Binding rulings series

Introduction

This item describes the binding ruling process and explains the role of the Rulings directorate in Inland Revenue's National Office. In addition, public and product rulings made by the Commissioner will be published in this series.

Background to binding rulings

For many years the Commissioner has provided taxpayers with advice on tax matters. In most cases tax is assessed in line with this advice. However, the Commissioner's statutory duty is to make correct assessments. Accordingly, the Commissioner cannot be required to assess on the basis of earlier advice when at the time of assessment he considers that the earlier advice is not in accordance with the law.

In practice, the Commissioner is reluctant to deviate from earlier advice. However, due to the overriding statutory duty to make correct assessments it is possible that the Commissioner may reverse a stated position. This can create uncertainty for taxpayers.

In its 1992 budget, the Government announced its intention to introduce a system for issuing binding rulings on tax matters. The underlying policy of this system is to give taxpayers certainty about the Commissioner's view on the tax implications of proposed transactions.

After extensive policy development, the Tax Administration Amendment Act 1995 was enacted. The Act inserts the binding rulings rules into Part VA of the Tax Administration Act 1994. Page 1 of TIB Volume Six, No.12 (May 1995) provides a full commentary on the binding rulings legislation.

Binding rulings are administered by the Rulings directorate, National Office, Inland Revenue.

Rulings directorate

The primary function of the Rulings directorate is to provide the Commissioner's policy on the interpretation and application of the tax laws administered by Inland Revenue. Before 1 April 1995, Rulings provided statements of policy to taxpayers and tax professionals in the form of non-binding rulings published in the TIB. These statements are of general application on areas of tax law where clarification is required.

Rulings will continue to provide non-binding statements of policy. However these will be limited to topics that the Commissioner is unable to make a binding ruling on, for example, statements of administrative practice such as this article or matters covered by the Tax Administration Act 1994 such as the imposition of penalties.

Rulings is not responsible for specific taxpayer advice other than in the form of formal determinations (depreciation, accruals, and livestock valuations) and from 1 April 1995, private binding rulings. In the past, Rulings has occasionally provided some specific taxpayer advice where that advice has given rise to issues of general application. However, with the introduction of the binding rulings regime Rulings will focus on its key functions of providing binding rulings, and general statements of policy (non-binding rulings) where it is not appropriate to make a binding ruling. Taxpayers and tax professionals who require specific taxpayer advice should in the first instance contact their district office, or in the case of corporate clients, the Corporates Unit.

Public rulings

A public ruling will bind the Commissioner in respect of any taxpayer to whom the ruling applies if the taxpayer calculates his or her tax liability in accordance with the ruling.

Public rulings will be initiated by the Commissioner. Taxpayers cannot apply for a public ruling, although they may suggest that the Commissioner issue a public ruling on a particular matter.

Rulings welcomes suggestions for public rulings, and these should be addressed to:

Manager (Rulings)
Inland Revenue
PO Box 2198
WELLINGTON

Rulings will acknowledge all suggestions and will indicate whether the topic is suitable for the Commissioner to make a public ruling. The letter of acknowledgment will also indicate a planned date for publishing the public ruling in this series.

Rulings will also invite comment on draft public rulings. Comments can be made using the Public Binding Rulings comment form found at the back of each TIB.

Public rulings process

1. Rulings will place an article in each TIB indicating that a draft public ruling is being prepared on a certain topic. The article will invite comment from the public on the ruling, and will indicate the date that the draft is available for the public and the date by which comment must be sent to the Manager (Systems) Rulings. (See page 51 of this TIB for the topics for comment during September).
2. Rulings will issue the draft to those people wishing to make comment.
3. Rulings will consider the comments received and rework the article where appropriate.

continued on page 2

from page 1

4. Once the public ruling is made Rulings will place a notice in the New Zealand Gazette, and also arrange for the ruling to be published in the TIB.
5. The public ruling will describe the arrangement and specify the period for which the ruling applies.

Application period

Each public ruling will specify a period for which the ruling will apply. In addition, a public ruling will only apply if the arrangement specified in the ruling is entered into during the period that the ruling applies.

The applicable period for a public ruling will vary. Several factors could influence the setting of the period, for example: the type of arrangement (whether it is a one-off or ongoing arrangement), the revenue type (e.g. income tax, GST), a changing business environment.

It is important to note that a public ruling only applies if the arrangement is entered into during the period. There are two factors to the application period for a public ruling. First, the arrangement specified in the ruling must be entered into during the period the ruling applies, and secondly, the ruling applies only for the period specified.

Example 1

A public ruling states that specified expenditure is deductible under section BB 7 of the Income Tax Act 1994. Under "The period for which this ruling applies" it is stated:

"This ruling applies to any person who incurs the (specified) expenditure within the period 1 April 1995 to 31 March 1998."

The application period in this example is specific to the date on which the taxpayer incurs the expenditure. A taxpayer who deducts the expenditure in an income year outside the application period could still rely on the ruling, as long as the expenditure was incurred within the application period.

Example 2

A public ruling states that specified income derived by a non-resident is assessable under section CN 2 of the Income Tax Act 1994. Under "The period for which this ruling applies" it is stated:

"This ruling applies to arrangements entered into between 1 April 1995 and 31 March 1998 and to income derived from such arrangements during the period 1 April 1995 to 31 March 1998."

There are two criteria to be met for this public ruling. For the ruling to apply, the arrangement must be entered into during the application period and the income derived from the arrangement must be derived during the application period.

Example 3

Under a public ruling, certain non-profit bodies can apply the tax exemption provisions of section CB 4 of the Income Tax Act 1994. Under "The period for which this ruling applies" it is stated:

"This ruling applies to income derived by (specified) non-profit bodies for the 1996 and 1997 income years, and includes non-profit bodies with non-standard balance dates corresponding to those income years."

The application period for this ruling relates to specific income years and recognises that taxpayers have early or late balance dates relevant to a particular income year.

Example 4

A public ruling states that GST registered persons who purchase (specified) goods from non-registered persons can claim a secondhand goods input tax deduction if the goods are used principally in their taxable activity. Under "The period for which this ruling applies" it is stated:

"This ruling applies to purchases of the (specified) goods during the period 1 April 1996 and 31 March 1998."

In this example the application period is determined by the date the secondhand goods are purchased, regardless of the registered person's taxable period. Registered persons may seek to make the deduction in their June 1998 GST return. Although the taxable period ends outside the application period, the ruling will apply as long as the purchase is made between 1 April 1996 and 31 March 1998.

Private and product rulings

Taxpayers can apply for private and product rulings. Private rulings provide an interpretation of the tax law that is specific to the taxpayer and an arrangement. When a taxpayer calculates his or her tax liability in accordance with a private ruling, the Commissioner is bound to assess that taxpayer in accordance with the ruling.

Product rulings provide an interpretation of the tax law on a particular product. A product ruling will define the product and specify its tax treatment. It will not state how the tax law applies to the product holder.

Private and product rulings process

1. A taxpayer who wishes to apply for a private or product ruling can obtain an application form from any IRD office. The application form for a private ruling is an IR 113. The application form for a product ruling is an IR 114. The completed application form, application fee of $210, and supporting documents should be sent to the following address:

Director (Rulings)
Inland Revenue
PO Box 2198
WELLINGTON

Taxpayers who are clients of Inland Revenue's Corporates Unit should deal directly with their account manager who will liaise with Rulings.

2. On receipt of the application form, Rulings will make the following checks to verify the validity of the application and then issue a letter of acknowledgement:
   - Has the IR 113, or IR 114, been fully completed and signed?
   - Is the application fee attached?
   - Does the Commissioner have the power to rule (refer to page 2 of the IR 113 or IR 114)?
   - Has the applicant made full disclosure (refer to page 2 of the IR 113 or IR 114)?
   - Is a draft ruling attached?
   - Have all other supporting documents been attached?
3. If the application is deficient, or the Commissioner has no power to rule, Rulings will contact the applicant (or agent) and either request the additional information, or advise that a ruling cannot be made. The application fee is still payable if no ruling is made.
4. Time spent formulating the ruling, in excess of the first two hours, is charged at $105 per hour. In addition, any fees for specific work or services will also be charged if the Commissioner requires external advice to issue a ruling.
5. If the application is valid, Rulings will issue a letter to the applicant (or agent) and advise who is dealing with the application and give an initial estimate of the fee for making the ruling. The Commissioner is required to advise the applicant of any changes to that fee estimate.
6. In most cases, the person dealing with the application will consult with the applicant during the formulation of the ruling. The legislation requires that the applicant be given the opportunity to consult if the Commissioner's proposed ruling differs from the draft provided by the applicant. If the matter is straightforward and the Commissioner's ruling does not differ from the draft provided, there may be no need for consultation.
7. The time taken to formulate each ruling will vary according to the complexity of the issue and the quality of the application. Applications can be processed more quickly if they contain a full disclosure and are accompanied by all relevant documents.
8. Once the ruling is completed it is issued to the applicant.
9. The first private ruling issued to a taxpayer for each income year will have a Private Rulings Disclosure Return (IR 115) and Private Ruling Disclosure Attachment (IR 115A) enclosed. Each subsequent ruling for that year to the same taxpayer will be accompanied by an IR 115A only. The IR 115 is an annual return and an IR 115A is required for each ruling that is valid during that year.
10. If there are any hourly or other charges to be made, Rulings arranges for an invoice to be issued to the applicant. Payment is due upon receipt of the invoice.
11. Notification of the issue of product rulings is made in the New Zealand Gazette and the rulings may be published in Inland Revenue's TIB.

Draft ruling to accompany application

Generally, the standard of application has been good, but some applicants have omitted the draft ruling.

There is no required format for a draft ruling. However, as a minimum, the draft ruling should identify the applicant's answer to the questions raised in the application. Some applicants have found it helpful to follow the format used by Rulings when drafting a private ruling. This format is set out below. Applicants are welcome to follow the format, but there is no requirement to do so.

Private ruling

This is a private ruling made under section 91E of the Tax Administration Act 1994.

Person to whom the ruling applies

This ruling applies to [Name and IRD number of applicant].

Taxation law

This ruling applies in respect of [quote section(s) and statute(s) to which ruling the applies].

The arrangement

The arrangement is [describe arrangement].

Assumptions

This ruling is based on the assumption(s) that [state key assumptions].

Ruling

[Clearly state the ruling]

The period for which the ruling applies

This ruling applies for the period [state the period ruling applies].

Associated non-profit bodies - $1,000 income tax exemption

Public ruling - BR Pub 95/1

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation law

This ruling applies in respect of section CB 4 (1)(k) of the Income Tax Act 1994.

Arrangements to which this ruling applies

This ruling applies when a non-profit body associated with a national or principal organisation ("associated non-profit body") seeks the $1,000 income tax exemption under section CB 4 (1)(k).

The period for which this ruling applies

This ruling applies to income derived by an associated non-profit body for the 1996, 1997, and 1998 income years, and applies regardless of the taxpayer's balance date.

The ruling

The $1,000 income tax exemption in section CB 4 (1)(k) is available to associated non-profit bodies which are separately identifiable taxable entities and which satisfy the other requirements of section CB 4 (1)(k).

This ruling is signed by me on the 15th day of August 1995.

Jeffrey Tyler
Director (Rulings)

Analysis of the ruling

This analysis of the ruling does not form part of the ruling.

All legislative references are to the Income Tax Act 1994.

Background

Generally, any assessable income derived by a taxpayer is subject to income tax. Non-profit bodies are eligible for a $1,000 income tax exemption under section CB 4 (1)(k).

Types of organisations which may be eligible to claim the $1,000 income tax exemption under section CB 4 (1)(k) are:

- Trade associations.
- Progressive associations.
- Political parties.
- Social clubs (including those amateur sports bodies that do not qualify for an income tax exemption under section CB 4 (1)(h)).

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
CB 4 (1)(h)	61(30)
CB 4 (1)(k)	61(34)

Application of legislation

Under section CB 4 (1)(k), an income tax exemption of up to $1,000 of income in any income year is available to those non-profit bodies that meet the criteria set out in that section.

Section CB 4 (1)(k) states:

> Income derived by any society, association, or organisation, whether incorporated or not, which is not carried on for the purposes of profit or gain to any proprietor, member, or shareholder and which is, by the terms of its constitution, rules, or other document constituting that society, association, or organisation or governing its activities, prohibited from making any distribution, whether by way of money, property, or otherwise, to any such proprietor, member, or shareholder:

Provided that the amount of the exemption under this paragraph in any income year shall not exceed $1,000 of the aggregate of that income.

For an organisation to qualify for the section CB 4 (1)(k) exemption, the organisation must not be carried on for the profit or gain of any member, and its constituting document must prohibit the organisation from making any distribution whether by way of money, property, or otherwise to its members or persons associated with the members.

Associated non-profit bodies are also eligible for the $1,000 exemption

Section CB 4 (1)(k) may also apply to bodies that are associated with a national or principal non-profit organisation (referred to in the ruling as "associated non-profit bodies"). It is not possible to define exactly what an associated non-profit body is for the purposes of this ruling, but examples are regional or district branches of a national office. The fact that an associated non-profit body shares its constituting document with other "aligned" or "group" organisations does not prevent the section CB 4 (1)(k) exemption from applying to it, provided its constituting documents meet the relevant criteria set out in CB 4 (1)(k) and it is able to demonstrate that it is a separately identifiable taxable entity.

Whether an associated non-profit body can be identified as a separately identifiable taxable entity is a question of fact, and each case must be considered on its own facts. The Commissioner considers that an associated non-profit body will be a separately identifiable taxable entity if, for example:

- It keeps separate financial statements; and
- It keeps separate records of receipts and payments; and
- Its activities are not just incidental to the national or principal body's activities; and
- It is situated in a geographical setting that is distinct from the national or principal body.

In addition to these characteristics, section CB 4 (1)(k) requires that:

- The associated non-profit body is not carried on for the purposes of profit or gain to any proprietor, member, or shareholder; and
- The constituting documents of the associated non-profit body prohibit the organisation from making any distribution, whether by way of money, property, or otherwise, to any proprietor, member, or shareholder of the organisation.

GST - sale of long-term residential properties

Public ruling - BR Pub 95/2

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation law

This ruling applies in respect of section 14(d) of the Goods and Services Tax Act 1985.

Arrangements to which this ruling applies

This ruling applies when a GST registered person sells a residential rental property in the course or furtherance of a taxable activity and the property has been rented out by the registered person for five years or more prior to the sale.

The period for which this ruling applies

This ruling applies to the sale of dwellings where the time of supply occurs between 1 April 1995 and 31 March 1998.

The ruling

For section 14(d) to apply, the property must have been:

- Rented out for five years by the same person who sold it: it is not sufficient that the property has been rented out for five years but by different owners; and

continued on page 6

from page 5

- Used exclusively for residential rental purposes during that period. If the property has been used partly for rental purposes and partly for other purposes (e.g. property development purposes) it has not been used exclusively for residential rental purposes and section 14(d) does not apply.

All the other requirements of section 14(d) must be satisfied before the exemption will apply.

This ruling is signed by me on the 15th day of August 1995.

Jeffrey Tyler
Director (Rulings)

Analysis of the ruling

This analysis of the ruling does not form part of the ruling.

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

Background

Generally, the sale of residential rental property is not subject to GST. As the provision of rental accommodation is exempt from GST, the sale of the property is not in the course or furtherance of a taxable activity. However, sometimes a residential rental property may be sold by a registered person in the course or furtherance of a taxable activity (such as the taxable activity of selling houses) and the sale is then subject to GST.

When a registered person ("the vendor") sells property in the course or furtherance of a taxable activity, the vendor must account for output tax on the sale. However, if the vendor has rented out the property as residential accommodation for five years or more before the date of the supply, section 14(d) exempts the sale from GST. Sometimes a property is rented out for residential accommodation for five years before the sale, but the owner of the property changes during that time. A property owner may have also used the property for another purpose as well as for residential accommodation during the five years.

Legislation

Section 14(d) states:

The following supplies of goods and services shall be exempt from tax:

...

(d) The supply, being a sale, by any registered person in the course or furtherance of any taxable activity of-

(i) Any dwelling; or

(ii) The reversionary interest in the fee simple estate of any leasehold land,-

that has been used by the registered person for a period of 5 years or more before the date of the supply exclusively for the making of any supply or supplies referred to in paragraph (c) or (ca) of this section:

Section 14(c) exempts:

(c) The supply of accommodation in any dwelling by way of-

(i) Hire; or

(ii) A service occupancy agreement; or

(iii) A licence to occupy.

Section 14(ca) exempts:

(ca) The supply of leasehold land by way of rental (not being a grant or sale of the lease of that land) to the extent that that land is used for the principal purpose of accommodation in a dwelling erected on that land.

Section 14(d) was introduced for the purposes of the Housing Corporation. Because the Housing Corporation sold a high number of houses it was carrying on the taxable activity of selling houses.

The reference to paragraph (ca) in section 14(d) took effect on 1 August 1990.

Application of legislation

In order to apply section 14(d), the vendor must satisfy all the following criteria:

- The supply must be by way of sale.
- The supply must be by a registered person in the course or furtherance of any taxable activity. The sale of a house used for residential rental purposes will usually be an exempt supply. However, a registered person may sell a property in the course of a taxable activity of selling residential properties. A person will usually have a taxable activity of selling residential properties if that person sells properties continuously or regularly. (See Case S36 (1995) 17 NZTC 7,237.)
- The property must have been used for residential, not commercial, rental purposes.
- The property must have been used exclusively for rental purposes. If the property has been used partly for rental purposes and partly for other purposes, section 14(d) does not apply. For example, a property developer who rents out property for residential purposes while trying to sell the property does not meet this test. A property developer can only take

advantage of the exemption in section 14(d) if the property has been used exclusively for rental purposes. When the property has been used for two purposes, one a taxable supply (property development) and one an exempt supply (rental accommodation), the property has not been used exclusively for the exempt purpose, so section 14(d) cannot apply.

- The vendor must have rented out the property for at least five years. It is not sufficient that the property has been rented out for a minimum of five years by different owners.

Example

This example does not form part of the ruling.

X sold a house in May 1992 to Y Ltd, a property developer. X rented out the house for 15 years prior to the sale. This sale is exempt from GST as it was not a sale in the course or furtherance of a taxable activity. Y Ltd claimed a "secondhand goods" input tax deduction as the property was acquired for the principal purpose of making taxable supplies. Y Ltd continued to rent out the property while developing it. In February 1995 Y Ltd sold the house in the course of its taxable activity of property development. Section 14(d) does not apply to this sale for two reasons:

- Y Ltd was trying to sell the property as part of the property development during the time that it was rented, therefore, it was not used exclusively for rental purposes.
- Y Ltd did not rent out the house for five years.

Y Ltd must account for output tax on the sale of the house.

Agreed Value Plan issued by FAI Metropolitan Life Assurance Company NZ Limited

Product ruling - BR Prd 95/1

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Taxation law

This ruling applies in respect of section BB 7 and section CB 5 (1)(h) of the Income Tax Act 1994.

Arrangement to which this ruling applies

This ruling applies to a life insurance product known as an Agreed Value Plan issued by FAI Metropolitan Life Assurance Company NZ Limited ("FAI") and set out in the policy of insurance known as the Reassure Plan Document.

Assumptions

This ruling is based on the assumption that the Life Insured is the same person as the Plan Owner.

Defined terms in this ruling have the same meaning as set out in the Reassure Plan Document.

The period for which this ruling applies

This ruling applies from 10 July 1995 to 31 March 1998.

The ruling

A. Agreed Value Plan

Based on the assumptions stated above, under an Agreed Value Plan where the Life Insured has not contracted for any of the optional benefits:

continued on page 8

from page 7

- Any benefits received by the Life Insured under the Agreed Value Plan by way of the Occupational Retraining Benefit, Rehabilitation Benefit, Spouse Accommodation Benefit, and Funeral Benefit will be exempt from income tax pursuant to section CB 5 (1)(h):
- All other benefits received by the Life Insured by way of a benefit under the Agreed Value Plan will be assessable for income tax in the hands of the Life Insured:
- All premiums paid by the Life Insured under the Agreed Value Plan will be deductible from the income of the Life Insured.

B. Agreed Value Plan with optional benefits

Based on the assumptions stated above, under an Agreed Value Plan where the Life Insured has contracted for the Hospital Care Benefit, Home Care Benefit, and Living Insurance Benefit:

- Any benefits received by the Life Insured under the Agreed Value Plan by way of the Hospital Care Benefit, Home Care Benefit, and Living Insurance Benefit will be exempt from income tax pursuant to section CB 5 (1)(h):
- The portion of premiums paid by the Life Insured under the Agreed Value Plan for the Hospital Care Benefit, Home Care Benefit, and Living Insurance Benefit will not be deductible from the income of the Life Insured.
- Any benefits received by the Life Insured under the Agreed Value Plan by way of the Occupational Retraining Benefit, Rehabilitation Benefit, Spouse Accommodation Benefit, and Funeral Benefit will be exempt from income tax pursuant to section CB 5 (1)(h):
- 1.5% of premiums paid by the Life Insured for the Agreed Value Plan (excluding premiums paid for the optional benefits) will not be deductible from the income of the Life Insured:
- All other benefits received by the Life Insured by way of a benefit under the Agreed Value Plan will be assessable for income tax in the hands of the Life Insured:
- The portion of premiums paid by the Life Insured under the Agreed Value Plan for all other benefits will be deductible from the income of the Life Insured.

Analysis of the ruling

This analysis of the ruling does not form part of the ruling.

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

Background

A ruling has been sought on whether FAI's Agreed Value Plan is a personal sickness or accident ("PSA") insurance policy or a loss of earnings ("LOE") insurance policy in terms of the Commissioner's policy statement Personal sickness or accident insurance policies and loss of earnings insurance policies (individual policies only) which appeared in TIB Volume Six, No. 4 (October 1994), and in particular:

- Whether the benefits under the Agreed Value Plan are assessable in the hands of the insured:
- Whether the premiums paid by the insured for the Agreed Value Plan are deductible.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 7	104
CB 5 (1)(h)	61(40)

Section CB 5 (1)(h) exempts from tax:

Income derived by any person, in respect of any period of incapacity for work, from any payment received by that person by way of a benefit under a personal sickness or accident policy of insurance, not being a payment calculated according to loss of earnings or profits:

Disablement Benefit

The Disablement Benefit is calculated with reference to the Life Insured's average monthly earnings immediately preceding Disablement Date. The Disablement Benefit contains a maximum cap on the benefit that can be paid, the maximum cap being the amount of the Monthly Benefit specified in the Current Schedule. It is clear from the Tax Information Bulletin that it is no longer the Commissioner's policy that an insurance policy that contains a cap is automatically a PSA policy and not an LOE policy. The Commissioner has recognised that there are commercial reasons for limiting the insurer's liability under loss of earnings policies. The Disablement Benefit is an LOE benefit.

Agreed Value Plan

The Agreed Value Plan contains a number of other benefits. These standard benefits (where no additional optional benefits are contracted for) are the:

- Occupational Retraining Benefit:
- Rehabilitation Benefit:
- Spouse Accommodation Benefit:
- Funeral Benefit.

These benefits are periodic payments of an amount specified under the Plan, and are payable during the period of incapacity. The amounts are not calculated with reference to loss of earnings or profit, and under the Commissioner's policy are exempt.

FAI's Agreed Value Plan is a mixed benefit policy because it contains both PSA and LOE benefits. The Commissioner accepts that under some mixed policies only a negligible amount of each premium relates to a flat sum benefit, and that the rest of the premium relates to benefits calculated according to loss of earnings or profits. If the amount of premium attributable to the flat sum benefits is two percent or less, the whole of each premium can be deducted.

Applying the Commissioner's policy to the Agreed Value Plan, the amount of premium that is attributable to the standard flat sum benefits is 1.5%. As this is less than 2%, the whole of the premium is deductible.

Even though the whole of the premium in relation to the Agreed Value Plan is deductible, the PSA benefits are still exempt under section CB 5 (1)(h). These flat sum benefits continue to be exempt, despite the premiums relating to these benefits being deductible.

Agreed Value Plan with optional benefits

The Agreed Value Plan also provides for a number of optional benefits. A ruling is sought on the income tax situation where a Life Insured contracts for the following benefits:

- Hospital Care Benefit:
- Home Care Benefit:
- Living Insurance Benefit.

The Commissioner's policy is that none of these benefits are calculated according to loss of earnings.

An Agreed Value Plan that includes the optional benefits is a mixed benefit policy because it contains both PSA and LOE benefits.

Where the Life Insured takes out the Hospital Care Benefit, the Home Care Benefit, and the Living Insurance Benefit the optional benefits account for 6.7% of the premium. The Life Insured will also receive the Occupational Retraining Benefit, Rehabilitation Benefit, Spouse Accommodation Benefit, and the Funeral Benefit. These benefits account for 1.5 % of the premium. In this case the portion of any premium relating to flat sum benefits is over 2% (1.5% + 6.7% = 8.2%), therefore, the premiums must be apportioned on the basis of benefits payable. The amount of any premium relating to exempt benefits is non-deductible, and any benefits received are non-assessable to the Life Insured.

Policy statements

This section of the TIB contains policy statements issued by the Commissioner of Inland Revenue. Generally, these statements cover matters on which Inland Revenue wishes to state a policy, but which are not suitable topics for public binding rulings.

In most cases Inland Revenue will assess taxpayers in line with the following policy statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of assessment we consider that the earlier advice does not follow the law.

GST and subdivisions - Court of Appeal decision in the Newman case

Summary

The Court of Appeal recently gave its judgment in *Newman v CIR* (1995) 17 NZTC 12,097. This case dealt with the issue of whether a one-off subdivision constitutes a “taxable activity” for GST purposes. The Court of Appeal held that the one-off subdivision and sale carried out by the appellant did not constitute a taxable activity.

This statement outlines the Commissioner’s interpretation of the meaning of “taxable activity” in the context of subdivisions in the light of the Court of Appeal decision in *Newman v CIR.*

The Commissioner’s policy is that:

- Whether or not an activity is a taxable activity depends on the facts of each case.
- A subdivision of land into two allotments, involving no development work, will not by itself amount to a taxable activity.
- In other circumstances, whether or not the activity is “continuous” and amounts to a taxable activity depends on all the facts of the particular activity. The Commissioner considers that the following factors are relevant in determining the existence of a “taxable activity”: the scale of the subdivision, the level of development work, the time and effort involved, the amount of financial investment, and the commerciality of the transaction. (The examples at the end of this item illustrate how the Commissioner considers these factors apply in different situations.)
- The one-off sale of other private assets will not in isolation constitute a taxable activity. However, the activity of constructing and selling a single commercial building does amount to a taxable activity.

This item replaces the policy under *Taxable Activity - Continuous or Regular* on page 32 of PIB 164 (August 1987).

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

Background

The subdivision of land typically consists of a number of steps undertaken over a period of months. This will usually involve arranging survey plans, engineering reports, and access to water, power and telephone lines, as well as obtaining the services of lawyers and real estate agents. Many of these steps are compulsory local authority requirements.

The TRA has discussed the GST treatment of the activity of subdividing land in several cases since the introduction of GST. The general approach adopted by the TRA has been to treat almost all subdivisions as taxable activities because of the continuous nature of the background steps involved in carrying out a subdivision.

The Court of Appeal in the *Newman* decision has now resolved the correct GST treatment of a subdivision that creates two allotments with no development work followed by the sale of one allotment. The Court of Appeal concluded that small-scale, private subdivisions of the kind carried out by the taxpayer in this case are not taxable activities. This type of activity will not generate any GST obligations for the subdivider. The correct GST treatment of other types of subdivision and development activities will depend on the facts surrounding each activity.

Legislation

Section 8(1) imposes GST on the supply (other than an exempt supply) in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity.

Section 6(1)(a) defines “taxable activity” to mean:

> Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

The main features of a taxable activity are:

- There is an "activity"; and
- The activity is carried on "continuously" or "regularly"; and
- The activity involves, or is intended to involve, the supply of goods and services to another person for a consideration.

Court of Appeal decision

Facts

The taxpayer was a builder who purchased a block of land in Queenstown on which he intended to build a family home for himself. During the construction of the house he subdivided the property to fund the completion of the house. The taxpayer did not carry out the subdivision in the course or furtherance of his taxable activity as a builder.

The Commissioner assessed output tax on the sale of the subdivided property. The taxpayer objected to the assessment. The TRA agreed with the assessment and held that an isolated subdivision transaction could constitute a "taxable activity".

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

Decision

The Court of Appeal held that the subdivision activity of the taxpayer did not constitute a taxable activity. In reaching this decision, the Court examined the activity as a whole. It made the general comment that the determination of whether or not a particular subdivision activity is a taxable activity will depend on the facts of each case. In relation to the taxpayer, the Court of Appeal noted that the activity was a straightforward subdivision that did not involve development work on the property. The activity involved neither repetition over time nor repeated acts.

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

The Court also agreed with the High Court judgment in *Tout v Cook* (1991) 13 NZTC 8,053 that the "one-off" development involved in that case was not a continuous or regular activity. In *Tout v Cook* the taxpayer purchased a residential property intending to cross-lease the property into two or three allotments, build a new home for herself, and sell the original house. The High Court held that this level of activity was neither "continuous" nor "regular".

Policy

"Continuously"

The Court of Appeal in *Newman v CIR* sets out general principles for interpreting the terms "continuously" and "taxable activity" in the context of subdivisions. Applying this decision, the Commissioner considers that:

- Whether or not a taxable activity exists depends on the particular facts of each case.
- A subdivision of land into two allotments, involving no development work, will not by itself amount to a taxable activity.
- In other circumstances, whether or not the activity is "continuous" and amounts to a taxable activity will depend on all the facts of the particular activity. The Commissioner considers that the following factors are relevant in determining the existence of a "taxable activity":
  - the scale of the subdivision
  - the level of development work
  - the number of sales of subdivided land
  - the time and effort involved
  - the level of financial investment
  - the commerciality of the transaction

  Therefore, the greater the number of allotments created and sold, the more extensive the development work, the more time and effort involved and the higher the financial commitment to the project, the more likely that there is a taxable activity. Note that the above list of factors is not exhaustive. No particular factor determines the existence of a taxable activity. The activity as a whole must be examined to see whether or not there is a taxable activity. The examples at the end of this item illustrate how the Commissioner considers these factors apply in different situations.
- The one-off sale of other private assets (e.g. a car) will not in isolation constitute a taxable activity. This is the result even if the process of sale involves a number of steps.
- The process of constructing and selling a commercial building is a continuous activity which falls within the definition of "taxable activity". This is because the transaction involves substantial development work, financial investment, and time and effort.

continued on page 12

from page 11

"Regularly"

If an activity is carried on either "continuously" ***or*** "regularly", that activity will satisfy the definition of "taxable activity" (provided the activity satisfies the other requirements of the section 6 definition of "taxable activity"). Therefore, if a person carries out the process of subdivision on a regular or repeated basis, a taxable activity will exist. This is the result even if each individual subdivision is not a taxable activity in its own right.

Sale of home following subdivision

Under the principles set out above, it is possible that a person who subdivides land on which a residence is located may be carrying on a taxable activity. In this situation, the Commissioner considers that only the newly-subdivided allotments form part of that person's taxable activity. The allotment containing the original home is separate from the taxable activity of subdivision and sale. Therefore, if the person later sells the residential home (and curtilage), that sale is not made in the course or furtherance of the taxable activity of subdivision. GST will not apply, provided that the residential home (and curtilage) do not form part of the assets of another taxable activity carried out by that person.

Examples

The following examples show how the Commissioner considers that the factors discussed under "Policy" apply to determine whether or not there is a taxable activity. These examples are illustrative only and do not cover the wide number of factual situations that may arise. Each case must be considered on its own facts.

In each of these examples it is assumed that the sales of subdivided land made exceed $30,000.

Example 1

Mr and Mrs Taylor are not registered for GST. They have owned their home (situated on a quarter hectare section) for 20 years. They subdivide this section, sell the rear section, and put the proceeds toward retirement savings. In the course of the subdivision, they arrange for a surveyor to prepare a plan, obtain the necessary approvals from their local authority, and instruct a lawyer and a real estate agent to carry out the sale of the subdivided section. The Taylors also arrange for the construction of sealed road access to the rear section to satisfy the local authority requirements. The Taylors continue to live in their home on the front section.

Are the Taylors carrying on a taxable activity?

GST treatment

The Taylors' subdivision activity is not a taxable activity for these reasons:

- They have not carried out the activity "continuously" under the principles in the *Newman* Court of Appeal case. The subdivision is a straightforward subdivision into two allotments. The activity does not involve substantial development work, financial investment, or time and effort; and
- They do not subdivide land on a regular basis.

Example 2

Mr and Mrs Burton have owned and lived in their home on a three hectare property for 10 years. Their family business begins to run into financial difficulties and they decide to subdivide their land into four, selling three bare allotments to raise some money for the business. They continue to live in their home.

The Burtons arrange for a surveyor to prepare a plan, obtain the necessary approvals from their local authority, and instruct a lawyer and a real estate agent to carry out the sale of the subdivided sections.

Are the Burtons carrying on a taxable activity?

GST treatment

The Burtons' subdivision activity is not a taxable activity. The activity as a whole is not carried on "continuously". The subdivision is a straightforward subdivision involving minimal time and effort by the Burtons.

However, this result might change if other factors were involved in the subdivision. For example, there may be a taxable activity if the Burtons had undertaken substantial earthworks, constructed roads, and made a large financial investment in developing the property before sale.

Example 3

Mr Wilson is not registered for GST. He lives on a two hectare block on a main highway. He subdivides the section into two, and builds a building suitable as a "Devonshire tea/craft" shop. Mr Wilson sells the subdivided land and building.

In the course of the subdivision, Mr Wilson arranges for a surveyor to prepare a plan, obtains the necessary approvals from the local authority, and instructs a lawyer and a real estate agent to carry out the ultimate sale. He also organises (using contractors) the construction of the shop, arranges access to electrical, telephone, and water supplies and constructs a fence around the subdivided property.

Is Mr Wilson carrying on a taxable activity?

GST treatment

Mr Wilson's activity of subdivision and construction and sale of a commercial building is a taxable activity. The subdivision (and related actions) alone would not have amounted to a taxable activity. However, the whole activity is "continuous" in nature because Mr Wilson invested a significant amount of time, effort, and money to both subdivide and develop the land, and build a commercial building on the subdivided allotment.

Example 4

Caitlin is not registered for GST. She inherits an undeveloped 20 hectare rural property with a rundown cottage on it. She subdivides the section into 6 lifestyle blocks and sells these sections over a 12-month period, retaining only a small piece of land containing the cottage with a small garden for herself.

In the course of the subdivision, Caitlin arranges for a surveyor to prepare a plan, obtains the necessary approvals from the local authority, and instructs a lawyer and a real estate agent to carry out the sale of the subdivided sections. She also obtains rural planning consent, undertakes extensive contouring and landscaping, constructs roads between the sections, and arranges for electrical, telephone, sewerage, and water supplies.

Caitlin refurbishes the cottage and lives there for two years before selling. Is she carrying on a taxable activity?

GST treatment

Caitlin's subdivision and development enterprise is a taxable activity. The activity is "continuous" as it involves extensive development work on the land, substantial time, effort, and financial investment, and six repeated sales of subdivided property. Caitlin must register for GST and account for GST on the sale of the six properties.

Caitlin does not need to account for GST on the sale of the cottage. She did not sell the cottage in the course or furtherance of her taxable activity of subdivision and development. The cottage was her personal residence and it did not form part of a taxable activity.

Example 5

Chris is registered for GST. He researches the property market and discovers that there are opportunities to make profits from subdividing beachfront properties. He then purchases an allotment of bare beachfront land which he intends to subdivide. Two months later he subdivides the section into two and sells both lots. Soon after he purchases a similar property, subdivides the property into two, and sells both lots. Chris repeats the same exercise one year later.

Is Chris carrying on a taxable activity?

GST treatment

Chris is carrying on the taxable activity of subdivision from the time of purchase of the first property. Although each individual subdivision may not amount to a separate "continuous" activity, Chris' overall activity of subdividing is "regular" in nature because he repeats the process over time.

Overseas travel expense claims

Summary

This item states the Commissioner's current policy on the treatment of deductions for travel expenses of taxpayers who travel overseas.

When travel relates to a group tour or conference, tour organisers may apply to their local Inland Revenue office for prior approval of tour and conference deductions. (See page 6 of TIB Volume Three, No.1 - July 1991.)

Regardless of prior approval of group or conference expenses, the Commissioner may review individual claims for overseas travel expenses after taxpayers file their annual income tax returns. Individual taxpayers may be entitled to a different proportion of the expenditure than has been approved previously for a group, because the Commissioner treats each claim on its own merits according to income tax law. Only those expenses that are necessarily incurred in connection with the income earning process are allowable as a deduction.

Employees who travel overseas for their employers are prohibited from claiming deductions for expenses incurred in producing income from employment.

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

Background

This item discusses:

- the information that a taxpayer should supply when asked by Inland Revenue to support a claim for overseas travel expenses
- the apportionment of private expenses
- claims for a companion's or a family member's overseas travel expenses.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 7	104
BB 8	106(1)
DE 1	105(2)

Section BB 7 states:

In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it -

(a) Is incurred in gaining or producing the assessable income for any income year; or

(b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year -

continued on page 14

from page 13

may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

Section BB 8 states:

Notwithstanding anything in section BB 7, in calculating the assessable income derived by any person from any source, no deduction shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters:

Section BB 8 (b) states:

Any expenditure or loss to the extent to which it is of a private or domestic nature:

Section DE 1 (1) states:

Notwithstanding anything in section BB 7, in calculating the assessable income derived by any taxpayer, no deduction shall be made in respect of any expenditure or loss to the extent to which it is incurred in gaining or producing income from employment.

Policy

When travel relates to a group tour or conference, tour organisers may apply to their local Inland Revenue office for prior approval of tour and conference deductions (see page 6 of TIB Volume Three, No.1 - July 1991). Applications should be sent to the district office nearest the principal tour organiser's base.

However, regardless of any prior approval for group or conference expenses, any individual taxpayer may be entitled to a deduction greater or less than that previously approved for groups, depending on the circumstances of the case. The Commissioner may review individual claims for overseas travel expenses after taxpayers file their annual income tax returns. The Commissioner treats each claim on its own merits according to income tax law. Only those expenses that are necessarily incurred in connection with the income earning process under section BB 7 are allowable as a deduction.

Under section DE 1 (1), taxpayers who are employees can not claim a deduction for expenses incurred while travelling overseas for their employers.

Information to support individual claims

Taxpayers will often combine business and holiday elements into the trip. The costs can be relatively high, and it is important to establish any private content. Inland Revenue may ask taxpayers to supply information to support a claim for overseas travel expenses. Information we may ask a taxpayer to supply includes: the itinerary, business contacts visited, business conducted, diversions from the business itinerary for private purposes, items of expenditure, and the total cost of the trip.

Apportionment

Section BB 8 (b) prohibits a deduction for any expenditure of a private or domestic nature. If an overseas trip contains a private element, an apportionment of some of the costs will be necessary. For example, a taxpayer who spends a week on holiday after finishing his or her business will not be able to claim any costs relating to accommodation and meals while on holiday. The Commissioner will take a reasonable approach and consider each case according to the individual circumstances.

In relation to airfares, when the holiday element is minor and incidental to the business purpose of the trip, the Commissioner may allow the full claim for the cost of the airfare. If there are clearly two advantages sought, an apportionment will be required for the cost of the airfare. An apportionment based on the number of days on business, over the combined number of business and private days, has been accepted as a reasonable method, although the method depends on the circumstances of the case: see TRA *Case G5* (1985) 7 NZTC 1,011.

The following examples demonstrate the tax treatment of different situations.

Example 1

Gertrude owns a transport business. In December last year she went to Europe to visit her parents on their 50th wedding anniversary and to negotiate contracts for her business. She was overseas for 42 days, and spent 11 days on business.

Gertrude would have gone to visit her parents regardless of whether she went over for business. However, Gertrude needed to go overseas at some stage during the year for business. Before she left, Gertrude contacted her business contacts overseas and arranged to meet them.

Gertrude travelled overseas for two different purposes. In her income tax return, Gertrude claimed a deduction of 11/42 of the cost of the airfare, and the cost of accommodation and meals she spent for the 11 days while on business.

The Commissioner would accept the deduction because in the circumstances it is an acceptable method of apportioning the expenditure. It is clear that Gertrude travelled overseas for two reasons.

Example 2

Fred owns a tin can store. He was running short of stock so he went to Australia to buy some rubbish cans. While he was overseas, Fred took the opportunity to spend a couple of days with his old friend Bert.

Fred spent a total of three days in Australia, two days on holiday and one day on business. In Fred's tax return he claimed as a deduction the total cost of the airfare, and the cost of the accommodation and meals for the day he spent on business.

In Fred's situation the Commissioner would allow the entire deduction. The holiday aspect of the trip is incidental to the main purpose of travelling overseas for business. Fred only visited Bert because he was there for business and took the opportunity to see him.

Example 3

Oscar had planned a holiday to America. While he was overseas, he took the opportunity to promote his tourism business at some shopping malls. In his income tax return, Oscar claimed as a deduction half the cost of the airfare and the accommodation and meal costs he spent while promoting the business.

In Oscar's situation the Commissioner would disallow the deduction for half the cost of the airfare because the holiday is the reason for travelling overseas. Oscar only decided to promote his business while overseas, so when he purchased the airline ticket his only purpose was to go holiday. However, the Commissioner would allow the deduction for the accommodation and meal cost while Oscar was on business.

Taxpayer accompanied by family member

In some situations a taxpayer may also claim travel expenses for a companion, spouse, or other family member. Examples of factors which might support such a claim are:

- The companion, spouse, or family member is employed full-time in the business and is actively engaged on business activities while overseas.
- The taxpayer travelling on business must be accompanied because of ill health. In this case, the expenses of the accompanying person (even if another family member) may also be allowed. The Commissioner may request a medical certificate if necessary.
- An associated overseas organisation expects that a taxpayer should be accompanied by a spouse.
- The taxpayer attends a conference and the companion or spouse contributes in some integral way to the conference.

Pensions payable to former employees

Summary

This item sets out the conditions under which a deduction can be made for pensions paid to former employees or their spouses under sections DF 4 and FF 17. To briefly summarise:

- A deduction from business income is only available if the specific tests of section DF 4 are met.
- Section DF 4 requires that the pension arrangements be recorded by deed.
- For close companies, the deductions are limited to payments made to bona fide employees.

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
BB 7	104
DF 1 (b)	106(1)(ma)
DF 4	151(1) and (2)
FF 17	151(1) proviso
OB 1 definition of "Close company"	2

Section DF 4 states:

(1) Subject to this section, the Commissioner may, in calculating the assessable income derived in any income year by any taxpayer from any business, allow a deduction in respect of any amount (being an amount which is not deductible otherwise than under this section and which is, in the opinion of the Commissioner, reasonable in the particular circumstances of the case) paid by the taxpayer in that income year by way of a pension to any former employee of the taxpayer in that business, or to the surviving spouse of any such employee, in consideration of the past services of that employee in that business of the taxpayer, where subject to section FF 17 the Commissioner is satisfied that -

(a) The pension is receivable by the recipient as of right under a deed for a fixed period or for life, or, in the case of a pension receivable by a surviving spouse, for a fixed period or for life or until the surviving spouse remarries; and

(b) Either -

(i) The employee retired from that employment; or

(ii) The employee ceased to be employed by the taxpayer by reason of redundancy or other similar circumstances.

(2) Notwithstanding subsection (1) or any other provision of this Act, no deduction shall be allowed in respect of any amount paid by way of a pension (being a payment which but for this subsection would have been allowable as a deduction under this section) where the taxpayer is a close company and the former employee or a relative of that employee is or was a shareholder in the company:

Provided that where the Commissioner is satisfied that the employee was employed as a bona fide employee of the company, the Commissioner may allow a deduction in accordance with subsection (1) of so much of the amount paid by way of a pension as the Commissioner determines would have been granted by the company in similar circumstances if that employee or a relative of that employee were not, or had not been, a shareholder in that company.

continued on page 16

from page 15

Section FF 17 states:

> For the purposes of section DF 4, where any part of the pension otherwise payable by an employer to a former employee is paid by the employer to any person other than the employee in accordance with an agreement made between the former employee and that other person under section 21 of the Matrimonial Property Act 1976 or in compliance with an order of the Court made under section 25 of that Act, section DF 4 (1) shall apply in the same manner and to the same extent to the amount of the part so paid as it would have applied if that amount had been, or formed part of, an amount paid by way of a pension to that former employee.

Section BB 7 is the general provision which allows for the deduction of expenditure from income in the calculation of assessable income. However, generally section DF 1 (b) denies a taxpayer any deduction for expenditure in respect of bonuses, gratuities, retiring allowances, or pensions paid or payable to or for the benefit of any employee, former employee, or relative of any such employee during or on the occasion of the retirement of the employee.

Expenditure on pensions can only be deducted under sections DF 4 and FF 17. In calculating the assessable income of a business for an income year, section DF 4 allows a deduction in respect of pensions paid by the taxpayer in that income year to a former employee or his or her surviving spouse. However, in summary, the Commissioner must be satisfied that:

- The amount of the expenditure is reasonable in the particular circumstances of the case; and
- The pension is receivable by the recipient as of right under a deed for a fixed period or for life, or the pension is receivable by a surviving spouse for a fixed period, for life, or until he or she remarries; and
- The employee has retired from that employment; or
- The employee was made redundant or ceased employment under other similar circumstances.

Under section FF 17, any amount of pension paid to any person other than the former employee is still deductible when it is paid in accordance with a matrimonial property agreement made under section 21 of the Matrimonial Property Act 1976 or in compliance with a Court order made pursuant to section 25 of that Act.

Proprietary and close companies

The Income Tax Amendment Act 1994 amended section 151(2) of the Income Tax Act 1976 (the former section DF 4). Before the amendment, section 151(2) referred to a "proprietary company". From 1 July 1994 the section refers to a "close company". This amendment is incorporated into section DF 4 (2).

Before 1 July 1994, section 151(2) prohibited any deduction from being made when the taxpayer was a "proprietary company" and the former employee or a relative of that employee was a shareholder in that company. However, if the Commissioner is satisfied that the employee was a bona fide employee, a deduction can be considered.

From 1 July 1994, section 151(2) (now section DF 4 (2)) prohibits any deduction from being made when the taxpayer is a "close company" and the former employee or a relative of that employee is or was a shareholder in that company. However, if the Commissioner is satisfied that the employee was a bona fide employee, a deduction can be considered.

Proprietary company

A proprietary company was a company which in relation to any income year, at the end of that year, had the following characteristics:

- The company was under the control of not more than four persons; or
- The company was being wound up or had been wound up, and was under the control of not more than four persons at the start of the winding up; and

in counting the number of persons:

- All the members of any partnership were deemed to be one person; and
- All trustees or beneficiaries of the estate of any deceased person were deemed to be one person.

Close company

From 1 July 1994 onwards, a close company is any company (excluding a special corporate entity) in respect of which at that time there are five or fewer natural persons whose aggregate voting interests (or, in the case when at the time a "market value circumstance" exists in respect of the company, whose aggregate market value interests in the company) exceed 50 percent.

When determining whether there are five or fewer natural persons, any natural person and all natural persons who are associated at the time with that natural person are treated as being one natural person.

Policy

When a taxpayer pays an amount of pension in an income year to a former employee or spouse, a deduction from business income will be allowed if the specific tests in section DF 4, as stated above, have been met. Further, deductions will only be allowed when the pension arrangements are recorded by deed.

For close companies, the deductions are limited to payments made to bona fide employees. Some factors that may indicate that a shareholder was a bona fide employee are:

- If source deduction payments were received from the company, they were reasonably reflective of the position and responsibility held by the person as an employee; or
- If the person was actively engaged in the activities of the company, the pension is reasonably reflective of that which would have been paid to an employee if that employee had not been a shareholder in the company.

Deed

As indicated above, one of the requirements is for the pension to be receivable by a recipient under a deed. For these purposes, a deed is an instrument which meets all the following criteria:

- It is in writing.
- It is signed by the employer of the employee, and the employer intends to be bound.
- It is attested to by at least one witness who must sign and (if the deed is executed in New Zealand) add his or her address and job description or calling.
- It states that the employer will provide for the payment of certain sums of money as a pension to the employee or in respect of that employee.

Example 1

John has been employed as an engineer for XTRA Company Ltd for 25 years and will soon be retiring. The company has agreed to pay him a pension upon retirement in recognition of his long service to the company. The company has drawn up a deed specifying that it will pay John a weekly pension, being 40% of the average of the last four years' salary which is $40,000. The pension will be payable for a period of 10 years from the date of his retirement. The deed is properly executed. The company is not a proprietary company or a close company.

In this case the company will be entitled to deduct any pension payments that it makes to John. The payments are to be made after John retires from the company, are considered to be reasonable given the circumstances of the case, and will be receivable as of right under a deed. The requirements of section DF 4 will be satisfied.

Example 2

Jenny has been working for PL Ltd for ten years. The company does not have any formal contracts of employment. It has agreed to pay Jenny a pension when she retires from the company. No formal documents have been drawn up.

As there is no deed, the company will not be entitled to any deduction under section DF 4 for any pension that it pays to Jenny.

Example 3

David is a shareholder-employee in MATEX Ltd, a clothing company. The company is a close company within the meaning of the Income Tax Act 1994. David has worked full-time in the company business for the last fifteen years, and is intending to retire in two years time with the company's approval. The company pays David a regular salary and deducts PAYE. The company agrees to pay David a pension of 50% of his current salary which is $100,000. This pension policy is also available to other employees. A deed is drawn up and is properly executed.

Factors that indicate that David is a bona fide employee are that he is working full-time in the company business and is paid a regular salary. It would need to be shown that the level of his salary is reasonably reflective of his position and responsibilities. An indicator that the pension amount is reasonable is that it is also available to other employees who are not associated with the company.

If David is a bona fide employee of the company and the level of expenditure is assumed to be reasonable, and, given that the payments will be made as of right under a deed, the company will be entitled to deduct any pension payments made to him.

Recovery of tax arising after estate distributed

Summary

This item sets out the Commissioner's current policy on the recovery of tax arising after an estate has been distributed.

The executor or administrator of an estate has a duty to ensure that the tax obligations of the deceased are satisfied. If a further tax liability of the deceased arises after the estate has been distributed, the executor or administrator is liable for that outstanding tax. However, the executor may recover this tax from the beneficiaries of the estate. In cases of serious hardship, the administrator or executor may obtain relief from the tax liability incurred by the deceased.

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

Background

When a person dies, he or she may have outstanding taxes to pay or may have income still to be returned. The executor or the administrator of the estate has a duty to ascertain details of the deceased's debts, and to make provision for their payment. However, despite this obligation, some executors and administrators distribute estate assets to beneficiaries when there are outstanding taxes owing to Inland Revenue.

continued on page 18

from page 17

Legislation

Cross-reference table

Tax Administration Act 1994	Income Tax Act 1976
43	11(2)
44(2)	12
108	25
113	23
176(1)	414(2)

Section OB 1 of the Income Tax Act 1994 defines "trustee" to include an executor or administrator.

Section 43 of the Tax Administration Act 1994 states:

(1) The executor or administrator of a deceased taxpayer shall in respect of all income derived by that taxpayer in the taxpayer's lifetime make the same returns as the taxpayer ought to have made or would have been bound to make if the taxpayer had remained alive; and the Commissioner may from time to time require the executor or administrator to make such further returns relative to that income as the Commissioner thinks necessary, and may assess the executor or administrator for income tax on that income in the same manner in which the taxpayer might have been assessed had the taxpayer remained alive.

(2) The tax so assessed shall be deemed to be a liability incurred by the deceased taxpayer in the deceased taxpayer's lifetime, and the executor or administrator of the taxpayer shall be liable for the same accordingly.

Under section 44(2), the Commissioner may require the executors or administrators of a deceased taxpayer to file a tax return to cover a specified period or income from a specified transaction. The Commissioner can require this at any time during an income year or in any subsequent year. If the return is not filed, or if the Commissioner is dissatisfied with it, he may issue an assessment for a sum that he considers reasonable.

Section 113 states:

(1) The Commissioner may from time to time and at any time make all such alterations in or additions to an assessment as the Commissioner thinks necessary in order to ensure the correctness thereof, notwithstanding that the tax already assessed may have been paid.

(2) If any such alteration or addition has the effect of imposing any fresh liability or increasing any existing liability, notice thereof shall be given by the Commissioner to the taxpayer affected.

Under section 108, the Commissioner is unable to alter an assessment if four years have passed since the end of the year in which the original assessment was issued, unless the return was fraudulent, wilfully misleading, or did not mention income of a particular nature or from a particular source.

The Commissioner may release an executor or administrator from liability in certain circumstances. (See section 176(1) of the Tax Administration Act 1994.)

Section 35 of the Trustee Act 1956 provides protection against creditors for executors and administrators. Trustees who advertise their intention to distribute an estate are protected against claims of which they have no notice if they distribute the estate after the time for notice has expired. The trustee must advertise in a newspaper in each locality in which claims against the estate are likely to arise.

Policy

An executor or administrator is responsible for ensuring that all the tax obligations incurred by the deceased during his or her lifetime have been met. Any tax liability that is assessed after the date of death is deemed to be a liability incurred during the taxpayer's lifetime, and the executor or administrator is responsible for paying it. An executor or administrator cannot use section 35 of the Trustee Act as protection against the Commissioner, as section 43 of the Tax Administration Act 1994 gives clear notice that there may be a debt owing to Inland Revenue.

The Commissioner may also reopen back-year assessments even if an estate has been distributed. Any tax liability that arises as a result of a reassessment is the responsibility of the executor or administrator. This is subject to the four-year limitation in section 108.

An executor or administrator has a right to recover from a beneficiary amounts paid by the executor to the Commissioner for debts owing by the deceased.

If the Commissioner is satisfied that the tax owing could cause serious hardship to the beneficiaries of the estate, he may at his discretion release the executor or administrator wholly or in part from the tax liability, and alter the assessment as is necessary for the purpose.

Case law

In the High Court decision *Public Trustee v Flower* (1991) 13 NZTC 8,042, the deceased had failed to declare interest he had received during the four years prior to his death. After the executor distributed the estate, he received an assessment from Inland Revenue. The executor sought to recover the amount from the beneficiary of the estate.

Justice Williamson stressed the importance of complying with section 11 (now section 43). His Honour held that, based on section 11(2) of the Income Tax Act 1976 (now 43(2) of the Tax Administration Act 1994), the liability of the executor to pay the income tax was clear. Justice Williamson commented that, because of section 11 of the Income Tax Act 1976, it may be that the protection against liability that some statutes afford an executor or administrator who has paid out an estate in good faith may not avail the executor or administrator against the Inland Revenue Department. Justice Williamson further held that the executor could recover the tax payable by the deceased from the beneficiary.

Family partnerships: Commissioner's ability to reallocate profits and losses

Summary

This item states the Commissioner's current policy on applying section GD 3 of the Income Tax Act 1994 to family partnerships. Section GD 3 is an anti-avoidance section which enables the Commissioner to reallocate income or losses between partners.

The Commissioner's policy is that income or losses may be reallocated having regard to the duties and responsibilities of each partner, the amount of capital (including assets) contributed to the partnership, and any other relevant matters.

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

Background

The Commissioner has discretion under section GD 3 to reallocate partnership profits, income or losses if, in his opinion, the allocation made by the partnership is not reasonable. Section GD 3 applies to partnerships when the partners are related. Section GD 3 also applies to partnerships and companies that employ relatives. Section DF 8 deals with payments of salary and wages to working partners. This item only deals with the allocation of profits and losses between partners who are relatives.

This item sets out the matters the Commissioner will take into account in deciding whether to reallocate profits, income, or losses.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
DF 8	167B
GD 3 (1)	97(1)
GD 3 (3)	97(3)
GD 3 (4)	97(4)
GD 3 (5)	97(4)
OB 1	2

When section GD 3 applies to partnership profits and losses

Section GD 3 applies to partnerships in the circumstances specified in section GD 3 (1). These can be restated as:

- A partnership carries on business and two of the partners are relatives, or, if a partner is a company, a director or shareholder of the company is a relative of any partner.
- A company carries on business in partnership with a relative of a director or shareholder of the company.

Relative

"Relative" is defined in section OB 1. A relative of someone is a person connected by blood relationship, marriage, or adoption, and includes a trustee for a relative.

The definition of "relative" expands on these concepts. People are connected by blood for the purposes of the definition if they are connected within the fourth degree. This means that there are four or fewer direct connections between two people. A direct connection is the relationship between a parent and child. For example, a sister and brother are connected to the second degree, and an aunt and niece are connected to the third degree.

People are connected by marriage if they are married, or if a person is married to a person who is connected by a blood relationship to the other. For example, a person and his or her brother-in-law are connected by marriage.

Finally, people are connected by adoption if one has been adopted as a child by the other, or as a child of a person who is within the third degree of relationship to the other.

When allocation of income is unreasonable

Under section GD 3 (1) the Commissioner may reallocate the share of profits or other income payable to or for the benefit of, or the share of losses borne by, the relative or company if he considers that the allocation is unreasonable. To determine whether an allocation is reasonable, the Commissioner must have regard to all of the following:

- the nature and extent of the services rendered
- the value of the contributions made by the respective partners by way of services, capital, or otherwise
- any other relevant matters.

If the Commissioner then forms the opinion that the amount of income or losses allocated to a relative is not reasonable, he may reallocate the profits, income or losses of the business or undertaking (before the deduction of any amount payable to the relative) between the partners in such shares as he considers reasonable.

Limit on Commissioner's ability to reallocate income

Section GD 3 (4) limits the Commissioner's ability to reallocate income or losses. The Commissioner cannot reallocate income or losses if a bona fide partnership contract exists. Under section GD 3 (5), a contract is bona fide if it meets all the following criteria:

- It is written and signed by all the parties to the contract or evidenced by deed signed by all the parties.

continued on page 20

from page 19

- No partner was under the age of 20 when the contract or deed was signed.
- The contract is binding on the parties for a term of at least three years and cannot be terminated by any party to the contract except for:
  - dissolution of the partnership by the death or bankruptcy of any partner, or at the option of the partners where a charge is made against a partner's share of the partnership property, under section 36 of the Partnership Act 1908; or
  - dissolution of the partnership by a court as provided for in section 38 of the Partnership Act.
- Each partner has real and effective control over his or her share of profits or other income to which he or she is entitled under the contract, as well as real and effective liability for his or her share under the contract of the losses incurred.
- The share of profits, or other income payable to a relative, or to a company of which a director or shareholder is a relative, does not constitute a gift for the purposes of the Estate and Gift Duties Act 1968.

"Gift" is defined in section 2(2) of that Act to mean:

> ...any disposition of property, wherever and howsoever made, otherwise than by will, without fully adequate consideration in money or money's worth passing to the person making the disposition

Application

Section GD 3 (3) provides that section GD 3 applies whether the partnership was entered into before or after the beginning of the income year.

Policy

The Commissioner may reallocate income or losses in proportions he considers reasonable. The Commissioner will exercise this discretion when he considers that the share of income or losses allocated to a relative is excessive, having regard to the value of the contributions made by the partners by way of services, capital or otherwise and any other relevant matters.

Section GD 3 is an anti-avoidance provision aimed at arrangements which allocate income or loss based on tax advantages, rather than on contributions to the partnership.

Information required

The Commissioner will consider the following information when evaluating the allocation of partnership profit, income, or loss:

- The services rendered by each partner. Relevant factors are the duties and responsibilities of each partner, time spent on partnership business, and any special skills or expertise of the partners.
- Capital contributions. Usually capital contributions are shown in the partnership accounts and this information will be relied on. The Commissioner may require more information if a partner has made assets available to the partnership and is not receiving rent or lease payments.
- Other relevant matters. These may include any special circumstances of the partnership business.

Reallocation of share of profits or loss

Using this information, the Commissioner will determine each partner's proportionate share in the partnership, and compare the allocation of profit, income, or loss made on this basis with the actual allocation made. The Commissioner may then reallocate profit, income, or losses on a reasonable basis. A reallocation is only made if it increases the tax payable by $100 or more.

A reallocation cannot be made if there is a bona fide contract, as defined in section GD 3 (5) and set out under the "Legislation" heading above.

Husband and wife partnerships

The question of whether a husband and wife are carrying on business in partnership, and - if there is a partnership - each spouse's share of partnership profit, income, and loss, depends on the facts.

The Partnership Act 1908 gives some guidance. Section 4 of that Act defines partnership as:

> the relation which subsists between persons carrying on a business in common with a view to profit.

Therefore, in terms of the statutory definition of partnership, there are three essential elements:

- a business
- carried on by two or more persons in common
- with a view to profit.

Section 27(a) of the Partnership Act goes on to state that as a general rule profits and losses are shared equally in the absence of any partnership agreement to the contrary:

> The interests of partners in the partnership property, and their rights and duties in relation to the partnership, shall be determined, subject to any agreement (express or implied) between the partners, by the following rules:
>
> (a) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm.

The Commissioner will take into account each spouse's capital contribution and services performed in the business in determining whether a partnership exists, and if so, whether there is any agreement as to the spouses' interests in partnership property.

Business assets transferred by matrimonial agreement are treated as having been contributed to the partnership in the proportions contained in the agreement.

Cases

Case B45 (1976) 2 NZTC 60,394

In this case the Commissioner reallocated income between the partners in a farming partnership. The partners were a taxpayer and the trustees of his family trust. Before the chairman A J Lloyd Martin, both parties agreed that section 106 of the Land and Income Tax Act 1954 (the equivalent section to section GD 3 of the Income Tax Act 1994) applied. The objectors disputed the Commissioner's method of reallocation.

The chairman referred to *Case 12*, 2 NZTBR 90, in which the Board commented at page 93 that "It does not necessarily follow that adherence to a formula will in every case provide the answer to the question posed for determination." And at page 94 "In concluding this determination we emphasise that varying conditions or circumstances might well warrant a different answer to a comparable problem."

In *Case B45* the chairman took into account the value of land provided by the trustees, livestock bailed by the taxpayer to the trustees, and management services provided by the taxpayer. The chairman allocated five percent rental for the land and the livestock, and a higher management fee for a period of the years in question, and found that the rest of the profits should be divided equally between the partners.

Case L64 (1989) 11 NZTC 1,374

Section 106 of the Land and Income Tax Act 1954 was also considered in *Case L64*. Judge Barber held that it was unreal to regard the five year old son of the taxpayer as providing services to his father's building business for which it was appropriate for him to receive wages. Amounts paid to the child were excessive under section 106.

Case S2 (1995) 17 NZTC 7,012

In a recent case, *Case S2*, Judge Barber upheld the Commissioner's assessment allocating rental losses equally between a husband and wife.

On the evidence, the husband and wife were equal owners and partners in respect of the rental property. Judge Barber did not accept that losses should be allocated on the basis of the husband and wife's contributions of 80 percent and 20 percent to a previously owned rental property, nor did he consider it important that the husband was responsible for administration and upkeep of the property.

The factors His Honour considered important were that the husband and wife were joint tenants and jointly liable under the mortgage, both were the ratepayers, contributions were made from matrimonial property, there was some muddlement in presenting partnership accounts, the wife contributed fully to the marriage, and the husband's claim that losses should all be allocated to him could be interpreted as self-serving from a taxation point of view.

Tokens, stamps and vouchers - GST on supply

Summary

This item states the Commissioner's policy on how GST applies to the purchase and redemption of tokens, stamps and vouchers. "Redemption" of a token, stamp, or voucher is the conversion of the token, stamp, or voucher into goods or services.

The purchase and redemption of tokens, stamps and vouchers involves two supplies. The sale of the token, stamp or voucher is the first supply. The goods and services supplied on conversion or redemption of the token, stamp or voucher is the second. Sections 10(16) and 10(17) ensure that GST is only charged once on tokens, stamps and vouchers. These provisions ensure that only the first or second supply is relevant for GST purposes, depending on whether the monetary value is stated on the token, stamp or voucher.

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

Background

The use of tokens, stamps and vouchers to pay for goods and services is well established. Examples are the use of milk tokens or bus tickets. The use of these products is increasing with changes in technology and the advent of things such as phone cards and photocopier cards.

This item provides some guidance on the Commissioner's view on the application of sections 10(16) and 10(17).

Legislation

Section 10(16) states:

Subject to subsection (15A) of this section, where a right to receive goods and services for a monetary value stated on any token, stamp (not being a postage stamp as defined in section 2 of the Postal Services Act 1987), or voucher is granted for a consideration in money, that supply shall be disregarded for the purposes of this Act, except to the extent (if any) that that consideration exceeds that monetary value.

Section 10(17) states:

Subject to subsection (15A) of this section, where a right to receive goods and services is granted in exchange for-

(a) Any token, stamp, or voucher for a consideration in money and the monetary value of that token, stamp, or voucher is not stated thereon; or

(b) A postage stamp (as defined in section 2 of the Postal Services Act 1987),-

continued on page 22

from page 21

the value of the supply of goods and services made upon redemption of that token, stamp, or voucher, or franking of that stamp or special stamp (as so defined) shall be nil.

Application of sections 10(16) and 10(17)

Sections 10(16) and 10(17) operate to ensure that GST is only charged once on the sale and redemption of tokens, stamps or vouchers. (Attached to this item is a flow chart that details how this legislation operates.)

Sections 10(16) and 10(17) relate to tokens, stamps and vouchers that give a right to receive goods and services. Sections 10(16) and 10(17) do not apply to tokens, stamps or vouchers that give a right to money. When a token, stamp or voucher gives a right to receive goods and services, but may also be converted into money, sections 10(16) and 10(17) still apply, with some modifications.

Section 10(16)

When the monetary value is stated on a token, stamp or voucher, section 10(16) applies and the first supply (the sale of that token, stamp or voucher) is disregarded for GST purposes. That is, GST is only charged on the second supply. This is the redemption or conversion of the token, stamp or voucher.

If the consideration paid by the purchaser exceeds the monetary value of the token, stamp or voucher, the first supply (the sale of the token, stamp or voucher) is not disregarded for GST purposes to the extent the consideration exceeds the monetary value.

If the token, stamp or voucher may be, and is, converted into money instead of goods and services, no GST is charged on the second supply.

Section 10(16) does not apply to postage stamps.

Section 10(17)

When the monetary value is not stated on a token, stamp or voucher, or a postage stamp is supplied, section 10(17) applies and the redemption or conversion of that token, stamp or voucher, or the franking of that postage stamp, has a nil value for GST purposes. That is, GST is only charged when the token, stamp, voucher or postage stamp is supplied, not when it is used.

Like section 10(16), under section 10(17) there are two supplies. However, under section 10(17) the second supply has a nil value.

GST will have been charged on the first supply even if the token, stamp or voucher may be converted into money or goods and services. If the token, stamp or voucher is redeemed for money, no GST should have been charged on the first supply. The supplier should reverse the GST on the first supply.

Section 10(15A) specifically deals with casino chips. It is dealt with in the following item in this TIB. Sections 10(16) and 10(17) do not apply to casino chips.

Policy

Whether tokens, stamps and vouchers are goods or services

Tokens, stamps and vouchers are choses in action and, accordingly, "services" as defined in section 2. Therefore, the supply of a token, stamp or voucher is a supply of services for GST purposes. (Section 2 defines "services" as anything which is not goods or money. Section 2 defines "goods" as all kinds of personal or real property, not including money or choses in action.)

A chose in action is a personal right of property that can only be claimed or enforced by action, and not by taking physical possession. The holder of a token, stamp or voucher is entitled to rights that cannot be enforced by taking physical possession. For example, if a retailer refused to convert a gift voucher into goods and services (when the retailer was obliged to convert the voucher), the holder of the voucher could only enforce his or her rights by legal action.

What is a "token", "stamp" or "voucher"

Section 2 does not define the terms "token", "stamp" and "voucher".

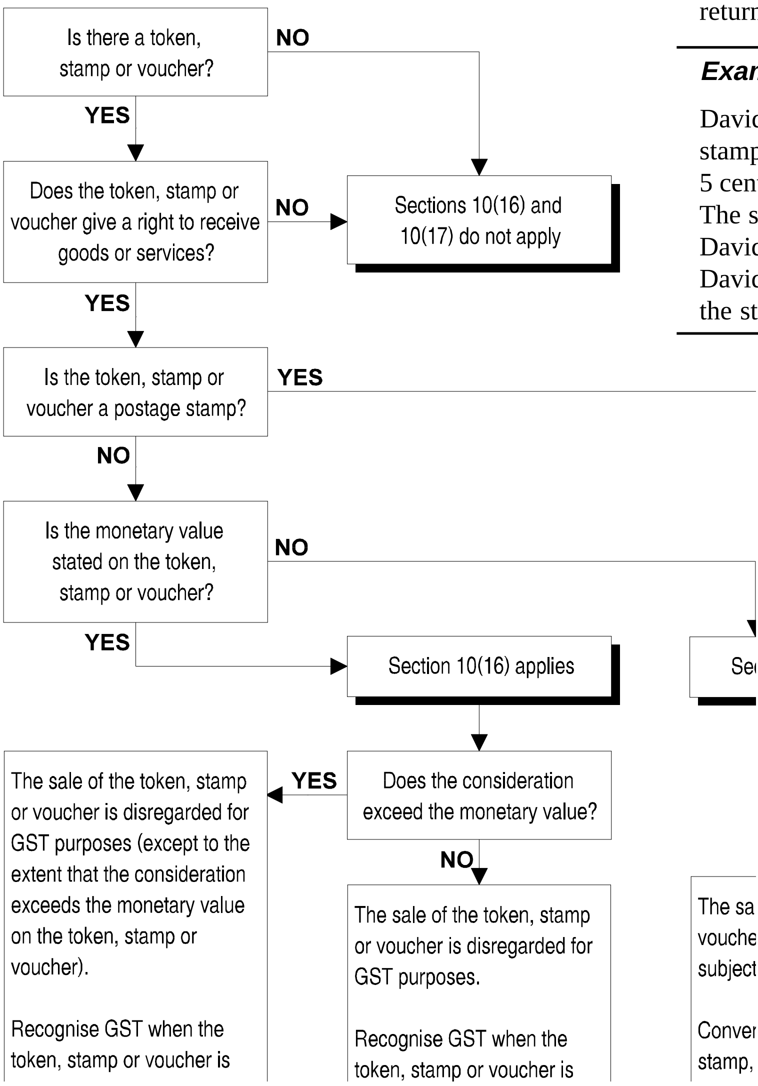
Historically "tokens" have been regarded as small coin-like objects such as a milk token or a disc used in a machine. Tokens have been used as a medium of exchange, passed to a trader in exchange for goods. "Vouchers" have been regarded as a slip of paper such as a book or record voucher. "Stamps" are understood to be small pieces of paper indicating payment of an amount or prepayment of some service, for example postage stamps. The ordinary meaning of the terms reflects this historical use of tokens and vouchers. (Note however that postage stamps, as defined in section 2 of the Postal Services Act 1987, are treated differently to other stamps. The value of supply for a postage stamp is calculated exclusively under section 10(17).)

With changes in technology and the advent of new means of receiving goods and services, the ordinary meaning of these terms is much broader. The Commissioner accepts that the definitions of these terms are wide enough to include many products denoting an entitlement to goods and services such as phone cards, rail passes, bus tickets, courier tickets or vouchers, and gift vouchers. In the context of the modern environment, the meanings of "token", "stamp" and "voucher" in the Act should have a wider, more modern meaning.

Example 1

David runs a small bookshop. As well as newspapers and magazines he sells bus tickets for travel on buses run by the Old Trafford City Council. The Old Trafford City Council bus tickets have no monetary value on them, but entitle the holder to ten trips per ticket. (Although each ticket has the number of sections stated on it, that does not amount to a monetary value.)

David sells a ticket to Brian, a commuter within Old Trafford. The ticket costs Brian $15. David should return GST on the ticket of $1.67. When Brian uses the ticket the value of the supply is nil, so no GST needs to be returned at the time of redemption.



Example 2

David also sells gift vouchers for a chain of book-shops. Each voucher entitles the holder to $20 of books or stationery, and has the monetary value stated on the voucher. David is entitled to sell the vouchers for $21 ($1 is an administration fee).

David sells a voucher to Paul. At the time of sale David should only account for GST on the $1 by which the consideration exceeds the monetary value of the voucher, that is $0.11. When Paul redeems the token at a bookshop, that bookshop should return GST on the $20, that is $2.22.

Example 3

David also sells stamps, including a new set of stamps issued with a face value of 50 cents, and a 5 cent surcharge to raise funds for medical research. The stamps have a 50 cent value on their face. David sells a stamp to Keith. At the time of sale David should account for GST on the full value of the stamp, that is $0.06 GST on the $0.55 stamp.

Casino chips - GST on supply

Summary

This item describes how GST applies to casino chips.

The purchase of a casino chip or the right to participate in a casino game is deemed to be for a supply of services. The value of the supply is the amount the player pays to the casino, less any amount the casino pays out as winnings or redemption of chips to the player.

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

continued on page 24

from page 23

Background

A casino has recently opened in New Zealand, so it is timely to provide guidance on the GST treatment of casino chips.

Legislation

Section 5(11B) states:

Notwithstanding anything in this Act, for the purposes of this Act where any person pays to a casino an amount in money-

(a) To purchase a chip or otherwise to participate in any game played or conducted in casino premises; or

(b) As commission in respect of participation in any game played or conducted in casino premises,-

the money so paid shall be deemed to be for the supply of services by the casino operator.

Section 10(15A) states:

Notwithstanding anything in subsection (16) or subsection (17) of this section, where a supply is deemed to be made under section 5(11B) of this Act, the consideration in money for the supply shall be deemed to be the amount of money (including cheques not collected) a person pays to the casino to purchase a chip or otherwise to participate in any game played or conducted on casino premises, or as commission in respect of participation in any such game, less any amount paid out by the casino as winnings in respect of gaming or for redemption of chips.

Application of section 10(15A)

Section 10(15A) specifically deals with casino chips. Sections 10(16) and 10(17) are not applicable to casino chips, but are dealt with in the item in this TIB entitled “Tokens, stamps and vouchers - GST on supply”.

The combined effect of sections 10(15A) and 5(11B), is that the value of a supply made by a casino is the amount the casino collects from a customer, less the amount the casino pays to a customer as winnings or for the redemption of chips.

Example

Shar’s Palace Casino sells $1,000 of casino chips to Porson, a keen gambler. Porson has a poor night, and loses $900 of his chips. His last gamble of $100 of chips wins him $300 plus the return of his stake. At the end of the night he collects his winnings of $300 and cashes in the $100 in chips he has retained.

Shar’s Palace Casino must account for GST of $66.67 on its supply to Porson, the consideration for that supply being $600 (the $1,000 of chips, less the winnings of $300, less the redemption of chips of $100).

Non-resident film renters - income tax treatment

Summary

Section CN 2 applies to non-residents and New Zealand companies controlled by non-residents who derive income from renting films in New Zealand (all called “non-resident film renters” in this item). Section CN 2 (2) deems non-resident film renters to have derived income from renting films in New Zealand equal to 10% of the gross receipts receivable from that activity. The non-resident film renter is subject to income tax on that income.

“Films” means motion picture films, television films, advertising films, slides, and videotapes.

Income within section CN 2 is not assessable under any other provision of the Act. The proviso to section CN 2 (1) states that section CN 2 does not apply when the income from renting films is a minor and relatively insignificant part of the renter’s business income. Each case must be examined on its facts to establish if the income from renting films is a minor and relatively insignificant part of the business income. Where the proviso excludes film rents from section CN 2, the rents will be subject to normal income tax rules, and the provisions of relevant double tax agreements.

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

Background

Section CN 2 is a special rule for non-resident film renters, which has existed in various forms since 1928. The rule was originally enacted because of the difficulties non-resident film renters have in determining the amount of profit they derive in each country in which they rent films. Rather than require non-resident film renters to determine accurately the profit derived from sales in New Zealand, the Act makes 10 percent of the gross rents assessable income.

Currently non-resident renters are subject to the non-resident company tax rate of 38 percent on their assessable income, making for an effective tax rate of 3.8 percent on gross rents. (Under the proposed changes to the international tax rules, the non-resident company tax rate will fall to 33 percent of assessable income, making for an effective tax rate of 3.3 percent on gross rents).

New Zealand resident companies that rent films and are under the control of non-residents are also taxed under section CN 2. They pay tax at the resident company rate of 33 percent on the 10 percent of gross rents, making for an effective tax rate of 3.3 percent on gross rents. Regardless of the rules applying to some New Zealand resident companies, this item uses the phrase “non-resident film renters”.

There has been some misunderstanding on the application of section CN 2. Some non-resident film renters are having non-resident withholding tax (NRWT) deducted from payments for rents. Non-resident film renters have been seeking refunds of NRWT and recalculation of their income tax liability under section CN 2. (This problem has not affected New Zealand resident companies, as they are obviously not subject to NRWT).

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
CN 2	224
NG 1	310
NG 2	311
OB 1	2

Section OB 1 defines "royalty" as:

"Royalty" includes a payment of any kind, whether periodical or not and however described or computed, to the extent to which it is derived as consideration for-

...

(d) The use of, or the right to use,-

(i) Any motion picture film; or

(ii) Any films or videotapes for use in connection with television; or

(iii)Any tapes for use in connection with radio broadcasting ...

Section CN 2 (1) states:

This section shall apply to any person, being-

(a) Any person not deemed to be resident in New Zealand; or

(b) A New Zealand company that is under the control of persons who are not deemed to be resident in New Zealand,-

in respect of the income derived by that person (whether as principal or agent or trustee) from New Zealand from renting films:

Provided that this section shall not apply to any such person in any case where the Commissioner is satisfied that the income from renting films is a minor and relatively insignificant part of the income of that person from any business.

Section CN 2 (5) states:

In this section-

"Film" means any exposed slide, strip, or motion film or any videotape; and includes-

(a) Any cinematograph film, whether or not it is accompanied by reproduction of sound:

(b) Any film intended for or capable of use on television:

(c) Any film used for advertising purposes:

(d) Any part of any film:

"Rents", in relation to films, means rents or other consideration for or in relation to the renting, hiring, or otherwise issuing films, or making other arrangements for their exhibition; and includes

(a) Any receipts from the sale or hire of film containers:

(b) Any receipts from the sale or hire of cinematograph or photographic materials, equipment, or accessories other than films:

(c) Any receipts from the sale or hire of advertising materials relating to any film,-

and "renting" has a corresponding meaning.

Section CN 2 (2) deems the non-resident film renter to have assessable income of 10 percent of the gross rents receivable by that person, and this amount is to be subject to income tax.

Under section CN 2 (3), income from renting films that comes within section CN 2 is not assessable under other provisions of the Act. Section CN 2 (3) also says that when calculating income other than film renting income, no account is to be taken of expenditure or loss incurred in connection with renting films. Section CN 2 (3) does not prevent the application of provisional tax rules including the imposition of additional taxes for underestimation and late payment of provisional tax, and the imposition of use of money interest. Provisional tax simply governs the timing of taxpayers' tax payments. Additional taxes are penalties for failing to pay tax, rather than an assessment of tax on income.

Additional taxes and penalties charged to non-provisional taxpayers are also not excluded by section CN 2 (3). Again, these do not amount to the assessment of tax on income.

Section NG 1 (2) states:

The NRWT rules shall apply to income (in this Act referred to as "non-resident withholding income"), being income that is deemed under this Act to be derived from New Zealand and that consists of-

(a) Dividends (other than investment society dividends) or royalties that are derived by a person who is not resident in New Zealand; or

...

not being income that is-

...

(e) Assessable under section CN 2...

Section NG 2 (1)(c) imposes NRWT of 15 percent on royalties.

Double Tax Agreements (DTAs) between New Zealand and other countries tend to have a definition of royalties (in relation to films) that is similar to the relevant part of the section OB 1 definition of "royalty". DTAs may limit the amount of NRWT that New Zealand can charge on the royalties. The limit is generally 10 percent.

continued on page 26

from page 25

Application of legislation

Definition of "film"

The section CN 2 (5) definition of "film" is wider in scope than motion picture or cinematograph films. It includes advertising films, slides, and videotapes and films intended for or capable of use on television. The definition requires a film to be tangible property. Therefore, "film" does not include a live telecast.

Definition of "rents"

The section CN 2 (5) definition of "rents" is wider than simply payments for the right to use and exhibit films. For example, also included as rents are receipts from the sale or hire of film containers.

Section CN 2: Receipts that are "rents" *and* "royalties"

When film rents also amount to royalties (as defined in section OB 1), those rents/royalties are subject to tax under section CN 2 rather than under the NRWT rules. Section NG 1 (2)(e) excludes from the NRWT rules income assessable under section CN 2, so there will be no NRWT liability.

When the income from renting films is a minor and relatively insignificant part of the business income, the proviso to section CN 2 (1) applies and those rents are not subject to tax under section CN 2 but are taxed under the NRWT rules (for non-residents) or the normal rules for business income (New Zealand companies).

Section CN 2 will apply whether or not the non-resident film renter's home country has a DTA with New Zealand. If there is no DTA, New Zealand may tax the rents/royalties under domestic law in the manner described above. If there is a DTA, New Zealand may tax the rents/royalties to a maximum of (usually) 10 percent. The section CN 2 rule effectively taxes the rents/royalties at 3.8 percent (for non-resident companies), complying with the obligations under a DTA.

Under some DTAs, when the recipient of royalties has a permanent establishment in the source country, the royalties are to be taxed under the business profits article. This does not change the tax treatment of non-resident film renters: they are subject to New Zealand tax under section CN 2.

If the rents come within the proviso to section CN 2 (1), and are subject to NRWT, the rate of NRWT New Zealand may impose will be determined by any DTA in effect. If there is no DTA, the normal NRWT rules apply for non-residents. (For New Zealand residents the income is subject to the normal rules for business income, not NRWT).

Section CN 2: Receipts that are "rents" but not "royalties"

When film rents do not also amount to royalties, those rents are taxable under section CN 2, subject to the relevant DTA.

If there is a DTA, the non-resident film renter is only subject to tax on those rents (as defined in section CN 2) if the renter has a permanent establishment in New Zealand. The non-resident film renter will either be taxed under section CN 2, or, where the proviso to section CN 2 applies, as business profits. If the renter does not have a permanent establishment in New Zealand, he or she is not subject to New Zealand tax on those rents.

If there is no DTA between New Zealand and the non-resident film renter's home country, the rents are subject to tax under section CN 2. If the rents come within the proviso to section CN 2, the rents are assessable as business profits for all non-resident film renters (non-residents and New Zealand companies controlled by non-residents).

Proviso to section CN 2 (1)

Section CN 2 will not apply when the non-resident film renter's income from renting films is a minor and relatively insignificant part of that person's business income.

"Minor and relatively insignificant" means that the income from renting films is minor and relatively unimportant when compared to the total business income of that non-resident film renter. The word "relatively" relates to the overall sources of business income. Income from film renting must be both minor and relatively insignificant. If the income from film renting is minor, but is not relatively insignificant, the proviso will not apply.

Each case must be examined on its own facts. Many cases will be easy to decide. For example, if a large motion picture producer distributes films in New Zealand through a subsidiary, that subsidiary will not have income from renting films that is a minor and relatively insignificant part of its business. (Assuming the principal focus of the subsidiary is distributing films.) Even if the parent company distributed the films, the parent company's income from renting would not be minor and relatively insignificant. In both cases the amount or significance of the income is more than minor and relatively insignificant.

On the other hand, when a non-resident rents a film as a one-off event, it is more likely to amount to a minor and relatively insignificant part of its income. When the payer of the rental is unsure if the non-resident comes within the proviso, he or she should seek further information from the payee. If still unsure, the rental payer should contact Inland Revenue's Masterton Office, which deals with non-resident film renters.

Examples

Example 1

A United Kingdom company (UK Co) distributes television films within New Zealand to a small New Zealand television network (NZ Network). UK Co does not have a permanent establishment in New Zealand. NZ Network pays UK Co a rental for each screening of a UK Co programme on NZ Network's channels. In the 1994-95 income year, NZ Network pays $110,000 to UK Co.

UK Co's rents are taxable under section CN 2. Ten percent of the rents are assessable income, that is $11,000. At the non-resident company tax rate of 38 percent, UK Co is liable to pay $4,180 in New Zealand tax. The DTA between New Zealand and the United Kingdom will not reduce this liability, as New Zealand may tax royalties (which includes these payments) up to a maximum of 10 percent of the gross income (maximum tax of $11,000).

Example 2

UK Co also sells some photographic materials in New Zealand: worth $20,000 in the 1994-95 income year.

At first glance this income also appears taxable under section CN 2, being a "rent" as defined in section CN 2 (5) (paragraph (b) of the definition of "rents"). However, the New Zealand/United Kingdom DTA does not allow New Zealand to tax UK Co's income because UK Co does not have a permanent establishment in New Zealand. (The DTA royalty article does not apply as the sale of photographic materials is not within the definition of "royalty".)

Example 3

An Australian company (Aus Co) is a publishing and multimedia company that is involved in magazines, sound recordings, television programmes, and motion picture films. It rents motion pictures in New Zealand, earning about $5,000,000. It has overall business income of NZ$150,000,000.

Aus Co is subject to the section CN 2 regime. Although its film renting income is less than 5 percent of its business income, the amount of NZ$5,000,000 cannot be said to be a minor and relatively insignificant part of business income. Therefore, Aus Co is subject to New Zealand tax on 10 percent of the $1,000,000 it earns from renting films in New Zealand. That is, it is subject to New Zealand tax of 38 percent on $100,000, which amounts to $38,000.

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

Subscriptions deductible for tax purposes

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: A stud stock farmer has asked if subscriptions paid to two local Agricultural and Pastoral Societies and the Automobile Association are tax deductible, and how the Commissioner of Inland Revenue views the legislation.

When deciding if fees and subscriptions are allowable as a deduction, it is necessary to determine whether such a deduction comes within the provisions of section BB 7.

Section BB 7 states:

In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it-

(a) Is incurred in gaining or producing the assessable income for any income year; or

(b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year-

may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

Fees and subscriptions paid to a trade or professional association are deductible when there is a sufficient connection between the expenditure and the taxpayer's income earning process. This type of expenditure is deductible under section BB 7 (a) as it is incurred in the gaining or producing of the taxpayer's income.

In this case, subscriptions paid to the Agricultural and Pastoral Societies are deductible, because of the relationship between the farmer's business and the holding of A & P shows where top stud stock is usually on display. Any written material put out by the society may also benefit the stud stock farmer.

As to membership of the Automobile Association, the stud stock farmer would not be entitled to claim the subscription paid as a deduction, unless he can demonstrate a sufficient nexus between the expenditure and his income earning activities.

Education course expenses - deductibility

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in production of assessable income: A Canadian company is in the process of setting up a New Zealand subsidiary. The subsidiary company will market a successful Canadian medical professional practice management training course. It is designed to help doctors train themselves in modern practice management techniques. The New Zealand manager has asked if an income tax deduction will be available to self-employed medical professionals who purchase the product.

Section BB 7 permits a deduction for expenditure incurred in gaining or producing assessable income for any income year, or necessarily incurred in carrying on a business for that purpose.

In this case, the cost to self-employed medical professionals of buying the training course is allowable as a deduction, as it is directly related to their business practice and is incurred in the maintenance or production of their assessable income.

Loan guarantor's loss when guarantee is called on - deductibility

Section EH 4 (section 64F(8), Income Tax Act 1976) - Income and expenditure where financial arrangement redeemed or disposed of: A taxpayer acted as guarantor for a loan taken out by a company of which she was a major (60%) shareholder. The guarantee was called on when the company failed. The taxpayer has asked if she can claim a deduction for the amount she was required to pay.

The guarantee provided by the taxpayer is a financial arrangement and the taxpayer/guarantor is the issuer in relation to that financial arrangement. A base price adjustment must be calculated at the time the payment is made under the guarantee. This results in expenditure or loss being incurred by the issuer.

Section EH 4 sets out the method of calculating income and expenditure when a financial arrangement matures or is remitted. A "financial arrangement" is defined in section OB 1 (section 64B, Income Tax Act 1976), and includes a debt or debt instrument.

Under section EH 4 (8):

...where and to the extent that a person (in this subsection called the "surety") suffers expenditure or a loss under a security arrangement and the expenditure or loss, in whole or in part, is due to-

(a) The actions of; or

(b) The occurrence, or failure to occur, of an event that was potentially or actually subject to the influence of -

the surety or any person with whom the surety was, during the term of the security arrangement, an associated person, no deduction shall be allowed to the surety or any person in relation to the expenditure or loss.

Section OB 1 defines a security arrangement as:

...in the definition of "security payment" and in the qualified accruals rules and sections CG 3 (b) and GC 8, means a financial arrangement that secures the holder against failure of any person to perform their obligations under a secured arrangement.

Section OD 7 (section 8, Income Tax Act 1976) defines when two persons are associated persons. Included as associated persons, in section OD 7 (1)(b), are:

A company and any other person (other than a company) where at the time -

(i) The person has a voting interest in the company equal to or exceeding 25%; or

(ii) In any case where at the time a market value circumstance exists in respect of the company, the person has a market value interest in the company equal to or exceeding 25%...

In this case, the taxpayer holds more than 25% of the shares in the company, and so she and the company are associated persons. Under section EH 4 (8), no deduction can be claimed for the loss if the expenditure or loss results from the actions of the taxpayer or an associated person.

If the expenditure or loss did not result from the actions of the taxpayer or an associated person, a full deduction for the expenditure or loss can be claimed.

continued on page 30

from page 29

However, section EH 5 (3) states:

Where a person receives a security payment in relation to a loss and a deduction is not allowable for the loss in calculating the assessable income of the person other than under this subsection, the person shall be allowed a deduction for the loss no greater than the amount of the security payment.

This means that if the taxpayer received a guarantee fee, and has returned the fee as income, she will be entitled to a deduction for any expenditure or loss up to the amount of the fee.

Values placed on exotic livestock

Section EL 1 (section 86, Income Tax Act 1976) - Valuation of trading stock generally: A taxpayer plans to acquire a business described as a "farm tourist centre". The business will own livestock of various breeds, some of them exotic. The taxpayer has asked if it is appropriate to apply the National Average Market Values to the livestock, or if the stock can be valued using other methods. The taxpayer considers that a basic value of $20,000 can be set for the total value of the livestock. Any sales, purchases, or natural increases, and the profits/losses arising from them, would show in the farm operating account.

Under section EE 1 (1) (section 85(2), Income Tax Act 1976), a taxpayer carrying on a business must take into account the value of trading stock (including livestock) at the beginning and end of each financial year to determine whether any assessable income has been derived. Section EL 1 provides the rules for valuing livestock that are not livestock used in dealing.

The National Average Market Values are used as a means of determining the value of trading stock. The stock on this farm, including the exotic animals, are not trading stock. They are an asset of the farm. No depreciation is available under current legislation.

Under section EL 1 (1)(c), non-specified livestock, which the stock in question are, must be valued under:

(i) The market value option; or

(ii) The replacement value option; or

(iii) The cost price option; or

(iv) The standard value option.

The proposal set out by the taxpayer to adopt a basic value for the livestock, to be used as the basis for reporting each time accounts are prepared and returns submitted to Inland Revenue, is not acceptable. A value must be put on the livestock under section EL 1 (1)(c).

Valuing livestock when estate continues farming activity previously carried on by deceased

Section EL 1 (section 85, Income Tax Act 1976) - Valuation of livestock generally: The trustees of a deceased farmer's estate plan to continue the farming activity previously carried on by the deceased. A trustee has asked how the trustees should value the estate's livestock at the end of their first year of trading.

Under section EL 1 (3), when a taxpayer is deriving income from livestock at the date of death, any livestock on hand at that date is to be valued at market value in the return of income to date of death.

If the livestock is then transferred to the trustee of the estate to continue the farming business, as that person is a new taxpayer the estate is subject to the other provisions of sections EL 1 to EL 10 in relation to the livestock.

The livestock enters the books of the estate at market value, and is valued at balance date according to the valuation scheme adopted by the trustee under section EL 1 (1)(d).

FBT cost price of secondhand motor vehicle obtained from associated person

Section GC 16 (section 336O(1A), Income Tax Act 1976) - Value of motor vehicle acquired from associated person: The manager of a company is considering purchasing a motor vehicle from a subsidiary company, so that it can be provided to an employee. The company realises that FBT will be payable, but the manager has asked whether there are any special rules to be considered when purchasing a vehicle in these circumstances.

Under section OD 7 (section 8, Income Tax Act 1976), the two companies are "associated persons". Normally, the value of a fringe benefit that consists of the unlimited private use or enjoyment, or availability for such private use or enjoyment, is 6% of the cost price of the vehicle, per quarter.

However, different rules apply when the vehicle is purchased from an associated person within 24 months of the date on which that associated person purchased the vehicle. Under section GC 16, the cost price is deemed to be the highest cost price of the motor vehicle paid by either of the associated persons.

Example

ABC Ltd and XYZ Ltd are associated persons. ABC Ltd purchased a new car for $40,000. Eighteen months later, ABC Ltd sells the car to XYZ Ltd for $32,000.

For FBT purposes, the cost price of the motor vehicle to XYZ Ltd is $40,000.

Carry forward of losses incurred by deceased to the estate

Section IE 1 (3) (section 188(3), Income Tax Act 1976) - Losses incurred may be set off against future profits: The trustee of a deceased's estate has asked if losses incurred by the deceased in his lifetime are able to be set off against income of his estate.

In general terms, the purpose of section IE 1 is to permit a taxpayer to carry forward losses incurred in one income year for set off against the taxpayer's assessable income in a later income year.

Under section IE 1 (3), any taxpayer who satisfies the Commissioner that he or she has incurred a loss in an income year may:

- Carry forward that loss to the next income year and deduct or offset the loss from assessable income in that next income year; and
- If the loss cannot be totally deducted or offset in that next income year, carry it forward to the next succeeding year and deduct or offset, and so on.

When a taxpayer dies, any losses that would otherwise have been available to the deceased to carry forward are lost and cannot be carried forward for deducting or offsetting against income derived by the estate. This is because, for tax purposes, the estate is a different taxpayer, and as it did not incur the loss it cannot benefit from it.

Training course - whether "remunerative work" for purposes of transitional tax allowance

Section KC 3 (section 50C, Income Tax Act 1976) - Transitional tax allowance: A home executive received a training benefit from New Zealand Income Support Service whilst attending a government-approved training course on child behaviour. She has asked if the training course constitutes "remunerative work" as this will affect the amount of rebate she is able to claim under the transitional tax allowance.

Section KC 3 allows a rebate for a "full-time earner" engaged in "remunerative work" for 20 hours per week or more, when the person's income for the income year is less than $9,880. Section KC 3 (3) defines "remunerative work" as work from, by, or through the performing of which a person derives income.

Although the taxpayer may have attended the course for more than 20 hours per week, in this case the rebate is not available because she does not meet the definition of a "full-time earner" contained in section KC 3. That definition requires a person to be engaged in remunerative work for not less than 20 hours per week. Study is not "remunerative work" as defined above, as the use of the word "work" in the definition implies that the remuneration must be received in return for actual personal services performed and not merely a training benefit paid for attending a training course.

Shareholder-employee salaries and liability for ACC premiums

Section OB 2 (2) (section 6(2), Income Tax Act 1976) - Meaning of "source deduction payment": A tax practitioner has asked whether shareholder-employee ND (no deduction) salaries are subject to ACC premiums when the business activity of the company is "passive", for example, rents.

Shareholder employee ND salaries are subject to premiums, regardless of the business activity of the company. Section OB 2 (1) defines the term "source deduction payment", and section OB 2 (2) contains the circumstances in which payments to shareholder-employees are not source deduction payments. Clause 2 of the Accident Rehabilitation and Compensation Insurance (Earnings Definitions) Regulations 1992 defines "earnings as an employee" to include payments which are not source deduction payments under section OB 2 of the Income Tax Act 1994.

ACC premiums are payable on all earnings as an employee, which are defined as:

- all source deduction payments; and
- all payments which are excluded from the definition of source deduction payments by section OB 2 (2).

It follows that shareholder-employee ND salaries are "earnings as an employee" for the purposes of imposing premiums under the Accident Rehabilitation and Compensation Insurance Act 1992.

Depreciation - special economic rate

Income Tax (Depreciation Determinations) Regulations 1993: A tax consultant has asked for details of the difference, if any, of a special economic rate of depreciation and a provisional economic rate of depreciation. If these involve a determination, is there a fee payable?

The difference between a special economic rate and a provisional economic rate is that a special rate is issued to take account of the particular circumstances of a taxpayer in relation to an asset. As a result of these special circumstances, the useful life of that asset is longer or shorter than the useful life used by the Commissioner in setting the general economic rate of depreciation for that class of asset and, therefore, the setting of a special rate is appropriate. The special rate is set for, and can only be used by, the taxpayer who made the application.

A provisional economic rate may be set when no applicable general rate has been set by the Commissioner, and may apply to all taxpayers who own that particular class of property, not just to the taxpayer who makes an application for a rate.

Fees are chargeable when a taxpayer applies for a special depreciation rate, but are not charged on applications for provisional depreciation rates.

Applications for a provisional depreciation rate are made on form IR 260A. Applications for a special depreciation rate are made on form IR 260B, which includes details of the fees payable.

Goods and Services Tax Act 1985

Grants and subsidies paid by the Crown and used for financial services

Section 5(6D) - Payment in the nature of a grant or subsidy: A GST registered company received a government grant which it used to acquire shares in a subsidiary company. The grant money was also used to purchase new machinery, by the company making a loan to its subsidiary to enable that company to purchase the machinery. An agent for the company has submitted that GST does not have to be accounted for in this instance as:

- The grant was used for financial services, which are exempt from GST.
- Making exempt supplies is excluded from the definition of a "taxable activity".

She has sought a ruling from Inland Revenue.

Under section 5(6D):

.... where any payment in the nature of a grant or subsidy is made on behalf of the Crown or by any public authority to -

(a) Any person (not being a public authority) in relation to or in respect of that person's taxable activity; or

(b) Any person for the benefit and on behalf of another person in relation to or in respect of that other person's taxable activity, -

that payment shall be deemed to be consideration for a supply of goods and services by the personto whom or for whose benefit the payment is made in the course or furtherance of that person's taxable activity.

"Taxable activity" is defined in section 6(1) as:

(a) Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

Excluded from that definition, at section 6(3)(d) is:

Any activity to the extent to which the activity involves the making of exempt supplies.

In this instance the grant was used by the registered person for two purposes. Firstly, to acquire shares in a subsidiary company. This is not an exempt activity,

continued on page 34

from page 33

as purchasing the shares does not involve the "making" of exempt supplies. Rather, in this case, the exempt supplies are being received by the company.

Secondly, making a loan to a subsidiary would normally be considered to be a financial service, and exempt from GST. However, in determining whether the grant is subject to GST it is necessary to examine the reason for the grant being made. In this case, the grant was given to enable the company to purchase new machinery for use in its taxable activity. The company chose to purchase that machinery by loaning the money to its subsidiary, rather than purchasing the machinery itself. That does not alter the initial rationale for receiving the grant.

Therefore, the grant is considered to have been received in respect of the company's taxable activity, and the recipient must account for GST on the value of the grant received.

Valuation of goods for insurance purposes

Section 5(13) - Indemnity payments: A taxpayer has asked if the value of goods covered by an insurance policy should be GST inclusive or GST exclusive. The amount of the premium is calculated on the value of the goods being insured. He has also asked how GST should be accounted for in the event of a claim being made against that policy.

When an insurance policy is silent on whether the indemnity value includes or excludes GST, the value of the goods to be insured and whether or not that value includes GST are matters for negotiation between the parties to the insurance contract. Such negotiations do not come within the authority of the Act.

Usually, for GST purposes premiums are calculated in one of two ways:

- When the value of the goods to be insured under the policy excludes GST, GST is added to the premium.
- When the goods are valued on a GST inclusive basis, the premium also includes GST.

Example

Goods are valued at $10,000 (excluding GST). If the premium is 2.5% of the specified value, the premium will be $250, plus GST of $31.25. The total premium is $281.25.

If the goods are valued on a GST inclusive basis, the premium will be calculated on $11,250 (including GST) at 2.5%, being $281.25 - also including GST.

Under section 5(13):

> ...where a registered person receives any indemnity payment pursuant to a contract of insurance, that payment shall, to the extent that it relates to a loss incurred in the course of making a taxable supply, be deemed to be consideration received for a supply of services performed on the day of receipt of that indemnity payment by that registered person in the course or furtherance of that person's taxable activity.

When a claim is made against a policy, for an asset that is part of a taxable activity and for which a GST exclusive value has been specified, the insurance company will add GST to the indemnity payment. The insurance company will make an input tax claim in its relevant GST return to recover the GST portion of the payment. The policy holder will return the GST received as output tax in the return covering the time of receipt of the payment.

When the value is GST inclusive, one-ninth of the payment will be GST. The insurance company will make an input tax claim, and the policy holder will return the output tax as above.

As already stated, the value of the goods being insured, and whether any claim should include GST, is a matter for negotiation between the insurance company and the policyholder. When taxpayers are uncertain of their position, they should check with their particular insurance company.

Medical services supplied to non-resident

Section 11(2)(e) - Zero-rated services: A representative of a non-resident medical insurance company has asked if the supply of surgical services, performed in New Zealand by a New Zealand resident on a non-resident patient, may be zero-rated for GST purposes.

Under section 11(2)(e), the supply of services is charged at zero percent when:

> The services are supplied for and to a person who is not resident in New Zealand and who is outside New Zealand at the time the services are performed...

For this provision to apply, the services must be supplied "for and to" the non-resident. Inland Revenue considers that the word "for" means the service must be supplied for the benefit of the person to whom the supply is made. In this instance, the surgical services are being supplied for the benefit of the patient, who will be in New Zealand at the time the service is performed.

The time the service is performed relates to the actual performance of the service, rather than the time of supply as defined in section 9.

We advised the non-resident medical insurance company that the fee for providing surgical services to a non-resident in New Zealand is not zero-rated. The supply of such services is subject to GST at the standard rate of 12.5%.

Power supply to farm - input tax deduction

Section 20 - Calculation of tax payable: A GST registered person has purchased a block of land in an isolated area on which he will farm dry stock. He has to pay the full cost of installing power lines to the property, which will supply electricity for electric fencing and water pumps. In the near future he plans to erect a number of buildings on the property, including a farm residence. He has asked if he can claim an input tax deduction for the full amount of the installation cost of the power lines, and if so, whether the private use adjustment he will have to make for the private use of the power used in the residence must include the installation cost.

Under section 20(3), a deduction may be made of the input tax paid or incurred by a registered person during a taxable period.

"Input tax" is defined in section 2 as:

> Tax charged under section 8(1) of this Act on the supply of goods and services made to that person:........
>
> being in any case goods or services acquired for the principal purpose of making taxable supplies.

Section 20(2) requires the registered person to hold a tax invoice (or debit or credit note) for the supply, at the time the GST return which includes that supply is filed. No tax invoice is required if the value of the goods or services supplied is less than $50, or the input tax claim is for secondhand goods.

In this case, provided he obtains a tax invoice, the registered person can claim an input tax deduction for the full value of the costs incurred in installing the power lines to the property.

continued on page 36

from page 35

In calculating the private use adjustment required under section 21(1), the taxpayer need only be concerned with the power used in the residence, (plus any supply charges that may be included in the power account). He will not need to include the installation costs in the calculation. However, when building the farm residence, the cost of connecting it to the established power supply will be a private expense for which no input tax deduction may be claimed.

Accident Rehabilitation and Compensation Insurance Act 1992

Honorarium - ACC premiums payable

Sections 102 and 114 - Premiums payable by earners who have earnings other than as an employee: A taxpayer who is an employee and has PAYE and ACC earner premiums deducted from her wages has recently become a Community Board member. She has asked if she must pay ACC premiums on the honorarium she receives.

People who receive payments as Community Board members are subject to the Income Tax (Withholding Payments) Regulations 1979. Under those regulations, such payments are subject to the deduction of withholding tax, rather than PAYE deductions.

For ACC purposes, recipients of withholding payments are treated as being self-employed. They must calculate and pay both employer and earner ACC premiums when they complete their tax returns. The premiums are payable at the same time as any terminal tax, i.e., by 7 February of the following year if the taxpayer has a 31 March balance date.

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.

Land acquired for purpose of erecting dwellinghouses - whether exempt from stamp duty

Rating: • • • •

Case: Howick Parklands Limited v CIR M No.1191/94

Act: Stamp and Cheque Duties Act 1971 - section 24(1)(b)

Keywords: *conveyance duty, subdivision, residential sections, purpose*

Summary: The High Court held that a developer who acquired land for subdivision with the purpose of having dwellinghouses erected was exempt from conveyance duty. The exemption will only apply if the Commissioner is satisfied that the dwellinghouses will be erected as soon as practicable after the date the instrument of conveyance is signed. It does not matter who builds the dwellinghouses nor does it matter if the developer does not own the land when the dwellinghouses are built.

Facts: The objector subdivided land for residential purposes and sold both vacant sections and sections with dwellinghouses erected on them prior to sale. Sale agreements of vacant sections contained a condition that purchasers start building approved dwellings within a specified time limit - usually two or three years. Such conditions were inserted as a means of promoting sales and enhancing sale prices.

Issue: The issue in this case was whether the conveyance duty exemption under section 24 (1)(b) for land acquired "for the purpose of having a dwellinghouse erected on it" is available to developers who acquire land for residential subdivision and sell vacant sections to purchasers who have agreed to erect a dwellinghouse.

Decision: Justice Fisher held that the objector's purpose when purchasing the land was the relevant purpose for the conveyance duty exemption.

His Honour considered the meaning of "having a dwellinghouse erected on it" in section 24(1)(b). Justice Fisher held that the phrase was satisfied if "at the time of acquisition the taxpayer had the purpose of exercising some form of power or control over others to require them to erect a dwellinghouse on the land". He also noted that this requirement would be satisfied if at the time of acquisition

continued on page 38

from page 37

the objector had "the purpose of entering into a contract which will require the other party to the contract to cause a dwellinghouse to be erected on the land, whether that other party erects it personally or in turn enters into another contract requiring erection by somebody else."

In considering the meaning of the word "purpose" in section 24(1)(b), Justice Fisher accepted in a revenue context, that "purpose" was concerned with the course of action proposed by the taxpayer, not the reasons for that course of action.

Justice Fisher concluded that the objector acquired the land for the purpose of having a dwellinghouse erected on it, and the objector was entitled to the exemption from conveyance duty under section 24(1)(b).

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

Whether sale of properties acquired for residential letting constitutes a taxable activity

Rating: • • •

Case: TRA No 93/144 and 94/24

Act: Goods and Services Tax Act 1985 - sections 6, 8, 14(c)

Keywords: *taxable activity, residential rental properties, property investment or dealing*

Summary: Taxpayers who continuously and regularly sell a large number of houses which were acquired for residential property letting are not carrying on a taxable activity of property dealing or investment if they sell the properties to reduce the size of their property letting activity. In this situation the sales form part of the exempt activity of supplying residential rental accommodation.

Facts: The taxpayers in this case are a husband and wife partnership and their private company. From 1984 to 1989 the taxpayers bought a large number of houses to let as rental properties and as a long term investment to provide a superannuation scheme for their retirement. However, once they had bought the houses the taxpayers had cashflow problems. To overcome this, they sold some of the houses to obtain cash and others to buy a clothing business. The business did not perform well so they sold more properties and put the money into the business. They sold 20 houses within a two and a half year period.

The objectors submitted that the sales were part of the activity of supplying residential accommodation and therefore exempt from GST. Alternatively they argued that the sales were excluded from GST because they were part of a recreational pursuit or hobby.

The Commissioner submitted that each property was sold in the course or furtherance of a taxable activity of supplying dwellings to third parties for investment purposes.

Decision: The taxpayers were not carrying out the taxable activity of property dealing or investment. They were carrying out the activity of domestic property letting, and in selling the houses they were reducing the size of their property letting activity.

Residential property letting is an exempt supply under section 14(c). Selling the houses used for residential property letting was not a taxable activity because section 6(3)(d) excludes from the term "taxable activity" any activity to the extent to which it involves the making of exempt supplies.

Judge Barber rejected the taxpayers' submission that the sale of the properties was part of recreational activity and therefore exempt under section 6(3)(a).

Comment: Inland Revenue is appealing this decision.

Partnership income and expenditure and loan remission

Rating: • • •

Case: Cooper v CIR M No.686/94

Act: Income Tax Act 1976 - sections 64F, 104 (Income Tax Act 1994 - sections EH 4, BB 7)

Keywords: *remission, capital, incurred*

Summary: The Court disallowed a partner's attempted deduction for expenditure because it was of a capital nature, and because it was not incurred by the partner, but by partners of a previous partnership.

On a second issue the Court ruled that a loan to the partnership was remitted when, as provided for in the loan agreement, the amount ceased to be payable by virtue of the lender's insolvency. Accordingly, the partners had remission income under section 64F.

Facts: The taxpayer was a partner in a goat and deer farming partnership. The partnership started before 1 October 1987, but the taxpayer did not join the partnership until September 1988. Before the partner joined the partnership the partnership incurred expenditure for:

- embryo transplant work
- deer and goat leasing
- farming and breeding of goats and deer.

The Commissioner allowed the partner a deduction for leasing, grazing and breeding of deer, as it was partially incurred after the partner joined the partnership. The amounts purportedly deducted were added back to the partner's 1988 tax assessment.

The partnership owed Woodstock Investments Limited (WIL) a sum of $2,600,000. The loan agreement between the partnership and WIL provided that the sum would cease to be owing in a number of situations, including WIL becoming insolvent. WIL became insolvent and the liability to pay the debt ceased immediately. The Commissioner treated the loan as remitted, and added a share of the remission income to the partner's 1991 tax assessment.

The case was a test case under section 33A of the Income Tax Act 1976. The objections of the other 37 partners in the taxpayer's partnership are subject to the decision in this case.

Decision: Justice Cartwright found for the Commissioner on both issues.

The partner was not entitled to any more of a deduction for his share of partnership expenditure than he had already received. There were two reasons for this.

- First, the partnership expenditure the partner sought to deduct was incurred before he joined the partnership. As a matter of law, the entry or exit of partners from a partnership dissolves the existing partnership and constitutes a new partnership. The expenditure of the previous partnership was not incurred by the new partnership, and was not deductible by the partners of the new partnership.
- Second, Her Honour found that the expenditure the partner sought to deduct was expenditure of a capital nature, and hence non-deductible.

The Commissioner also succeeded on the remission issue. The debt between the original partnership and WIL, although entered before the constitution of the new partnership, had attached to the new partnership. On the construction of the loan agreement, Her Honour found that the obligation to repay the loan

continued on page 40

from page 39

ceased on WIL becoming insolvent. That meant that the loan was remitted and the base price adjustment under section 64F(2) triggered. The remission was without fully adequate consideration. The income from the base price adjustment was properly attributed to the partners of the partnership.

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

Whether payments made for restraint of trade

Rating: • • •

Case: Henwood v CIR CA 300/93

Act: Income Tax Act 1976

Keywords: *revenue/capital distinction, restraint of trade, apportionment*

Summary: Payments under a restraint of trade agreement made to an actor for television commercials were capital payments, and non-assessable.

Facts: The taxpayer was a well-known actor. He had entered into an agreement that in consideration of certain payments, he would appear in the two commercials and would not be associated with the promotion of other similar products for the period during which he received payments. He received $25,000 in the first year and $17,500 in the second year.

The Commissioner did not accept that these payments were of a capital nature, and a case was stated to the TRA. The TRA held that $5,000 of the fee was for acting services, and the remainder was in respect of the restraint of trade agreement. On appeal, the High Court held that the payments were not referable to the restraint of trade agreement. The taxpayer appealed.

Decision: By a majority, the Court of Appeal held that the payments received by the taxpayer were of a dual nature. They were referable both to the performance of acting services and to the restraint of trade provision.

The Court of Appeal followed the apportionment of the payment (between the acting services and the restraint of trade provision) that the TRA had made.

Comment: Inland Revenue is not appealing this decision.

Flower bulbs and tubers - whether cost deductible as revenue expenditure

Rating: • •

Case: TRA Nos. 93/215 and 94/135

Act: Income Tax Act 1976 - Sections 85, 104 and 106(1)(a) (Income Tax Act 1994 - EE 1, BB 7, BB 8 (a)).

Keywords: *bulbs, tubers, revenue or capital*

Summary: The taxpayer's expenditure for bulbs and tubers was incurred in gaining or producing assessable income or was necessarily incurred in carrying on a business for that purpose. The expenditure was deductible as a revenue item.

Facts: The taxpayer was a small company carrying on business as a flower farmer. It claimed a deduction for $32,931.80 for the purchase of flower bulbs for lilies in the year ended 31 March 1990. The taxpayer also claimed a deduction for expenditure on the purchase of lily bulbs of $2,424.42 for the year ended 31 March 1990 and $3,443 for the year ended 31 March 1991.

The Commissioner disallowed the deductions.

Decision: Judge Barber held that the Commissioner had acted incorrectly in disallowing the deductions for the purchase of bulbs and tubers. The expenditure for bulbs and tubers was incurred in gaining or producing assessable income or was necessarily incurred in carrying on a business for that purpose. The expenditure was deductible as a revenue item.

Based on the facts of the case Judge Barber concluded that:

- In the context of the change in character of the bulbs and tubers, the hazards of flower growing and their short lifespan, the initial stock cannot be regarded as representing an enduring benefit to the taxpayers, or the expenditure relating to a business structure.
- The payments cannot realistically be regarded as being made once and for all.
- The bulbs and tubers were items turned over in the course of making profits. This concept is more akin to a revenue outlay, or circulating capital or stock in trade, than fixed capital.

Judge Barber considered it significant that, one way or another, the seed or bulbs or tubers or plants changed form and character each season.

It was not necessary for Judge Barber to consider whether the expenditure was for trading stock or whether bulbs and tubers in the ground at balance date are included within the scope of the definition of trading stock or must be brought to account as assessable income.

Comment: Inland Revenue is appealing this decision.

Land subdivision development - whether accrual rules apply to costs

Rating: • • • •

Case: Thornton Estates Limited v CIR Unreported CP 135/94

Act: Income Tax Act 1976 - sections 85, 104, 104A
(Income Tax Act 1994 - sections OB 1, BB 7 and EF 1)

Keywords: *subdivision costs, development expenses, trading stock, used*

Summary: Land subdivision development expenses can be claimed as deductions but the value of the land and expenditure in developing the land must be brought into account as a revenue item for tax purposes.

Facts: The objector carried on business as a property developer. In August 1991, it purchased a block of land for subdivisional development. The subdivisional development started soon after, with earthworks being physically started in September 1991. A few sections were sold in the year ended 31 March 1992, and the main sales occurred later.

In its return for the year ended 31 March 1992, the objector claimed deductions for the cost of the land, development costs and other miscellaneous expenses directly attributable to using the land. The objector did not bring into account the value of the land, or any expenditure on developing the land, as a revenue item for tax purposes.

Decision: The judgment dealt with the following issues:

(a) Whether the cost of buying the land and of subsequent development by the objector in the income year ended 31 March 1992 was deductible in that year under section 104 of the Income Tax Act 1976, even though a sale of that land or part of it would not arise until a subsequent income year.

continued on page 42

from page 41

(b) If so, what impact (if any) did section 104A (the accrual regime) have on the tax deduction permitted by section 104.

(c) General income tax, accountancy and commercial principles require a developer to treat land as if it is trading stock, to bring the cost of the land and any associated development costs to account at balance date as a revenue item, and to hold them on revenue account until the land is sold. The question arises as to whether the general principles are overridden by the specific statutory directive contained in section 85(1) of the Act, that for the purposes of section 85, land is not trading stock.

Justice Hansen first reviewed some general principles of statutory interpretation. The scheme and purpose of legislation need to be considered. Then, if the words of the Act are clear, they must be followed, even if they lead to a manifest absurdity. But if the words of an Act have two possible interpretations they are not clear, and if one interpretation leads to an absurdity and the other does not, the Court will adopt the one which does not lead to an absurdity.

Cost of land and development deductible

On the first issue, Justice Hansen found that the objector incurred expenditure in connection with the acquisition and development of the land. The objector was therefore entitled to tax deductions for that expenditure under section 104

Cost of land and development subject to accrual regime

The next question was whether the cost of buying the land and subsequent development expenditure was subject to the accrual rules of section 104A. This revolved around the question of whether the expenditure could be divided into an expired portion and an unexpired portion. Once the unexpired portion was identified, sections 104A(3) and (4) provided that only the expired portion of the relevant accrual expenditure may be claimed as a deduction in a particular year. The objector contended that all the land developed by it was “used” in the production of assessable income for the year ended 31 March 1992 in the sense that it had all been actively committed to and engaged in that production.

Justice Hansen held that even though this interpretation was consistent with the ordinary meaning of the word “used”, its application would defeat the scheme and purpose of the legislation. The legislation should be interpreted in accordance with its purpose, which was to achieve tax symmetry by the matching of income and expenditure. He ruled that the cost of purchasing the land and subsequent development expenditure was subject to the accrual rules of section 104A and should be brought into account as revenue items.

Land as trading stock

On the third question, the Judge agreed with Justice Tipping in *Murray Darnill Ltd v TRA* (1994) 16 NZTC 11,126 that section 85(1) of the Act did not mean that land should be excluded from the concept of trading stock for all purposes. The land of a developer is trading stock and should be treated as revenue rather than as a capital item. However, by definition, land is not trading stock for the purposes of section 104A.

Comment: The taxpayer is appealing this decision.

Management fees and entertainment expenses - whether capital or revenue expenditure

Rating: • •

Case: TRA 94/71

Act: Income Tax Act 1976 - ss 104, 106 (Income Tax Act 1994 - sections BB 7, BB 8)

Keywords: *management fees, entertainment expenditure, capital, income*

Summary: The Authority found as a fact that certain management fees paid by the taxpayer were in connection with the taxpayer's business income earning process and were deductible. However, the taxpayer had not proved that certain entertainment expenditure was in connection with its income earning process as distinct from its activity to earn exempt income or increase an investment of capital. This expenditure was therefore not deductible.

Facts: The taxpayer company was set up by two friends to undertake media ventures. One undertook the executive work while the other was a sleeping partner. The executive partner spent a considerable amount of time in creating, assessing and pursuing production ventures for the taxpayer but none came to fruition. Funds were lodged with the taxpayer so that it could better fund its projects. However, after the sleeping partner had to withdraw for financial reasons, the taxpayer effectively ceased functioning and used the funds for a takeover of shares in a radio company.

Decision: Judge Barber's findings were as follows:

Management fees

Management fees paid by the taxpayer to the company of the executive partner related to management time spent by the executive partner for the taxpayer in working on projects of a media nature.

The work was not preliminary to and investigatory of starting a business (which would have made the expenditure of a capital nature) but work which was preliminary to and investigatory of business projects.

The fact that the work ceased before it came into income made no difference. It was not necessary for a project to get past development proposals and feasibility studies for those activities to be part of an income earning process by the taxpayer. However, Judge Barber noted that income or profit resulting from the activity was a very significant factor to be taken into account in ascertaining whether a business has existed.

The fees had no relationship to the executive's work for the taxpayer aimed at deriving dividend or exempt income for the taxpayer from the radio station company. (If the fees had been so related, they would not have been deductible. This was because the income from the radio station company would have been exempt as an intercompany dividend.) Also, the management fees did not relate to the share takeover of the radio station (which would have been of a capital nature).

Entertainment expenditure

The taxpayer had not proved that certain entertainment expenditure was incurred in connection with the income-earning process, and this expenditure was not deductible.

Comment: Neither Inland Revenue nor the taxpayer is appealing this decision

Whether taxpayer had a right of objection to notice issued under section 276

Rating: • • •

Case: Instant Finance Corporation (1987) Limited v CIR CP 325/94

Act: Taxation Review Authority Regulations 1974 - regulation 5(3) Income Tax Act 1976 - sections 2, 12, 19, 26, 266, 268, 269, 272(2) and 276 (Income Tax Act 1994 - OB 1, HK 1, HK 3, HK, 4, HK 5, HK 11 and Tax Administration Act 1994 - sections 44, 92, 114)

Keywords: *judicial review, assessment, objection*

Summary: The High Court allowed the applicant's request for a judicial review and overturned the decision of the Taxation Review Authority in *Case 65* (1992) 14 NZTC. The High Court directed that the Commissioner's decision to disallow the objection to an assessment under section 276 be reviewed.

Facts: On 29 March 1990 the Commissioner gave notice to Instant Finance Corporation (1987) Limited ("the applicant") that it was invoking section 276 to recover outstanding tax of $652,689.56. This tax had been earlier assessed to Instant Finance Co Limited ("the original company") and the Commissioner held that the applicant was liable for the tax of the original company under section 276.

The applicant objected to the assessments issued on the grounds that section 276 did not apply. The Commissioner treated the notice as a valid objection and disallowed the objection in full. On 20 November 1990 the applicant requested that the objection be considered by the TRA. The Commissioner noted the request to state a case. On 27 June 1991 the Commissioner advised the applicant it had no right to object to the notice, as invoking section 276 did not amount to an "assessment".

The applicant applied to the TRA for an order allowing its objection under regulation 5(3) of the Taxation Review Authority Regulations 1974 on the grounds that the Commissioner had not as required by regulation 5(1), filed its case within six months of the applicant filing its case.

The TRA found for the Commissioner and held that regulation 5(3) could not apply because the Commissioner was not required to issue an assessment against the applicant as the tax always remained the liability of the original company.

Issue: The issue here is whether the applicant had a right of objection in its capacity as a "new company" under section 276 of the Act.

Decision: The High Court found for the applicant and allowed the application for judicial review. Justice Barker directed the TRA to hear and determine the applicant's application under regulation 5(3) for an order allowing its objection.

His Honour held that the liability of the applicant, as deemed agent of the original company, was imposed by section 276. This liability must be quantified either by reference to a previous assessment or by a determination by the Commissioner of an assessment of the original company.

His Honour considered it would be illogical if under section 276(3) a new company could have objection rights if the original company's tax liability had not been assessed but, no objection rights if the original company's tax liability had already crystallised.

Justice Barker also considered justice required that the applicant be given the opportunity to challenge the Commissioner's application of section 276. His Honour thought it would not be stretching the legislation to contend that the notice issued under section 276 is an assessment of the new company, in a limited way.

Comment: Inland Revenue is appealing this decision.

Shareholder remuneration - whether remuneration paid is excessive

Rating: • • •

Case: G S Matthews (Chemist) Ltd v CIR M 1542/93
Troon Place Investments Ltd v CIR M 1541/93

Act: Income Tax Act 1976 - section 190 (Income Tax Act 1994 - section GD 5)

Keywords: *excessive remuneration, deemed dividend*

Summary: The High Court considered the issue of excessive shareholder remuneration for the purpose of section 190.

The High Court found that the remuneration allocated by G S Matthews (Chemist) Ltd (Matthews Chemist) to the shareholder-employees was not excessive for the purpose of section 190. However, the remuneration allocated by Troon Place Investments Ltd (Troon Investments) was found to be excessive.

Facts: The objector companies are related proprietary companies with common shareholders.

Matthews Chemist carries on the business of retail pharmacists and chemists. In the 1990 and 1991 income years it claimed deductions for shareholder remuneration of $104,990 and $128,698 respectively.

Troon Investments is a property investment company, leasing commercial properties. Its sole source of income is from rents. In the 1990 and 1991 income years it claimed deductions for shareholder remuneration of $27,494 and $34,062 respectively.

During the periods under objection the shareholders went on an extended overseas holiday. In their absence they appointed a manager to take over the pharmacy business and gave power of attorney to their accountant.

The Commissioner amended the taxable income of each company, and disallowed a substantial portion of the remuneration paid to the shareholders. Both companies objected to the assessments issued on the grounds that the Commissioner had incorrectly treated the shareholder remuneration as deemed dividends.

Issue: The issue was whether the Commissioner acted correctly in amending the assessment for each company and treating the shareholder remuneration as excessive for the purpose of section 190.

Decision: Justice Tompkins held that the proviso to section 190 did not apply to both objectors as all three of the paragraphs to the proviso had not been satisfied. He found that the shareholders were not employed substantially full time in the business of either company while they were away overseas, even though they had participated in the administration and management of each company.

Justice Tompkins rejected the Commissioner's view that remuneration should be determined by reference only to the services rendered during the period to which section 190 applied. Justice Tompkins held that the Commissioner should consider services rendered during prior periods to determine if the remuneration for a particular tax year is reasonable. In each case it will be a matter of fact and degree whether the remuneration reasonably reflects the services performed.

In the case of Matthews Chemist, Justice Tompkins said that "the excellent results achieved during the two years in question, as well as the 1989 year, were the products of the time, efforts and business and entrepreneurial skills both

continued on page 46

from page 45

[shareholders] had put into the business during the preceding years, as well as their contribution during those two years." Accordingly, Justice Tompkins found in favour of Matthews Chemist and held that the remuneration allocated to the two shareholders was reasonable.

Justice Tompkins reached a different conclusion for Troon Investments. He considered that the method used by the Commissioner was appropriate in calculating a reasonable assessment of shareholder remuneration. He did not think that the shareholders' entrepreneurial skill and judgment over the preceding years played a real role in the derivation of the company's rental income in the years in dispute. Justice Tompkins confirmed that the Commissioner had acted correctly in treating shareholder remuneration as excessive for the purpose of section 190.

Comment: Inland Revenue is not appealing this decision.

Proposed guidelines on taxation of specific allowances

The legislation setting out the tax treatment of allowances paid to employees was modified as of 1 April 1995. We explained the impact of these changes on page 7 of TIB Volume Six, No. 12 (May 1995). We have also drafted a TIB item outlining the general tax treatment of allowances, and hope to publish it in the near future.

We plan to issue guidelines on how to calculate the tax liability of specific types of allowances paid to employees. These guidelines will indicate what the Commissioner will generally accept as satisfying the statutory tests for:

- the conditions justifying the payment of an allowance
- the amount of the allowance that would be accepted as a reimbursement of expenditure without proof being provided
- proof of the expenditure.

Suggestions invited

We are presently considering the classes of allowances for which we should provide guidelines. The proposed allowances include those relating to the following:

- telephones
- transfers
- overtime meals
- accommodation
- travel (home to work)
- travel (business)
- out of pocket expenses
- cleaning
- tools
- clothing
- entertainment
- home offices

We would like to hear from you if you have any views on the types of allowances people need guidance on so that we can decide on priority areas. It would be useful if you could also provide the following details on these allowances: the rate of payment, the amount of tax free reimbursement, the number of people receiving the allowance, and the conditions under which an employer pays those allowances.

We are also interested in your views on what should be the correct amount of the tax free allowance, and what conditions should justify the payment of a tax free allowance.

Please send your submissions, by 24 September 1995, to:

Director (Rulings)
National Office
Inland Revenue Department
PO Box 2198
WELLINGTON.

New tax bills - commentaries available

The Taxation (International Tax) Bill and Taxation (Miscellaneous Issues) Bill were introduced into Parliament on 17 August.

If you are already on our commentary mailing list you will soon receive a detailed commentary on the policy intent of the measures proposed in these bills.

If you wish to join the mailing list to receive these commentaries, please send your name and address to:

Legislative Affairs
Inland Revenue Department
P O Box 2198
WELLINGTON or fax (04) 474 7217

Upcoming TIB articles

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

Policy statements

- Applications to retain records in Maori
- Assessability of retraining payments made on termination of employment
- Difference between a taxable activity (GST) and a business activity (income tax)
- Remission of underestimation penalty when taxpayer makes an incorrect interpretation
- Employer premium rate for a taxpayer in partnership on earnings other than as an employee
- Enquiries about zero-rating of goods and services

Public binding rulings

- Effective date of GST registration when applicant requests backdated voluntary registration
- GST: secondhand goods input tax deduction for forestry rights
- Deduction by companies for gifts of money
- Lease duty on lease variations or renewals
- Conveyance duty - conveyance by direction of intermediary

Booklets available from Inland Revenue

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

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

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

General information

Binding rulings (IR 115G) - May 1995: *Explains binding rulings, which commit Inland Revenue to a particular interpretation of the tax law once given.*

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

Inland Revenue audits (IR 297) - May 1995: *For business people and investors. It explains what is involved if you are audited by Inland Revenue; who is likely to be audited; your rights during and after the audit, and what happens once an audit is completed.*

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

New Zealand tax residence (IR 292) - Apr 1994: *An explanation of who is a New Zealand resident for tax purposes.*

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

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

Provisional tax (IR 289) - Jun 1995: *People whose end-of-year tax bill is over $2,500 must generally pay provisional tax for the following year. This booklet explains what provisional tax is, and how and when it must be paid.*

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

Rental income (IR 264) - Apr 1995: *An explanation of taxable income and deductible expenses for people who own rental property. This booklet is for people who own one or two rental properties, rather than larger property investors.*

Reordered Tax Acts (IR 299) - Apr 1995: *In 1994 the Income Tax Act 1976 and the Inland Revenue Department Act 1974 were restructured, and became the Income Tax Act 1994, the Tax Administration Act 1994 and the Taxation Review Authorities Act 1994. This leaflet explains the structure of the three new Acts.*

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

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

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

Student Loan repayments (SL 2) - Jan 1995: *A guide to making student loan repayments.*

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

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

Taxes and Duties (IR 295) - May 1995: *A brief introduction to the various taxes and duties payable in New Zealand.*

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

Business and employers

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

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

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

Entertainment Expenses (IR 268) - May 1995: *When businesses spend money on entertaining clients, they can generally only claim part of this expenditure as a tax deduction. This booklet fully explains the entertainment deduction rules.*

Fringe benefit tax guide (IR 409) - Nov 1994: *Explains fringe benefit tax obligations of anyone who is employing staff, or companies which have shareholder-employees. Anyone who registers as an employer with Inland Revenue will receive a copy of this booklet.*

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

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

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

PAYE deduction tables - 1996
- Weekly and fortnightly (IR 184X)
- Four-weekly and monthly (IR 184Y)
Tables that tell employers the correct amount of PAYE to deduct from their employees' wages.

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

Retiring allowances and redundancy payments (IR 277) - Jun 1994: *An explanation of the tax treatment of these types of payments.*

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

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

Resident withholding tax and NRWT

Approved issuer levy (IR 291A) - May 1995: *For taxpayers who pay interest to overseas lenders. Explains how you can pay interest to overseas lenders without having to deduct NRWT.*

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

Non-resident withholding tax guide (IR 291) - Mar 1995: *A guide for people or institutions who pay interest, dividends or royalties to people who are not resident in New Zealand.*

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

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

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

Non-profit bodies

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

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

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

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

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

Company and international issues

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

Controlled foreign companies (IR 275) - Nov 1994: *Information for NZ residents with interests in overseas companies. (More for larger investors, rather than those with minimal overseas investments)*

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

Foreign investment funds (IR 275B) - Oct 1994: *Information for taxpayers who have overseas investments. (More for larger investors, rather than those with minimal overseas investments).*

Imputation (IR 274) - Feb 1990: *A guide to dividend imputation for New Zealand companies.*

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

Child Support booklets

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

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

Child Support - an introduction (CS 3) - Mar 1992: *A brief introduction to Child Support.*

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

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

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

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

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

Due dates reminder

September

5 Large employers: PAYE deductions and deduction schedules for period ended 31 August 1995 due.

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

1995 end-of-year payment of income tax, Student Loans and earner/employer premium due for taxpayers with October balance dates.

Tax returns due for all non-IR 5 taxpayers with May balance dates.

QCET payments due for companies with October balance dates with elections effective from the 1996 income year.

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

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

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

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

RWT on dividends deducted during August 1995 due.

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

29 GST return and payment for period ended 31 August 1995 due.

30 Non-resident student loan repayment: second 1996 instalment due. *(We will accept payments received on Monday 2 October as in time.)*

October

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

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

1995 end-of-year payment of income tax, Student Loans and earner/employer premium due for taxpayers with November balance dates.

Tax returns due for all non-IR 5 taxpayers with June balance dates.

QCET payments due for companies with November balance dates with elections effective from the 1996 income year.

(We will accept payments received on Monday 9 October as in time for 7 October.)

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

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

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

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

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

RWT on interest due deducted 1 April 1995 to 30 September 1995 due for six-monthly payers.

RWT on dividends deducted during September 1995 due.

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

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

Public binding rulings: your chance to comment before we finalise them

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.

In most cases the draft will be available on the date shown below. However, we will notify you if we are unable to supply it at that date for any reason.

We must receive your comments by the "Comment deadline" shown if we are to take them into account in the final ruling. Please send them ***in writing, to the address below***; as we don't have the facilities to deal with your comments over the phone or at our local offices.

Name ______________________________

Address ______________________________

____

____

Ruling	Date Available	Comment Deadline
☐ **2108:** Employer's liability to deduct PAYE from Employment Court awards for lost wages	01/09/95	22/09/95
☐ **2817:** Debt forgiveness in consideration of natural love and affection	1/09/95	22/09/95
☐ **2882:** The relationship between the unit trust and qualifying trust definitions	08/09/95	29/09/95
☐ **3046:** Tax treatment of credit card companies' frequent flyer schemes	08/09/95	29/09/95
☐ **2335:** Tax deductions and bonus payments	15/09/95	06/10/95

Ruling	Date Available	Comment Deadline
☐ **2403:** The taxation of Dutch social security pensions in NZ when they are received by a NZ resident who is not a NZ citizen	15/09/95	06/10/95
☐ **2818:** Serviced apartments not exempt from conveyance duty	22/09/95	13/10/95
☐ **2890:** GST and futures contracts	22/09/95	13/10/95
☐ **1647:** Assessability and deductibility of payments made under the Employment Contracts Act 1991 for humiliation, loss of dignity, and injury to feelings	29/09/95	20/10/95
☐ **2956:** GST treatment of general school fees paid to integrated schools	29/09/95	20/10/95

INLAND REVENUE
TE TARI TAAKE

No envelope needed - simply fold, tape shut, stamp and post.

Affix
Stamp
Here

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

Attention Public Rulings Consultation

Contents continued - questions and legal case notes

Questions we've been asked (pages 28-36)

Legal decisions - case notes (pages 37-46)

Volume Seven, No.2 August 1995

Contents

This TIB has no appendix