item explains the Commissioner's policy on applying section 4 of the Goods and Services Tax Act 1985 to determine the "open market value" of a supply.

The concept of the "open market value" of a supply is the calculation of the consideration in money that the supply would fetch in the open market between a willing seller and a willing buyer. Section 4 sets out

three successive methods of determining the "open market value" of a supply. The tests in order are:

- The consideration in money that the supply would fetch at that date in New Zealand if freely supplied in similar circumstances between people who are not associated persons.
- The consideration in money that a similar supply would fetch if freely supplied at that date in New Zealand in similar circumstances between people who are not associated persons.
- Other methods approved by the Commissioner which provide a means for establishing an objective approximation of the consideration in money for a supply of the goods and services in question.

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

Background

The Act imposes GST on the value of supplies made by a registered person. Normally, the value of a supply will be the monetary consideration for the supply. However, there are occasions when the Act requires the value of the supply for the consideration for the supply to be set at the open market value. The sections that deal with these occasions are:

- Section 2, in determining the consideration for "input tax" (as defined) when the supply involves a supply of secondhand goods between associated persons or when the consideration does not relate solely to the supply of secondhand goods.
- Section 5(3A), when input deductions are available upon deregistration for goods or services purchased on or before the 30th September 1986. (This applies only to non-profit bodies or to registered persons who voluntarily registered and did not make sufficient supplies to be deemed liable to be registered.)
- Section 10(2)(b), when part or all of the consideration for the supply is not consideration in money.
- Section 10(3), when these three conditions are met:
  - The supply is between associated persons.
  - Consideration for the supply is nil or is below the market value of that supply.
  - The supply is not a fringe benefit.
- Section 10(8), when goods are deemed to have been supplied by a person as a result of either the cessation of that person's registration, or the goods are subsequently applied for the purpose of making exempt supplies or for private use.
- Section 21(5), when goods and services, acquired prior to 1 October 1986 and for which no deduction has previously been claimed, are subsequently applied for the principal purpose of making taxable supplies.
- Section 61(3A), when a company, as a registered person, acquires goods and services from a non-registered company before amalgamation.
- Section 76(2)(d) gives the Commissioner the power to deem any supply of goods and services or consideration for such goods and services to be at the open market value when the Commissioner is satisfied that persons have entered into an arrangement to defeat the intent and application of the Act.

Legislation

Section 4 states:

4(1) For the purposes of this section -

(a) The term "similar supply" in relation to a supply of goods and services, means any other supply of goods and services that, in respect of the characteristics, quality, quantity, functional components, materials, and reputation of the goods and services first mentioned, is the same as, or closely or substantially resembles, that supply of goods and services.

(b) The open market value of the supply shall include any goods and services tax charged pursuant to section 8(1) of this Act on that supply.

4(2) For the purposes of this Act, the open market value of any supply of goods and services at any date shall be the consideration in money which the supply would generally fetch if supplied in similar circumstances at that date in New Zealand, being a supply freely offered and made between persons who are not associated persons.

4(3) Where the open market value of any supply of goods and services cannot be determined under subsection (2) of this section, the open market value shall be the consideration in money which a similar supply would generally fetch if supplied in similar circumstances at that date in New Zealand, being a supply freely offered and made between persons who are not associated persons.

4(4) Where the open market value of any supply of goods and services cannot be determined pursuant to subsection (2) or subsection (3) of this section, the open market value shall be determined in accordance with a method approved by the Commissioner which provides a sufficiently objective approximation of the consideration in money which could be obtained for that supply of those goods and services.

4(5) For the purposes of this Act the open market value of any consideration, not being consideration in money, for a supply of goods and services shall be ascertained in the same manner, with any necessary modifications, as the open market value of any supply of goods and services is ascertained pursuant to the foregoing provisions of this section.

Section 4 sets out three successive methods for determining the open market value of the supply. They are not alternative methods. Taxpayers can only use the subsequent methods when the previous methods are not applicable. The methods for determining the open market value, in order, are:

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- The consideration in money which the supply of those goods and services would generally fetch if supplied in similar circumstances at that date in New Zealand, if it was a supply freely offered and made between persons who are not associated persons.
- The consideration in money that a similar supply would generally fetch if supplied in similar circumstances at that date in New Zealand, if it was a supply freely offered and made between persons who are not associated persons.
- A method approved by the Commissioner which provides a sufficiently objective approximation of the consideration in money which could be obtained for that supply of those goods and services.

Policy

Section 4 uses the terms "similar circumstances", "freely offered", and "similar supply" in the tests for determining the open market value of a supply. The Commissioner's interpretation of these phrases and their application is set out below.

Similar circumstances

Sections 4(2) and 4(3) use the term "similar circumstances". The Commissioner considers that this term emphasises that in determining the open market value of the goods and services one must also look at the circumstances surrounding the sale. For example, the supply may be a forced sale or it may be a retail sale. In both examples this may affect the open market value of the supply. The quantity of the goods and services may also have significant bearing on the open market value.

Freely offered

Sections 4(2) and 4(3) use the term "freely offered". The Commissioner considers that this term emphasises that the open market value must be considered from the point of view that the seller and the purchaser are willing participants and are not associated persons. The term contemplates that they have both entered the market, and are not prepared to buy or sell for other than a reasonable price under the particular circumstances.

Similar supply

The phrase "similar supply" is defined in section 4(1)(a) and is used in section 4(3). When the open market value cannot be based on the supply of the same goods or services, it must be calculated on the basis of a supply of goods or services of a similar nature. These goods and services should be as near equivalent as possible to the goods and services supplied, and ideally they should be able to replace the original goods and services and perform the same function.

Section 4(1)(a) states the factors to consider in determining whether goods and services are similar. These factors are; characteristics, quality, quantity, functional components, materials, and the reputation of the goods and services.

Method approved by the Commissioner

Section 4(4) enables the Commissioner to approve a method the taxpayer adopts to determine the open market value of that supply. The Commissioner will treat each case on its merits. As far as possible the methods adopted to arrive at the open market value should be achieved by applying a degree of flexibility to the other two valuation methods. For example, the only similar supply available in New Zealand may be between persons who are associated. However, the associated persons may arrive at an open market value based on a cost-plus method which may be acceptable to the Commissioner.

Some of the factors the Commissioner considers in approving a method to calculate the open market value are:

- costs of production and likely profit margin
- the demand for the goods or services and the amount of consideration paid for similar or the same goods and services previously.

The Commissioner does not consider that the book value of an asset is an appropriate means of calculating its open market value.

Adverse event income equalisation scheme

Introduction

This item sets out the legislative and procedural requirements of the Adverse Event Income Equalisation Scheme that was introduced with effect from 1 April 1993.

The Livestock Valuation Consultative Committee recommended such a scheme to the Government after reviewing livestock valuation methods during 1992. The Committee considered that there should be some income tax relief for farmers forced to sell capital livestock because of an adverse event. The adverse event scheme runs alongside the existing income equalisation scheme (referred to in the legislation as the main income equalisation scheme).

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

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
EI 11 to EI 16	185A to 185F
OB 1 "maximum deposit"	185A

Intention of the scheme

The intention of the adverse event income equalisation scheme is to defer income tax on additional income which is generated by the forced sale of livestock, from the year of sale to the year the livestock is replaced by either purchasing or home breeding.

To achieve this aim, the additional income is calculated by comparing the sale price with the value of the animals as if they had still been on hand at the end of the income year. So farmers don't have to wait until the livestock values are announced, values for the previous year are used in the calculation. This is explained in more detail under "Maximum deposits" below.

Adverse events are self-assessed

The adverse event is self-assessed by the farmer. When a farmer makes a deposit to the scheme, he or she must give the Commissioner a statutory declaration describing the relevant event or occurrence, and specifying how the farm business is affected by the event. A form (IR 139) is available from Inland Revenue for this purpose.

The adverse event could result from fire, flood, drought, or other natural event or sickness or disease among livestock. It does not have to be an event that affects a whole area or region. A localised event such as a fire that only affects an individual farm will qualify. As long as there is a reduction in the carrying capacity on the taxpayer's farm which results in abnormal sales of livestock and the farmer is unable to replace that livestock in the same income year, a deposit to the adverse event scheme can be made.

Deposits

The farmer must send a completed IR 139 form to the local Inland Revenue office with every deposit. This form asks for the normal name, address, IRD number etc., and also requires the farmer or agent to tell us the location of the farm, the nature of the adverse event and the type, class, number, and sale price of the animals the farmer was forced to sell. The form and the payment of the deposit must arrive at Inland Revenue within one month from the closing balance date of the income year of forced sale. No extensions of time are permitted.

Example

If there is a forced sale of livestock during the year to 30 June 1995, the payment must reach Inland Revenue before the end of July 1995.

Interest at a daily rate (currently 6.5% p.a.) is paid on the deposits from the date of payment to the scheme.

Farmers can make deposits at any time after the forced sale of livestock. They do not have to wait until the end of the income year. Farmers can make more than one deposit to the scheme each year, especially when livestock is reduced progressively because of a continuing or recurring adverse event, such as a prolonged drought.

Example

A farmer with a 30 June balance date is forced to sell 20% of his capital livestock in January 1995 because of a drought. The maximum deposit from this sale is deposited into the adverse event income equalisation account in February 1995. The drought continues, and in April 1995 the farmer is forced to sell further livestock. The maximum deposit from this second sale can be deposited in the account soon after the sale, or held and deposited in the account within one month of the farmer's closing balance date. Alternatively, the farmer could delay the deposit of the excess from both sales until the month after balance date. Regardless of the timing of the deposits, provided they are made before the cut-off date (one month after balance date), they will be deductible for income tax purposes (in this example) in the 1995 income year.

Maximum deposits

The maximum deposit to the adverse event income equalisation scheme is defined in section OB 1. The maximum deposit is the difference between:

- the sale price of the livestock sold because of the adverse event, and
- the previous year's closing value for the class of livestock that the livestock sold would have been classed at the end of the year of sale if it had not been sold.

Example

A South Island farmer using the herd scheme for all classes of merino sheep is affected by a drought during the 1995 income year. The farmer is forced to sell 400 rising five-year old ewes in December 1994. The maximum deposit is calculated as follows:

Sale price of 400 ewes at $40/head	$16,000
Book value of ewes at $37/head (closing book value of rising 5-year and older ewes for the 1994 year (1994 herd values)	$14,800
Maximum deposit	$ 1,200

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Example

A farmer uses the national standard cost scheme for all sheep. A drought forces the reduction in capital livestock by 400 mixed-aged ewes. These animals were in the mature inventory grouping under the average cost inventory system. The opening value of the mature inventory grouping during the year of forced sale was $20.50 per head. The maximum deposit is calculated as follows:

Sale price of 400 ewes at $40/head	$16,000
Opening book value ($20.50/head)	$ 8,200
Maximum deposit	$ 7,800

Withdrawals

The deposit(s) can be withdrawn at any time, in one lump sum or in instalments, once the farmer has done all of these things:

- provided details of how the farm was affected by an adverse event, and shown that he or she was forced to sell livestock which could not be replaced in the same income year
- let us know the type, class, number, and sale price of the stock sold
- made a deposit to the adverse event income equalisation account and sent it to the local Inland Revenue office with the completed statutory declaration form IR 139.

The withdrawal or refund is assessable in the year of withdrawal. There is no minimum period in which deposits to the adverse event income equalisation scheme must remain in the account. The time between deposit and withdrawal can be as short as one day. However, the one day rule will only be effective if the withdrawal is made in the month following balance date, because of the timing of the deductibility and assessability for deposits and withdrawals.

Any deposits that remain in the adverse event account for more than one year, along with the net interest which forms part of the deposit, automatically transfer to the main income equalisation account. The amount transferred is treated as a deposit to the main account from the date the amount was originally paid into the adverse event account. The 3% interest payable under the main scheme will run from the date of transfer (one year from the date of the original payment to the adverse event account). Normal rules for withdrawal apply to the transferred deposits in the main account.

The maximum period that any adverse deposits can remain in either scheme is five years from the closing balance date of the year of deposit, or four years from the year the deposit was transferred from the main scheme.

Deposits and withdrawals - usual timing

Because of the nature of the scheme, it is most likely that farmers will make deposits within the month that follows their balance date. This has certainly been the pattern over the last two income years. This allows the deposit to be deductible from assessable income in the year of the adverse event and assessable in the next income year, even though the deposit and withdrawal were made in the same month.

Example

An adverse event (drought) occurs during November/December 1994, and a farmer is forced to reduce her livestock numbers. She has a 30 June balance date, and makes a deposit to the adverse event income equalisation scheme of $4,500. She makes the deposit on 10 July 1995, which is within the month after balance date. She requests a withdrawal of the deposit a week later on 17 July.

The $4,500 is deductible from her assessable income in the year ending 30 June 1995 and is added to her assessable income in the year ending 30 June 1996.

National average market values of specified livestock - 1995

Under section EL 8 of the Income Tax Act 1994 (the Act), the Governor-General has announced by Order in Council the national average market values of specified livestock for the 1994/95 income year.

The values listed below apply to animals valued under the herd scheme.

High-priced livestock

The trigger price for high-priced livestock purchased in the 1994/95 income year is the greater of these two amounts:

1. $500
2. five times the greater of these two amounts:

   (a) the national average market values listed below; or

   (b) the national average market values declared for the 1993/94 income year.

The trigger price for animals purchased during the 1994/95 income year is shown in the right hand column below.

High-priced livestock cannot be valued under the herd scheme but must be capitalised and written off at an assigned percentage. The assigned percentages for the 1994/95 income year remain the same as the 1993/94 income year. They are shown in the table at the end of this item.

Type of livestock	Classes of livestock	Average market value per head	High-priced trigger price
		$	$
Sheep	Ewe hoggets	29	500
	Ram and wether hoggets	28	500
	Two-tooth ewes	38	500
	Mixed-age ewes (rising three-year and four-year old ewes)	33	500
	Rising five-year and older ewes	25	500
	Mixed-age wethers	25	500
	Breeding rams	117	690
Beef cattle	***Beef breeds and beef crosses:***		
	Rising one-year heifers	215	1,665
	Rising two-year heifers	333	2,450
	Mixed-age cows	412	3,185
	Rising one-year steers and bulls	276	2,130
	Rising two-year steers and bulls	410	3,025
	Rising three-year and older steers and bulls	544	3,745
	Breeding bulls	1,109	7,755
Dairy cattle	***Friesian and related breeds:***		
	Rising one-year heifers	408	2,405
	Rising two-year heifers	723	4,200
	Mixed-age cows	830	5,040
	Rising one-year steers and bulls	192	1,820
	Rising two-year steers and bulls	350	2,760
	Rising three-year and older steers and bulls	489	3,615
	Breeding bulls	763	6,920
	Jersey and other dairy cattle:		
	Rising one-year heifers	328	2,065
	Rising two-year heifers	610	3,735
	Mixed-age cows	723	4,630
	Rising one-year steers and bulls	115	1,270
	Rising two-year and older steers and bulls	230	2,180
	Breeding bulls	605	6,095
Deer	***Red deer:***		
	Rising one-year hinds	123	615
	Rising two-year hinds	212	1,060
	Mixed-age hinds	255	1,275
	Rising one-year stags	164	820
	Rising two-year and older stags (non-breeding)	319	1,595
	Breeding stags	1,580	8,645
	Wapiti, elk, and related crossbreeds:		
	Rising one-year hinds	166	830
	Rising two-year hinds	269	1,345
	Mixed-age hinds	321	1,605
	Rising one-year stags	208	1,040
	Rising two-year and older stags (non-breeding)	377	1,885
	Breeding stags	1,851	9,255

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Type of livestock	Classes of livestock	Average market value per head	High-priced trigger price
		$	$
Deer (Cont'd)	***Other breeds:***		
	Rising one-year hinds	43	500
	Rising two-year hinds	76	500
	Mixed-age hinds	89	505
	Rising one-year stags	59	500
	Rising two-year and older stags (non-breeding)	107	535
	Breeding stags	298	1,620
Goats	***Angora and angora crosses (mohair producing):***		
	Rising one-year does	34	500
	Mixed-age does	42	500
	Rising one-year bucks (non-breeding)/wethers	15	500
	Bucks (non-breeding)/wethers over one year	21	500
	Breeding bucks	174	870
	Other fibre and meat producing goats (Cashmere or Cashgora producing):		
	Rising one-year does	12	500
	Mixed-age does	16	500
	Rising one-year bucks (non-breeding)/wethers	10	500
	Bucks (non-breeding)/wethers over one year	13	500
	Breeding bucks	87	500
	Milking (dairy) goats:		
	Rising one-year does	61	500
	Does over one year	104	520
	Breeding bucks	261	1,305
	Other dairy goats	114	570
Pigs	Breeding sows less than one year of age	195	975
	Breeding sows over one year of age	263	1,410
	Breeding boars	341	1,705
	Weaners less than 10 weeks of age (excluding sucklings)	40	500
	Growing pigs 10 to 17 weeks of age (porkers and baconers)	89	500
	Growing pigs over 17 weeks of age (baconers)	125	745

Assigned percentages of high-priced livestock

Under the livestock valuation regime owners of high-priced livestock have the choice of using straight line rates or diminishing value rates as the assigned percentage write down.

The rates for the 1994/95 income year are unchanged from last year. They are shown in the table opposite.

Livestock Category	Straight line rate	Equivalent diminishing rate
Sheep	25%	33%
Cattle	20%	26%
Stags	20%	26%
Other deer	15%	22%
Goats	20%	26%
Pigs	33%	40%

A taxpayer who wishes to apply the diminishing value rate to an animal must clearly use the diminishing value rate in the financial statements that support the tax return. Once a taxpayer makes this election it is irrevocable. If there is no such clear use of the diminishing value rate, the straight line rate will apply.

Taxation of income from illegal activities

Summary

This item states the Commissioner's policy on the taxation of income from illegal activities.

A person who earns income from an illegal activity is treated no differently under tax law to a person earning income from a legal activity. Tax must be paid on the assessable income derived from any illegal business or other illegal activity.

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

Background

The legality of an activity used to derive income does not affect the assessability of that income. Just because an activity is unlawful does not prevent income generated from that activity from being taxable.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 4	65(2)(a),(b),(e), and (1)

Section BB 4 states broadly what is included in assessable income. The broad classes of assessable income are business profits, monetary remuneration, profits from the sale of personal property (if the taxpayer's business is dealing in such property, or if the property was acquired for resale) or any scheme devised for the purpose of making a profit, and income derived from any other source. What is included in assessable income is further defined in Part C.

A person who earns income from an illegal activity has the same rights and obligations for tax purposes as a person who earns income from a legal activity. The tax laws make no distinction between income earned legally and income earned illegally.

Cases

A leading case on the taxation of profits from illegal activities is the Privy Council decision in *Minister of Finance v. Smith* [1927] A.C. 193. This decision considered whether the profit from illegal trafficking in liquor was taxable. Their Lordships could find no valid reason for deciding that the legislation intended to exclude people making profits from illegal activities. Indeed, they pointed out that to exclude such people would increase the tax burden on lawful businesses.

There are few New Zealand tax cases in this area. In *Case D57* (1980) 4 NZTC 60,852 a taxpayer was assessed with profits from the sales of an illegal drug. The taxpayer objected, not against the taxation of such profits (which was not in dispute), but on the grounds that the Commissioner did not have a sufficient basis to support the assessment. The TRA upheld the Commissioner's assessment.

Policy

A taxpayer who earns assessable income from any illegal business or other illegal activity must file a tax return and declare that income. Assessable income must be calculated in the normal manner, supported by appropriate documentation.

Assessable income earned from illegal activities is also liable to ACC earner premium and employer premium if applicable.

People who earn income from illegal activities who have not declared all their assessable income can make a voluntary disclosure to the Commissioner (as can people who earn income from legal activities). If they do this before they are investigated (or are aware of being investigated) they will not be prosecuted or have their name published. They will also have penal tax charged at a reduced rate.

A person who earns income from an illegal activity can object in the normal way to any assessment made by the Commissioner.

The information that Inland Revenue holds on a person's tax affairs is confidential. By law we cannot disclose the source of a taxpayer's income or the nature of his or her activities to the Police.

Special Audit activities

Inland Revenue now has a specialist unit, Special Audit, that conducts investigations into the tax affairs of people who earn income from illegal activities. Special Audit uses information from a number of sources to help with its investigations.

Examples of people audited to date include drug dealers, prostitutes, and dealers in stolen goods.

If you have any enquires about the taxation of income from illegal activities, contact:

The Manager
Special Audit
P. O. Box 12467
WELLINGTON

Phone (04) 472-1032.

Non-resident shipping operators operating within New Zealand's coastal waters

Operators' and agents' tax obligations

Introduction

This item sets out the Commissioner's view on the tax obligations of non-resident shipping operators who operate in New Zealand's coastal waters. It also comments on the tax obligations of payers of non-resident shipping operators who make contract payments for services performed in New Zealand.

In this article, the term "cargo" includes merchandise, goods, livestock, mails, and passengers.

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

Background

The Maritime Transport Act 1994 came into effect on 1 February 1995, and allows non-resident shipping operators to carry domestic cargo within New Zealand provided certain conditions are met.

Before this, non-resident shipping operators were only allowed to transport international cargo within New Zealand's coastal waters (that is, cargo embarked from outside New Zealand for delivery to New Zealand, and cargo embarked from within New Zealand for delivery outside New Zealand). Non-resident shipping operators were not permitted to ship or embark cargo in New Zealand for delivery to other ports in New Zealand. The carrying of domestic cargo within New Zealand was limited to New Zealand shipping operators.

The tax treatment of income generated by non-resident shipping operators from transport of international cargo is summarised below.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
CB 2 (1)(c)	61(19)
CN 1	223
FB 2	245
OE 4	243

Cargo shipped or embarked outside New Zealand

A non-resident shipping operator's income generated from cargo shipped or embarked on any ship at a port outside New Zealand for carriage to any New Zealand port or ports is deemed to be derived from New Zealand under section OE 4 (1)(a), (q) and/or (u), on the basis that the non-resident shipping operator is deriving income:

(a) ....from any business wholly or partly carried on in New Zealand:

(q) ...from contracts wholly or partly performed in New Zealand:

(u) ..derived directly or indirectly from any other source in New Zealand.

However, under section FB 2, the income deemed to be derived from New Zealand under section OE 4 (1)(a) and (q) may be apportioned between its source in New Zealand and its source elsewhere. The amount of income that is so apportioned or attributed to a source in New Zealand is deemed to be income derived from New Zealand, and is assessable for income tax accordingly.

Relief from any New Zealand income tax liability may be given to a non-resident shipping operator when a double tax agreement ("DTA") exists between New Zealand and the operator's country of residence. In most cases, non-resident shipping operators are residents of countries with whom New Zealand has a DTA, and such DTAs provide relief from New Zealand tax for the transport of international cargo.

If no relief is available under a DTA, the income apportionable or attributable to a New Zealand source may be calculated on a time basis.

Cargo shipped or embarked in New Zealand for delivery outside New Zealand

5% of the non-resident shipping operator's gross income generated from cargo shipped or embarked on any ship at any port in New Zealand for carriage outside New Zealand is deemed to be taxable income under section CN 1 (1).

Under section CN 1 (2) the Commissioner may exempt a non-resident shipping operator's income from tax when the Commissioner is satisfied that, in corresponding circumstances, a New Zealand resident shipping operator would not be liable to, or would be exempt from, income tax in the non-resident shipping operator's country of residence.

A non-resident shipping operator may also be entitled to relief from New Zealand tax under a DTA that New Zealand may have with the non-resident shipping operator's country of residence.

Effect of the Maritime Transport Act 1994

Following the introduction of the Maritime Transport Act 1994, non-resident shipping operators are now able to generate income from a new source - from the transport of cargo embarked in New Zealand for delivery to other ports in New Zealand.

The income derived from such activity has specifically been deemed to be derived from New Zealand under section OE 4 (1)(t), and is accordingly assessable for income tax in New Zealand. The full amount of the contract payment is assessable income, as section CN 1 does not apply: the cargo is not being shipped or embarked for delivery outside New Zealand. Nor do the apportionment provisions of section FB 2 apply.

However, the non-resident shipping operator may be entitled to relief from New Zealand tax under a DTA.

Application of the Income Tax (Withholding Payments) Regulations 1979

The item "Income Tax (Withholding Payments) Regulations 1979 - Aircraft and Shipping Operators" in TIB Volume Two, No.2 (August 1990), confirmed the Commissioner's policy on how the Income Tax (Withholding Payments) Regulations 1979 (the Regulations) apply to non-resident shipping operators' income from transporting international cargo to and from New Zealand.

That item stated that the Regulations do apply to payments made to non-resident shipping operators for their contract activities carried out in New Zealand, but that the Commissioner would not seek to apply the regulations to these payments. This policy was made on the basis that most payments made to non-resident shipping operators were exempt from New Zealand tax under section 223(3) of the Income Tax Act 1976, or not subject to tax under a DTA.

The above TIB was published before the introduction of the Maritime Transport Act 1994. The policy set out in it still applies to the transport of international cargo.

However, this policy does not extend to the shipping or embarking of cargo in New Zealand for delivery in New Zealand by non-resident shipping operators. Payments made for such services performed are subject to the Regulations, as non-resident shipping operators are considered to be "non-resident contractors". The payer of the contract payment must deduct withholding tax at the rate of 15 percent.

For a detailed summary of how the Income Tax (Withholding Payments) Regulations 1979 apply to contract payments made to non-resident contractors, see the following item below.

A non-resident shipping operator may be entitled to apply for a certificate of exemption or special tax rate certificate. This will be especially relevant to those non-resident shipping operators who are eligible for relief from New Zealand tax under a DTA.

Employers' PAYE obligations

A non-resident shipping operator must deduct PAYE from salary and wages paid to employees when the employees are present in New Zealand in the service of the non-resident shipping operator. PAYE may not have to be deducted when Inland Revenue is satisfied that the employee is or will be exempted or provided with relief from New Zealand tax, either under section CB 2 (1)(c) [92 day rule] or by the operation of a DTA.

See the following item for more information about a non-resident contractor's obligations as an employer.

Enquiries

If you have any enquiries about non-resident shipping operators, contact:

The Supervisor (Compliance Support)
Oil & Minerals Portfolio
Corporates Unit
Inland Revenue Department
P O Box 895
WELLINGTON

Telephone: (04) 802-6000
Facsimile: (04) 384-5883

Non-resident contractors' withholding tax

Who is affected by the withholding tax rules

Introduction

This item is a general explanation of the non-resident contractors' withholding tax ("NRCWT") rules, and how they apply to contract payments made to non-resident contractors for work carried out in New Zealand.

The NRCWT rules are contained within the Income Tax (Withholding Payments) Regulations 1979 ("the Regulations").

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

Background

Non-resident contractors are liable to income tax in New Zealand on any income they derive in New Zealand from any business or contract wholly or partly carried on or performed in New Zealand. The liability arises under sections BB 3 (b) and OE 4 (1)(a), (q), (s), (t), and (u) of the Income Tax Act 1994.

During the late 1970s to early 1980s, the number of non-resident contractors performing services in New Zealand increased substantially as a result of the then Government's "Think Big" projects.

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In response to this increase, the NRCWT rules were introduced with effect from January 1982. The Regulations were initially focused on activities associated with large construction-related projects (hence the definition of "contract project" in the Regulations) and to a lesser extent, on the provision of equipment and personnel.

With effect from 22 March 1990, an amendment to the definition of "contract activity" was made so that it included all contracts for service, whether or not they were in connection with a "contract project". This amendment ensures that any non-resident person who undertakes any contract for service in New Zealand is subject to the Regulations.

The Regulations require the payer of the contract payment to deduct a 15% withholding tax from the gross contract payment at the time of payment to the non-resident contractor. The non-resident contractor may get relief from the withholding tax by obtaining a certificate of exemption or a special tax rate certificate from the Commissioner. The Commissioner will not issue certificates retrospectively.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 3	242
CB 2 (1)(c)	61(19)
NC 7	343A
NC 18	350A
OE 4	243

Under Part N of the Act, a person who contracts with a non-resident contractor must deduct NRCWT from contract payments that are declared to be "withholding payments" as defined in the Regulations.

Note: Do not confuse non-resident contractors' withholding tax with the withholding tax imposed under the non-resident withholding tax ("NRWT") legislation. NRWT applies to interest, dividends, and royalties (as defined in section OB 1) that non-residents derive from New Zealand. For more information about NRWT, see the various TIBs issued on the subject or Inland Revenue's information booklet "Non-Resident Withholding Tax - Payer's Guide" (IR 291).

Under Regulation 4 of the Regulations, all payments of the classes specified in the Schedule to the Regulations are withholding payments for the purposes of Part XI of the Income Tax Act 1976. The Schedule is made up of Parts A, B, D, and E. Part E of the Schedule to the Regulations consists of "contract payments to non-resident contractors", and prescribes the rate of tax deduction to be 15c per $1.

A number of terms used in the Regulations require clarification. These terms are defined in regulation 2, and the following paragraphs explain them:

Non-resident contractor

The term "non-resident contractor" means any person (within the meaning of section OB 1) who is not resident in New Zealand and who under a contract or agreement or arrangement undertakes any contract activity. The term does not apply to contracts of service between an employer and employee.

Contract activity

"Contract activity" has a very broad and expansive meaning. In relation to a non-resident contractor, it means:

(a) The performing or rendering of any work or contract service in New Zealand, being work or a contract service in connection with, or in relation to, any contract project :

(ab) The performing or rendering of any work or contract service in New Zealand, whether or not that work or contract service is carried on or carried out in connection with, or in relation to, any contract project:

(b) The granting, providing, or supplying of the use, or the right to use, in New Zealand (whether or not in connection with, or in relation to any contract project), any personal property or any services of any person, being a person other than the non-resident contractor:

The Regulations do not apply to any contract activity that is performed outside New Zealand.

There are few activities that do not meet the definition of either "contract project" or "contract service". If you are unsure whether the nature of the services provided by a non-resident contractor comes within the definition of "contract activity", contact Inland Revenue for more information.

Contract project

A "contract project" means any undertaking, project or scheme carried on, carried out, or performed in New Zealand, in connection with most types of construction and installation projects. The Regulations contain an extensive list of the types of activities that are considered to fall under the umbrella of a contract project.

Contract service

A "contract service" is defined as any service of any kind performed by a non-resident contractor. The definition contained in regulation 2 states that without limiting the meaning of "contract service" the term includes:

any advisory, analytical, architectural, consultancy, designing, diving, drilling, engineering, inspection, management, procurement, professional, scientific, surveying, technical, or weather forecasting service, and any service in respect of or in relation to any feasibility, financial, or marketing study or evaluation.

The definition provides examples of the types of services that come within the meaning of "contract service", but it is not limited to those examples specified.

Contract payment

The term “contract payment” is defined as any payment to a non-resident contractor in relation to any contract activity. The following are all specifically excluded from the definition:

- A payment that is a royalty within the meaning of section OB 1.
- A cost reimbursing payment to the extent that the payment made to the non-resident contractor constitutes reimbursement of expenditure incurred by the non-resident, but excludes any payment made when the non-resident and that other person are associated persons. The cost reimbursing payment must not include any profit element.
- A payment for the supply of labour or the operation or maintenance of fishing vessels to which clauses 8 and 9 of Part A of the Schedule to the Regulations apply.

Certificate of exemption

Under regulation 5(1A), if a non-resident contractor applies in writing to the Commissioner, the Commissioner may issue an exemption certificate to that person. The certificate of exemption will specify that no NRCWT is to be deducted from contract payments made in respect of the contract activity stated on the certificate, and will specify the period for which the certificate is valid. The Commissioner can only issue an exemption certificate to the non-resident contractor if the conditions of one of the following three subparagraphs of regulation 5(1A) are satisfied:

(a) The Commissioner is satisfied that any income derived, or which may be derived, by the non-resident contractor is not subject to income tax under the Act, by reason of relief provided by a double tax agreement (“DTA”) or for any other reason.

(b) The non-resident contractor gives to the Commissioner a bond or other form of security which is satisfactory to the Commissioner, to secure payment on terms acceptable to the Commissioner of any income tax payable or which may become payable under the Act in respect of the contract activity. (See Inland Revenue for further details on bond requirements.)

(c) The Commissioner is satisfied that the non-resident has, in the 24-month period immediately preceding the application, paid every amount of income tax correctly payable under the Act, and in all other respects complied with the obligations arising under the Act, and will continue to comply in the future.

An application for an exemption certificate must be in writing, stating under which sub-paragraph of regulation 5(1A) an exemption certificate is requested. A certificate will not be issued to cover a retrospective period.

Special tax rate certificate

A non-resident contractor may apply to the Commissioner for a special tax rate certificate (also known as a reduced rate certificate). Under regulation 6A, when a person applies for such a certificate the Commissioner has the discretion to issue one specifying that NRCWT is to be deducted at a rate of withholding tax specified in the certificate. The certificate can be issued at a rate higher or lower than the standard NRCWT rate.

A non-resident contractor will usually request a special tax rate certificate when the person’s actual/potential New Zealand tax liability is less than or greater than the standard 15 percent withholding tax rate. The rate at which a special tax rate certificate is issued is calculated on the basis of the expected revenue and expenditure of the contract. Calculation of the taxable profit is to be made in accordance with New Zealand tax law. A certificate will not be issued to cover a retrospective period.

Accounting for withholding tax

Non-resident contractors’ withholding tax is withheld from each contract payment made to the non-resident contractor at the standard or special tax rate. Payers must ensure that they hold a fully completed IR 13 withholding payment deduction certificate on the non-resident contractor’s behalf. When the payer does not hold a fully completed IR 13 certificate, withholding tax must be deducted at the non-declaration rate of 30c per $1 under section NC 7.

The payer does not have to withhold any NRCWT if the non-resident contractor produces a valid certificate of exemption. Alternatively, the non-resident contractor may produce a valid special tax rate certificate authorising the payer to withhold tax at a lesser or greater rate as specified on the certificate.

The tax deducted is paid to Inland Revenue in the same way as monthly PAYE deductions, i.e., it is treated the same as if PAYE had been deducted from an employee’s salary or wage. The payer includes the IR 13 withholding payment deduction certificate with the annual IR 68P PAYE tax reconciliation. The “employee’s” copy of the IR 13 certificate goes to the non-resident contractor as evidence of tax paid on the non-resident contractor’s behalf.

Failure to deduct NRCWT will result in grossing up the payment made to the non-resident contractor, and the payer will be liable for the deficient tax deductions. The penal provisions of the Act may also be imposed. However, in a situation where the payee (non-resident contractor) subsequently refunds to the payer the NRCWT that should have been deducted from the contract payments, Inland Revenue may refund to the payer the grossed up portion paid to the Commissioner.

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Interim tax

The NRCWT withheld is an interim tax paid on account of a non-resident contractor's annual income tax liability. The tax is neither a minimum nor a final liability. The non-resident contractor's final New Zealand income tax liability is determined by way of annual assessment, at which stage a refund of any overpaid tax can be made or additional payment sought from the non-resident as appropriate.

When Parts A, B, and D of the Schedule to the Regulations also apply

The clauses contained in Parts A, B, and D of the Schedule to the Regulations identify classes of payments that are subject to withholding tax. The clauses do not attach themselves to any particular class of taxpayer, i.e., they do not distinguish between resident and non-resident persons.

Sometimes a non-resident who performs contract services in New Zealand is held to be a non-resident contractor (to which Part E of the Schedule to the Regulations applies), as the services performed come within the definition of "contract activity". However, the nature of the payment may also be subject to withholding tax under one of the specific clauses contained in Parts A, B, and D of the Schedule to the Regulations. In circumstances such as these, the rate of withholding tax applicable to that specific class of payment, as stated in Parts A, B, and D of the Schedule, will apply. An example of this situation is highlighted in Example 7 below.

Non-resident contractor's tax obligations as an employer

A non-resident contractor must deduct PAYE from any salary and wages paid to any employee who is present in New Zealand in the service of that non-resident contractor. The obligation to deduct PAYE from employees' remuneration is not removed by the fact that the employees may be non-residents themselves, or that the employer (non-resident contractor) may not have a New Zealand tax liability.

Non-resident contractors who have employees present in New Zealand undertaking the contract activity on their behalf must make arrangements with Inland Revenue to account for all of the following:

- PAYE
- fringe benefit tax (FBT)
- ACC employer premium
- ACC earner premium
- specified superannuation contribution withholding tax (SSCWT).

For more information about employers' tax obligations, see our "Employers' Guide" (IR 184). You can get a copy from any Inland Revenue office.

PAYE must be deducted until such time as each individual employee's right to relief from New Zealand tax can be established to Inland Revenue's satisfaction. Sometimes an employee may be exempted, or provided with relief, from New Zealand tax by exemption under section CB 2 (1)(c) ["92 day rule"] or in accordance with a DTA ["183 day rule"].

It is not always possible for a non-resident contractor to determine in advance whether an employee will be entitled to the exemption provided by section CB 2 (1)(c) or to relief under a DTA.

In certain circumstances a bond or other security may be lodged with the Commissioner to waive the requirement to make tax deductions from salary or wages payable to a non-resident employee. An example is when the employee is ultimately likely to be exempt from tax in New Zealand, under the "92 day rule" or the "183 day rule" (explained below). An employer who wants to make such an arrangement must apply in writing under section NC 18, stating the grounds and detailing the undertakings in respect of securities guaranteeing payment.

Any decision not to deduct PAYE must be made with the consent of the Commissioner.

Section CB 2 (1)(c) - "92 day rule"

Income derived by a non-resident employee for services performed in New Zealand is exempt from tax under section CB 2 (1)(c) if all the following criteria are met:

- The employee is a non-resident for New Zealand tax purposes.
- The employee's visit did not exceed a period of 92 days.
- The employee has not been present in New Zealand for a period or periods exceeding in the aggregate 92 days during that income year.
- The employee's income earned in New Zealand is subject to tax in the employee's country of residence.
- The employer is not resident in New Zealand.
- The employee is not a public entertainer (as defined in the sub-section).

If section CB 2 (1)(c) does not exempt the employee's income from New Zealand income tax, relief may still be available under a DTA.

Double tax agreements - "183 day rule"

A non-resident employee may seek relief from New Zealand tax if a DTA exists between New Zealand and the country in which the employee is a tax resident. Relief may be available under the "Dependent services" article contained within the DTA. Usually, there are three common requirements, all of which an employee must meet to obtain relief under the treaty. They are:

- The employee's presence in New Zealand must not exceed in aggregate 183 days in any 12-month period.
- The remuneration is to be paid by, or on behalf of, an employer who is not a resident of New Zealand.
- The remuneration is not to be borne by a "permanent establishment" or fixed base of the employer in New Zealand.

Note that some DTAs refer to an "income year" or "financial year" or "fiscal year" instead of a 12-month period in respect of an employee's presence in New Zealand. These references are to New Zealand's deemed income year of 1 April to the following 31 March.

Applications and enquiries

Applications for certificates of exemption must contain the following information:

- The name of the non-resident contractor and the person's tax residence.
- A detailed description of the contract activity to be performed by the non-resident contractor in New Zealand, including details of what contract activities are to be performed in and out of New Zealand by the contractor.
- A copy of the contract entered into between the non-resident contractor and the payer.
- Details of the contract period, expected contract payment dates, and contract amounts.
- Names of all the non-resident contractor's employees who will be present in New Zealand performing the contract activity, and their (expected) arrival and departure dates in and from New Zealand.
- A brief background of any previous contract activity performed in New Zealand in the past 2 years, and comments on any anticipated contract activity that the non-resident contractor is likely to undertake in New Zealand within the next 12 months.

Applications for special tax rate certificates (reduced rate certificates) must include the same information as required for applications for exemption certificates, and also a budgeted profit and loss statement that discloses total revenue and expenditure for the contract activity. Inland Revenue needs this information to calculate the non-resident contractor's New Zealand taxable profit.

In determining a non-resident contractor's New Zealand tax liability, Inland Revenue will firstly establish whether the non-resident contractor's income will be assessable under New Zealand domestic tax legislation. If the income is assessable, we will check the relevant DTA (if any) to see if there is any tax relief.

When considering whether a DTA provides a non-resident contractor with relief from New Zealand tax, the most common issues that will arise are:

- whether the income is deemed to be a royalty within the meaning contained in the DTA; and
- whether the non-resident contractor is an enterprise, and if so, if it has a permanent establishment in New Zealand at the time the contract activity is performed; or
- if the non-resident contractor is an individual, what relief is provided by either the "Dependent services" or "Independent services" articles of the DTA, whichever applies to the contractor.

Many DTAs contain articles dealing with particular areas or industries, that may or may not provide a non-resident contractor with relief from New Zealand tax. It is therefore important not to assume that because one DTA provides relief to a resident of one country, the same relief will be provided to a non-resident contractor who is the resident of another country.

If you are applying for a certificate of exemption or a special tax rate certificate, or if you have any enquiries about the withholding tax, contact:

The Supervisor (Compliance Support)
Oil & Minerals Portfolio
Corporates Unit
Inland Revenue Department
P O Box 895
WELLINGTON

Telephone: (04) 802-6000
Facsimile: (04) 384-5883

The Corporates Unit also deals with the other associated tax issues of a non-resident contractor, i.e., PAYE, GST, and FBT.

Examples

The following examples illustrate the different types of contract payments that are deemed to be "payments to non-resident contractors" and therefore subject to the withholding payments regulations. These examples do not discuss the non-resident contractor's New Zealand income tax liability in respect of any relief provided by the operation of a DTA.

Note: Payers must deduct NRCWT from all payments made to a non-resident contractor unless the non-resident contractor holds a valid certificate of exemption, or the non-resident contractor has a valid special tax rate certificate specifying that a different rate of withholding tax is to apply.

Example 1

A non-resident individual specialises in the computer programming of robotics machinery. She is contracted by a New Zealand manufacturing company to undertake a two-month contract in New Zealand writing a computer programme for one of the company's new automated plants. The non-resident is in business in her own right as a computer software consultant.

The regulations apply to this contract. The contract performed in New Zealand comes within the

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definition of "contract activity", as the non-resident is performing a contract service. The non-resident therefore comes within the meaning of a "non-resident contractor".

The Regulations still apply if the New Zealand manufacturing company contracts a non-resident company to provide the computer programming services, and that company sends one of its employees to New Zealand to perform the services contracted. They do not distinguish between a non-resident individual and a non-resident company. Withholding tax must be deducted from the contract payment made by the New Zealand manufacturing company to the non-resident company.

Example 2

A non-resident demolition expert is contracted by a New Zealand company to demolish a tall industrial chimney at one of the company's sites in New Zealand. The non-resident is required to provide all the necessary equipment and personnel to carry out the contracted work. The non-resident brings an employee to New Zealand to assist in the demolition contract.

The withholding payments regulations apply to this contract. The contract comes within the definition of "contract activity", as the non-resident person is performing contract services in connection with a "contract project". The demolition expert is therefore considered to be a non-resident contractor.

Note: The salary paid to a non-resident contractor's employee, while the employee is present in New Zealand, is sourced here in terms of section OE 4 (1)(c). The non-resident contractor must deduct PAYE from the salary derived, unless Inland Revenue can be satisfied that the employee will be exempt from New Zealand tax under section CB 2 (1)(c) or a DTA.

Example 3

A non-resident company has vehicles, vessels, and aircraft available for worldwide hire. A New Zealand company contracts the non-resident company to supply a small submarine on bare boat charter for a period of eight months for use in New Zealand. The contract provides for payment of a monthly rental fee. The contract also contains provision for the non-resident company to supply suitably qualified personnel to operate the submarine if required by the New Zealand company. An additional fee is chargeable for these services.

The withholding payments regulations apply to this contract. The contract payment is being made for the supply of, or the right to use, in New Zealand personal property: such services come within the definition of "contract activity". The non-resident company is therefore considered to be a non-resident contractor.

The New Zealand company does not have a suitably qualified operator to operate the submarine, so it exercises its option under the contract for the non-resident company to supply an operator. The non-resident company has on call a number of independent operators whom it may contract. The non-resident contracts an independent operator who is qualified to operate the submarine. The non-resident contractor then sub-contracts the operator's services out to the New Zealand company.

In this situation, the New Zealand company must apply the Regulations to the full gross payment it makes to the non-resident company for both the hire of the submarine and the personnel. The non-resident company must apply the Regulations to the contract payments it makes to the submarine operator, as the operator is a non-resident performing a "contract activity" in New Zealand, and is therefore also considered to be a "non-resident contractor".

Example 4

A New Zealand company engages the services of a marketing company in Melbourne to undertake a marketing study in Australia of possible consumer interest in small appliances that are manufactured in New Zealand.

The withholding payments regulations do not apply to this contract. The contract services provided by the Melbourne company are not performed in New Zealand, and are therefore not subject to the Regulations. The income does not have a source in New Zealand.

Example 5

A large New Zealand company engages the services of a prestigious New York financial institution to research a variety of different offshore loan options that it may use when funding the purchase of new plant and equipment. All the research is undertaken in the financial institution's offices located in Manhattan.

The withholding payments regulations do not apply to this contract. All the contract services are performed outside New Zealand, so they are not subject to the Regulations. The income does not have a source in New Zealand.

Example 6

A non-resident company specialising in the manufacture of compressed fibreboard fabricating machinery sells machinery to a New Zealand timber company that is in the business of manufacturing compressed fibreboards. Fabrication of the machinery takes place outside New Zealand, and the non-resident company arranges for transport of the machinery to the New Zealand client's premises. The machinery is all computer-controlled, and specially trained personnel are required to operate and maintain it.

The contract to supply the machinery includes the requirement for the non-resident company to supply specialist engineering personnel to supervise the installation of the machinery at the resident company's New Zealand plant, and to provide the New Zealand company's personnel with training in the use and maintenance of the machinery.

The withholding payments regulations apply to that part of the contract payments that relates to providing personnel as supervisors to oversee installation of the machinery, and for the training services, as both these activities are performed in New Zealand. The supervisory and training services come within the definition of "contract activity".

The payments made for the actual supply of the machinery are not subject to the Regulations, as there is no source in New Zealand. The machinery was fabricated outside New Zealand.

Note: The salaries paid by the non-resident company to its employees while they are present in New Zealand are sourced here in terms of section OE 4 (1)(c). However, the employees may be entitled to relief from New Zealand tax because of section CB 2 (1)(c) or the dependent services article of a relevant DTA.

Example 7

The New Zealand company in the previous example is so impressed with the machinery supplied by the non-resident company that it enters into a further agreement with the non-resident company to manufacture and market the compressed fibreboard fabricating machinery in New Zealand.

The non-resident company grants the New Zealand company exclusive rights to manufacture, market, and distribute the machine in New Zealand. The licence granted entitles the New Zealand company to the use of the trademark, technical information, specifications and plans, and access to the non-resident company's technical staff.

The New Zealand company pays a royalty to the non-resident company for the trademark and knowhow. The non-resident company charges the New Zealand company an hourly rate for the services of its staff in support of the New Zealand company's operations.

The Regulations do not apply to this contract. The Regulations do not apply to royalties (as defined in section OB 1) as they are specifically excluded from the definition of "contract payment" contained in the Regulations. The royalties paid for the trademark and knowhow are subject to non-resident withholding tax (NRWT), which is imposed under Subpart NG of the Act. NRWT applies to interest, dividends, and royalties that are derived from New Zealand by a non-resident.

The fees paid to the non-resident company for the assistance provided by its staff also constitute royalties, as the fees come within the terms of paragraph (f) of the definition of "royalty" contained in section OB 1. Paragraph (f) states that the supply of any assistance, furnished as a means of enabling the application or enjoyment of the trademark or knowledge, is a royalty.

Example 8

A non-resident freelance journalist comes to New Zealand to report on the New Zealand visit of an important overseas dignitary. A New Zealand newspaper company contracts the non-resident journalist to write a cover story on the visit of the overseas dignitary, for which a contract fee is payable. The newspaper will hold all rights to the story written.

The withholding payments regulations apply to this contract. The contract is a contract for service, not a contract of employment, which the non-resident contractor performs in New Zealand (story written in New Zealand). The contract service comes within sub-paragraph (ab) of the definition "contract activity" and so the contractor meets the definition of a "non-resident contractor". However, the non-resident contractor provisions of Part E of the Schedule to the Regulations clash directly with clause 1 of Part B of the Schedule, which includes coverage of contributions by freelance journalists to newspapers. Clause 1 of Part B provides for a different rate of withholding tax to that specified in Part E of the Schedule to the Regulations.

In such cases, the appropriate rate of withholding tax set down in the specific clause is to be used. In this example, the rate applicable to the class of payment specified in clause 1 of Part B would apply.

NZ Superannuation and pay period taxpayers - correction

In TIB Volume Six, No 12 (May 1995) we published and article on the recent amendment to the pay-period taxpayer provision for New Zealand Superannuitants.

Under the "Key features" heading we said that a superannuitant doesn't have to file a tax return if his or her other income from employment, interest and dividends, ***etc*** (emphasis added) is less than $3,120. The inclusion of "etc" was a mistake; the pay-period taxpayer provision applies only when a taxpayer derives income from employment, interest or dividends, or a combination of these.

Income Tax (Deemed Rate of Return (1994-95 Income Year)) Regulations 1995

The Income Tax (Deemed Rate of Return (1994-95 Income Year)) Regulations 1995 were made on 13 June 1995. The regulations prescribe a deemed rate of return of 12.45% which will be used to calculate foreign investment fund (FIF) income under the deemed rate of return calculation method in the FIF rules. This rate will apply for the 1994-95 income year.

Under the FIF rules any income that a foreign entity earns on behalf of a New Zealand resident will be taxed on a current basis, as long as the New Zealand investor does not have a controlling interest in the entity. The deemed rate of return method is set out in section CG 19 of the Income Tax Act 1994. It is one of the four methods for calculating FIF income.

Under the deemed rate of return method FIF income is calculated by multiplying the value of a person's FIF interest by a percentage which is prescribed by regulation. That percentage is the "deemed rate of return".

The Income Tax (Deemed Rate of Return (1994-95 Income Year)) Regulations 1995 prescribe a rate of 12.45% which will apply for all types of FIF interests for which a taxpayer uses the deemed rate of return method. This includes interests in superannuation and life insurance policies.

Taxpayers in financial difficulties

Section 177 of the Tax Administration Act gives the Commissioner the authority to remit and defer the payment of certain taxes owed by taxpayers who are in financial difficulties.

In the appendix to this TIB there is a full policy statement on how and when the Commissioner will exercise this authority, to enable these taxpayers to settle or rearrange their outstanding obligations. It applies to individuals (including self-employed people), companies, trustees, incorporated societies and any other taxpayers.

Questions we've been asked

This section of the Tax Information Bulletin sets out the answers to some day-to-day questions that people have asked. We have published these as they may be of general interest to readers.

These items are based on letters we've received. A general similarity to items in this package will not necessarily lead to the same tax result. Each case will depend on its own facts.

Income Tax Act 1994

Gratuity payment received by a volunteer worker upon retirement - assessability

Section BB 4 (b) (section 65(2)(b), Income Tax Act 1976) - Items included in assessable income: A person had worked as volunteer for a large organisation for many years. When she retired, the organisation paid her a gratuity. She has asked why the payment is subject to income tax.

Although the volunteer received no monetary remuneration for the time she worked, the gratuity paid by the organisation is subject to income tax.

If a payment is made from one party to another in return for services, the payment is treated as monetary remuneration under section BB 4 (b). "Monetary remuneration" is defined in OB 1, broadly as:

any salary, wage, allowance, bonus, gratuity, extra salary, compensation for loss of office or employment, emolument of whatever kind, or other benefit in money, in respect of or in relation to the employment or service of the taxpayer; and includes:

- any expenditure on account of an employee; and
- any benefit from a share option or purchase scheme.

The gratuity payment is part of the volunteer's assessable income. The payment was made in relation to her previous service with the organisation, and has the characteristics of income rather than those of a gift.

Farmer's costs in obtaining a pilot's licence

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: A farmer with a large property in a remote area of New Zealand has asked if he may claim the costs of obtaining a pilot's licence as a business expense. Due to the property's size and limited access, using a light aircraft would enable him to check his livestock and property far quicker than would travel by car or horseback. He anticipates that any private or recreational flying would be minimal.

Section BB 7 allows a deduction for any expenditure or loss to the extent to which it is incurred or necessarily incurred in gaining or producing assessable income for any income year. However, section BB 8 (a) (section 106(1)(a), Income Tax Act 1976) prohibits a deduction for capital expenditure. Expenditure of a private or domestic nature is also excluded, at section BB 8 (b) (section 106(1)(j)).

The Commissioner considers that expenditure made to bring into existence an asset or advantage, (whether tangible or intangible) for the enduring benefit of the trade or business is a capital payment. In this case there is an enduring benefit from obtaining the pilot's licence, so the expenditure is capital in nature and non-deductible.

The farmer is entitled to deduct expenses incurred in running his farming business, but he must make an adjustment for private or domestic expenses. Accordingly, once the farmer had obtained his licence, he will be able to deduct the business-related flying costs.

We expect the farmer to make a private use adjustment for the costs incurred in the "private" flying. He should use his pilot's logbook as the basis of apportionment between business and private use.

Farmhouse interior decoration expenses - deductibility

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: A farmer plans to totally redecorate the interior of her farmhouse. She is aware of the Commissioner's policy of allowing a 25% income tax deduction for the use of the farmhouse as an administrative base for a business, and wonders if this policy extends to 25% of interior maintenance costs.

Section BB 7 allows a deduction for any expenditure or loss to the extent to which it is incurred in gaining or producing assessable income for any income year, or is necessarily incurred in carrying on a business for that purpose.

Expenditure incurred on repairs, maintenance, alterations, etc., must be on revenue account for it to be deductible. It must be deductible under the normal deductibility provisions of section BB 7, and not be capital expenditure. Expenditure required to maintain an asset in the condition it was upon acquisition will be on revenue account, and, therefore, deductible.

In this case the interior maintenance costs relate to wallpapering and painting the interior of the farmhouse. The expenditure is regarded as being on revenue account as the maintenance does not improve the farmhouse over and above what it was like when purchased. The maintenance is to make good normal wear and tear and not of sufficient magnitude to be on capital account. Twenty-five percent of the expenditure is deductible for income tax purposes.

If the farmer can demonstrate that more than 25% of her farmhouse is used for the farming business, she can claim a deduction based on the actual use.

Goods forfeited to Customs - deductibility

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: An importer has had a consignment of imported goods declared forfeited under section 270 of the Customs Act 1966. He has asked if the cost of the goods is a deductible expense for income tax purposes.

Section BB 7 allows a deduction for any expenditure or loss to the extent to which it is incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for that purpose.

Although the importer loses the forfeited goods, they were ordered and paid for, for the purposes of resale. The cost of purchasing the goods is an expense necessarily incurred in carrying on a business for the purpose of gaining or producing his assessable income. It is a deductible expense for income tax purposes.

Depreciating newly-acquired assets

Section EG 2 (section 108A, Income Tax Act 1976) - Formula for calculating depreciation deduction: Under the former depreciation rules, Inland Revenue's policy was to allow a depreciation claim for part-year use of plant and machinery as follows:

- When plant and machinery was used for less than six months before the end of the income year, half the full depreciation allowance could be claimed.
- When plant and machinery was used for six months or more, a full year's depreciation could be claimed.

A taxpayer has asked if this policy continues to apply under the current rules.

Under the new depreciation rules taxpayers must claim depreciation for each calendar month or part month that they own the asset: the former policy no longer applies. The new rules are based on ownership of the asset, rather than use as was the case under the former rules.

The basic formula for calculating deductions for depreciation on "depreciable property" is set out in section EG 2 as:

$$a \times b \times \frac{c}{12}$$

In this formula:

a is the depreciation rate

b is the adjusted tax value (if using the diminishing value method) or cost (if using the straight line method)

c is the number of months or part months in the income year during which the taxpayer held the property.

This increases or reduces the deduction both when the asset was only owned for part of the year, and when the taxpayer's income year was shorter or longer than 12 months.

"Depreciable property" is defined in section OB 1 (section 107A, Income Tax Act 1976) as:

> ...any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons -
>
> (i) In gaining or producing assessable income; or
>
> (ii) In carrying on a business for the purpose of gaining or producing assessable income...

Livestock valuation at farmer's death

Section EL 5 (6) (section 86D, Income Tax Act 1976) - Herd scheme for specified livestock: A farmer who valued her livestock under the herd scheme died in September 1994. The executor of her will has asked how to value the deceased's livestock for the tax return to date of death. The trust has kept the livestock and is maintaining the farming activity.

Under section EL 1 (3) (section 85(4C), Income Tax Act 1976), when a taxpayer who was deriving income from livestock dies, the deceased's executor or administrator must value the livestock on hand at date of death at market value.

Under section EL 5(6), the livestock values to use are the previous year's national average market values if both of these conditions apply:

- Any livestock owned by the deceased taxpayer is sold or otherwise disposed before 1 February.
- The tax return to date of death is filed before the national average market values are declared.

If these conditions aren't met, the current year's national average market values must be adopted, i.e. the national average market values declared for the year in which death occurred.

Solo parent's entitlement to housekeeper rebate

Section KC 4 (section 54, Income Tax Act 1976) - Rebate in certain cases for housekeeper: A solo parent who receives the Domestic Purposes Benefit has asked if he can claim the housekeeper rebate.

Under section KC 4 (2)(a), a widow, widower, or a divorced, unmarried, or separated person can claim the rebate when the housekeeper is either of these:

- A person or institution providing care and control of the child.
- A person looking after the taxpayer's home, and the Commissioner is satisfied that the taxpayer is physically inform or disabled.

A child is defined in section KC 4 (2) as:

> ...any child who is under the age of 18 years, or who is suffering from any mental or physical infirmity or disability affecting his or her ability to earn his or her living.

An institution can be a creche, day nursery, play centre, or kindergarten; but if the child is more than 5 years old the institution cannot be a school.

A taxpayer who pays for the services of a housekeeper can claim a rebate of 33 cents for each dollar paid to the housekeeper, up to a maximum rebate of $310. The taxpayer cannot also claim the same payment under any other rebate (for example, the donations and school fees rebate).

If the solo parent in this case meets the above criteria, he is eligible to claim the rebate.

Family Support maximum age of entitlement

Section KD 2 (section 374D, Income Tax Act 1976) - Family Support credit of tax: A taxpayer has asked if her daughter's entitlement to Family Support will cease on her daughter's birthday. Her daughter turned 18 in January 1995 and plans to stay at school.

Section KD 2 (6)(a) allows a Family Support tax credit for a child who is 18 years or over, and is:

- not financially independent; and
- still attending school or a tertiary educational establishment.

This entitlement stops at a date determined by the Commissioner, being no later than 31 December in the year in which the child turns 18.

A person is financially independent if he or she is in full employment, or receiving a student allowance, a training allowance, or a benefit under Part 1 of the Social Security Act 1964.

In this case, Family Support will continue to be paid up to the first payment date after 31 December 1995, provided the daughter remains at school (or other tertiary education establishment), and does not become financially independent.

If at any time before 31 December the daughter leaves school (or other tertiary education establishment) or becomes financially independent, Family Support will cease.

Family Support entitlement - effect of overseas trip

Section OB 1 (section 374A, Income Tax Act 1976) - Definition of "qualifying person": A couple who receive Family Support plan to make several overseas trips of three to six weeks' duration in the coming income year. The couple's two children, aged eight and twelve years, will stay in New Zealand with an aunt during their parents' absence. The couple have asked whether their Family Support entitlement will continue while they are overseas and, if not, if the aunt will be entitled to claim it.

Family Support is payable to a "qualifying person". Section OB 1 defines "qualifying person" for Family Support purposes as a person who meets these three conditions:

- He or she is aged 16 years or over.
- He or she is the principal caregiver of one or more dependent children.
- ***Either*** he or she is both resident and present in New Zealand for a continuous period of 12 months at any time; ***or*** each of the dependent children referred to above are both resident and present in New Zealand.

The term "principal caregiver" is also defined in section OB 1 and means, for any dependent child:

> ...the person ... who has the primary responsibility for the day to day care of the child, other than on a temporary basis; ...

A principal caregiver does not have to be a parent.

In this case, while the parents are overseas (and thus not both resident and present in New Zealand for a continuous period of 12 months at any time), the children have remained both resident and present in New Zealand. Therefore, the parents meet the second part of the "qualifying person" definition.

However, to meet the first part of the definition, the parents must be able to show that they are still the "principal caregiver" of the children.

In this instance, although the children are being looked after by their aunt while the parents are overseas, the parents will still be the "principal caregiver". This is because the parents remain responsible for the day today care of the children. In this regard, they have arranged for the aunt to mind the children in their absence. The parents' entitlement to Family Support will continue while they are overseas.

Cost price of a motor vehicle for FBT purposes

Schedule 2 (Tenth Schedule of the Income Tax Act 1976) - Value of fringe benefit provided to employees: A company manager has asked whether the cost price of a motor vehicle includes or excludes GST for fringe benefit tax purposes.

Schedule 2, clause 2, provides that for the purpose of determining the value of a fringe benefit that consists of the private use or enjoyment of a motor vehicle, the cost price includes any GST paid when acquiring the motor vehicle and is not reduced by any amount of input tax on the supply of the vehicle.

The value of the fringe benefit is then calculated at 6% of the GST inclusive cost price of the motor vehicle (or 24% when FBT is paid annually). For example:

$35,000 x 6% = $2,100

However, clause 3 does give the taxpayer the option of accounting for FBT on the GST exclusive cost price of the motor vehicle. In such a case, the 6% figure is increased by the current rate of GST (12.5%) in accordance with the following formula:

6 + (6 x a)

where "a" is the rate of GST expressed as a percentage.

The value of the fringe benefit provided by the company in this case would be calculated as follows:

$31,111 x (6 + (6 x 12.5%)% = $2,100

Income Tax (Withholding Payments) Regulations 1979

Certificate of Exemption not issued whilst applicant in arrears

Regulation 5 - Exemption certificates: A taxpayer who has arrears of Child Support payments and who has not filed income tax returns as required, has requested a certificate of exemption from withholding tax. He has queried Inland Revenue's right to withhold the issue of a certificate.

Regulation 1(3) states that the regulations apply to every withholding payment made. The Schedule to the regulations provides the rate of tax to be deducted from withholding payments.

Regulation 5 allows the Commissioner to issue a certificate of exemption from withholding tax at his discretion.

In exercising his discretion, the Commissioner will only issue a certificate of exemption to a business taxpayer with a proven record of good accountability to Inland Revenue for returns and payments, e.g. if the applicant has a good record as a provisional taxpayer.

A certificate of exemption will not be issued or renewed while a taxpayer remains in default of either returns or tax payments, unless the District Commissioner gives approval in exceptional circumstances.

The Commissioner has determined that a certificate of exemption will not be issued to this taxpayer, as he owes money to Inland Revenue and has not filed all the required tax returns.

Goods and Services Tax Act 1985

Goods sold by tender

Section 5 - Meaning of the term "Supply": A GST registered company is contemplating selling three business vehicles by way of tender. The manager has asked how GST should feature in the newspaper advertisement that the company will place, and what advice she should give to people submitting tenders who are unsure of the GST implications.

Section 5(1) defines the term "supply" for GST purposes. It states:

For the purposes of this Act, the term "supply" includes all forms of supply.

As the vehicles in question are business assets, one-ninth of the value received from the sale of the vehicles will be GST. The method of sale does not alter this.

If any (or all) of the vehicles are sold to associated persons of the company, and the purchaser is not entitled to claim an input tax deduction, the value of the supply (including GST) will be deemed to be the greater of the consideration received, or the open market value of the cars.

The GST Act does not specify how goods or services must be advertised. Case law has established that when a price does not specify if it is includes or excludes GST, the price will include GST. The tender may be submitted on either a "GST inclusive" or a "GST exclusive" basis. We suggest that the advertisement and any documents issued to people wishing to tender should specify the basis under which the tenders would be accepted. The registered person can then be sure that all the tenders are priced on the same basis.

If the person submitting the successful tender is registered for GST, he or she may ask for a tax invoice to be issued so that an input tax deduction can be claimed for the GST paid. The tax invoice must be issued within 28 days of being requested.

Zero-rating of overseas postage

Section 11 - Zero-rating: A taxpayer has mailed a letter overseas, incurring GST at the standard rate of 12.5% on the postage. A large parcel, destined for the same overseas address, had GST charged at zero-percent. The taxpayer wonders why the zero-rating option is not available for a standard letter.

Any mail, whether domestic or international, which has postage paid by the use of postage stamps or Automatic Stamping Machine (ASM) impressions, must have GST charged at the standard rate of 12.5%.

In order to take advantage of the zero-rating provisions of section 11, New Zealand Post are required to maintain sufficient records to satisfy both Inland Revenue and New Zealand Customs that the goods to which the postage fee related have been exported. This incurs considerable time and cost on their part.

However, New Zealand Post offer the zero-rating option when items are sent using the Customs Parcels or CourierPost International services. Fees for these two services are not paid for by using either postage stamps or ASM impressions, and reflect the additional administrative costs incurred by New Zealand Post in complying with the record keeping requirements for tax and other purposes.

GST registered person acquiring a business from a non-registered person

Section 20(3)(a)(ia) - Deductions from output tax: A GST registered person recently purchased a small business from a non-registered person. The vendor's turnover was approximately $20,000 per annum and the selling price was $12,700, comprising:

Goodwill	$5,000
Office Furniture	$6,500
Office Supplies	$1,200

The registered person has asked if she may claim a GST input tax deduction for the purchase price of the business using the secondhand goods provisions.

The Commissioner's policy on what constitutes secondhand goods is set out in TIB Volume Six, No. 5 (November 1994) at page 1. A secondhand good is a good that another person has owned for his or her own use.

Section 2 defines "goods" as:

> means all kinds of personal or real property; but does not include choses in action or money.

When a registered person buys secondhand goods from an unregistered person for use in the registered person's taxable activity, the registered person is entitled to an input tax deduction equal to the tax fraction (i.e., 1/9th) of the price of the goods, to the extent that payment has been made in the taxable period.

In this case the registered person is entitled to claim an input tax deduction on the basis that she is a registered person buying secondhand goods from an unregistered person. Business furniture and supplies are personal property that come within the definition of "goods". However, the registered person cannot claim an input tax deduction for goodwill as this does not come within that definition.

Failure of a GST registered branch to fulfil its obligations

Section 56 - Branches and Divisions: A business with a number of branches is considering applying to Inland Revenue to register the branches separately for GST purposes. A representative of the parent body has asked what the parent body's responsibility would be if one of the branches failed to furnish returns or pay GST.

Section 56(2) allows the Commissioner to register any branch or division as a separate registered person, if each such branch or division maintains an independent system of accounting and can be separately identified by reference to the nature of its activities or location.

Section 56(1) states:

> Where a taxable activity is carried on by any registered person in branches or divisions, that registered person may apply in writing to the Commissioner for any such branch or division to be registered as a separate person for the purposes of this Act.

Section 56(5) states:

> Where any branch or division separately registered pursuant to this section makes default in doing anything required to be done under this Act, the liability for the doing of that thing shall revert to the registered person first mentioned in subsection (1) of this section.

Therefore, in this case, if the branch fails to furnish returns or pay GST, the liability for such actions becomes the responsibility of the parent body.

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.

Prevention of pollution incentive - whether expenditure qualifies

Rating: • • • •

Case: Waste Management NZ Limited v CIR CA 55/94

Act: Income Tax Act 1976 - section 124 (Income Tax Act 1994 - section DJ 10)

Keywords: *approval costs, public relations costs, valuation fees, expenditure in the construction*

Summary: The activity contemplated by section 124 necessarily involves preparatory work and almost inevitably involves obtaining planning approval. These costs are part of the construction of earthworks and other improvements and are therefore deductible under section 124.

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Facts: Waste Management NZ Limited has operated for many years in the collection, treatment and disposal of waste. In 1988 the company bought a 80 hectare property to develop for waste disposal. From 1989 substantial work was done on the development of the site. Most of this was preparatory testing and design, and seeking planning approval. Very little physical work was done until late 1992. In its returns for the years ended 31 December 1988 to 31 December 1990 the company claimed the following expenses:

- Legal costs for planning consents
- Public relations costs for presenting the project to the public and the council
- Valuation fees for reports on the effect of the project
- Project management costs
- Engineering costs for feasibility study
- Survey costs
- Geology costs (test bores and analysis)
- Landscaping design costs
- Engineering design costs

The High Court held that the approval costs, public relations costs, and valuation fees were not deductible as these were costs of land acquisition, not costs in the construction on land.

Waste Management appealed in respect of the expenditure that the High Court held not to be deductible. The Commissioner cross-appealed in respect of the expenditure that the High Court held to be deductible.

Decision: The Court of Appeal held that the requirement that the expenditure be incurred in business was met. For the purposes of section 124 it did not matter that the expenditure was for preparatory expenses or that it was of a capital nature.

The Court said that the crucial question was whether the expenditure was incurred "in" the construction of earthworks or similar improvements. "In" is synonymous with "in regard to" or "with respect to".

The Court considered the subject matter, the purpose of the section, and the workability of any suggested yardstick. The Court held that the activity contemplated by the section necessarily involves preparatory testing and design work to enable construction to proceed. The nature and scale of the activity almost inevitably involves obtaining planning approvals.

The Court found that given the subject matter and the statutory purpose of the Act, the total expenditure was referable to the construction of the earthworks or other improvements. All the activities to which the expenditure related were inherent in carrying out the construction.

Comment: Inland Revenue is not appealing this decision.

Commercial building - whether sold as a going concern

Rating: • • •

Case: TRA 94/91

Act: GST Act -section 11(1)(c)

Keywords: *commercial rental property, going concern*

Summary: A commercial rental property which is 42 percent tenanted and 58 percent vacant can be sold as a going concern. This may occur when the vendor does not cease the commercial rental activity and the vacancy is of a temporary nature which is merely a part of the ordinary letting cycle.

Facts: The taxpayer is a private company that owned a commercial rental property consisting of two units. Both units had tenants until 1991 when the tenant of the southern unit defaulted on the rent and left. The taxpayer sought to re-let the unit but was unable to find a tenant. In 1992 the taxpayer sold the property subject to the existing lease of the northern unit (which made up 42 percent of the property).

The taxpayer treated the sale as being zero-rated. The Commissioner concluded that the sale was not of a taxable activity as a going concern and assessed the taxpayer for GST on the sale.

Decision: Judge Barber found that this was the supply of a taxable activity as a going concern.

Judge Barber said whether or not there is a supply of a taxable activity as a going concern is a matter of fact and degree. It is necessary to consider the facts overall. He said it can be misleading to focus on the percentage of the property that is let at the time of the sale. In this case Judge Barber concluded that the vendor supplied a building in which commercial letting took place. At no stage did the activity of commercial letting cease. Although the southern unit was vacant at the time of the supply and had been for the previous nine months, this vacancy was part of the ordinary commercial letting cycle.

Judge Barber then commented that if the use of the southern unit as a commercial rental property had stopped before the time of the supply, then there was a supply of part of a taxable activity as a going concern. He said that the taxable supply could be apportioned between the part that is a going concern (the northern unit) and part that is not a going concern (the southern unit).

Comment: Inland Revenue is not appealing this decision.

Trust deed arrangement - whether exempt from stamp duty

Rating: • • •

Case: J C Gray & R W Newcombe as Trustees of the Estate of K F Gray v CIR Unreported AP No.353/93

Act: Stamp and Cheque Duties Act 1971 - section 17(f)

Keywords: *conveyance duty, deed of advancement, deed of family arrangement*

Summary: The case established on its facts that a valid deed of advancement under a trust was an instrument of conveyance by a trustee to a beneficiary and exempt from conveyance duty.

Facts: In August 1977 Mr K F Gray created a trust referred to as the K F Gray Trust for Children, of which he and his wife were trustees. The beneficiaries of that trust were such of the trustee's children who attained the age of 30. On the same day Mr K F Gray transferred the estimated value of his interest in the J S Gray estate to the trust for a consideration of $52,444.71. Stamp duty was paid on this transaction.

On 13 February three new deeds were entered into. They were:

- The trust deed for the Ken Gray (No.1) Family Trust
- The trust deed for the Ken Gray (No.2) Family Trust
- The deed of advancement between Mr and Mrs Gray as trustees of the K F Gray Trust for Children, and the same people as trustees of the Ken Gray (No.1) Family Trust.

On 6 October 1989 a deed of family arrangement was entered into in respect of Mr J S Gray's estate.

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The Commissioner issued conveyance duty assessments for the deed of advancement and the deed of family arrangement. The taxpayer objected. The Commissioner disallowed the objection.

Decision: For the deed of advancement Justice Neazor found that so long as the exercise of the power of advancement was not attacked the advancement to the Ken Gray (No.1) Family Trust was entitled to relief from conveyance duty pursuant to section 17(f). That section includes an exemption from conveyance duty for an instrument of conveyance by a trustee to a beneficiary entitled under the trust. His Honour considered that section 17(f) removed the requirement to pay duty when all that was involved was a beneficiary acquiring what was already its entitlement. It did not matter that another as well as the beneficiary obtains a contingent benefit.

His Honour considered whether or not the deed of family arrangement fell within the exemption in section 17(f) was a matter to be determined by the beneficiaries' entitlement under the will of J.S. Gray, and not by reference to any arrangement amongst themselves to partition the farm belonging to that estate. He therefore held:

- The transfer of land by the Public Trustee to the Ken Gray (No.1) Family Trust was subject to conveyance duty.
- The transfer of land by the Public Trustee to the Ken Gray (No.2) Trust was subject to conveyance duty.

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

First farm purchase - whether taxpayer entitled to stamp duty exemption

Rating: • •

Case: TRA 94/124

Act: Stamp and Cheque Duties Act 1971 - section 22B

Keywords: *first farm exemption, principal occupation*

Summary: Judge Willy decided that the taxpayer's principal occupation was farming, and that the taxpayer was therefore entitled to the conveyance duty exemption.

Facts: On 7 December 1989 the taxpayer purchased a farm property. By a declaration dated 26 April 1990 the taxpayer advised the Commissioner that he intended to actively farm the land within two years from the date of purchase. He also intended that the farming business would be his principal occupation. The Commissioner granted the taxpayer a first farm conveyance duty exemption under section 22B.

The taxpayer's 1992 tax return showed that he received income from employment. On 16 July 1992 the Commissioner issued an amended assessment revoking the conveyance duty exemption. The basis of the amended assessment was that the conditions of section 22B had not been met.

Decision: Judge Willy found that the taxpayer's principal occupation during the two year period was that of a farmer and that the taxpayer was entitled to the conveyance duty exemption.

The taxpayer's evidence was highly significant to the outcome of the case. Judge Willy found the most crucial evidence showing that the farming business was the taxpayer's principal occupation was that the taxpayer passed up an opportunity to advance his career at his place of employment.

Other factors taken into account were:

- The net result of the taxpayer's financial arrangements is that the gross income from the farm significantly exceeded the income from his employment.
- The taxpayer's aim in life was to be a farmer.
- Farming was not a means to supplement the taxpayer's employment income.
- The taxpayer and his family made a huge financial commitment to the purchase and maintenance of the farm especially given the taxpayer was only 29 years old.
- Although the taxpayer received a significant sum from grazing other farmers' stock on his land, this was only possible because of the taxpayer's work in developing the land.

Comment: Inland Revenue is not appealing this decision.

Charitable trust's gaming machine duty liability

Rating: •

Case: TRA 94/92

Act: Gaming Duties Act 1971 - section 12B

Keywords: *gaming machine duty, society, gaming machine operator*

Summary: Judge Barber held that an unincorporated charitable trust was a "gaming machine operator" for the purposes of the Gaming Duties Act 1971 even though it was incorrectly granted a licence to operate gaming machines by the Internal Affairs Department. The trust was liable to pay gaming machine duty because it was conducting a dutiable game otherwise than under a licence.

Facts: The objector was an unincorporated charitable trust which was created in May 1987. In May 1988 an application on behalf of the Trust was made to the Internal Affairs Department for a licence to operate gaming machines. The licence was granted in December 1988 and stated the objector was a "society". The Commissioner assessed the objector for gaming machine duty on the grounds that it was licensed as a gaming machine operator. However, the objector claimed that it was not liable for gaming machine duty as it was not a "society" and it was not a gaming machine operator.

Decision: Judge Barber found that the objector was not a "society" and was incorrectly granted a licence to operate gaming machines. As such he determined that the licence was ineffective. Even so, the objector was still liable for the duty. This was because there were two limbs to section 12B of the Gaming Duties Act 1971. The trust did not come within the ambit of the first limb which required it to be a society licensed under the Gaming and Lotteries Act 1977. However, Judge Barber considered that the trust was a gaming machine operator in accordance with the second limb as it was conducting dutiable games otherwise than pursuant to a licence.

Comment: The taxpayer is appealing this decision.

Whether amounts paid by taxpayer were interest or advances of capital

Rating: • • •

Case: Finnigan v CIR CA 30/94

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

Keywords: *interest deductibility*

Summary: The Court of Appeal overturned the High Court decision and allowed the appellant an interest deduction. The Court of Appeal found that the appellant's debt had not been extinguished, and that he was bound to pay interest on that debt.

Facts: Mr Finnigan was a shareholder in Aquabank Holdings Limited (Aquabank). His shares were only partially paid. Aquabank was in financial difficulties. A number of shareholders in Aquabank, including Mr Finnigan, formed the Phoenix partnership (Phoenix). Phoenix borrowed $1,070,000 and applied $520,000 towards buying some properties from Aquabank subsidiaries. The other $550,000 was lent to Phoenix's partners, including Mr Finnigan, for those partners to apply their share of the loan towards paying up their unpaid shares in Aquabank. Mr Finnigan's share of the loan was $33,333.

After the shares were fully paid up, the partners transferred the Aquabank shares to Phoenix. Their capital accounts with Phoenix were credited with 20 cents for every Aquabank share transferred. Mr Finnigan's capital account was credited with $87,677. Mr Finnigan paid Phoenix interest on the $33,333 loan, and claimed $4, 766 as an interest deduction for the income year ending 31 March 1988. The Commissioner denied the deduction.

In the High Court (reported as (1994) 16 NZTC 11, 027) Justice Anderson found for the Commissioner. His Honour considered the loan from Phoenix to Mr Finnigan was extinguished by Mr Finnigan's transfer of Aquabank shares to Phoenix. Mr Finnigan had no contractual liability to pay interest to Phoenix. The "interest" payments were in fact advances of capital by Mr Finnigan to Phoenix. Mr Finnigan appealed to the Court of Appeal.

Decision: The Court of Appeal found for Mr Finnigan and allowed the interest deduction.

The Court was persuaded by the arguments of Mr Finnigan's counsel that Mr Finnigan's debt to Phoenix was not extinguished by Phoenix's payment for Aquabank shares, and that Mr Finnigan's payment to Phoenix was interest.

The Court first stated the legal principles governing the characterisation of transactions. Parties may choose whatever lawful arrangements they like, and the true nature of their transactions can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. This is the case unless the arrangements are a sham or a statutory provision such as section 99 applies. The arrangements in this case were neither a sham, nor arrangements to which section 99 applied.

The Court noted that Phoenix recorded the payments from partners as interest income, that the total loans to partners of $550, 000 were recorded as partnership assets, and that the capital account credits were recorded as a partnership liability. The Court also noted that individual partners assumed liability for the $550, 000 debt, and the interest on that sum was paid by Phoenix's individual partners. The Court found that each partner (including Mr Finnigan) was contractually liable to pay interest on the sum lent to him or her by Phoenix.

The Court found that Mr Finnigan's debt to the partnership was not extinguished by the crediting of Mr Finnigan's capital account with an amount for the transfer of his Aquabank shares to Phoenix. The Court found that the two amounts were not offset against each other, they remained separate sums. One sum was a loan by Phoenix to Mr Finnigan, the other was an entry which reflected Mr Finnigan's capital contribution to Phoenix. The Court said that set-off does not happen automatically in such a case. It may happen if the parties agree, but in this case they did not. Therefore, Mr Finnigan's debt to Phoenix was not extinguished.

There was some discussion as to whether Mr Finnigan's interest payments to Phoenix were payable in gaining or producing assessable income. The argument was that the money was borrowed to pay a debt, and that there was no evidence that the shares would produce dividends in the future. The Court did not consider this issue as it had not been raised in the High Court. The Court considered it too late for the Commissioner to raise this further ground of appeal.

Comment: Inland Revenue is not appealing this decision.

Whether debts written off are bad

Rating: • •

Case: DM Graham v CIR, Edwards Graham Limited and BD Edwards v CIR HC Napier AP 11/92

Act: Income Tax Act 1976 - section 104, 106(1)(b) (Income Tax Act 1994 - BB 7, DJ 1(a))

Keywords: *bad debts*

Summary: A special partnership provided engineering services to a Sri Lankan company. The partnership wrote off amounts as bad debts in three successive years and claimed deductions for these amounts. Cases were stated after the Commissioner disallowed the deductions. Justice Doogue held that the debts were properly written off as bad in each of the years concerned.

Facts: A special partnership called Edwards Graham Ltd and company contracted to supply services to Carsons Construction Company Ltd ("Carsons") , a Sri Lankan company. Universal Equipment (Hawkes Bay) Ltd ("Universal") also contracted to supply machinery to Carsons. Mr Edwards, who was a partner in the partnership, was a director of Carsons and had a family interest in Universal. The partnership continued to supply services to Carsons in the 1982, 1983 and 1984 income years, and wrote off as bad debts for those year's payments due for those services of NZ $185,100, $67,375 and $55,522.

Mr Edwards gave evidence that because of political unrest, uncustomary weather and problems with the machinery, Carsons was unable to pay Universal or the partnership. He said "there was no reasonable expectation that we would be paid for the services provided by the partnership". Mr Edwards gave evidence that he regarded the partnership as having a long-term commitment to Carsons because of the possibility of future profitable dealings. He also gave evidence that it was essential that the partnership continue to assist Carsons as, in terms of the export guarantee policy upon which Universal was relying for payment of the sums owed, it was important that none of the conditions were voided.

In November 1983 Mr Edwards negotiated an agreement whereby:

- Carsons' interest in the claims against a shipping company and the insurer were assigned to the partnership and Universal
- the partnership and Universal waived their claim to monies owing totalling US$400,000.
- a schedule of payments by Carsons was agreed.

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As a result of the agreement the partnership received certain payments, which resulted in full recovery of the 1982 bad debts, partial recovery of the 1983 bad debts and no recovery of the 1984 bad debts.

Decision: Justice Doogue held that the question in this case was solely one of fact. He held that "reasonable and prudent business persons would have regarded the debt as unlikely to be recovered". He said he was satisfied by Mr Edwards' evidence that "... notwithstanding that he might have had some hope for some future recovery of some part of the indebtedness, he had good reason to believe at the time of writing off that the debt was unlikely to be recovered". He concluded "However, looked at overall, the appropriate course ... would have been to apply the proviso to s.106(1)(b) of the Act". Under that proviso, amounts received on account of such bad debts must be credited as income in the year in which they are received and are accordingly subject to tax.

Comment: Inland Revenue is not appealing this decision.

Whether interest payable by Commissioner on conceded case

Rating: • •

Case: Chatswood Estate Limited v CIR CP 216/92

Acts: Judicature Act 1908 - section 94A, Limitation Act 1950.

Keywords: *restitution, interest*

Summary: The plaintiff took a claim for interest on tax paid to the Commissioner in 1977 and refunded in 1990.

The High Court held that the Commissioner had acted in accordance with his statutory powers in conceding the case and that neither party had made a mistake in law. It therefore dismissed the plaintiff's claim for relief under the general equitable restitution principle set out in *Woolwich Building Society v Inland Revenue Commissioners* (No. 2) [1992] 3 All ER 737 and the alternative claim for relief under the Judicature Act 1908 for a mistake in law.

Facts: The plaintiff claimed a foreign exchange loss in the income tax year ended 30 June 1977. The Commissioner disallowed this claim and issued an assessment for tax payable of $99,670. The Commissioner was appealing a decision on the same issue to the Court of Appeal, so the plaintiff elected to reserve the right to object and await the outcome of the appeal.

The case to the Court of Appeal did not resolve the issue in dispute and the objection process between the plaintiff and the Commissioner was revived. The plaintiff objected to the 1977 assessment in 1987. The Commissioner disallowed the objection on 10 March 1988 and the plaintiff requested that the case be stated to the High Court. On 3 September 1990, the Commissioner conceded the case and refunded the tax paid in 1977.

The plaintiff initiated legal proceedings to recover interest on the amount the Commissioner had refunded. He maintained that:

- The scheme of the Income Tax Act does not permit the Commissioner to concede the case. In support of this argument the plaintiff relied on the House of Lords decision in *Woolwich Building Society v Inland Revenue Commissioners* (No.2) that a taxpayer has a prima facie right to recover taxes plus interest paid under an ultra vires demand by the public authority.
- There had been a mistake of law under section 94A of the Judicature Act 1908. The plaintiff argued that the Commissioner had made a mistake in issuing the assessments.

The Commissioner disputed these claims and argued that the Limitation Act 1950 barred the cause of action because it occurred six years before the commencement of the action.

Decision: Justice Greig found in favour of the Commissioner and held that no interest was payable on the moneys received and held by the Commissioner on the 1977 assessment. The bases for his conclusion were that:

- The Commissioner is obliged under the Income Tax Act to ensure the correctness of the assessment and is empowered to alter assessments for this purpose at any time. The Commissioner is not obliged to proceed in every case and may concede a case on the facts or the law. Therefore, the Commissioner had not departed from the statutory procedures or misconstrued the statute in conceding the case in 1990. Consequently, *Woolwich Building Society v Inland Revenue Commissioners* (No.2) did not apply to this case.
- In the event that he was wrong in distinguishing *Woolwich Building Society v Inland Revenue Commissioners* (No.2), Justice Greig considered that there was no general equitable principle that interest is recoverable as of right.
- There was no operative mistake in this case and that what had occurred was a legal assessment and demand, payment in response and in compliance with the legislation. Therefore, section 94A of the Judicature Act did not apply.
- The Limitation Act did not provide the Commissioner with a defence because the cause of action only arose at the time that the Commissioner conceded the case in 1990. This was within the six year time limit.

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

Whether motor vehicle available for private use or enjoyment

Rating: • • •

Case: TRA 93/195

Act: Income Tax Act 1976 - section 336N(1) (Income Tax Act 1994 - CI 1)

Keywords: *fringe benefit, motor vehicle, available for private use or enjoyment*

Summary: The Taxation Review Authority held on the facts that the objector did not make the motor vehicle in question available for the private use or enjoyment of its shareholder-employees. The Commissioner had acted incorrectly in making fringe benefit tax assessments in this fact situation.

Facts: The Taxation Review Authority found on the facts that:

- The shareholder/employees (husband and wife) owned two company vehicles, vehicle one and vehicle two. This case concerned vehicle two - a Chevrolet Caval.
- Vehicle two was purchased solely for business purposes - the fact that the vehicle was a Chevrolet Caval and the husband was a member of the Chevrolet club was insufficient evidence to regard the vehicle as having been purchased as a collector's item.
- The Chevrolet was garaged overnight and often all day at home, rather than at their company's factory. There was no secure garaging for the vehicle at the factory premises.
- The home was not the main place of business, but it was used to a large degree for business purposes. One room was used as an office, another had an industrial sewing machine in it and the garage and other areas were used to

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store business items and industrial sewing machines. The garage also stored the Chevrolet. At least 10 per cent of the home was used for business purposes.

- The Chevrolet was only used for business deliveries and transporting goods and matters such as banking and wages. The finding also took into account the fact that the wife used the Chevrolet from time to time to transport work to the home for finishing work and back to the factory the next day.
- The shareholder/employees used their third and private vehicle for all private motoring.
- The husband wrote a letter to the wife expressly forbidding any private use and requiring the wife to garage the vehicle at her home as the factory premises were unsuitable.

The issue was whether the Chevrolet Caval car owned by the objector company was available for the private use or enjoyment of the objector's employees.

Decision: Judge Barber, in acknowledging that the case turned precisely on its own facts, held that the Chevrolet was not available for the private use or enjoyment of the shareholder/employees. The Commissioner therefore acted incorrectly in making FBT assessments in this case.

His Honour commented that in his view "a vehicle cannot be available for private use if the employee is not only forbidden to use the vehicle but does not use it and does not need to use it because of the availability at all times of the employee's own private vehicle." Looking at the evidence before him, Judge Barber found that the Chevrolet was not available for use of the wife because she was forbidden to use it, did not use it and did not need to use it.

His Honour then went on to consider the various arguments that had been submitted. He noted in particular the Commissioner's argument that the husband and wife would sometimes use the vehicle in order to go home, as opposed to going home and working, and that on those occasions there would have been private use and enjoyment of the vehicle. Noting that the home was a work place and therefore travel between home and the factory was travel between two workplaces, Judge Barber commented that he was not prepared to regard that type of travel as being private in nature for the purposes of fringe benefit tax.

Noting the Commissioner's desire to test the evidence and the scope or meaning of the word "available" in the FBT rules, His Honour agreed with the Commissioner's argument that normally travel between a home and factory would be private travel by an employee. However His Honour went on to note that on a particular set of facts such travel may be travel between one place of work and another place of work. Judge Barber acknowledged that a line must be drawn somewhere and that such issues are matters of fact and degree.

His Honour referred to Justice McKay's reasoning in the statutory interpretation case *Alcan NZ Limited v CIR* (1994)) 16 NZTC 11,175, and comments that this may be the type of situation envisaged by Justice McKay where if words are capable of a number of meanings then a meaning which is unjust or absurd cannot have been intended. Referring to the fact situation before him Judge Barber found that it would be "quite unjust to suggest that a company should pay fringe benefit tax on the basis of a vehicle being available to shareholder/employees when they were permitted to use the vehicle for work purposes only, and complied with that direction, and owned and used their own vehicle for all private motoring".

Comment: Inland Revenue is appealing this decision.

Deductibility of holiday pay and depreciation

Rating: • • •

Case: King Country Electric Power Board v CIR AP 358/93

Act: Income Tax Act 1976 - sections 104, 108 and 197C(13) (Income Tax Act 1994 - sections BB 7, EG 1)

Keywords: *holiday pay, deductibility, depreciation, loss on sale*

Summary: The High Court considered two issues. On the first issue the High Court found that the Commissioner acted correctly in disallowing the objector's claim for a deduction for holiday pay accrued before 1 April 1987. The holiday pay was incurred in the year it was accrued rather than when it was paid out to employees.

On the second issue, the High Court found that the Commissioner also acted correctly in reducing the objector's claim for a deduction for a loss on the sale of a computer from $13,009.59 to $1445.51.

Facts:

Deductibility of accrued holiday pay

The objector is an energy supply authority with numerous employees. The employees' holiday entitlements were governed by the Holidays Act 1981 and by two industrial awards.

In the income year ended 31 March 1988, the objector claimed a deduction for holiday pay accrued before 1 April 1987 amounting to $125,064. The amount of $125,064 was paid out in the 1988 income year when the leave was taken by the employees.

The Commissioner disallowed the deduction stating that the expenditure was incurred in the 1987 income year when the holiday pay was accrued.

Loss on sale of computer

Before 1 April 1987, the Energy Supply Authority (or the Board as it then was) was tax exempt. It owned a computer which it had purchased new in April 1979. It had been writing down the value of the computer over the years at rates which coincided with those recognised for tax purposes, even though the Authority's income was exempt from tax. The book value of the computer as at 1 April 1987 was $13,409.59. The computer was obsolete and sold during 1988 for $400. The loss on sale was $13,009.59 (known as "terminal depreciation"). The objector claimed the $13,009.59 as depreciation in the 1988 year of sale. The Commissioner disallowed the majority of the claim and apportioned the $13,009.59 between the 1988 year of sale, and years in which the objector had been exempt from tax. The Commissioner allowed one ninth of that figure which resulted in an allowance of $1,445.51 as depreciation.

The objector argued, based on section 197C(13), that it should be treated in the same way as an ordinary taxpayer depreciating its assets over previous years in producing assessable income. On that basis it should be allowed the whole of the loss in the year of sale.

The Commissioner submitted that section 197C(13) merely provided an opening value from which future depreciation could be calculated and it was not intended to remove his discretion under section 108.

Decision:

Deductibility of accrued holiday pay

Justice McGechan stated that the accrued holiday pay would be deductible, if at all, under section 104 and referred to the decisions relating to treatment of

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holiday pay and long service leave. His Honour said that he could not reconcile the reasoning of the Australian High Court in *Nilsen Development Laboratories Pty v FC of T* (1981) ATC 4031 with the Privy Council in *Commissioner of Inland Revenue (Hong Kong) v Lo & Lo* (1984) 1 WLR 896. In *Nilsen's* case, the High Court took the view that the expense was not incurred until the time of payment. In *Lo & Lo*, the Privy Council held that the expense was incurred before payment.

Justice McGechan preferred to follow the reasoning in *Lo & Lo*; his view was that when an employee is entitled to money, even if not yet taking leave or resigning and not yet calling for it, and it is certain the money will need to be paid within the foreseeable future, it is unrealistic to say the employer has not "incurred" a liability. There is no "perhaps" about the certain obligation to pay in the future. The hand will be in the pocket.

Justice McGechan found that the $125,064 accrued to 31 March 1987 was incurred in the 1987 year, and was not deductible in the 1988 year.

Loss on sale of computer

Justice McGechan considered the purpose behind section 197C(13). He found two features that stood out. First, legislation was required to provide Energy Authorities with opening values for tax purposes or else there would be uncertainty over appropriate values. Secondly, there was a recognised Inland Revenue approach to "start up" taxpayers, involving apportionment of loss on sale between previous exempt income years and subsequent assessable income years. Loss on sale could well arise through insufficient depreciation in previous years, rather than all in the final year of sale. Some of that loss could be properly regarded as attributable to those previous years, and there should not be a tax benefit in respect of previous exempt years.

Justice McGechan thought that legislature intended to do no more than lay down clear rules for determining opening asset values. He did not think Parliament also intended to allow terminal depreciation which would give benefits more properly attributable to years in which exempt income had been derived. Accordingly, Justice McGechan confirmed that the Commissioner's apportionment of the terminal depreciation was not in error.

Comment: We do not know if the taxpayer will be 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:

- Employment, commission agents and deductions
- Individual claims for overseas travel expenses
- Remission of underestimation penalty when taxpayer makes an incorrect interpretation
- Assessability of retraining payments made on termination of employment
- Applications to retain records in Maori
- Determining permanent place of abode
- Income tax treatment of replacement of fruit vines and trees by regrafting or replanting
- Income tax treatment of remitted specified suspensory loans
- GST and the de minimis rule
- Successive supplies in the building and engineering industries
- Impact of GST on preparation of income tax accounts
- Policy in light of "Newman" Court of Appeal decision

Due dates reminder

July

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

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

Tax returns due to be filed for all non-IR 5 taxpayers with balance dates from 1 October 1994 to 31 March 1995.

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

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

FBT return and payment for quarter ended 30 June 1995 due.

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

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

RWT on dividends deducted during June 1995 due.

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

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

August

5 Large employers: PAYE deductions and deduction schedules for period ended 31 July 1995 due. *(We will accept payments received on Monday 7 August as on time.)*

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

Tax returns due to be filed for all non-IR 5 taxpayers with April balance dates.

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

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

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

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

RWT on dividends deducted during July 1995 due.

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

(For all payments due on 20 August, we will accept payments received on Monday 21 August 1995 as on time.)

31 GST return and payment for period ended 31 July 1995 due.

Public binding rulings: Your chance to comment before they are finalised

This list shows the Public Binding Rulings that Inland Revenue is currently preparing. To give us your comments on any of these draft rulings, please tick the appropriate boxes, fill in your name and address, and return this page to us at the address below. We will send you a copy of the draft as soon as it's available.

We must have your comments by the "Comment deadline" shown if we are to take them into account in the final ruling.

Name ______________________________

Address ______________________________

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Ruling	Date Available	Comment Deadline
☐ **2149:** Trading stock distributed for nil or inadequate consideration - income tax implications	7/7/95	28/7/95
☐ **2597:** Non-resident film renters - income tax treatment	7/7/95	28/7/95
☐ **2012:** Associated non-profit bodies - income tax and RWT exemption	7/7/95	28/7/95
☐ **2808:** GST - sale of long term residential properties	7/7/95	28/7/95
☐ **2209:** GST tax invoice requirements when employee incurs expense on employer's behalf	7/7/95	28/7/95

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Manager (Systems)
Rulings Directorate
National Office
Inland Revenue Department
P O Box 2198
WELLINGTON

Attention Public Rulings Consultation

Volume Six, No.14 June 1995

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