Binding rulings

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The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates tax liability based on it.

For full details of how binding rulings work, see our information booklet "Binding Rulings" (IR 115G) or the article on page 1 of TIB Volume Six, No.12 (May 1995) or Volume Seven, No.2 (August 1995). You can order these publications free of charge from any Inland Revenue office.

Dispositions where the transferor reserves a benefit or advantage in real property - gift duty implications

Public ruling BR Pub 96/1

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

Taxation law

This ruling applies in respect of sections 2(2) (definition of "gift" and "disposition of property"), 61, 62, 63, 66, 67, and 70, of the Estate and Gift Duties Act 1968.

Arrangements to which this ruling applies

This ruling applies when a taxpayer disposes of real property and keeps or reserves a benefit or advantage in that property.

The period for which this ruling applies

This ruling applies to dispositions of real property made between 1 April 1996 and 31 March 1999.

The ruling

All legislative references in this ruling are to the Estate and Gift Duties Act 1968.

Link between section 70(2) and the definition of "gift"

A gift is defined in section 2(2) as a disposition of property without fully adequate consideration. Section 61 imposes gift duty on a dutiable gift. Where there is a dutiable gift, section 70(2) may apply to affect the value of the gift. Where there is, prima facie, no gift, section 70(2) may apply to create a gift. That is, it is sometimes necessary to refer to section 70(2) to determine whether there is a gift for the purposes of section 2(2). Section 70(2) prevents reductions in the value of dutiable gifts where there is a disposition of property with a reservation of a benefit or advantage to the transferor of the property. Section 70(2) requires the definition of "gift" to be read so that the value of any reserved benefit or advantage is not part of the consideration for the disposition of property. This means that the value of any benefit or advantage reserved to the transferor is ignored when considering whether the disposition of property is a gift, that is, whether the disposition is made for fully adequate consideration.

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Application of section 70(2)

Where a transferor grants an interest in property to himself or herself, and later transfers the remainder or reversion to another person (including the trustees of a trust), the interest kept by the transferor is not a reservation for the purposes of section 70(2) and the section does not apply. Where the transferor grants an interest in property to himself or herself, and simultaneously transfers the remainder or reversion to another person, the interest kept by the transferor will not be a reservation for the purposes of section 70(2) as long as the transferor is owner of the interest kept by him or her at all times during the transfers. (That is, the transferee does not at any time take ownership of the interest kept by the transferor.)

When transferors keep or reserve an interest in the property they may keep or reserve an equitable or a legal interest. It is not necessary to keep or reserve a legal interest using the provisions of the Land Transfer Act 1952.

Where a transferor transfers property to another person, subject to the other person granting an interest back to the transferor, there is a reservation by the transferor of the interest granted back to him or her for the purposes of section 70(2). If the transferor has reduced the price of the property transferred because of the interest granted back by the transferee, section 70(2) will apply.

In particular:

- Where a transferor grants a life interest (including a lease for life) to himself or herself, and then transfers the remainder interest to another person, there is no reservation of interest and section 70(2) will not apply.
- Where a transferor grants a lease for a term of years to himself or herself, and then transfers the reversion interest to another person, there is no reservation of interest and section 70(2) will not apply.
- Where a transferor transfers property to another person with a reduction in the price of the property because the other person grants a life interest (including a lease for life) back to the transferor, section 70(2) will apply.
- Where a transferor transfers property to another person with a reduction in the price of the property because the other person grants a lease for a term of years back to the transferor, section 70(2) will apply.
- Where a transferor transfers property to another person with a reduction in the price of the property because the other person grants a licence to occupy back to the transferor, section 70(2) will apply.

It is not possible for a transferor to grant himself or herself a licence to occupy. A transferor who purports to do so, and reduces the price of the property in reliance on such a grant, is either subject to section 70(2) if the transferee grants the licence to occupy back to the transferor, or subject to gift duty more generally if the transferee has no obligation to grant the licence back, yet still only pays the reduced price for the property.

Sliding value clauses

Frequently, documents evidencing the disposition of property provide that the consideration shall be a fixed amount or such higher amount as the Commissioner accepts will not give rise to a gift for gift duty purposes. The Commissioner accepts that where section 70(2) might otherwise apply, and the parties use the sliding value clause to increase the consideration so there is no gift, gift duty will not be payable.

Valuation of retained interests

Section 66 requires every dutiable gift to be valued as at the date of the making of the gift, and section 67 gives the Commissioner a general discretion as to how property is valued. When valuing the amount attributable to the interest the transferor has kept, the transferor may use an actuary, valuer, or the Tables in the Second Schedule.

When there is more than one transferor, and all are entitled to a life estate or lease for lives, the value of the right should take account of the longest remaining life expectancy of the transferors. The value of the right relates to the time the transferees are out of possession of the property.

This ruling is signed by me on the 23rd day of January 1996.

Martin Smith
General Manager (Adjudication & Rulings)

Analysis of public ruling BR Pub 96/1

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

All legislative references are to the Estate and Gift Duties Act 1968 unless otherwise stated.

Summary

Section 70(2) prevents the value of any benefit or advantage reserved from a gift being deducted from the value of the dutiable gift. Those benefits or advantages are not taken into account when determining whether there was a gift in the first place.

Section 70(2) only applies where there is a dutiable gift (a disposition of property for an inadequate consideration). To determine whether there has been a dutiable gift, the following three-step analysis is required:

- Identify the property that the transferor transfers to the transferee. Does the transferor transfer only part of his or her property to the transferee, or does the transferor transfer all of the property to the transferee with the transferee granting some property back to the transferor?
- Identify the value of the property sold to the transferee.
- Identify the consideration given by the transferee for that property (excluding the value of any benefit reserved by the transferor).

If the transferee's consideration for the property is less than the value of the property, the section 2(2) definition of "gift" is triggered, and assuming the requirements of section 63 are met, there is a dutiable gift.

Because section 70(2) will apply when there is a reservation of a benefit or advantage from property, the first of the three steps is for that reason very important, and can lead to quite different treatment of apparently similar transactions. This analysis particularly focuses on that first step.

Different treatment of similar transactions under section 70(2)

- Where a transferor grants an interest in property to himself or herself, and later sells the remainder or reversion to another person, there is no reservation for the purposes of section 70(2) and the section does not apply. The most obvious example is a person who grants himself or herself a life estate or a lease for life, and then disposes of the remainder of his or her interest to another person. As the life estate or lease for life is, in law, a distinct item of property separate from the remainder, gift duty is concerned with the remainder which was transferred, not the life estate or lease for life which the transferor kept throughout; but
- Where a transferor transfers property to another person free of encumbrances, subject to the other person granting an interest back to the transferor, there is a reservation by the transferor of the interest granted back to him or her for the purposes of section 70(2). Accordingly, the sale of a fee simple to another person conditional on the other person granting a life estate, lease, or licence to occupy to the transferor, is a reservation by the transferor of that life estate, lease, or licence to occupy. The transferor would not be able to deduct the value of the reserved interest from the value of any dutiable gift, because of section 70(2).

Included in the first category above is the case where the transferor keeps an interest and simultaneously grants the remainder to the transferee. The interest kept by the transferor will not be a reservation for the purposes of section 70(2) as long as the transferor is owner of the interest kept by him or her at all times during the transfers. (That is, the transferee does not at any time take ownership of the interest kept by the transferor.) Support for this comes from the decision in *Ingram v IRC* [1995] BTC 8,010 discussed below.

It is important to distinguish between a grant of a lease and the grant of a licence to occupy. A licence to occupy

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can only be granted by one person to another. A transferor can not grant himself or herself a licence to occupy, and must receive the grant of such a licence from another person, such as the trustees of a family trust. Therefore, licences to occupy will always amount to reservations for the purposes of section 70(2), as they cannot be separated and retained by a transferor prior to a transfer.

It is also important to distinguish between a grant of a life estate and a licence to occupy. A transferor may grant himself or herself a life estate, but cannot grant himself or herself a licence to occupy (unless it amounts to a lease). “Licence to occupy” is often used as a cover-all term for the types of disposition discussed below. When considering gift duty it is the precise legal meaning of phrases such as “life estate”, “lease for life”, and “licence to occupy” that must be considered.

Section 70(2)

The concept underlying section 70(2) is that where there has been a gift, the value of the gift is not reduced by any advantage that the person making the gift might retain. So, for example, a person might gift her house and agree with the recipient that the equivalent of rent will be paid by the recipient to her until she dies. The transferor would then say that the value of the gift is not the value of the house - as the value of the house is offset by a substantial commitment to the transferor. The net value of the gift would then depend on how long the transferor could be expected to live and receive rent. However, section 70(2) requires that any benefit being reserved out of a gift in this way is disregarded for gift duty purposes. Accordingly, for gift duty purposes the value of the gift is simply the value of the house, and no account is taken of the commitment to pay the equivalent of rent.

This analysis sets out the application of section 70(2) by referring to five arrangements. The application of section CE 1 (1)(e) of the Income Tax Act 1994 is the subject of public binding ruling BR Pub 96/2.

It is important to recognise that with section 70(2) apparently minor differences in arrangements can have major effects on the legal consequences.

This analysis sets out the gift duty treatment of the following arrangements:

1. Transferor grants a life estate (including a lease for life) to himself or herself, and then transfers the remainder interest to another person.
2. Transferor grants a lease for a term of years to himself or herself, and then transfers the reversion interest to another person.
3. Transferor transfers the property to another person, subject to the other person granting him or her a life estate (including a lease for life), which the other person does.
4. Transferor transfers the property to another person, subject to the other person granting him or her a lease for a term of years, which the other person does.
5. Transferor transfers the property to another person, subject to the other person granting him or her a licence to occupy, which the other person does.

The gift duty implications of these structures are discussed below.

Legislation

Gift duty is imposed by part IV of the Act. Some of the key definitions and provisions relating to gift duty follow.

Section 2(2) defines “gift” as:

> “Gift” means 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:
>
> Provided that where the consideration in money or money’s worth is inadequate, the disposition shall be deemed to be a gift to the extent of that inadequacy only.

“Disposition of property” is also defined in section 2(2):

> “Disposition of property’’ means any conveyance, transfer, assignment, settlement, delivery, payment, or other alienation of property, whether at law or in equity; and, without limiting the generality of the foregoing provisions of this definition, includes- ...

Therefore, for there to be a gift there must be a disposition of property without fully adequate consideration. There is a gift only to the extent of the inadequate consideration.

Section 61 imposes gift duty on dutiable gifts, at rates set out in section 62. Section 63 provides a definition of dutiable gift. A gift is a dutiable gift if the donor is domiciled in New Zealand or is a body corporate incorporated in New Zealand, or the property the subject of the gift is situated in New Zealand.

Under section 66, a gift is valued at the date it is made. Section 67 allows the Commissioner to value property in such manner as he thinks fit, subject to restrictions in sections 68 and 69.

Section 70 states:

> (1) For the purposes of this section-
>
> **“Ascertainable”** means ascertainable as at the date of the disposition to the satisfaction of the Commissioner:
>
> **“Benefit or advantage”** means any benefit or advantage whether charged upon or otherwise affecting the property comprised in the disposition or not, and whether-
>
> (a) By way of any estate or interest in the same or any other property; or
>
> (b) By way of mortgage or charge; or
>
> (c) By way of any annuity or other payment, whether periodical or not; or

(d) By way of any contract for the benefit of the person making the disposition; or

(e) By way of any condition or power of revocation or other disposition; or

(f) In any other manner whatever;-

but does not include any annuity or other payment, whether periodical or not, if and so far as the annuity or payment-

(g) Is of a fixed or ascertainable amount in money payable over a fixed or ascertainable period, or for life, or at a fixed or ascertainable date or dates, or on demand; and

(h) Is secured to the person making the disposition-

(i) By a mortgage or charge over the property comprised in the disposition; or

(ii) By an agreement for the sale and purchase of land comprised in the disposition; or

(iii) By an agreement in writing to lease land comprised in the disposition; or

(iv) By deed,-

in each case executed by the person acquiring the beneficial interest under the disposition.

(2) Where any disposition of property is, in whole or in part, a dutiable gift, and is made in consideration of, or with the reservation of, any benefit or advantage to or in favour of the person making the disposition, no deduction or allowance shall be made in respect of that benefit or advantage in calculating the value of the dutiable gift.

(3) Notwithstanding anything in section 78 of this Act, the Commissioner may permit the cancellation or alteration of any instrument creating or evidencing a disposition of property to which this section applies, if application in writing is made by the parties to the instrument within 6 months after the date of the instrument, or within such extended time as the Commissioner thinks fit to allow in the special circumstances of the case. On evidence to his satisfaction being produced of any such cancellation or alteration, the disposition shall not constitute a dutiable gift except to the extent to which the transaction as altered constitutes a dutiable gift.

Therefore, after imposing gift duty the Act provides a valuation regime, including certain prohibitions for deductions when valuing.

Section 76 allows relief for gift duty for the subsequent gift of a reserved benefit where section 70(2) has applied. The section states:

When the donor of a dutiable gift to which section 70 of this Act applies (in this section referred to as the original gift) subsequently makes a dutiable gift of the whole or any part of the benefit or advantage (as defined in that section) created or reserved on the making of the original gift, there shall be deducted from the gift duty otherwise payable in respect of that subsequent gift (so far as that gift duty extends) an amount calculated in accordance with the following formula:

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

where-

a is the value of that benefit or advantage comprised in that subsequent gift, either at the date of the gift, or at the date of the original gift, whichever is the less; and

b is the value of the original gift; and

c is the amount of gift duty paid on the original gift.

Link between section 70(2) and the definition of “Gift”

The value of any benefit or advantage reserved by a transferor within section 70(2) is not consideration from the transferee for the disposition of property by the transferor. This means that when deciding whether there is a “gift” (a disposition of property at an under-value), the value of the reserved benefit or advantage is not part of the consideration given by the transferee. For example, if a transferor sold his or her fee simple estate to another person, subject to the other person granting a life interest back, the value of the life interest is not consideration from the transferee to the transferor.

If this were not the case, and the transferee paid full value for the rest of the “gift”, section 70(2) would have no effect. Every reserved benefit or advantage would also be consideration from the transferee for the transferor’s disposition of property. There would be no disposition of property without fully adequate consideration, and therefore no gift.

To avoid section 70(2) being ineffectual, there must be limits on the forms of consideration that are effective in the section 2(2) definition of a gift (see for example *Commissioner of Stamps v Finch* (1912) 32 NZLR 514 (CA)). In *Finch* the issue of a predecessor to section 70(2) being ineffectual was considered and rejected by the court in the following terms:

(per Edwards J at page 532) For these reasons certain classes of monetary consideration are excluded by the statute in the determination of what is and what is not a gift for taxation purposes

(per Chapman J at page 533) If a donor reserves to himself any benefit or advantage in the same or any other property gift duty has nevertheless to be paid without any deduction in respect of what is reserved, and great care has been used in drafting the Act to make this provision effective.

This is also the view of Adams and Richardson’s *Law of Estate and Gift Duty* (5th ed, 1978, Wellington, Butterworths):

Section 70 is difficult to reconcile with the definition of “gift” in section 2. It appears to be framed on the assumption that when a disposition is made for inadequate consideration the dutiable value of the gift is ascertained by deducting the value of the inadequate consideration from the value of the disposition. Thus section 70 prohibits the “deduction or allowance” of certain types of benefit “in calculating the value of a dutiable gift”.

But the definition of “gift” does not provide for the deduction of an inadequate consideration from the “value” of a gift. Under the scheme of the definition a disposition is a gift only to the extent of the inadequacy of any consideration given for it. Consider the following example:

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A gives B $100 in return for B's promise to repay $75.

This is not a gift of $100 from which $75 is deducted in calculating the value of the dutiable gift. There is merely a gift of $25, that being the inadequacy of the consideration.

If a "benefit or advantage" within the meaning of section 70 constitutes a "consideration" for the purposes of the definition of "gift" it does not form part of the gift and section 70(2) does not apply to it. Since it appears that every "benefit or advantage" is also "consideration" it could be argued that section 70 has no effect. This possibility was adverted to by two of the judges in [*Finch*] (Edwards J at p532 and Stout CJ at p524).

To give section 70 the effect obviously intended by the Legislature it must be taken as limiting the types of benefit or advantage that may constitute a "consideration" within the meaning of the definition of "gift". This appears to have been the approach adopted in the cases: see for example [*Finch*, 533].

Difference between keeping an interest and reservation of a benefit or advantage

Section 70(2) applies where there is a "reservation" of a benefit or advantage. The cases discussed below establish that:

- If a transferor sells property free of encumbrances, for example a fee simple estate, subject to the transferee granting an interest back to the transferor, there is a reservation.
- If a transferor transfers a property in which the transferor has an interest referable to a prior independent transaction, and after disposal the transferor still has an interest referable to that prior independent transaction, there is no reservation.

In the Court of Appeal case, *Lees v CIR* (1989) 11 NZTC 6,079, Justice Richardson stated the test for whether there is a reservation (in the context of section 12, a provision relating to estate duty), at page 6,081:

> The test in that regard is whether the disponor disposed of the whole interest reserving an interest out of that which was disposed of, or whether the disponor disposed of a particular interest and merely retained the remaining interest in the property.

In *Finch*, the only New Zealand case on the predecessor to section 70(2), Chapman J drew the same distinction:

> ... I do not find that any of the language is apt to describe something which is not and never was reserved out of the gift or the value of the gift, but is an independent item of property retained by the donor.

In *Finch* the Commissioner of Stamps assessed gift duty on the transfer of an undivided moiety (½ share) of land to the transferor's two sons as tenants in common in equal shares. The transferor retained the remaining moiety. The value of the whole land was about £2,200, each moiety being worth just less than £1,100. The sons paid the father £100 in cash to ensure the value of the gift was less than £1,000, then the exemption level for gift duty. The Commissioner assessed gift duty on the whole value of the land, arguing the moiety the transferor retained was a reservation of a benefit or advantage in the land. Alternatively, the Commissioner argued that if the gift was only the moiety transferred, the £100 was a reservation of a benefit or advantage. The transferor argued that the moiety retained was not a reservation of a benefit, nor was the £100 payment.

The five judges in the Court of Appeal all found for the transferor on both counts. All agreed that the transferor had not "reserved" a benefit or advantage in the land by retaining his moiety. In the words of Justice Denniston, at page 525:

> ...I think it is clear that the donor has retained nothing. He has created separate estates or interests in the land, each of which is as capable of being separately dealt with as would be separate parcels of the land itself. It might as reasonably be said that a conveyance of a part of the land would involve a retention of the remainder.

Stout CJ and Chapman J also held that a benefit or advantage had to be reserved from the interest actually given, not the entire estate from which the interest came.

There are a number of Australian and United Kingdom cases that discuss whether there is a reservation of a benefit or advantage from the disposition of property.

In *Nichols v IRC* [1975] 2 All ER 120 (CA) the transferor sold his property to his son, on condition that the son leased the property back to the transferor, and that the son executed a covenant to repair. The son granted the lease and covenant as required. The Commissioners assessed death duty on the property, claiming that the transferor had not been entirely excluded from the gift.

The Court concluded (pages 126 to 127) that the sale of the fee simple, subject to the lease back, was a grant of the whole fee simple with something reserved out of it. It was not a gift of a partial interest with the transferor retaining various interests by holding them back from the disposition of property. Although obiter dicta, the Court's opinion was consistent with previous authority including *Earl Grey v Attorney-General* [1900] AC 124; [1900-3] All ER Rep 268 (HL); and *Oakes v New South Wales Commissioner of Stamp Duties* [1953] 2 All ER 1563 (PC).

A number of cases have found that there was not a reservation from the disposition of property. One of these is *Munro v Commissioner of Stamp Duties* (NSW) [1934] AC 61; [1933] All ER Rep 185 (PC). In that case the transferor entered into a partnership with his six children: the partnership farming the transferor's land. Four years later he gifted a portion of the land to each of the children. On the transferor's death the Commissioner attempted to assess death duty on the gifted land. The Privy Council held that the gifted property could not be brought back into the deceased's estate. In the speech of the Privy Council, Lord Tomlin said (page 188 of the All ER Rep judgment):

It is unnecessary to determine the precise nature of the right of the partnership at the time of the transfers. It was either a tenancy during the term of the partnership or a licence coupled with an interest. In either view what was comprised in the gift was, in the case of each of the gifts to the children and the trustees, the property shorn of the right which belonged to the partnership, and...the benefit which the donor had as a member of the partnership in the right to which the gift was subject was not...a benefit referable in any way to the gift.

This is consistent with *Finch*; *Commissioner of Stamp Duties (NSW) v Perpetual Trustee Co Ltd* [1943] AC 425; [1943] 1 All ER 525 (PC) and *Re Cochrane* [1906] 2 IR 200 (CA).

Where the transferor keeps an interest and simultaneously transfers an interest to the transferee, there will not be a reservation for the purposes of section 70(2) as long as the transferor is owner of the interest kept by him or her at all times during the transfers. (That is, the transferee does not at any time take ownership of the interest kept by the transferor.) This is supported by the decision in *Ingram*. The transferor's interest was acquired by her simultaneously with the interests granted to the transferee. In finding that there was no reservation the court said:

Unless it could be said that there had been a period or point of time at which the trustees and beneficiaries had had a more extensive interest out of which the leasehold interests had been carved, **the subject matter of the gift made by Lady Ingram was the property shorn of those leasehold interests**. [Emphasis added.]

In summary, an interest that the transferor grants to himself or herself (before gifting the remainder or reversion) does not amount to a reservation, whereas an interest that the transferor gives will be a reservation if he or she later receives a grant back of that interest. There will be a reservation even where the original gift is conditional on the interest being granted back.

Application of section 70(2) to the specific arrangements

Distinguishing leases from licences, and life estates from licences

A practical issue is whether the arrangement employed involves a lease or a licence. If it is a lease, a transferor can grant it to himself or herself. However, if it is merely a licence, the transferor cannot grant it to himself or herself, and must receive a grant back from another person. It is not easy to distinguish the two. However, the gift duty treatment of the arrangements discussed below varies considerably depending on the precise method used. It is important for precise language to be used. The term "licence to occupy" is not a catch-all term for life estates and leases. Instead, a "licence to occupy" is merely a personal permission to occupy land. Many so-called "licences to occupy" may be leases (for life or otherwise), or life estates.

A further issue from case law is whether the right granted by the transferor to himself or herself or by another person to the transferor is a life estate or a right of personal residence (a licence to occupy). Again this is important. If the grant is a grant of a life estate, the transferor can grant it to himself or herself. If the grant is a licence, the transferor cannot grant it to himself or herself, and must receive a grant back from another person.

A line of cases establishes that a life estate is created by words showing an intention to do so; see for example *Holden v Allen*, *Goodbehere & Allen* (1903) 6 GLR 87, *Holland v McKenzie* [1932] NZLR 1153. If the words clearly grant less than a life estate, there will only be a licence to occupy, as in *Re Edwards* [1950] NZLR 516 and *Re Denton* [1956] NZLR 104.

No requirement for the interest to be a legal interest

With all the methods discussed below, when transferors keep or reserve an interest in the property they may keep or reserve an equitable or a legal interest. It is not necessary to keep or reserve a legal interest using the provisions of the Land Transfer Act 1952.

1. ***Transferor grants a life interest (including a lease for life) to himself or herself, and then transfers the remainder interest to another person***

This arrangement does not involve a reservation of interest by the transferor. If the separation of the life interest occurs before the sale to the other person, the subsequent sale is treated as the sale of one interest while keeping another. Section 70(2) does not apply, and accordingly whether duty is payable, and if so how much, will be determined on the value of the remainder estate.

The Property Law Act 1952 (PLA) gives the transferor authority to grant a life estate to himself or herself. Under section 49 of the PLA, the transferor may transfer an estate or interest in land to himself or herself individually or jointly with others. Section 66A of the PLA provides that covenants in a transfer by the transferor to himself or herself (under section 49 of the PLA) are enforceable.

Example 1

A creates a life estate in a property, and then sells the remainder interest to the trustees of his family trust. A's property is worth $175,000. The value of the life estate is $60,000. The sale price for the remainder is $115,000. The sale price is outstanding as an unsecured debt owed by the trust to A.

The Commissioner will not assess A for gift duty on the $60,000 that the trust does not pay for the property. The trust gave full value for the remainder interest by agreeing to pay A the $115,000. Accordingly, there is no question of gift duty on the $115,000. Section 70(2) has no application because there is no reservation from the disposition of property to the trustees.

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2. *Transferor grants lease for a term of years to himself or herself, and then transfers the reversion interest to another person*

This arrangement does not involve a reservation of interest by the transferor. If the transferor's separation of the lease occurs before the sale of the reversion to the other person, the transaction is treated as the sale of one interest with no reservation of the other. Section 70(2) does not apply, and accordingly whether duty is payable, and if so how much, will be determined on the value of the remainder estate.

A transferor can grant a lease to himself or herself in New Zealand. At common law a person could not grant a lease to himself or herself, *In re Nichol* [1931] NZLR 718, 727, *Rye v Rye* [1962] AC 496; 1 All ER 146. However, because a lease is an estate or interest in land, this rule has been abrogated in New Zealand by sections 49 and 66A of the PLA (*Harding v CIR* [1977] 1 NZLR 337; 2 NZTC 61, 145).

At common law when the same person owned the freehold and the leasehold interest in a property there was merger of the interests, and the lesser interest (the lease) ceased to exist. In equity, merger depended on the intention of the parties. Section 30 of the PLA adopts the equitable rule, so there will only be merger where the parties intend it to occur. Clearly, when a person creates a lease and grants it to himself or herself, the intention is for the estates to remain separate.

Example 2

B creates a lease for fifty years in her favour over her property, and simultaneously sells the reversion interest to her only child, C. B's property is worth $250,000. The value of the lease is $100,000. The sale price for the reversion is $150,000. The sale price is outstanding as an unsecured debt owed by C to B.

The Commissioner will not assess B for gift duty on the $100,000 that C does not pay for the property. C gave full value for the reversion interest by agreeing to pay B the $150,000. Accordingly, there is no question of gift duty on the $150,000. Section 70(2) has no application because there is no reservation from the disposition of property to C.

3, 4, and 5. Transferor transfers the property to another person, subject to the other person granting him or her an interest (life estate, lease, or licence to occupy), which the other person does

Section 70(2) will apply if there is a dutiable gift. The value of the property sold will include the value of the reserved interest. If the other person only pays for the remainder interest (that is, the value of the fee simple less the value of the life estate, lease or licence) there will not be fully adequate consideration. (As discussed above, the value of the life estate, lease, or licence is not treated as consideration for the sale of property.) There will be a dutiable gift. Section 70(2) will apply and deny a deduction for the value of the benefit or advantage reserved to the transferor.

There is no legal impediment to a transferor granting property to another person, and the other person granting a life estate, lease, or licence to occupy back to the transferor. When the other person receives the unencumbered fee simple, that person has the power to grant an interest of a life estate, a lease for life, or a licence to occupy back to the transferor. The formalities of any lease or life estate in such circumstances are discussed above under methods one and two.

It is clear from case law (*Earl Grey*, *Nichols*, *Oakes*) that these arrangements involve reservations from the disposition of property, notwithstanding that the transferor's original sale may be conditional on the grant back of a particular interest.

Example 3

D has decided to sell her family home to a family trust. She wishes to ensure that she has a right to occupy the property for the rest of her life. She sells the property to the trustees of the trust. A condition of the sale is that the trustees grant D a licence to occupy. The trustees comply with this condition.

The property has a market value of $200,000. A valuer and actuary value the licence to occupy at $50,000. The sale price of the property is $150,000, which D leaves owing as a debt, repayable on demand.

The Commissioner will assess D for gift duty. Section 70(2) applies to deny a deduction (for the value of the licence to occupy) from the value of the gift. Therefore, the property is disposed of without fully adequate consideration ($150,000 c.f. $200,000). There is a gift, and gift duty will be charged taking into account the normal exemptions.

The Commissioner would still assess D for gift duty if, instead of using a licence to occupy, she had requested and received a life estate or a lease for life or a lease for a term of years.

Transferor purports to grant a licence to occupy to himself or herself, and then transfers the remainder interest to another person

It is not legally possible for a transferor to grant a licence to occupy to himself or herself. A licence, unlike a lease, is not an estate or interest in land. A licence is a personal permission to enter land and use it for a particular purpose. As Gresson P said in *Baikie v Fullerton-Smith* [1961] NZLR 901, 906, a licence is an authority that prevents the grantee from being regarded as a trespasser on someone else's property. A licence must be granted from a licensor to a licensee. Without comparable provisions to sections 49 and 66A of the PLA applying to licences, a land owner cannot licence himself or herself to be a licensee.

Accordingly, a transferor who purports to grant himself or herself a licence to occupy is treated in either of the following ways:

- Where the transferor deducts an amount from the value of the property disposed of, but the transferee has no obligation to grant a licence back, the transferor is liable to gift duty as the property is transferred to the other person for less than fully adequate consideration.
- Where the transferor deducts an amount from the value of the property disposed of, and the transferee has an obligation to grant a licence back, the treatment discussed above for cases 3, 4, and 5 applies and section 70(2) is invoked.

Example 4

E purports to grant to himself a licence to occupy over a property, and purports to sell the remainder interest to his three children. There is no obligation expressed in the documents for the children to grant a licence back to C. C's property is worth $175,000. The value of the licence to occupy is estimated to be $60,000. The sale price for the remainder is $115,000. The sale price is outstanding as an unsecured debt owed by the children to C.

The Commissioner will assess C for gift duty on the $60,000 that the children do not pay for the property. It is not possible for C to grant himself a licence to occupy. Therefore, C is selling the children the fee simple of the property. The children only pay C $115,000 for a property worth $175,000. Accordingly, there is gift duty on the $60,000.

If C gets a licence to occupy from the children, Example 3 above sets out the gift duty treatment and the application of section 70(2) to such a grant to C.

Sliding value clauses

Commonly, documents evidencing the disposition of property provide that the consideration shall be a fixed amount or such higher amount as the Commissioner accepts will not give rise to a gift for gift duty purposes. The Commissioner accepts that where section 70(2) might otherwise apply, and the parties use the sliding value clause to increase the consideration so there is no gift, that gift duty will not be payable.

Amendment of documents

Under section 70(3), the Commissioner may permit the cancellation or amendment of any instrument creating or evidencing a disposition of property to which section 70 applies. Application in writing must be within six months of the date of the instrument, or within such extended time as the Commissioner thinks fit to allow in the special circumstances of the case. Documents that are amended or redrawn will be reconsidered to see whether section 70(2) applies to them.

Valuation of retained interests

Section 66 requires every dutiable gift to be valued as at the date of the making of the gift, and section 67 gives the Commissioner a general discretion as to how property is valued. Under sections 68 and 69, when valuing the amount attributable to the interest the transferor has kept, the transferor may use an actuary, valuer, or the Tables in the Second Schedule. (The Commissioner may review use of the Tables in the future. If so, any new method will have application only from the date of publication of any change in policy.)

When there is more than one transferor, and all are entitled to a life estate or lease for lives, the value of the right should take account of the longest remaining life expectancy of the transferors. The value of the right relates to the time the transferees are out of possession of the property. If all transferors have a right of occupation until their respective deaths, the discount of the property's value to the transferees relates to the longest expected occupation of any of the transferors.

Subsequent gift of reserved benefit

Where gift duty has been paid on a gift valued under section 70, any gift duty on a subsequent gift of the reservation or benefit or any part of it is subject to an amount calculated using the formula given in section 76. The section 76 formula is:

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

where:

a is the value of the benefit or advantage comprised in the subsequent gift, either at the date of the gift, or at the date of the original gift, whichever is the less; and

b is the value of the original gift; and

c is the amount of gift duty paid on the original gift.

Example 5

Assume original gift valued at:	Inadequacy	$12,000
	Reservation	$30,000
		$42,000

Gift duty on $42,000 = $1,050

Proportion borne by reservation $= \frac{\$30,000}{\$42,000} \times \$1,050 = \$750$

Therefore, the limit of allowances under section 76 is $750. If there is a subsequent gift of the reservation of $30,000 the treatment is as follows. Gift duty on $30,000 is $150. The allowance calculated above is $750. Accordingly, the duty payable is nil.

Dispositions where the transferor reserves a benefit or advantage in real property - income tax implications

Public ruling - BR Pub 96/2

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

Taxation law

This ruling applies in respect of sections CE 1 (1)(e), EB 1 (1), EB 2, and OB 1 (definition of "lease" and "leasehold estate") of the Income Tax Act 1994.

Arrangements to which this ruling applies

This ruling applies when a taxpayer (transferor) disposes of real property and another taxpayer (transferee) receives the property either subject to an interest still held by the transferor or subject to an obligation to grant an interest back to the transferor.

The period for which this ruling applies

This ruling applies to dispositions of real property made between 1 April 1996 and 31 March 1999.

The ruling

Section CE 1 (1)(e) includes within a person's assessable income all rents, fines, premiums, or other revenues derived by a land owner from:

- Any lease, licence, or easement affecting the land; or
- The grant of a right to take profits from the land.

Where a transferor grants an interest in property to himself or herself, and later grants the remainder or reversion to another person (including the trustees of a trust), the interest kept by the transferor does not constitute assessable income under section CE 1 (1)(e).

Where a transferor grants a property interest to another person, subject to the transferee granting an interest back to the transferor, the transferee may have assessable income under section CE 1 (1)(e). The transferee will have assessable income where:

- The transferee is indebted to the transferor and the value of the interest granted by the transferee is deducted from that indebtedness; or
- The price the transferee pays for the property is reduced by netting off from the market value of the property the value of the obligation to grant an interest to the transferor; or
- The transferor otherwise pays the transferee for the grant.

The assessable income will be equal to the reduction in indebtedness, the reduction in price, or the amount otherwise paid.

If the value of interest granted by the transferee is not paid for, or is not used to reduce the price the transferee pays or the transferee's indebtedness, the transferee does not have assessable income from the grant.

Where a transferor grants a property interest to another person, and the transferee grants a freehold interest to the transferor, such as a life estate or lease for

life, section CE 1 (1)(e) does not apply. A freehold interest does not come within section CE 1 (1)(e)'s requirement that there be a lease, licence, easement, or profit.

This ruling is signed by me on the 23rd day of January 1996.

Martin Smith
General Manager (Adjudication & Rulings)

Analysis of public ruling BR Pub 96/2

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

This analysis sets out the application of section CE 1 (1)(e) when a taxpayer disposes of real property and keeps or reserves interests in that property.

The gift duty implications of such transactions are the subject of public binding ruling BR Pub 96/1.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
CE 1	65
EB 1	75
EB 2	80
OB 1	2

Under section CE 1 (1)(e), a person's assessable income includes:

All rents, fines, premiums, or other revenues (including payment for or in respect of the goodwill of any business, or the benefit of any statutory licence or privilege) derived by the owner of land from any lease, licence, or easement affecting the land, or from the grant of any right of taking the profits of the land.

Application of legislation

Section CE 1 (1)(e) deems a person's assessable income to include all rents, fines, premiums, or other revenues derived by a land owner from:

- Any lease, licence, or easement affecting the land; or
- The grant of a right to take profits from the land.

No income tax implications where an interest is kept

Where the transferor effectively keeps an interest in land prior to a disposition of the remainder to another person, section CE 1 (1)(e) does not apply. The owner of land (the transferor) has not derived a rent, fine, premium, or other revenue from a lease, licence, easement, or profit; instead the owner has simply kept an interest in the land. The transferee has also derived no income as he or she never owned the interest that the transferor kept.

A transferor can grant himself or herself a life interest or lease over land, before disposing of the remainder or reversion to another person. However, it is not legally possible for a transferor to grant a licence to occupy to himself or herself. A licence is not an estate or interest in land. A licence is a personal permission to enter land and use it for a particular purpose. A licence must be granted from a licensor to a licensee.

Example 1

A creates a life estate in a property, and then transfers the remainder interest to the trustees of his family trust. A's house is worth $175,000. The value of the life estate is $60,000. The sale price for the remainder is $175,000 less the $60,000. The sale price is outstanding as an unsecured debt owed by the trust to A.

The Commissioner will not assess A for income tax under section CE 1 (1)(e) on the $60,000 value of the life estate. Section CE 1 (1)(e) has no application when a property owner keeps some part of his or her own property.

Income tax implications when an interest is reserved

Where the transferor reserves an interest by receiving a grant of an interest from the transferee, section CE 1 (1)(e) generally applies. There are three parts to section CE 1 (1)(e):

- There must be either a rent, fine, premium, or other revenue.
- The income must be derived by a land owner.
- The income must be derived from a lease, licence, easement, or profit.

When the transferee is granting an interest to a transferor, the transferee is the land owner. Accordingly, it is the transferee who is at risk of being subject to income tax.

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Income that is "premiums or other revenues"

For section CE 1 (1)(e) to apply there must be income from granting an interest back to the transferor. Where a grant back to the transferor is for no consideration section CE 1 (1)(e) will not apply (there may, however, be a gift duty effect).

Where:

- The transferee is indebted to the transferor and the value of the interest granted by the transferee is deducted from that indebtedness; or
- The price the transferee pays for the property is reduced by netting off from the market value of the property the value of the obligation to grant an interest to the transferor; or
- The transferor otherwise pays the transferee for the grant,

the transferee may have assessable income if the other requirements (discussed below) of section CE 1 (1)(e) are met.

The assessable income will be equal to the reduction in indebtedness, the reduction in price, or the amount otherwise paid.

Under section CE 1 (1)(e), the value attributed to the interest granted by the transferee to the transferor is either a rent, fine, premium, or other revenue. A payment for the grant of a licence to occupy, or a lease, is included within the term "premiums, or other revenues". The Court of Appeal in *Romanos Motels Limited v CIR* [1973] 1 NZLR 435 found that an amount paid for goodwill and a lease of a motel was included within the term "premiums, or other revenues", notwithstanding that such a sum would normally be considered a capital sum. In *Capel v CIR* (1987) 9 NZTC 6,195 the High Court found that a goodwill payment was a capital sum, yet the payment was still assessable under the then equivalent to section CE 1 (1)(e). A payment for buying a licence to occupy, or a lease, would also normally be considered a capital sum. However, *Romanos* and *Capel* are authority for the proposition that such a payment is included within the term "premiums, or other revenues".

Derivation of premiums or other revenues

The premium or other revenue is "derived" by the transferee (the land owner). Where there is a grant to the transferor of the licence to occupy or lease, this results in a reduction of the debt owing by the transferee to the transferor. The reduction comes about because the licence to occupy or lease has value to the transferor and the transferee, and the amount the transferor should pay for the licence or lease is credited against the debt owing to the transferor. The reduction is an amount equal to the value of the interest granted to the owner. Although the transferee does not actually receive an amount of cash from the transferor, he or she does derive the income. Under section EB 1 (1), a person derives income, even where it has not been received, when an amount has been, for example, credited in account or otherwise dealt with in the person's interest or behalf. A reduction of indebtedness is an example of this, and so the transferee "derives" the income. Another example, is a netting off of obligations.

Income derived from lease, licence, easement, or profit

Where the transferee grants the transferor a lease or a licence to occupy, and there is a sum attributable to that grant, the grant satisfies the requirement that the income is derived from any lease, licence, easement, or profit. Accordingly, the transferee is subject to income tax on an amount equal to the value of the sum attributable to the grant.

Example 2

B has decided to transfer her family home to a family trust. She wishes to ensure that she has a right to occupy the house for the rest of her life. She transfers the house to the trustees of the trust. A condition of the sale is that the trustees grant B a licence to occupy. The trustees comply with this condition.

The house has a market value of $200,000. A valuer and actuary value the licence to occupy at $50,000. The sale price of the house is $200,000, which is reduced by $50,000 to $150,000 to take into account the value of the licence to occupy. The $150,000 is left owing by D as a debt repayable on demand.

The trust has assessable income under section CE 1 (1)(e) for the value of the licence to occupy.

However, where the lease is a lease for life, the transferee is not subject to income tax. Section OB 1 defines "lease" as any disposition by which a leasehold estate is created. "Leasehold estate" is also defined in section OB 1: it does not include a freehold estate. As a lease for life is a freehold estate, it is not a "lease" for the purposes of section CE 1 (1)(e).

Where the transferee grants a life estate to the transferor, the grant is not a lease, licence, easement, or profit. Instead, it is a grant of a freehold estate in land. Accordingly, the transferee is not subject to income tax.

Example 3

C and D decide to transfer their home to a family trust. They wish to ensure that they have a right to occupy the house for the rest of their lives. They transfer the house to the trustees of the trust. A condition of the sale is that the trustees grant C and D life estates in the property. The trustees comply with this condition.

The house has a market value of $250,000. The life estates are worth $75,000. The sale price of the house is $250,000, which C and D leave owing as a debt, repayable on demand. The debt is reduced by $75,000 upon the grant of the life estates.

The trust will not have assessable income under section CE 1 (1)(e), because the grant of a life estate is not income derived from a lease, licence, easement, or profit.

If the lease is not a lease for life, section CE 1 (1)(e) will apply in the same way as would occur with the grant of a licence, see example 2 above.

Spreading of income

When a taxpayer derives income under section CE 1 (1)(e), section EB 2 (1) allows the person to apportion that income between the income year in which it is derived and up to five subsequent income years.

Bad debts - writing off debts as bad for GST and income tax purposes

Public ruling - BR Pub 96/3

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

Taxation law

This ruling applies in respect of section DJ 1 (a)(iii) of the Income Tax Act 1994 and section 26(1)(c) of the Goods and Services Tax Act 1985.

Arrangements to which this ruling applies

This ruling applies when a person claims to have written off a debt (or part of a debt) as a bad debt and seeks an income tax deduction or a deduction from GST output tax for the debt (or part thereof).

The period for which this ruling applies

This ruling applies to income tax deductions and deductions from GST output tax claimed in the period 1 March 1996 to 28 February 1999.

The ruling

A debt (or part of a debt) must be both bad and written off before any person can claim an income tax deduction or a deduction from GST output tax (assuming that other legislative requirements in the Goods and Services Tax Act 1985 and the Income Tax Act 1994 are also satisfied).

Debt must be "bad"

Whether or not a debt (or part of a debt) is bad is a question to be determined objectively rather than a question to be determined by the subjective opinion of any particular individual. The objective test that any person should ask himself or herself in deciding whether or not a debt is bad, is whether the facts would indicate to a reasonable and prudent business person that, on the balance of probabilities, it is unlikely that the debt will be paid.

If the facts indicate to a reasonable and prudent business person that, on the balance of probabilities, it is unlikely that the debt will be paid, then the debt is bad at that point in time. The debt may then be written off. Events following the writing-off may result in additional information which could indicate that a debt (or part of a debt) previously written off as bad is no longer bad. However, this does not mean that the debt was not bad at the time of the writing-off, and does not require any change to the income tax return or GST return in which the bad debt deduction was claimed. Of course, any recovery of any part of the debt previously claimed as a bad debt deduction must be returned in the period recovered.

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At the time of deciding whether a debt is bad, a person will need to have sufficient information to enable a reasonable and prudent business person to form the view that it is unlikely that the debt will be paid. The facts that need to be gathered depend on the circumstances surrounding any particular case. While no factor is decisive in itself, factors that are likely to be relevant in most cases are:

- The length of time a debt is outstanding - the longer a debt is outstanding, the more likely it is that a reasonable and prudent business person would consider the debt to be bad.
- The efforts that a taxpayer has taken to collect a debt - the greater the extent to which a person has tried (unsuccessfully) to collect a debt, the more likely it is that a reasonable and prudent person would consider the debt to be bad.
- Other information obtained by a creditor - a creditor may have obtained particular information about a debtor, e.g. through business or personal networks, that would be a factor in leading a reasonable and prudent business person to conclude that a debt is bad. For example, a creditor may know that the debtor is in financial difficulties and has defaulted on debts owed to other creditors.

A debtor does not need to be insolvent for a debt to be bad (although this will often be the case).

A debt may still be bad even though a person is taking action to recover the debt. Recovery action may be taken for a number of reasons, even though a reasonable and prudent business person would think it unlikely that the debt will be recovered.

A person cannot make a deduction by way of a provision for doubtful debts (being an estimate of the amount of debts that will become bad in the future). Bad debts are individually identifiable debts rather than a general provision.

Debt must be "written off"

A bad debt must be written off by authorised persons in accordance with the accounting and record keeping systems maintained by a taxpayer. In all cases the records kept by a taxpayer must comply with the record keeping requirements contained in the Tax Administration Act 1994 and the Goods and Services Tax Act 1985.

In cases where a taxpayer maintains a debtors ledger, the balance in the debtors ledger for the individual debtor must be reduced by the amount of the bad debt. An entry in a general ledger recognising the debt as bad does not also have to be made for the debt to be written off for income tax and GST purposes.

In cases where debtors ledgers are not maintained, action must be taken that shows that the business accounting system treats the debt as bad. Particular examples where the Commissioner accepts that a debt has been written off are:

- Where a taxpayer's only records of debts are copies of invoices issued; placing the invoice in a "bad debts" file indicating on the invoice whether all or part of the invoiced amount is bad is sufficient.
- If a taxpayer's only records of debts are copies of invoices and copies of statements of account issued from a duplicate account book, marking the copy of the final statement sent out "bad debt" (indicating the amount of the debt that is bad) is sufficient. Alternatively, it would also be sufficient for the taxpayer to place the relevant invoice in a "bad debts" file indicating on the invoice whether all or part of the invoiced amount is bad.

Merely claiming a deduction from output tax in a GST return does not amount to the writing-off of a bad debt.

In all cases, the taxpayer must cease to recognise the debt as an asset for accounting purposes.

There is no requirement that a debt must be written off and claimed as a bad debt deduction in the income year or GST taxable period in which the debt becomes bad. However, when a bad debt deduction is claimed, the necessary accounting entries must physically have been made, or necessary action taken as the case may be, before the end of the income year or GST taxable period in which the bad debt is claimed. Writing-off cannot be backdated.

This ruling is signed by me on the 29th day of January 1996.

Martin Smith
General Manager (Adjudication & Rulings)

Analysis of public ruling BR Pub 96/3

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

All legislative references to the Goods and Services Tax Act 1985 are cited as references to the GST Act. All other legislative references in this item are to the Income Tax Act 1994 unless otherwise indicated.

Background

The Income Tax Act 1994 and the Goods and Services Tax Act 1985 allow deductions for bad debts for taxpayers and/or registered persons if certain criteria are met. Criteria common to both Acts are the requirements that a debt must be both bad and written off before any deduction can be made.

The ruling sets out the test to apply when deciding whether or not a debt is "bad" and what is a sufficient "writing-off" of a bad debt.

Legislation - Income Tax Act 1994

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 7	104
CE 1 (1)(d)	65(2)(jc)
DJ 1 (a)	106(1)(b)
EH 1	64C
EH 3 (3)	64D(3)
EH 4	64F
EH 5	64G
EH 6	64I
OB 1	2
OD 7	8

In calculating the assessable income derived by any person, section BB 7 allows a deduction, except as otherwise provided in the Act, for any expenditure or loss to the extent to which it is incurred in gaining or producing the assessable income for any year or is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any year.

However, notwithstanding section BB 7, section DJ 1 (a) prohibits the deduction of bad debts, except when and to the extent that a number of criteria are satisfied. Section DJ 1 (a)(iii) sets out one of these criteria, namely that the debt must be proved, to the satisfaction of the Commissioner, to have been actually written off as a bad debt by the taxpayer in the income year.

Other section DJ 1 (a) criteria (in summary form) that must also be satisfied are:

- If the debt is an amount owing in respect of a financial arrangement and the accruals rules apply to the taxpayer for the financial arrangement, the deduction must be permitted under section EH 5 (see below); and
- If the debt is not an amount owing in respect of a financial arrangement where the accruals rules apply, the bad debt must not be a loss of capital subject to section BB 8 (a); and
- Where:
    - The taxpayer is a company; and
    - The debt is owed by a company ("the debtor"); and
    - The amount giving rise to the debt is taken into account in calculating a loss ("the resultant loss") incurred by the debtor or any other company funded (directly or indirectly) by the debtor; and
    - Any one or more amounts have been allowed under section IG 2 or section 191A of the Income Tax Act 1976 as a deduction to the taxpayer (or to any other company which is at any time in the

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income year in which the resultant loss is incurred in the same group of companies as the taxpayer), in any income year commencing on or after 1 April 1993 and preceding the income year in which the bad debt is written off, in respect of the resultant loss, -

the loss must exceed the aggregate of the amounts so allowed as a deduction.

Section EH 5

Section EH 5 deals with amounts written off as bad debts in respect of financial arrangements. The main type of arrangement, in relation to bad debts, that is excluded from the definition of "financial arrangement" in section OB 1, is a short term trade credit. This is not a financial arrangement because it is an "excepted financial arrangement" (see paragraph (d) of the definition of "excepted financial arrangement" in section OB 1). "Short term trade credit" is defined in section OB 1 as:

...any debt for goods or services where payment is required by the vendor within 63 days after the supply of the goods or services:

Arrangements entered into before the introduction of the accruals rules are also excluded from the definition of "financial arrangement".

Revenue bad debts

Section EH 5 (1) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement. Section EH 5 (1) will only apply in limited circumstances to a cash basis holder. This is because section EH 5 (1) only applies when and to the extent that:

- A person derives income in respect of the financial arrangement under:
  - Section EH 1 - one of the methods of calculating accrual income; or
  - Section EH 3 (3) - the adjustment required in any year when a person ceases to be a cash basis holder; or
  - Section EH 4 - the base price adjustment calculated in the year a financial arrangement matures or is transferred; or
  - Section EH 6 - the post facto adjustment for financial arrangements which have the effect of defeating the intent and application of the accrual regime; and
- The amount written off is attributable to that income.

Capital bad debts

Section EH 5 (2) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 5 (2) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 5 (1)) when:

- The person carries on a business which comprises holding or dealing in such financial arrangements and the person is not associated with the person owing the amount written off (see section OD 7 for test of association); or
- The financial arrangement is a trade credit and the person carries on the business of dealing in the goods or services for which the trade credit is a debt. "Trade credit" is defined in section OB 1 to mean any debt for goods and services, other than a short term trade credit.

Security payments

Under section EH 5 (3), when a person receives a security payment for a loss and a deduction is not otherwise allowable for the loss, the person is permitted a deduction for the loss up to the amount of the security payment.

Bad debts recovered

Under section CE 1 (1)(d), amounts received on account of a bad debt for which a deduction has previously been allowed must be included as items of assessable income.

Legislation - Goods and Services Tax Act 1985

Section 26 of the GST Act is the main provision applying to bad debts for GST purposes. Section 26 applies to registered persons who account for GST on an invoice or hybrid basis. It also applies to registered persons who account for GST on a payments basis when the relevant supply is by way of a hire purchase sale or a door to door sale.

Section 26 allows a registered person to make a deduction from output tax for that portion of the amount of tax charged in relation to a supply as the amount written off as a bad debt bears to the total consideration for the supply. To claim the deduction, the registered person must satisfy a number of criteria. Section 26(1)(c) sets out one of these criteria, namely that the registered person must have written off as a bad debt the whole or part of the consideration not paid to that person.

The other criteria (in summary form) that must also be satisfied are that the registered person must have:

- Made a taxable supply for consideration in money (from which the bad debt arose); and
- Furnished a return in relation to the taxable period during which the output tax on the supply was attributable, and properly accounted for the output tax on the supply.

A proviso is effective if goods are supplied under a hire purchase agreement to which the Hire Purchase Act 1971 applies. In this case the registered person makes a deduction from output tax of the tax fraction (being the tax fraction applicable at the time the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement.

There is also a special provision for registered persons who supply contracts of insurance relating to earthquakes, wars, and fires (see section 26(1A)).

Bad debts recovered

Under section 26(2), when any amount for which a deduction from output tax has properly been made is wholly or partly recovered, output tax must be returned on that amount (to the extent of the recovery) in the taxable period in which it is wholly or partly recovered.

Application of legislation - Debt must be "bad"

A debt must be "bad" before it can be written off and before any deduction can be claimed for that debt. The question of whether a debt is bad is a question of fact. In evaluating the facts, the Commissioner will apply an objective test. The objective test that will be applied is whether the facts would indicate to a reasonable and prudent business person that, on the balance of probabilities, it is unlikely that the debt will be paid.

This objective test was outlined by Barber DJ in *Case N69* (1991) 13 NZTC 3,541 on page 3,548:

> Naturally, the debts in question must be "bad" to be written off as bad in terms of s. 106(1)(b). This is a question of fact. Generally, an application of that criterion will not be difficult as the debtor will be insolvent. However, the debtor does not need to be insolvent for the debt to be bad. It is only necessary that there be a bona fide assessment that the debtor is unlikely to make payment of the debt. If there is a clear understanding or arrangement that there be long term credit, and if the taxpayer believes that the terms of the credit will be met, then the debt cannot be treated as bad because it is merely a situation of deferred payment. In my view, as well as the need for the writing off to be made bona fide, the circumstances must indicate to a reasonable and prudent business person that, on the balance of probability, the debt is unlikely to be recovered. This is an objective test.
>
> The creditor taxpayer may, of course still hope for recovery and is quite entitled to institute recovery procedures. It is not necessary to have taken recovery or legal steps. ... It does not follow from the taxpayer hoping for or seeking recovery that a debt is not bad. However, usually, when a debt is assessed as bad, in terms of the type of criteria I have outlined, hopes or efforts of recovery will be futile.

The test was cited with approval by Justice Doogue in the High Court decision of *Graham v CIR, Edwards Graham Ltd & Edwards v CIR* (1995) 17 NZTC 12,107, 12,111.

A similar test to that outlined by Barber DJ was outlined by Justice Tompkins in the High Court decision of *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263, 12,269:

> The term "bad debt" is not defined in the Act. It, therefore, should be given its normal commercial meaning. It is a question of fact to be determined objectively. A debt becomes a bad debt when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid in whole or in part by the debtor or by someone else either on behalf of the debtor or otherwise.

Taxpayer's opinion

A debt is a bad debt if a reasonable and prudent business person would think that the debt is bad. A taxpayer in business is, in all likelihood, a reasonable and prudent business person. In most instances, the taxpayer's opinion will suffice.

However, the Commissioner also recognises that taxpayers have a financial interest in claiming that a debt is bad. Writing off a debt as bad entitles a taxpayer to:

- A deduction in calculating income for income tax purposes, worth up to 33 percent of the debt:
- A GST deduction from output tax of the tax fraction of the debt.

Because of this, the Commissioner may inquire into the decision to treat a debt as bad in the course of tax audits. Taxpayers may, therefore, wish to document and retain evidence in relation to their decisions to treat debts as bad to show that they made reasonable decisions. Documentation may include noting down the information from which the decision was made that the debt was bad, and keeping copies of any correspondence relating to the debt.

Information required

The amount of information required to decide whether a debt is bad depends on the particular circumstances of each case. If the amount involved is small, a reasonable and prudent business person is likely to make limited enquiries and take limited recovery action. Particular knowledge or information obtained by a taxpayer may also reduce the need for enquiry.

Recovery action

A creditor is likely to have taken recovery action in most cases before a deduction for a bad debt is made. It is through taking recovery action that most creditors will form an opinion as to whether a debt is bad. While recovery action is being taken, a debt can only be considered bad to the extent that a reasonable and prudent business person would consider, on the balance of probabilities, it unlikely that the debt will be paid.

In some instances, taking recovery action may carry with it the reasonable expectation of recovery of some part of the amount involved. However, this will not always be the case. The decision to take recovery action and the extent of that action will depend on the circumstances surrounding any particular case. In some cases, the creditor may take only limited recovery action because enough information is held to form a reasonable view that the debt is bad. The amount of information needed depends on the circumstances.

Conversely, the creditor may take recovery action even when a reasonable view has been formed that the debt is bad. There are a number of reasons why the creditor might take recovery action, even when it is believed that it is unlikely that the debt will be recovered. This may be the case, for example, when the creditor has a policy

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of pursuing debtors to a certain extent to discourage customers defaulting on debt.

Provision for doubtful debts

Persons in business who provide credit often find it prudent to make some provision for the likelihood that some of their debtors will not pay. This allowance is generally calculated by estimating a percentage on the basis of past history, and applying that percentage to the total amount of debts owed to the business at balance date.

Bad debts are individually identifiable debts that are unlikely to be recovered (in practical terms). The provision for doubtful debts is an estimate of the amount that will become bad debts in the future. The Income Tax Act and the GST Act do not allow any deduction for provisions for doubtful debts.

Debts which are partially bad

In some cases there may be no reasonable expectation that the debt will be fully recovered, but there may be a reasonable expectation of partial recovery. In this case the part that the creditor has no reasonable expectation of recovering is a bad debt.

Examples of when a debt is/is not bad

Example 1

A supplier has supplied goods on credit to Mr B. Mr B owes the supplier $2,000 for the goods. The supplier knows that Mr B has left town, and that mail addressed to him is returned marked "Gone No Address".

In this case it is reasonable to assume that the debt will not be recovered. The money owed by Mr B is a bad debt.

Example 2

C owes $100,000 to a company. The credit controller for the company has considered the likelihood of default on every loan currently owing to the company. The credit controller has estimated the likelihood of default for C to be five percent and wants to know if the company can consider $5,000 of that loan (5% of the $100,000 owing) to be a bad debt.

Making an estimate of the likelihood of default on debts is not sufficient for a debt (or a percentage thereof) to be bad. It is not reasonable to assume that the debt is bad.

Example 3

A local dairy has supplied $10 worth of bread and cigarettes to Mrs D on credit. Mrs D used to call into the shop every other day, but has not called into the shop for eight weeks and the $10 is still owing.

Given the small amount owing, it is reasonable for the dairy to make no further enquiries. On the basis of the information that the dairy has, it can be assumed that the money is unlikely to be recovered. It is a bad debt. However, if the sum involved was larger, it may be reasonable to expect the dairy to make some further enquiry.

Example 4

A solicitor has done work for Mr O and billed him for $1,700. The solicitor is on the Board of Trustees of the school attended by Mr O's children. Furthermore, several of the solicitor's other clients and business associates deal with Mr O on a regular basis. The solicitor has sent out a number of reminder bills because the bill is four months overdue, but has had no response. Several of the solicitor's friends and associates have mentioned that Mr O is in financial difficulty and has had one of his vehicles repossessed. The solicitor's office clerk has noted that Mr O's name has been cited in the Gazette several times over recent months in respect of Court action for unpaid debts.

It is reasonable for the solicitor to characterise Mr O's debt as a bad debt.

Example 5

A debtor of Mr F is a company in liquidation. Mr F has given the liquidator notice of a debt of $10,000 owed for goods and services supplied. Mr F is an unsecured creditor. The liquidator has held a meeting of creditors. Mr F attended the meeting and received formal notice of the outcome of the meeting. The liquidator has stated that unsecured creditors will probably receive something between 45 and 50 cents in the dollar.

It is reasonable for Mr F to assume that $5,500 of the total debt is bad. Mr F is entitled to write off that part of the debt that is bad and claim a deduction for income tax and GST purposes.

At a later date, Mr F receives a letter from the liquidator, who advises that the estimate of the likely recovery has been revised. It is now expected that unsecured creditors will be paid between 70 and 75 cents in the dollar.

This does not affect the answer given above. Also, it has no effect on Mr F's GST return or income tax return if Mr F has claimed a deduction for the bad debt. If at any stage Mr F receives payment of any part of the 55 cents in the dollar written off, Mr F must:

- Include it as income in the income tax return for the year in which it is received (this will give rise to an income tax liability unless there are losses to offset against it, and may give rise to a provisional tax liability, depending on the taxpayer's circumstances); and
- Account for GST on the amount recovered in the same proportion as Mr F was allowed a deduction from output tax when the bad debt was written off.

Application of legislation - Debt must be "written off"

The Income Tax Act and the GST Act allow taxpayers and/or registered persons deductions for bad debts written off. It is not enough that a debt is bad, the bad debt must also be written off. Writing off the bad debt is important because this will fix the time at which the deduction can be made. Note that there is no requirement that a debt be written off in the year it becomes bad. As Justice Tompkins in the High Court decision of *Budget Rent A Car Ltd v CIR* (supra) on page 12,271 stated:

> A debt is not normally deductible. It does not become a deductible debt if and when it becomes a bad debt. It becomes a deductible debt, if it has been incurred in the production of assessable income, when it is written off. It is the writing off that converts the debt into a deductible debt. It follows that the crucial time is the time of the writing off, not the time the debt becomes a bad debt. It also follows that the income year referred to in s 106(1)(b) is not the year the debt became bad. In my view, the income year referred to is the year during which the bad debt was "actually written off".
>
> There is no provision in the Act that requires the bad debt to be written off in the year the debt became bad. Had that been the intention of the legislature, it would have said so ...

Barber DJ in the Taxation Review Authority discussed the requirement to write off bad debts in *Case N69* (1991) 13 NZTC 3,541. Barber DJ said on page 3,547:

> I consider it elementary that the writing off of a debt as bad requires something more than the mere recognition by the taxpayer, or one or more of its executives, that a debt is unlikely to be paid. It could be reasoned that only a decision of the taxpayer to write off a debt is needed, subject to the debt being bad. However, I consider that, in terms of sec 106(1)(b), book-keeping steps must also be taken to record that the debt has been written off. Desirably, the steps would comprise a directors' resolution, if the taxpayer is a corporate, and appropriate book-keeping entries. However, it would be adequate for a responsible officer or executive of a corporate or business to merely make the appropriate book-keeping entries if he or she has that authority. An unincorporated sole trader or small unincorporated business would not, of course, have a directorate so that book entries by the trader or his or her manager will suffice. In my view, it is not possible to write off a debt as bad without the making of authorised journal entries in the books of account of the business.

In all cases, taxpayers must be able to clearly show that a bad debt has been written off. In cases where debtors ledgers are maintained, the writing-off will be able to be clearly shown by the appropriate book-keeping entries having been made in the debtors ledger by authorised persons. In cases where debtors ledgers are not maintained (generally where the business operations are small and the accounting systems unsophisticated), other action must be taken that shows that the business systems treat the debt as bad.

In all cases the business records kept by the taxpayer must comply with the requirements of section 22 of the Tax Administration Act 1994 and section 75 of the GST Act.

The necessary writing-off must take place before the end of the income year or GST taxable period in which the bad debt deduction is claimed. Sometimes it may be difficult from a practical point of view to make all the necessary accounting entries before the end of the income year or GST taxable period. It is, therefore, important to review all debts before the end of an income year or GST taxable period to ensure that any bad debts can be deducted in that year or GST taxable period. Writing-off cannot be back dated. The writing-off must be in the income year or GST taxable period for which the bad debt is claimed.

Accounts kept by taxpayers

Most taxpayers in business keep double-entry accounts. If a person keeps double-entry accounting records, the bad debt must be struck out of the records on which the double-entry accounts are based. Generally, this means that the balance in the debtors ledger for the individual debtor must be reduced by the amount of the bad debt.

In cases where a taxpayer does not keep double-entry accounting records and/or does not keep a debtors ledger, the person must write the debt off according to the form of records used. This means that however the person records the debt owing, the record showing the amount owed by the bad debtor must illustrate that the creditor has no reasonable expectation of getting payment for the amount of the bad debt.

For example, if the only record of debtors is a copy invoice book, it is acceptable to write across the copy invoice "BAD DEBT", with the date and a brief note of the reason (e.g. "Bankruptcy notice in newspaper").

Keeping records for credit control or other purposes

For a variety of reasons, a creditor may keep a separate record of bad debts written off. For example, the records may be necessary if the creditor should ever have the opportunity of collecting the debt in the future, or the creditor may want to keep a record of problem customers to avoid future difficulties.

As long as these records are quite separate from the accounting base records they will not affect the write-off. If the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off.

More than one set of accounts

Some businesses have more than one set of accounts. For example, a company may prepare:

- Financial accounts for financial reporting purposes to satisfy the requirements of the Companies Act 1955 or 1993; and
- Management accounts as a basis for management decision-making and control.

The sets of accounts may be prepared in quite different ways. For example, there are statutory requirements set

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out in the Financial Reporting Act 1993 for preparing financial reports that are not required when preparing management accounts; and management accounts may be prepared on the basis of estimates for some elements in order to provide very quick reports.

When the different sets of accounts rely on the same underlying debtor records, there is no problem. As long as the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off. However, if the debt is still recognised as an asset in the underlying records, it is not written off.

If the different sets of accounts rely on different underlying debtor records (which is very rare), the creditor should refer to the accounts that are relied on to represent the firm's financial position. For a company, these will be the accounts that are used to satisfy the company's financial reporting obligations under the relevant Companies Act.

Examples of when a bad debt is/is not written off

These examples do not form part of the ruling.

General facts

The following facts apply to all the examples:

- The taxpayer's income tax balance date is 31 March.
- The only question relates to whether a debt has been written off. All other criteria are satisfied.
- The debt is for goods and services supplied for money.
- The supply has been included in the taxpayer's assessable income for income tax purposes.

In the examples where the taxpayer is registered for GST purposes, the following additional facts apply:

- The taxpayer files GST returns on a two-monthly invoice basis.
- The supply has been included in a GST return.

Example 1

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is written up on 31 March 1995. The entries written up include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 1995.

Example 2

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is written up on 1 April 1995. The entries written up include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 1996.

Example 3

The taxpayer does not maintain a debtors ledger and is registered for GST. There is no indication on her underlying debtor records to show the status of the debt. She has claimed a deduction from output tax for the bad debt in her GST return for the taxable period ending 31 January 1996. That return was prepared in February 1996.

The taxpayer is not entitled to the deduction from GST output tax. She is not allowed a deduction for the bad debt in the income year ending 31 March 1996. Claiming the deduction from output tax for GST purposes is not a sufficient writing-off of the bad debt.

Example 4

The taxpayer does not maintain a debtors ledger and is not registered for GST. The taxpayer's only records of debts owing to her are copies of invoices she has issued. She has placed the invoice for the debt in question in a file marked "BAD DEBTS" in February 1996.

The taxpayer is allowed a deduction for the bad debt in the year ending 31 March 1996.

Example 5

The taxpayer maintains a debtors ledger and is not registered for GST. She wrote up the debtors ledger on 31 March 1995. The entries written up include a journal entry writing off a bad debt. The taxpayer's accountant prepares her accounts in June 1995. In the course of preparing the accounts, the accountant makes a general ledger entry recognising the bad debt as a result of the debtors ledger entry made by the taxpayer on 31 March 1995.

The bad debt is deductible in the year ending 31 March 1995. That is because the underlying accounting record of the debt was altered to recognise the bad debt on 31 March 1995.

Example 6

The taxpayer does not maintain a debtors ledger and is not registered for GST. Her only records of debts owing are copies of invoices issued. On 15 March 1995 she placed the invoice for the debt in question in a file marked "BAD DEBTS". The amount of trade creditors in the taxpayer's balance sheet as at 31 March 1996 includes the bad debt. The taxpayer's profit and loss statement for the year ending 31 March 1996 includes as income the sale that has become a bad debt. The profit and loss statement does not recognise any expense for bad or doubtful debts.

The taxpayer's income tax return for the year ending 31 March 1996 includes the profit and loss statement and a "tax reconciliation statement" showing the difference between the accounting

income and the amount she believes to be income for income tax purposes. The tax reconciliation statement includes a deduction for the bad debt.

The taxpayer is not allowed a deduction for the bad debt. Although the debt has been written off in the underlying accounting records, she has not ceased to recognise the debt as an asset for accounting purposes.

Example 7

The taxpayer does not maintain a debtors ledger and is not registered for GST. His only records of debts owing are copies of invoices and statements issued. In February 1996 the taxpayer became aware that a debt was bad. He stopped sending out statements for the debt and took no other action on it. In particular, he sent out no statements on the account in February and March 1996. The taxpayer continued to send out statements on all the other debts owing, including overdue accounts. The taxpayer keeps carbon copies of the statements of account in the duplicate account book from which the statements for issue are prepared. The taxpayer has tagged the final statement sent out in respect of the debt, marking it "bad debt".

The taxpayer is allowed a deduction for the bad debt in the year ending 31 March 1996. The cessation of statements of account, recorded by their absence in the duplicate account book, and the tagging of the final statement amounts to writing off the debt in his accounting system.

National Insurance Life and Health Limited's Executive Income Protection Agreed Value Contract

Product ruling - BR Prd 95/15

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

Taxation law

This ruling applies in respect of sections BB 4, BB 7, BB 8 (c), and CB 5 (1)(h) of the Income Tax Act 1994.

Arrangement to which this ruling applies

This ruling applies to an insurance product known as an Executive Income Protection Agreed Value Contract ("Agreed Value Contract") issued by National Insurance Life & Health Limited.

Assumptions

This ruling is based on the assumptions that:

- The Agreed Value Contract is taken out by an individual and provides cover for that individual.
- The terms and conditions of the Agreed Value Contract are contained in the policy document Income Insurance Policy Executive Protection.

The Income Insurance Policy Executive Protection contains defined terms. Where those defined terms are used in this ruling they have the same meaning.

The period for which this ruling applies

This ruling applies from 1 November 1994 to 31 March 1998.

The ruling

A. Agreed Value Contract

Based on the assumptions stated above, under an Agreed Value Contract where the Insured Person has not contracted for any of the Optional Benefits:

- Any benefit received by the Insured Person under the Agreed Value Contract by way of the Partial Disability Benefit will be assessable in the hands of the Insured Person under section BB 4:

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- The portion of premium paid by the Insured Person under the Agreed Value Contract for the Partial Disability Benefit will be deductible from the income of the Insured Person under section BB 7:
- The Waiver of Premium Benefit has no income tax consequences:
- All other benefits received by the Insured Person under the Agreed Value Contract will be exempt from income tax under section CB 5 (1)(h):
- All other premiums paid by the Insured Person under the Agreed Value Contract will not be deductible from the income of the Insured Person under section BB 8 (c).

B. Agreed Value Contract Optional Benefits

Based on the assumptions stated above, under an Agreed Value Contract where the Insured Person has contracted for any of the Optional Benefits:

- Any benefit received by the Insured Person under the Agreed Value Contract by way of the Lump Sum Benefit, Serious Care Benefit, or Business Expenses Benefit will be exempt from income tax under section CB 5 (1)(h):
- The portion of premium paid by the Insured Person under the Agreed Value Contract for the Lump Sum Benefit, Serious Care Benefit, or Business Expenses Benefit will not be deductible from the income of the Insured Person under section BB 8 (c):
- Any benefit received by the Insured Person under the Agreed Value Contract by way of the Premium Payback Benefit will not be assessable income under section BB 4:
- The portion of premium paid by the Insured Person under the Agreed Value Contract for the Premium Payback Benefit will not be deductible from the income of the Insured Person under section BB 7:
- Any benefit received by the Insured Person under the Agreed Value Contract by way of the Redundancy Benefit will be assessable in the hands of the Insured Person under section BB 4:
- The portion of premium paid by the Insured Person under the Agreed Value Contract for the Redundancy Benefit will be deductible from the income of the Insured Person under section BB 7.

Signed

Simon Sherry
Rulings

Analysis of product ruling BR Prd 95/15

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

All legislative references are to the Income Tax Act 1994.

Background

A ruling has been sought on the assessability of benefits and the deductibility of premiums under National Insurance Life & Health Limited's Agreed Value Contract.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 4	65(2)
BB 7	104
BB 8 (c)	106(1)(k)
CB 5 (1)(h)	61(40)

Without in any way limiting the meaning of the term, section BB 4 deems a number of items to be assessable income unless expressly excluded by the Act.

Section BB 7 states that:

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.

Section BB 8 provides that notwithstanding anything in section BB 7, no deduction (except as expressly provided in the Act) can be made in respect of:

(c) Any expenditure or loss to the extent to which it is incurred in gaining or producing income which is exempt from income tax:

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:

Agreed Value Contract (where no optional benefits are contracted for)

Monthly Benefit

A benefit received under a personal sickness or accident ("PSA") policy is exempt from income tax under section CB 5 (1)(h), and premiums paid for a PSA policy are non-deductible under section BB 8 (c).

A PSA policy is a policy that provides for payment of a sum or sums specified in the insurance policy and which is payable if the insured person is incapacitated as a result of an accident or sickness.

National Insurance Life & Health Limited's Monthly Benefit is specified in the Policy Summary and is not calculated according to loss of earnings or profits ("LOE"). Therefore, the Agreed Value Contract is a PSA policy of insurance. The benefits payable under the policy (the Monthly Benefit, Hospital Benefit, Recurrent Disability Benefit, and Inflation Protection Benefit) are PSA benefits.

Partial Disability Benefit

A LOE benefit is calculated with reference to income lost by the insured as a result of incapacitation.

National Insurance Life & Health Limited's Partial Disability Benefit is calculated with reference to the Insured Person's pre-disability monthly income. The Partial Disability Benefit is calculated with reference to earnings or profits lost by the Insured Person. Therefore, the Partial Disability Benefit is a LOE benefit and is assessable income in the hands of the Insured Person under section BB 4.

The premiums paid by the Insured Person for the Partial Disability Benefit will be deductible from the income of the Insured Person under section BB 7.

Waiver of Premium Benefit

The Commissioner's policy *Personal sickness or accident insurance policies and loss of earnings insurance policies (individual policies only)* in TIB Volume Six, No. 4 (October 1994) states that an insurance policy may provide that premiums do not have to be paid during incapacity. The Commissioner's policy is that this benefit does not have income tax consequences. It is simply a reduction of a private expense and does not give rise to income.

Agreed Value Contract Optional Benefits

Lump Sum Benefit

The Lump Sum Benefit is the payment of the Monthly Benefit. As discussed above the Monthly Benefit is a PSA benefit. Therefore, the Lump Sum Benefit is a PSA benefit.

Any benefit received by way of the Lump Sum Benefit will be exempt from income tax under section CB 5 (1)(h). The portion of premium paid for the Lump Sum Benefit will not be deductible from the income of the Insured Person under section BB 8 (c).

Serious Care Benefit

The Serious Care Benefit is the payment of the Monthly Benefit shown in the Policy Schedule. The Monthly Benefit shown in the Policy Schedule is a PSA benefit. Therefore, the Serious Care Benefit is a PSA benefit.

Any benefit received by way of the Serious Care Benefit will be exempt from income tax under section CB 5 (1)(h). The portion of premium paid for the Serious Care Benefit will not be deductible from the income of the Insured Person under section BB 8 (c).

Business Expenses Benefit

The Business Expenses Benefit is paid where the Insured Person is unable to work in his or her usual occupation due to Illness. The Business Expenses Benefit is a monthly benefit paid in respect of Business Expenses, the proof of which or payment of which has been supplied to National Insurance Life & Health Limited to its satisfaction. The total amount of Business Expenses that National Insurance Life & Health Limited will be liable for in any month will not exceed the amount specified in the Policy Schedule.

Where the Agreed Value Contract is taken out by an individual and provides cover for that individual, the Business Expenses Benefit is derived in respect of a period of incapacity for work and the payment is not calculated according to loss of earnings or profits. Therefore, the Business Expenses Benefit is a PSA benefit which is exempt from income tax under section CB 5 (1)(h). The premiums paid for the Business Expense Benefit will not be deductible from the income of the Insured Person under section BB 8 (c).

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Premium Payback Benefit

The Premium Payback Benefit is not assessable income in the hands of the Insured Person under section BB 4.

The Premium Payback Benefit is not income according to ordinary concepts and usages. Whether or not a particular receipt is income depends on its quality in the hands of the recipient (see *Reid v CIR* (1985) 7 NZTC 5,176 at 5,183). The Premium Payback Benefit does not have the character of income in the hands of the Insured Person.

The portion of premium paid for the Premium Payback Benefit will not be deductible from the income of the Insured Person under section BB 7.

Redundancy Benefit

National Insurance Life & Health Limited's Redundancy Benefit is calculated with reference to the Insured Person's pre-disability monthly income. The Redundancy Benefit is calculated with reference to earnings or profits lost by the Insured Person. Therefore, the Redundancy Benefit is a LOE benefit and is assessable income in the hands of the Insured Person under section BB 4.

The premiums paid by the Insured Person for the Redundancy Benefit will be deductible from the income of the Insured Person under section BB 7.

National Insurance Life and Health Ltd's Executive Income Protection Indemnity Value Contract

Product ruling - BR Prd 96/1

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

Taxation law

This ruling applies in respect of sections BB 4, BB 7, BB 8 (c), and CB 5 (1)(h) of the Income Tax Act 1994.

Arrangement to which this ruling applies

This ruling applies to the Lump Sum Benefit, Business Expenses Benefit, Premium Payback Benefit, and Waiver of Premium Benefit provided for in the Executive Income Protection Indemnity Value Contract ("Indemnity Value Contract") issued by National Insurance Life & Health Limited.

Assumptions

This ruling is based on the assumptions that:

- The Indemnity Value Contract is taken out by an individual and provides cover for that individual.
- The terms and conditions of the Indemnity Value Contract are contained in the policy document Income Insurance Policy Executive Protection.

The Income Insurance Policy Executive Protection contains defined terms. Where those defined terms are used in this ruling they have the same meaning.

The period for which this ruling applies

This ruling applies to:

- existing policies renewed on the anniversary after 1 November 1994; and
- new policies written after 1 November 1994,

to 31 March 1998.

The ruling

Based on the assumptions stated above, under an Indemnity Value Contract:

- Any benefit received by the Insured Person under the Indemnity Value Contract by way of the Lump Sum Benefit will be assessable in the hands of the Insured Person under section BB 4:
- The portion of premium paid by the Insured Person under the Indemnity Value Contract for the Lump Sum Benefit will be deductible from the income of the Insured Person under section BB 7:
- Any benefit received by the Insured Person under the Indemnity Value Contract by way of the Business Expenses Benefit will be exempt from income tax under section CB 5 (1)(h):
- The portion of premium paid by the Insured Person under the Indemnity Value Contract for the Business Expenses Benefit will not be deductible from the income of the Insured Person under section BB 8 (c):
- Any benefit received by the Insured Person under the Indemnity Value Contract by way of the Premium Payback Benefit will not be assessable income under section BB 4:
- The portion of premium paid by the Insured Person under the Indemnity Value Contract for the Premium Payback Benefit will not be deductible from the income of the Insured Person under section BB 7:
- The Waiver of Premium Benefit has no tax consequences.

Signed

Martin Smith
General Manager (Adjudication & Rulings)

Analysis of product ruling BR Prd 96/1

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

All legislative references are to the Income Tax Act 1994.

Background

A ruling has been sought on whether the Lump Sum Benefit, Business Expenses Benefit, Premium Payback Benefit, and Waiver of Premium Benefit under National Insurance Life & Health Limited's Executive Income Protection Indemnity Value Contract are assessable in the hands of the Insured Person, and whether the premiums paid for the benefits are deductible from the income of the Insured Person.

Legislation

Cross-reference table

Income Tax Act 1994	Income Tax Act 1976
BB 4	65(2)
BB 7	104
BB 8 (c)	106(1)(k)
CB 5 (1)(h)	61(40)

Without in any way limiting the meaning of the term, section BB 4 deems a number of items to be assessable income unless expressly excluded by the Act.

Section BB 7 states that:

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.

Section BB 8 provides that notwithstanding anything in section BB 7, no deduction (except as expressly provided in the Act) can be made in respect of:

(c) Any expenditure or loss to the extent to which it is incurred in gaining or producing income which is exempt from income tax:

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

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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:

Indemnity Value Contract

Lump Sum Benefit

Income received under a loss of earnings ("LOE") policy is assessable and the premiums are deductible. LOE policies are policies which provide for benefits calculated with reference to income lost by the insured as a result of incapacitation. National Insurance Life & Health Limited's Monthly Benefit is calculated with reference to earnings or profits lost by the Insured Person. Therefore, the Monthly Benefit is a LOE benefit.

The Lump Sum Benefit is the payment of 100 times the Monthly Benefit. The Lump Sum Benefit indemnifies the Insured Person for loss of earnings or profits. The benefit is calculated with reference to the income lost by the insured as a result of incapacitation.

Any benefit received by way of the Lump Sum Benefit will be assessable in the hands of the Insured Person under section BB 4. The portion of premium paid for the Lump Sum Benefit will be deductible from the income of the Insured Person under section BB 7.

Business Expenses Benefit

The Business Expenses Benefit is paid where the Insured Person is unable to work in his or her usual occupation due to illness. The Business Expenses Benefit is a monthly benefit paid in respect of Business Expenses, the proof of which or payment of which has been supplied to National Insurance Life & Health Limited to their satisfaction. The total amount of Business Expenses that National Insurance Life & Health Limited will be liable for in any month will not exceed the amount specified in the Policy Schedule.

Where the Indemnity Value Contract is taken out by an individual and provides cover for that individual, the Business Expenses Benefit is derived in respect of a period of incapacity for work and the payment is not calculated according to loss of earnings or profits. To the extent that the benefit is income, the Business Expenses Benefit is a personal sickness or accident benefit which is exempt from income tax under section CB 5 (1)(h). The premiums paid for the Business Expenses Benefit will not be deductible from the income of the Insured Person under section BB 8 (c).

Premium Payback Benefit

The Premium Payback Benefit is not assessable income in the hands of the Insured Person under section BB 4.

The Premium Payback Benefit is not income according to ordinary concepts and usages. Whether or not a particular receipt is income depends on its quality in the hands of the recipient (see *Reid v CIR* (1985) 7 NZTC 5,176 at 5,183). The Premium Payback Benefit does not have the character of income in the hands of the Insured Person.

The portion of premium paid for the Premium Payback Benefit will not be deductible from the income of the Insured Person under section BB 7.

Waiver of Premium Benefit

The Commissioner's policy on *Personal sickness or accident insurance policies and loss of earnings insurance policies (individual policies only)* in TIB Volume Six, No. 4 (October 1994) states that an insurance policy may provide that premiums do not have to be paid during incapacity. This benefit does not have income tax consequences. It is simply a reduction of a private expense and does not give rise to income, i.e., the benefit is not assessable income and the portion of premium paid for the Waiver of Premium Benefit is not deductible.

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.

Motor vehicle reimbursing rates

This item reproduces an item that appeared in the February 1996 issue of "Tax Update", the Employers' Newsletter, and also contains additional information under the heading "Further comment".

Inland Revenue mileage rates

In our July 1995 issue of "Tax Update" we introduced the new motor vehicle reimbursing rates that employers could use to reimburse employees for the work related use of private motor vehicles. These rates were to apply from 1 August 1995. However, in our September issue we told you that certain employers could delay using the rates until 1 April 1996.

Since then we have received a number of comments and suggestions on the rates. After considering these and consulting various organisations we have agreed to amend them. They now include an interest component based on a loan at 50% of the average purchase price of a motor car, being the estimated amount borrowed for motor vehicle purchases. The term of the loan is for a period of three years at the FBT interest rate (currently 10.6%).

The following rates will apply from 1 April 1996. Shareholder-employees and self-employed people can use these rates up to a maximum of 5,000 km of work related travel per year.

Standard rates

These rates are the Inland Revenue mileage rates introduced in August 1995 with the new interest component added.

Motor vehicles annual work related kms

1 to 3,000 km	62 cents per km (previously 56 cents)
3,001 km and over	19 cents for each km over 3,000 (running costs - same as previously)
Motor vehicles - flat rate	28 cents per km (previously 26 cents)

Motor cycles annual work related kms

1 to 3,000 km	31 cents per km (previously 28 cents)
3,001 km and over	10 cents for each km over 3,000 (running costs - same as previously)
Motor cycles - flat rate	14.5 cents per km (previously 14 cents)

Flat rate formula

The rates for motor cars are based on an average total running of 15,000 kilometres per annum (12,000 private running and 3,000 kms work related). The flat rate of 28 cents per kilometre has been calculated as follows:

3,000 kms x 62 cents =	$1,860	
12,000 kms x 19 cents =	$2,280	
	$4,140	÷ 15,000 kms
		= 27.6 cents

Rounded to 28 cents per kilometre

You can use average rates with this formula to suit your particular circumstances. That way you won't have to keep accumulative records for each employee.

Example

A number of employees travel close to 10,000 work related kilometres per year on average. The flat rate their employer could use for all those employees would be:

3,000 kms x 62 cents =	$1,860	
7,000 kms x 19 cents =	$1,330	
	$3,190	÷ 10,000 kms
		= 31.9 cents

Rounded to 32 cents per kilometre

Individual special rates

Many people felt that the standard rates did not adequately compensate those employees who used their vehicles almost exclusively for work purposes or who travel considerable distances each year. To take these

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employees into account we have developed the individual special rate formula. This method allows fixed costs such as depreciation, interest, insurance, and registration to be better apportioned to work related travel. The data used to calculate the standard rates were split into the Automobile Association's cc rating bands in order to calculate the individual special rate. The appropriate average fixed costs are divided by the total estimated annual travel (both work related and private) and the result is added to the running costs.

As with the new rules on allowances which came into effect from 1 April 1995, you do not need our prior approval if you want to calculate reimbursement using the individual special rates.

The fixed and running costs are as follows:

cc rating	Fixed costs (total)	Running costs (cents per km)
Up to 1,300 cc	$4,214	16.7c
1,301 - 1,600 cc	$4,507	17.2c
1,601 - 2,000 cc	$5,475	19.1c
over 2,000 cc	$6,308	22.2c

The calculation of an individual special rate would be as follows.

Example 1

An employee uses a 2,500 cc car, and travels on average 52,000 kms per annum for both work related and private running.

Annual running:

Fixed costs of $6,308 / 52,000 km	=	12.13 cents per km
Plus running costs		22.20 cents per km
Individual special rate	=	34.33 cents per km

Rounded to 35 cents for each kilometre of work related travel.

The advantage of using this method is that you only use the flat rate for work related travel. It also benefits those who use a vehicle almost exclusively for work purposes.

Example 2

A pizza delivery driver uses his own 1,500 cc car entirely for the job. The only private running is from home to place of work which amounts to 1,000 km per year. He estimates that the work related travel will amount to 12,000 km for the year. The calculation of the individual special rate is:

Annual running:

Fixed costs of $4,507 / 13,000 km	=	34.66 cents per km
Plus running costs		17.02 cents per km
Individual special rate	=	51.68 cents per km

The employee can be reimbursed at a rate of 52 cents for each work related kilometre.

Averaging

You can calculate average individual special rates to suit groups of employees rather than calculate a special rate for each employee. The special rates can be different for separate groups of employees of the same employer.

Example

Office staff of an employer could be reimbursed using the standard rate. The sales staff could be reimbursed using a special rate calculated as in the above examples, but using the average annual travel of the salespersons instead of the individual annual kilometres.

Employees can also be grouped according to the similarities of the work related distances they travel, e.g. rural and urban salespersons can have separate rates.

Periodic changes to adjusted flat rates and special rates

From time to time circumstances will change that will affect the reimbursement rates being made to employees. These rates will be relatively simple to adjust as these changes occur. There will be some risk in making estimates at the beginning of each income year, but as the year progresses the kilometres travelled can be monitored and changes made as necessary.

However, once a rate has been set for an individual or group, that rate can continue as long as there are no significant changes in expenditure or circumstances in which the vehicle(s) are used.

Reimbursing actual expenditure

Instead of using any of the three alternatives discussed above, an employee's actual expenditure can be reimbursed. If you do this you must make sure that both you and your employee keep accurate records, including details of private and work related expenditure to justify the reimbursements.

If you want to know more about these rates contact your local Inland Revenue office.

Further comment

This is to clarify the paragraph in the item on periodic changes to any of the rates.

Regardless of whether the employer uses the adjusted flat rates, the individual special rates, or reimburses using actual expenditure, we do not expect the employer to change those rates unless there are significant changes either in expenditure or in the circumstances under which the rates were set in the first instance.

This will be especially so where the rate applies to a group of employees.

We accept that some costs or expenditure in the initial years of car ownership reduce over a period of time, but these are offset by increases in other costs. For example, depreciation and interest charges decrease while repairs

and maintenance costs increase. Changes to these costs are not considered to be "significant" in the context of the above paragraph.

Significant change could be the reduction in total annual distance travelled by an individual employee. For example, if a salesperson is promoted to sales manager and the travel for work related purposes reduces considerably. In this case we would expect the rates to be recalculated or the employee to move to the standard rate.

Review of rates

Inland Revenue intends to monitor motor vehicle rates on an annual basis, but we will publish changes to the rates only when there is a significant change in costs. It may well be that the rates announced in the February 1996 "Tax Update" will not be changed for a number of years. We do not expect to announce new rates every year.

Vehicle logbooks - required content and quality

Summary

This item explains the required content and quality of logbooks kept to establish the business use of a motor vehicle. It is an expansion of the commentary in TIB Volume Six, No.3 (September 1994).

Taxpayers who use a vehicle for both business and private purposes can keep a logbook to establish the proportion of business use. The logbook is generally kept for a 90 day test period every three years.

Inland Revenue has noted that logbooks maintained by many taxpayers do not record the required details or are of poor quality. If a logbook does not record the required details or is of poor quality the Commissioner may ask for a new logbook to be kept.

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

Background

Taxpayers who use a vehicle for business and private purposes usually record details of vehicle use in a logbook. The logbook establishes the proportion of business to private use. This proportion may be used for these purposes:

- to apportion vehicle running costs and depreciation for income tax
- to determine whether a vehicle is used principally in the making of taxable supplies for GST
- to calculate private use adjustments for GST
- in some cases, to determine the number of days each quarter the vehicle is available for private use and enjoyment for FBT purposes.

Logbooks are maintained for a three month test period. The proportion of business use established during that test period is then applied for three years, the logbook application period. TIB Volume Six, No.3 (September 1994) discusses these aspects of logbooks in more detail.

Inland Revenue has noted that many taxpayers, although maintaining a logbook, do not record the required details. In addition many logbooks are illegible or incomplete.

When reviewing a logbook the Commissioner must be satisfied that the business use proportion established by the logbook during the three month logbook test period is representative of the three year logbook application period. If the logbook is incomplete, illegible or does not record the required details the Commissioner cannot form such an opinion. In these circumstances the Commissioner has the discretion to either require another logbook to be maintained for another 90 day period; or to deem the taxpayer not to have maintained a logbook for the three year logbook application period.

The effects of not maintaining an adequate logbook could include:

- being required to maintain another logbook for three months
- having income tax deductions for running costs and depreciation limited to 25%
- having GST input tax claims for the purchase of motor vehicles disallowed or delayed for three months
- having FBT assessed as if the vehicle was available for private use and enjoyment on every day.

Minimum logbook requirements

Section DH 3 (2) requires that a logbook meets these conditions:

- It is kept for a period of not less than 90 consecutive days
- It records complete and accurate details of the reasons for and the distance of journeys undertaken for business purposes, and such other details as required by the Commissioner.
- It records the total distance travelled by the motor vehicle during the period the logbook is maintained.

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- It is kept for a period that represents or is likely to represent the average business and private use of that vehicle over the three year logbook application period.

Inland Revenue requires that the following information be recorded in a logbook, in a legible and understandable format:

- the start date of the 90 day logbook test period
- the odometer reading at the start of the 90 day logbook test period
- the date of each business journey
- the starting odometer reading for each business journey
- the ending odometer reading for each business journey
- the origin and destination of each business journey
- the reason for each business journey
- the time of each business journey when the use of the vehicle is subject to time constraints (for example under a business hours (sometimes known as a nine to five) lease);
- the end date of the 90 day log book test period
- the odometer reading at the end of the 90 day logbook test period.

Example one at the end of this item is a logbook containing this information.

(Continued in opposite column)

Alternatively logbooks can record all journeys (business and private), whether the journey was business or private and just record the starting or ending odometer reading for each journey rather than both. Example two at the end of this item is a partial logbook containing this information.

Inland Revenue expects that most business journeys recorded in logbooks can be cross referenced to other records, such as diaries, appointment books, quotes, invoices etc. Cross references of this type allow Inland Revenue to verify logbook entries.

Inland Revenue does not require that logbooks be kept in any particular format. The examples in this item use a columnar format, but the required details could be recorded in a diary, in a daybook, on quote or order forms etc. Whatever format is used Inland Revenue must be satisfied that the records are complete and accurate and that the required details have been kept.

At the end of the 90 day logbook test period the following calculation should be performed to determine the business use percentage for the vehicle:

$$\text{business use percentage} = \frac{\text{total business distance travelled}}{\text{total distance travelled}}$$

Inland Revenue expects the totals used in this calculation to be easily reconciled with the entries in the logbook.

Example one

Vehicle Logbook

Vehicle description: Ford Fairmont
Vehicle registration number: XX1234

Date	Time	Starting kms	Ending kms	Difference	Origin/destination	Reason
1 Feb 96		65423				
10 Feb 96	9.08am	65423	65555	132	Office/Mr Hammer/Office	Quote
5 Mar 96	4.30pm	67345	67349	4	Office/Bank/Office	Banking
25 Mar 96	4.30pm	68216	68220	4	Office/Bank/Office	Banking
5 Apr 96	8.30am	68250	68271	21	Office/Mrs Marsh/Office	Delivery
14 Apr 96	6.00am	68554	68963	409	Office/Rotorua	Industry conference
17 Apr 96	5.00pm	68972	69382	410	Rotorua/Office	Industry conference
30 Apr 96			70125	980		

Calculation of business use percentage:

$$\text{business use percentage} = \frac{\text{total business distance travelled}}{\text{total distance travelled}} = \frac{980}{(70125 - 65423)} = 20.84\%$$

Example two

Vehicle Logbook

Vehicle description: Mini
Vehicle registration number: XX1235

Date	Time	Starting kms	Difference	Business/ Private	Origin/destination	Reason
15 Mar 96		150265	0			
15 Mar 96	8.00am	150265	3	Private	Home/Office	
15 Mar 96	9.00am	150268	42	Business	Office/Airport/Office	Collect samples
15 Mar 96	12.05pm	150310	6	Private	Office/Home/Office	
15 Mar 96	2.00pm	150316	4	Business	Office/Bank/Office	Banking
15 Mar 96	2.30pm	150320	70	Business	Office/JT Ltd/Office	Deliver samples
15 Mar 96	4.45pm	150390	3	Private	Office/Home	
15 Mar 96	Ending	150393				

Calculation of business use percentage[1] :

$$\text{business use percentage} = \frac{\text{total business distance travelled}}{\text{total distance travelled}} = \frac{(42 + 4 + 70)}{(150393 - 150265)} = 90.6\%$$

1. Note: This logbook was only maintained for one day for illustrative purposes. Actual logbooks must be maintained for the 90 day logbook test period.

Questions we've been asked

This section of the TIB 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

Hotel licensee's licence application - deductibility

Section BB 7 (section 104, Income Tax Act 1976) - Expenditure or loss incurred in the production of assessable income: A hotel licensee has asked whether a tax deduction is available for an unsuccessful application for a special licence. The licensee regularly applies for special "one-off" licences. In the past, a deduction has been allowed for the costs incurred in making successful applications.

Section BB 7 allows a deduction for expenses incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for that purpose. Members of the liquor trade are required to make more or less regular appearances before the Licensing Control Commission, with legal representation, to apply for such things as special licences (such as a licence to trade on a specific Sunday or a late licence). As such costs are incurred in the course of business, the legal expenses that the licensee incurs are tax deductible, whether or not the Commission's decision on the application is favourable.

The above applies to an existing licence holder who incurs costs as part of the ongoing running of his or her business. The expenses incurred by a new entrant to the licensed trade for a new liquor licence are not tax deductible. Such costs are a capital expense, and a tax deduction is prohibited by section BB 8 (a) (section 106(1)(a), Income Tax Act 1976).

Farm lease payments - deduction for cottage

Section DD 1 (a) (section 106(1)(e), Income Tax Act 1976) - Certain deductions not permitted - rents: A full-time farmer leases the farm that he works from another party. The lease includes the use of a cottage which he uses as his residence. He has asked if a tax deduction is available for the whole lease payment.

Section BB 7 (section 104, Income Tax Act 1976) allows a general deduction for expenditure that is:

- incurred in gaining or producing assessable income; or
- necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

Section DD 1 (a) 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 the following sums or matters:
>
> (a) Rent of any dwellinghouse or domestic offices, save that, so far as any such dwellinghouse or offices are used in the production of the assessable income, the Commissioner may allow a deduction of such proportion of the rent as the Commissioner may think just and reasonable.

Therefore, the Act restricts any deduction for domestic rent to the proportion (if any) that relates to the production of assessable income.

This means that the farmer must first apportion the rent he pays between the farm and the cottage. The farm rent is completely deductible, but the cottage rent is only deductible to the extent that it relates to the production of assessable income. Rather than requiring a calculation to be made, the Commissioner's policy is to allow full-time farmers a deduction of 25% of the outgoings associated with a domestic dwelling that is situated on the farm property. This means that the farmer is able to claim a deduction of 25% of the rent that he pays for the farm cottage.

Depreciation - application fee for special economic rate

Section DJ 5 (section 165, Income Tax Act 1976) - Expenditure relating to determination of liability to tax: A taxpayer who was charged a fee by Inland Revenue when she applied for a special economic rate of depreciation has asked if the fee is a deductible expense.

Section DJ 5 states:

> ... the Commissioner shall allow a deduction in respect of any expenditure incurred by the taxpayer during that income year in connection with -
>
> (a) The calculation or determination of the assessable income of the taxpayer for any income year.

The expenses covered by this section include legal fees and accounting fees.

Inland Revenue considers that the taxpayer's costs associated with applying for a special rate of depreciation have been incurred in determining her assessable income. We therefore told her that the fee was a deductible expense.

Stockyard roof - depreciation

Section DO 4 (section 127, Income Tax Act 1976) - Expenditure on land improvements used for farming or agriculture: A farmer has added a roof, built of permanent materials, to a portion of her stockyards. She has asked how this additional item is dealt with for depreciation purposes.

Under section DO 4, a taxpayer is entitled to a deduction for expenditure incurred on land improvements used for farming or agriculture, except in the year the taxpayer sells or otherwise disposes of the land. The deduction is on a diminishing value basis at a rate set out in Part A of Schedule 7 (Thirteenth Schedule, Income Tax Act 1976). Under Part A of Schedule 7, the cost of construction on the land of structures for shelter purposes is deducted at a rate of 10 percent on the diminished value.

However, under section DO 4 (3), the percentage of diminished value is determined according to the year in which the expense is incurred. If the expense is incurred before the end of the 1995 tax year, the percentage of diminished value is 125 percent of the rate shown in Part A of Schedule 7, i.e. 12.5 percent. If the expense is incurred in the 1995-96 tax year, the percentage of diminished value is 120 percent of the rate shown, i.e. 12 percent.

The increased rates are applied to the diminished value each year unless the farm is sold.

Depreciation on buildings and chattels rented short-term

Section EG 1 (section 108, Income Tax Act 1976) - Annual depreciation deduction: A company looks after properties for people who go overseas for short periods of up to two years. It manages its clients' properties, collects rents, and

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files tax returns. The company has asked whether making a claim for depreciation is mandatory when the property is only let for a short period, and, if not, if there is any alternative to claiming depreciation.

Individuals renting out a property for a short period may not necessarily be in the business of providing rental accommodation. This means that returning rental income, particularly when a loss results, must be considered in the context of whether or not a business exists, and will be based on the facts of each case.

Under section EG 1 (1), when a taxpayer owns depreciable property, depreciation must be deducted from the total income in that year. Depreciation reflects the reduction in value of the asset that is occurring as the asset is used.

The Commissioner does not have a discretionary power to exempt any taxpayer from claiming depreciation. However, to reduce the compliance cost of claiming depreciation on each of a number of small assets, under section EG 3 (1)(c) (section 108B, Income Tax Act 1976), a taxpayer may elect to use the pool method of depreciation. Broadly, this allows assets acquired for not more than the “maximum pooling value”, i.e., $2,000 or a greater amount set by the Commissioner under section EG 11 (6) (section 108J, Income Tax Act 1976), (such as the chattels in this case) to be pooled and depreciated as one asset.

Although the person owning the property is absent from New Zealand, it is probable that he or she will remain a New Zealand resident for tax purposes. Before filing the client’s tax return, the company must establish the client’s tax residence. If the person remains a resident, the return will have to include not only rental income but that person’s world-wide income.

Child’s boarding expenses - whether housekeeper rebate can be claimed

Section KC 4 (section 54, Income Tax Act 1976) - Rebate in certain cases for housekeeper: A taxpayer has had to place his eight-year old daughter in a boarding school so that he can earn a living. He is aware that he cannot claim the school attendance fees against his income tax, but wonders if the boarding fees could be subject to the housekeeper rebate. The boarding fees can be readily identified from those charged for tuition.

Section KC 4 allows a rebate in certain circumstances for payments made for child care and/or home help for disabled persons. The circumstances in which the section applies are contained in the housekeeper definition in that section.

The term “housekeeper” for the purposes of the rebate when the care and control of a child is involved means any of the following:

- a person who exercises that care and control in the home of the taxpayer
- a person who does so elsewhere, outside of the home
- an institution as defined.

“Institution” means:

> ... any creche, day nursery, play centre, kindergarten, or similar body; but does not, in relation to the care and control of a child who is 5 years of age or over, include any institution which is, in any way, concerned with the education of the child.

“Child” means:

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

In this case, the taxpayer is not eligible for the housekeeper rebate because his daughter’s boarding school is not included in the definition of an “institution” which specifically excludes any institution concerned with the education of a child who is 5 years old or over.

Family Support - determining "family income" when Child Support paid or received

Section KD 1 (section 374B, Income Tax Act 1976) - Determination of assessable income: A taxpayer who is a liable parent for Child Support purposes has asked whether the Child Support payments he is required to make can be taken into account and deducted when calculating "family income " for Family Support purposes.

Briefly, the answer to this question is "yes", Child Support payments made by a liable parent can be deducted when calculating the family income for Family Support purposes.

Section KD 1 (1) states:

...Notwithstanding any other provision of this Act, for the purposes of this Subpart, in calculating under this Act the assessable income derived or in ascertaining the loss incurred by any person in any income year-

(a) Income of any of the kinds referred to in sections CB 1 (a), CB 1 (d), CB 5 (f), CB 9 (a), and CB 9 (d), derived by the person in the income year, shall be deemed not to be exempt from tax; and

(b) A deduction shall be allowed of -

(i) The amount of any payment, made by the person during the income year, of the kind referred to in section CB 9 (a); and ...

Section CB 9 (a) (section 61(15), Income Tax Act 1976) exempts from tax income derived by a person in the form of payments from alimony, maintenance, child support, or spousal maintenance.

Therefore, for the purposes of calculating any family support entitlement, any payments of child support made are deductible from the income derived by the person. Similarly any payments of child support received are included as income derived by the person.

In this case, the taxpayer was advised that he should deduct the child support payments he has made from the family income when he calculates his family support entitlement.

Goods and Services Tax Act 1985

Properties sold by High Court rating sale - GST

Section 5(2) - Goods sold in satisfaction of a debt: A local authority has brought High Court proceedings in order to conduct rating sales for the recovery of rates arrears. Of the properties concerned, two are dwellings on sections and two are sections only. A council representative has asked for the GST implication of these auction sales.

Under section 5(2) when goods are taken by a creditor and sold to satisfy the debts of the former owner, the goods are deemed to be supplied in the course or furtherance of a taxable activity conducted by the former owner who is deemed to be a registered person. GST is therefore payable by any purchaser of the goods, unless one of the following has occurred:

- The person whose goods were sold (the debtor) has provided the creditor with a statement, in writing, to the effect that the sale would not have been a taxable supply if the sale had been conducted by the debtor, with the reasons why that is the case. For example, the debtor is not registered for GST and the sale is that of a private dwelling.

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- The person who seized the goods (the creditor) has not been able to obtain the written statement above, but has determined from "reasonable information held" that the supply of those goods would not have been a taxable supply.

In the Appendix to Tax Information Bulletin Volume One, No.8 (January 1990), Inland Revenue determined "reasonable information held" to be:

- Details of the customer's or borrower's GST status obtained by the retailer or financier from the person at the time he or she entered into the hire purchase agreement or loan, and whether the goods used as security form part of a taxable activity if the customer or borrower was registered. In addition, the documentation should also contain a covenant requiring the customer or borrower to advise the retailer or financier of any change in registration for GST.
- Information from the accountant, solicitor, neighbour of the person whose goods are sold, gained at the time of exercising the power of sale.

We advised the council representative that if the council was satisfied that the sales would not be a taxable supply, it need take no further action regarding GST.

However, if any sale were subject to GST, under section 17(1) the person selling the goods, i.e., the council, would be responsible for charging GST on the sale and accounting for it to Inland Revenue. To do this, the council would need to file a special GST return (GST 121 - Goods and Services Tax Return for Goods Sold in Satisfaction of Debt) and send it to Inland Revenue, along with the payment, by the last working day of the month following the month in which the sale was made. A separate return must be furnished for each person whose property is sold.

GST on supplies between flat-owning company and land owner

Section 14 - Exempt supplies: A GST registered flat-owning company collects maintenance and administration levies from residents, and passes on a high proportion of them as rent to the land owner. The company accounts for GST on the levies collected, but cannot claim input tax deductions on the portion paid out as rent. The company's representative considers this situation to be unfair and has asked if it is correct.

A flat-owning company is a company whose only significant asset is a residential property, and whose shareholders are entitled to use or occupy the property. Flat-owning companies receive income from subscriptions or levies imposed upon shareholders. This income is used to meet administration and management costs, as well as depreciation, repairs and maintenance, and other outgoings on the property. If the income from these subscriptions exceeds, or is likely to exceed, $30,000 in any twelve-month period, the flat-owning company must register for GST.

In this case, a large proportion of the levies collected by the flat-owning company is used to pay rent to the land owner. Section 14(ca) exempts from GST:

> 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.

As the rent is an exempt supply, no GST is charged by the land owner. Therefore, no input tax deduction is available to the flat-owning company.

Non-resident company - whether liable to register for GST

Section 51 - Persons making supplies in course of taxable activity to be registered: An Australian company operates a mail order service in Australia and plans to extend its operations in New Zealand. The company director has asked if the company will be required to register for GST purposes. All packaging of the products will be completed in Australia, and the products will be mailed direct from Australia.

Under section 51(1), a taxpayer is required to register for GST in either of the following situations:

- if the total value of supplies made in New Zealand in that month and the previous 11 months has exceeded $30,000
- if the total value of supplies made in New Zealand in that month and the next 11 months is likely to exceed $30,000.

For a non-resident supplier, the key issue is whether the goods or services are supplied in New Zealand.

Section 8(2) deems that goods and services are supplied in New Zealand if the supplier is resident in New Zealand. Goods and services are deemed to be supplied outside New Zealand if the supplier is not resident in New Zealand.

In some circumstances, supplies made by a non-resident are deemed to be made in New Zealand and subject to GST if either of the following conditions apply:

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

Under section 8(2)(b), a supply by a non-resident to a GST registered person in New Zealand is deemed to be supplied outside New Zealand, as long as the supply was for the New Zealand resident's taxable activity. Such a supply will not be liable for GST unless both the supplier and the recipient agree that the supply takes place in New Zealand.

In this case, the Australian company is not required to register for GST as the company's operations and services are physically performed outside New Zealand.

Legal decisions - case notes

This section of the TIB 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.

Transitional tax allowance (income under $9,880 rebate) - Education Officer's entitlement

Rating: •

Case: TRA No. 94/158

Act: Income Tax Act 1976 - section 50C (Income Tax Act 1994 - sections KC 3 and OB 1)

Keywords: *fulltime earner, remunerative work*

Summary: The Taxation Review Authority found as a fact that the taxpayer had been paid for at least 20 hours of work per week and was therefore entitled to a rebate under section 50C.

Facts: The taxpayer was a member of the Student Executive at a tertiary institution, where he was employed as an Education Officer. The taxpayer sought to claim the transitional tax allowance under section 50C for the income years 1992 and 1993. The Commissioner disputed that the taxpayer was entitled to the rebate on the grounds that the taxpayer did not work more than 20 hours per week in the relevant period.

The factual issue in the case was whether the objector was paid for 20 hours of work or more per week.

Decision: Judge Barber held that the objector was paid a lump sum each term for job performance as Education Officer on the basis of working at least 20 hours per week on the tasks and duties of that position. Accordingly, the objector was a fulltime earner and qualified for a rebate under section 50C.

Comment: Inland Revenue is not appealing this decision.

Valuation of property for property speculation tax

Rating: •

Case: B J R Fox v CIR HC Auckland M 925/95

Act: Property Speculation Tax Act 1973 - sections 6(1) and 7 (Act repealed 1979)

Keywords: *valuation, property speculation tax*

Summary: The taxpayer appealed the decision of the Taxation Review Authority upholding the Commissioner's assessment of the appellant for property speculation tax on the purchase and subsequent sale of a property. The appeal was rejected because the High Court declined to interfere with the TRA's factual assessment of the valuations of the property and there was no evidence presented to make different valuations from the TRA.

Facts: The appellant purchased property A in August 1975 for $30,000. In November 1975 the appellant entered into two agreements to swap property A for another property. Under one agreement, the appellant sold property A for $30,000 to a Mrs P. Under the second agreement, the appellant bought property B from Mrs P for $65,000. The Commissioner accepted the value of property A at the time of purchase was $30,000 but assessed the value of property A at the time of sale at $50,000. The taxpayer objected and a case was stated to the TRA.

The TRA held that the appellant was liable for property speculation tax on the net profit made on the sale of property A as assessed by the Commissioner. The Court upheld the Commissioner's assessment that the true value of property A at the time of sale was $50,000 and the value at the time of purchase was held to be $30,000. The basis for the valuation at the time of purchase was the value stated in the agreement for sale and purchase. The valuation at the time of sale was made by the TRA on the basis of evidence of other valuations which were different from the values in the agreements for sale and purchase.

The taxpayer appealed the decision of the TRA to the High Court. The taxpayer had three arguments:

- The Commissioner and the TRA had no power to adopt a higher valuation than the consideration actually received on the sale of the property.
- The Commissioner was obliged to adopt the course of valuation provided for in section 6.
- If the valuation by the Commissioner of property A at the time of sale at $50,000 was correct, then this valuation should have been applied to the purchase.

Decision: The High Court rejected all three of the appellant's arguments and held that the appellant was subject to property speculation tax as assessed by the Commissioner. In relation to the appellant's first argument, the Court held that it could not interfere with the factual determination of the TRA as to the value of the property at the time of sale.

The appellant's second argument was regarded by the Court as untenable because section 6(1) expressly states it is subject to section 7.

The Court rejected the appellant's third argument because there was no evidence presented to the Court to value the property at the time of purchase at other than the value of $30,000 assigned to the property in the agreement for sale and purchase.

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

GST input tax deduction allowed on farm house built for homestay accommodation

Rating: • • •

Case: TRA No. 92/176

Act: Goods and Services Tax Act 1985 - section 2

Keywords: *input tax, principal purpose, taxable activity*

Summary: The Taxation Review Authority found that the objector constructed a farmhouse for the principal purpose of providing farm homestay accommodation and was entitled to claim a GST input tax deduction for the construction costs of the building.

Facts: The objector is a farming partnership comprising three family trusts. The objector sought GST input tax deductions for the construction costs of a farmhouse built to provide farm homestay (holiday or tourist) accommodation. The objector was also developing the surrounding farm land to complement the farm homestay.

The Commissioner contended that the principal purpose for building the farmhouse was to provide private accommodation for the farmer and his family. The Commissioner also argued that the taxpayer was not conducting a taxable activity because there had been no actual homestay activity.

Decision: Judge Barber held that full input tax deductions were available. The principal purpose of building the farmhouse was to establish a homestay business and not to provide a residential home.

Judge Barber confirmed his observations in *Case S16* (1995) 17 NZTC 7,123 relating to the "principal purpose test":

- In ascertaining the taxpayer's principal purpose, the Court must make an overall assessment of what the taxpayer says was the intention at the relevant time, the evidence of the witnesses, and the so-called objective facts, particularly those relating to the use of the goods by the taxpayer.
- It is useful, and possibly determinative, to consider the taxpayer's use of the property in order to ascertain the principal purpose for which the taxpayer acquired the supply. "Purpose" and "use" are not the same concepts, but an objective consideration of "use" will help ascertain whether a good was acquired for the principal purpose of making taxable supplies.
- In ascertaining what is the principal use of real property, it is relevant to consider an area breakdown of the property - identifying the private, taxable (for making taxable supplies), and common purpose areas.

Judge Barber found that the farmhouse was built primarily to establish a farm homestay business and that more than 50 per cent of the building was available to the homestay business. This finding was made on the basis of attributing 50 percent of common areas to the homestay activity. The size, design and layout of the farmhouse were also related to the homestay purpose.

Although the farmer and his family needed to live somewhere and a substantial reason for building the house was to accommodate them, on the facts this purpose was consequential to the nature of the farming and farm homestay enterprises.

Judge Barber rejected the Commissioner's contention that the taxpayer had not commenced a taxable activity. In planning strategies for the homestay operation, preparing advertising material, and constructing accommodation, the objector may have commenced the taxable activity. In any event, the construction activity forms part of the objector's overall farming activity.

Comment: Inland Revenue is not appealing this decision.

GST - whether issuing a discount card is a financial service

Rating: • • • •

Case: TRA No. 95/11

Act: Goods and Services Tax Act 1985 - sections 3(1)(c), 3(1)(ka) and 6

Keywords: *financial services, debt security, input tax*

Summary: The objector's act of issuing a card that entitles the card holder to discounted meals at certain restaurants was not the supply of a financial service and therefore was not an exempt supply. Accordingly, the objector was entitled to register for GST and receive input tax deductions.

Facts: The objector company sells a card to members that enables the card holder to obtain a 50 per cent discount on the price of meals at certain restaurants. In return for the card, the card holder members pay the objector a fee plus 25 percent of the cost of meals eaten by members. The card holders are required to own a pre-arranged credit card and must agree to allow the objector to immediately debit the credit card with the cost of the meal incurred plus 25 per cent of that cost. The company also contracts to make payments of agreed sums of money to the restaurants involved in the scheme. While the restaurants receive only half the retail value of their meals, the restaurants benefit in receiving an advance payment for meals, they are left with no bad debts, and there is a prospect of enhanced business.

The Commissioner contended that the objector did not have a "taxable activity" as defined by section 6 because the objector is supplying financial services which are exempt from GST under sections 3(1)(c) and 3(1)(ka). The Commissioner contended that the objector was therefore not entitled to receive input tax deductions.

Decision: The TRA held that the objector was not supplying "financial services" to the card holders or the restaurants.

Judge Willy first considered whether the arrangements between the objector and the restaurants amounted to the supply of financial services in the form of a debt security. He looked at the analogous definition of a "debt security" in the Securities Act 1978.

Judge Willy held that the arrangements in this case were in the nature of a "debt security" but nevertheless did not amount to the supply of "financial services" under section 3(1)(c). The scheme was within the definition of a "debt security" because the objector had "a right to be paid money that is owing by any person." However, there were no "financial services" supplied because section 3(1)(c) is intended to refer to transactions such as the issue of stock or a debenture, and shares which can be negotiated, and did not apply to the simple debtor and creditor relationship that existed between the objector and the restaurants. Section 3(1)(ka) did not apply either because there was no debt security.

Judge Willy also considered whether the objector supplied financial services to the card holders. Judge Willy held that the transaction was not in the nature of a debt security because there was no loan between the objector and the card holder. Payments by the card holder to the objector were not payments under a loan but were payments for services provided by a third party to the contract.

Comment: Inland Revenue is appealing this decision.

Whether activity constitutes "carrying on a business"

Rating: • • •

Case: J L Slater and Others v CIR HC Auckland M 611/94

Act: Income Tax Act 1976 - sections 104(b) and 112(2)(a)
(Income Tax Act 1994 - section BB 7)

Keywords: *carrying on a business, purpose, deduction, depreciation*

Summary: The Court upheld the Commissioner's assessment that the activities of the objector partnership did not have the requisite operational nature to constitute a "business" for two of the three income years in question.

Facts: The objectors are members of a die-owning partnership scheme operated by Lemmington Holdings Ltd. The way in which the scheme was intended to operate was that Lemmington Holding Ltd would manufacture a die or set of dies and sell it to the partnership, guaranteeing their repurchase at a much-reduced book value after three years. The die would be used by Lemmington's subsidiary, Dina Plastics Ltd, to mass produce plastic consumer items. Lemmington Holdings Ltd was to organise the export sale of the products on behalf of the partnership and then account to the partnership for the proceeds after commission.

Lemmington Holdings Ltd advertised the advantages of the scheme as being that the partnership would be entitled to a number of export and development allowances. The partnership would also be able to make allowances for depreciation on the dies.

However, the scheme did not operate as it was intended. The dies were not capable of any production runs and there was never any production using the partnership's dies.

The objectors claimed a series of deductions for the income years 1981 to 1983. The Commissioner disallowed all the claimed general deductions on the basis that the partnership had not been carrying on a business within the meaning of section 104(b). The Commissioner also disallowed the first year depreciation on the dies because the partnership had not been engaged in any business to satisfy section 112(2)(a).

The members of the partnership objected and a case was stated to the High Court.

There were two issues:

(i) whether the partnership was "carrying on a business" within the meaning of section 104(b).

(ii) whether the partnership was "engaged in any business" within the meaning of section 112(2)(a).

Decision: Justice Fisher held that the partnership had carried on a business for one of the income years claimed but not in the other years. His Honour examined the meaning of business. He did not see any material difference in the phrases "carrying on a business" in section 104(b) and "engaged in any business" in section 112(2)(a).

Justice Fisher applied the test for business used in *Grieve v CIR* [1984] 1 NZLR 101 (CA). As it was accepted that the objectors had a subjective profit purpose, the sole question was whether the activity which accompanied that purpose was sufficient to amount to a commercial activity for the purposes of a "business."

Justice Fisher said that although there was no minimum period for carrying on a business, the activity must have continuity and be more than mere preparation to be a business. Setting up a business structure, purchasing plant, or organising the decision-making structures would not suffice because this was not "carrying on a business" in an operational sense but "setting up a business."

Justice Fisher said the focus should be on the taxpayer's activities, not the activities of others. He found that there was no operational activity conducted on behalf of the partnership in the 1981 income year, the activities being merely preliminary steps to set up the partnership. However, in the 1982 income year the requisite business activity was present in attempts by the partnership to gain production orders. Justice Fisher could not find similar activities in the 1983 income year which would constitute carrying on a business because the activities in that year were restricted to trying to extricate the partners from the agreement with Lemmington Holdings Ltd.

On the issue of depreciation of the dies, Justice Fisher held that depreciation was allowable for the 1982 income year because in that year the dies had been used to produce samples. Justice Fisher held that there could be no allowance for depreciation in 1981 and 1983 because the partnership was not engaged in any business in those income years.

Comment: Neither Inland Revenue or the taxpayers are appealing this decision.

Company arrangement held not to be a tax avoidance scheme

Rating: • • • •

Case: TRA No. 95/33

Act: Income Tax Act 1976 - sections 99 and 104
(Income Tax Act 1994 - sections BB 9 and BB 7)

Keywords: *tax avoidance, personal exertions rule, deductibility, financial advice*

Summary: The TRA found that an arrangement where the objector who was employed by a company as a chiropractor in which he owned 50 percent of the shares was an arrangement to avoid tax when the company set off the income from the chiropractic business against accumulated losses. However, there was no tax advantage to the objector that needed to be counteracted.

On a second issue relating to other income years, the TRA held that the profits made by the company could not be deemed to be the income of the objector. The TRA rejected the Commissioner's contention that the profits from the chiropractic business should be treated as being derived from the personal exertions of the objector.

Facts: The objector had practised in business on his own account as a chiropractor since 1984. In 1987 he purchased 50 percent of the shares in a company which had been established to operate a garage business. The remaining 50 percent of the shares were sold to the objector in 1992. The company had losses of approximately $130,000 to be carried forward. In 1987 the objector sold his chiropractor business to the company for a nominal consideration. He began working for the company as a chiropractor and was paid a salary. All advertisements for the chiropractic services were made in the name of the objector not the company. The company returned profits from the chiropractic business which were set off against the company's accumulated losses.

The Commissioner invoked section 99 against the objector for the 1987 income year, contending that the off setting of profits against the losses of the company was an arrangement to avoid tax.

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For the income years 1988 to 1992 the Commissioner made an assessment in which he deemed the profits made by the company to be the income of the objector. The objector was assessed for tax on those earnings. Relying on the principle in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1993) 15 NZTC 10,106 PC, the Commissioner contended that the objector continued to derive the income that resulted from his personal exertions and was therefore subject to tax on those earnings.

The Commissioner also disallowed the deduction of a payment of $24,000 made by the objector to his professional advisers for advice on the arrangement he entered into.

The taxpayer objected and a case was stated.

Decision: Judge Willy held that there was an arrangement to avoid tax under section 99 in this case. However, he held that there was no tax advantage to the objector from the arrangement that needed to be counteracted under section 99. This was because once section 99 had been applied to disallow the offset of the company's income against its losses, the company would have paid more tax than the objector individuals if the scheme had not been entered into. That is, the company would have paid tax at the flat rate for companies of 48 per cent which would be a greater amount than the objector would have paid under the three stage progressive scale applying to individuals.

In relation to the assessment of the income years 1988 to 1992, Judge Willy held that the Commissioner had acted incorrectly in treating the profits from the chiropractic business as being derived from the personal exertions of the objector. The decision of the Court in *Hadlee* did not apply in this case because it was concerned with fundamentally different arrangements. In the present case, the objector was employed by the company and, in the absence of a sham or the application of section 99, there were no other grounds on which to uphold the Commissioner's assessment.

Judge Willy held that a deduction of $20,000 could be made for professional financial advice pursuant to section 104 (a) and (b) but a $4000 management fee was not deductible.

Comment: Inland Revenue is not appealing this decision.

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.*

Overseas Social Security Pensions (IR 258) - Sep 1995: *Explains how to account for income tax in New Zealand if you receive a social security pension from overseas.*

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 Loans - how to get one and how to pay one (SL 5) - Jan 1995: *We've published this booklet jointly with the Ministry of Education, to tell students everything they need to know about getting a loan and paying it back.*

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.*

Trusts and Estates - (IR 288) - May 1995: *An explanation of how estates and different types of trusts are taxed in New Zealand.*

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.*

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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.*

Taxes and the taxi industry (IR 272) Feb 1996: *An explanation of how income tax and GST apply to taxi owners, drivers, and owner-operators.*

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 custodian's guide (CS 71B) - Nov 1995: *Information for parents who take care of children for whom Child Support is payable.*

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 liable parent's guide (CS 71A) - Nov 1995: *Information for parents who live apart from their children.*

Child Support administrative reviews (CS 69A) - Jul 1994: *How to apply for a review of the amount of Child Support you receive or pay, if you think it should be changed.*

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 - how the formula works (CS 68) - 1996: *Explains the components of the formula and gives up-to-date rates.*

What to do if you have a problem when you're dealing with us (CS 287) - May 1995: *Explains how our Problem Resolution Service can help if our normal services haven't resolved your Child Support problems.*

Due dates reminder

March 1996

5 Large employers: PAYE deductions and deduction schedules for period ended 29 February 1996 due.

7 Provisional tax and/or Student Loan interim repayments: first 1997 instalment due for taxpayers with November balance dates.
Second 1996 instalment due for taxpayers with July balance dates.
Third 1996 instalment due for taxpayers with March balance dates.

20 Large employers: PAYE deductions and deduction schedules for period ended 15 March 1996 due.

Small employers: PAYE deductions and deduction schedules for period ended 29 February 1996 due.

Gaming machine duty return and payment for month ended 29 February 1996 due.

RWT on interest deducted during February 1996 due for monthly payers.

RWT on dividends deducted during February 1996 due.

Non-resident withholding tax (or approved issuer levy) deducted during February 1996 due.

29 GST return and payment for period ended 29 February 1996 due.

31 Fourth instalment of 1996 Student Loan non-resident assessment due.

(We will accept payments received on Monday 1 April as in time for 31 March 1996.)

April 1996

5 Large employers: PAYE deductions and deduction schedules for period ended 31 March 1996 due.

7 Provisional tax and/or Student Loan interim repayments: first 1997 instalment due for taxpayers with December balance dates.
Second 1996 instalment due for taxpayers with August balance dates.
Third 1996 instalment due for taxpayers with April balance dates.

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

20 Large employers: PAYE deductions and deduction schedules for period ended 15 April 1996 due.

Small employers: PAYE deductions and deduction schedules for period ended 31 March 1996 due.

Employers: yellow copies of IR 12 and IR 13 certificates for year ended 31 March 1996 to be given to employees.

FBT return and payment due for quarter ended 31 March 1996.

Gaming machine duty return and payment for month ended 31 March 1996 due.

RWT on interest deducted during March 1996 due for monthly payers.

RWT on interest deducted 1 October 1995 to 31 March 1996 due for six-monthly payers.

RWT on dividends deducted during March 1996 due.

Non-resident withholding tax (or approved issuer levy) deducted during March 1996 due.

30 GST return and payment for period ended 31 March 1996 due.

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Oops - about that number on the January TIB

When you received your January TIB, you may have noticed that the number on the front cover was "Volume Seven, No.6", which was co-incidentally the same number as appeared on the December 1995 TIB.

We humbly apologise for this error - the Janaury 1996 TIB should of course be Volume Seven, No.7 (as shown at the top of all the pages inside it).

Please could you therefore correct the number shown on the Janaury front cover accordingly.

Volume Seven, No.8 February 1996

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