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This TIB has no appendix.

Inland Revenue
Te Tari Taake

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This is an Inland Revenue service to people with an interest in New Zealand taxation.

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Binding rulings

This section of the TIB contains binding rulings that the Commissioner of Inland Revenue has issued recently.

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.

Trading stock – tax treatment of disposals

Public ruling BR Pub 98/8

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

Taxation Laws

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

This Ruling applies in respect of sections CD 3, FB 3, and OB 1 (definition of "trading stock") of the Income Tax Act 1994.

The Arrangement to which this Ruling applies

This Ruling applies to sales and dispositions of property (including contracts of sale of, and agreements to sell property) that is part of the trading stock of a business owned or carried on by the vendor.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- When stock is sold in the ordinary course of business, section CD 3 applies to include within gross income, amounts that are "derived" from that sale. For these purposes, such derivation occurs when the income is earned, being when a legally enforceable debt arises, or the right to be paid otherwise crystallises.
- If trading stock is sold outside the ordinary course of business, and/or together with any other assets of the business (whether the whole of the business or only a part of the business), section FB 3 applies to include within gross income for that year, all amounts received from the sale or disposition of that trading stock, or as the case may be, the price at which the Act deems the trading stock to have been realised. The date of sale or disposition differs, depending on whether a clearly expressed intention of the parties exists as to when property in the goods is to pass:
  - If a clearly expressed intention of the parties as to the time of passing of property is evident from the terms of the contract, the conduct of the parties and the circumstances of the case, the date of sale or disposition will be the date the parties intended property in the goods to pass.
- If no clearly expressed intention as to the time of passing of property can be determined, the date of sale or disposition will be determined according to the appropriate statutory presumption contained in section 20 of the Sale of Goods Act 1908. In short:
  - If there is an unconditional contract for goods that are specific and in a deliverable state – the date the contract becomes unconditional.
  - If the vendor must do something to make such goods deliverable – the date such action is completed, and the buyer is notified.
  - If the vendor must weigh, measure, or test such goods in order to ascertain the selling price – the date such action is completed and the buyer is notified.
  - If goods are delivered to a buyer on "sale or return" or similar terms – the time at which the buyer signifies his or her approval or retains the goods without notifying rejection within an agreed or reasonable timeframe.
  - If unascertained or future goods are sold by description – when the goods are in a deliverable state and unconditionally appropriated to the contract by either party with the assent of the other.

The period for which this Ruling applies

This Ruling will apply from 1 February 1999 to the end of the 2002 income year.

This Ruling is signed by me on the 16th day of December 1998.

Martin Smith
General Manager (Adjudication & Rulings)

Commentary on public ruling BR Pub 98/8

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in public ruling BR Pub 98/8.

Background

Where the trading stock of a business is being sold or disposed of, there has been some confusion about the point in time when the consideration is to be included in gross income. The confusion centres on whether the proceeds from the sale or disposal of trading stock should be included in gross income when delivery and payment occurs, or upon the sale and purchase agreement becoming unconditional. Inland Revenue became aware of this issue in the context of livestock sales, but the legal principles which determine this issue are applicable to trading stock *per se* and this public ruling applies to all trading stock.

Further confusion arose in terms of the question of whether section CD 3 or FB 3 applied to sales of trading stock made in the ordinary course of business.

In order to address the question, it has been necessary to look at the history of the sections, case law, and general principles of contract law as well as the effect of the Sale of Goods Act 1908 on contracts of sale of property.

Legislation

Part EE of the Act ensures that the value of trading stock at the beginning and end of the income year is taken into account when calculating the income of a business for tax purposes.

Section CD 3 states:

> The gross income of any person includes any amount derived from any business.

Section FB 3 states:

> Where in any income year the whole or any part of the assets of a business owned or carried on by any taxpayer is sold or otherwise disposed of (whether by way of exchange, or gift, or distribution in terms of a will or on an intestacy, or otherwise, and whether or not in the ordinary course of the business of the taxpayer or for the purpose of putting an end to that business or any part of it), and the assets sold or otherwise disposed of consist of or include any trading stock, the consideration received or receivable for the trading stock or, as the case may be, the price which under this Act the trading stock is deemed to have realised shall be taken into account in determining the taxpayer's gross income for that year, and the person acquiring the trading stock shall, for the purpose of calculating the person's taxable income for that year or for any subsequent income year, be deemed to have purchased it at the amount of that consideration or price. This section shall, with any necessary modifications, apply in any case where a share or interest in any trading stock is sold or otherwise disposed of by any taxpayer.

"Trading stock" is defined in section OB 1. It is defined slightly differently for the purposes of different sections of the Act, and over time. However, for the purposes of this discussion, it is sufficient to state that it includes anything produced or manufactured, anything held for sale or exchange, and livestock, but that it does not include land or financial arrangements to which the qualified accruals rules apply.

Application of the legislation and case law

Which section applies?

Section CD 3 includes within gross income amounts derived from any business. If sales of trading stock occurred in the ordinary course of business, it would be expected that section CD 3 would apply to include such amounts within gross income. However, a broad and literal interpretation of section FB 3 would include amounts received from the sale of trading stock, whether or not the sale occurred in the ordinary course of business.

In order to resolve this apparent inconsistency, it is necessary to examine the history and interpretation of the sections and their overseas equivalents.

History of section FB 3

Section FB 3 was introduced in 1939 as part of a whole stock sub-code. It was acknowledged by the Hon. Mr Nash (recorded in NZ Parliamentary Debates Vol 256, 1939: 537) that the whole of the sub-code followed, to a large extent, the procedure adopted in Australia. However, the equivalent Australian subsection was explicit that it applied only to sales that were **not** made in the ordinary course of business. By expressly including the extra words in the New Zealand subsection, it must be presumed that Parliament had intended to address every possible existing and future mischief.

Prior to 1939, there was no stock sub-code in the Act, and the forerunner to section CD 3 operated to tax proceeds from the sale of trading stock.

The case of *Commissioner of Taxes v Doughty* [1926] NZLR 279 dealt with a single sale of stock (soft goods and drapery) when assets were moved from a partnership into a company vehicle. The Court of Appeal held that a profit derived from the sale of trading stock was assessable to tax, regardless of whether the stock was sold in the ordinary course of business or in a wind-up of the business, relying for support on *Anson v Commissioner of Taxes* [1922] NZLR 330. The Privy Council reversed the decision and said the sale was a result of a "slump market" and this was the sale of the whole business unit, which must be distinguished and certainly was not a sale made in the course of the taxpayer's business. Accordingly, the increase in the value of stock sold was not subject to tax.

In 1924 (after the *Doughty* case had been brought to the Commissioner's attention, but before the Court of Appeal decision had been given), an amendment was made to (then) section 79(1)(a) of the Land and Income Tax Act 1923, which included within assessable income "all profits or gains derived from any business". The words added to the precursor to the current section CD 3 were "including any increase in the value of stock in hand at the time of transfer or sale of the business...". The additional sentence remained in place long after the enactment of the precursor to section FB 3 in 1939.

It appears that the words "whether or not in the ordinary course of business" included within section FB 3 had been included to prevent the section being circumvented, and to ensure that income from the sale of trading stock was always taxed, regardless of how it was effected. No consideration appears to have been given to the overlap between the application of the two sections.

Interpretation of section FB 3

In *Hansen and Ors v CIR* [1972] NZLR 193, it was held by the Court of Appeal that the precursor to section FB 4 (which deals with apportioning the consideration attributable to trading stock where such trading stock is sold together with other assets) could be used to permit the Commissioner to calculate the value of stock sold along with any other assets of the business, whether or not the overall purchase price agreed to by the parties specifically attributed an amount to the stock value. Haslam J discussed the history of the introduction of the "stock sub-code" and also subsequent changes to what are now sections FB 3 and FB 4. At page 205, he stated that:

> … the Legislature intended that sections 98 to 102 inclusive should constitute a sub code for dealing with liability for taxation when trading stock (including livestock) is disposed of **with other assets**. (emphasis added).

Whilst the conclusion reached by Haslam J is practically workable, and would clarify the inter-relationship between sections CD 3 and FB 3, it does not necessarily reconcile with a literal interpretation of section FB 3. Even if the words "whether or not in the ordinary course of business" are read down, the section applies even where "...the whole or any part of the assets of the business ... [that are] sold or otherwise disposed of **consist of** or include trading stock". Therefore, the section will apply where the assets consist solely of trading stock, and there is no requirement that they be sold along with different assets.

What is required, however, is that the "whole or any part of the assets of a business" have been sold or disposed of. This appears to require more than merely the sale of individual items of trading stock in the ordinary course of business. It suggests that the section applies to larger transactions involving other assets, and/or multiple items of trading stock where the sale is more akin to the sale or disposal of **a group of business assets**. Whilst trading stock is technically an asset of the business, ordinary English language usage would not normally see the ordinary sale of an individual item of trading stock described as a disposal of "part of the assets of a business".

In addition, it is relevant to note that the current structure of the Act clearly indicates that Part F deals with apportionment and re-characterisation of transactions. Such heading and structure of the Act imply that the section should not operate for sales of stock made in the ordinary course of business, but rather in more involved fact situations or where the Act treats transactions in a special way. Section AA 3(1) states that the meaning of a provision is to be found by reading the words in context and in light of the way that the Act is organised.

The better view is that section FB 3 does not apply to normal sales of trading stock made in the ordinary course of business, and applies only where the whole, or part, of the assets of a business are sold (whether the trading stock is sold along with other assets, or a group of trading stock items are the only items sold). It is inherent in such a view that the words "whether or not in the ordinary course of business" are included in the section to effect the intent of Parliament that the section should not be rendered inapplicable by means of a taxpayer seeking to argue that it is in the ordinary course of their business to effect such compound sales. Such a conclusion arguably requires a degree of reading down of those words, but results in a workable operation of the Act, and seems to reflect the Parliament's intention.

The result is that section CD 3 should apply to include within gross income all amounts derived from the sale of trading stock in the ordinary course of business, unless the trading stock is sold together with other items of trading stock, or assets of the business itself, in a way that suggests that (the whole or) a part of the business is being disposed of.

Section FB 3 will apply to include within gross income the value of trading stock sold or disposed of outside of the ordinary course of the business operations, or along with other assets of the business in such a way. Specific instances when section FB 3 will operate will include instances where large blocks of different types of stock are sold to a purchaser, a part of the business is sold, or the entire business is sold by the owner.

When determining the timing of gross income from stock sales, it will be important to ascertain which section applies. Section CD 3 includes proceeds from the sale of trading stock at the point in time they are "derived". Section FB 3 includes such proceeds at the point in time the trading stock is "sold or otherwise disposed of". This distinction can arguably be explained by the fact that ordinary derivation rules are to apply if usual trading stock sales occur in the ordinary course of a taxpayer's business. If the circumstances are otherwise, however, the Act may be seen to be "tightening" the test of the time of assessability.

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When amounts from the sale of trading stock are "derived"

Section CD 3 operates to include within gross income amounts from the sale of trading stock sold in the ordinary course of business. It is settled law that the timing of derivation and the method of accounting "should be that which is calculated to give a substantially correct reflex of the taxpayer's true income". (*C of T (SA) v The Executor Trustee and Agency Company of South Australia Limited (Carden's Case)* (1938) 63 CLR 108; *CIR v Philips (NV) Gloeilampenfabrieken* [1955] NZLR 868; *CIR v Farmers Trading Company Limited* (1982) 5 NZTC 61,200). It is also settled law that the word "derived" means more than merely received. It connotes the source or origin rather than the fund or place from which the income was taken, and means flowing, springing, or emanating from, or accruing (*Philips*). There are also established principles that business taxpayers should use the accrual method of calculating income in order to give a correct reflex of income. This means income could be derived even if payment has not yet been received, or a bill even rendered.

The general principle is that income is "derived" when it is earned, and has "come home" to the taxpayer. This will be the point at which a legally enforceable debt arises, or the right to be paid otherwise crystallises. In looking at whether a debt has been created, case law tends to show that this is in effect a two-stage enquiry. The first stage is to ascertain whether the parties have agreed, or a statute has imposed a requirement, as to when a debt is created. When this is clear, for the purposes of income tax, the income in question is considered to have been derived at that time. If there is no such agreement between the parties or statutory imposition, it is necessary to look at the general law to determine when a debt is created and thus when the income is derived.

The leading New Zealand case on derivation is *CIR v Farmers Trading Company Ltd* (1982) 5 NZTC 61,200. This case dealt with the question of when business profits were derived from trading stock sold when the company made "budget" sales (where the customer paid the purchase price over a period of five months by way of monthly instalments). It was held that such sales were fundamentally different to hire purchase sales because the title and the property passed with the possession of the goods, and the vendor could only sue for outstanding instalments. It was held that the business profits were derived when the stock was sold and a debt in favour of the vendor was created.

Richardson J (as he then was), cited *Carden's Case* with approval and, in particular, he restated that "the foundation of the accruals system is the view that the accounts should show at once the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due." At page 61,208, his Honour stated:

> The real question in this case is when trading profits are derived. Where a sale is made in the course of trade during the year any profit on sale must be recognised. That involves having regard to the debt arising in favour of the vendor and bringing it into account if it is practicable to do so.
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> ...
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> On sale of trading stock a debt arises in favour of the vendor. The stock leaves his account and prima facie the debt for which it was exchanged should be brought into account in its place. It is implicit in the legislation that trading debts cannot be ignored in the calculation of business profits and must be brought into account on a proper basis if that is feasible.
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> ...
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> [T]here may be no realistic way to reflect the debts in the trader's account. But in principle debts arising from sale of trading stock during an income year must be recognised in arriving at the profits derived in that year.

The Australian case of *J Rowe and Son Pty. Ltd v FCT* 71 ATC 4157 is consistent with the principles expressed in *Farmers Trading*. In this case the Full Court of the High Court considered when income was derived from the sale of stock by a retailer of household goods, in circumstances where the goods were purchased by customers but to be paid for by periodic instalments over an agreed term of 12 months or more. The sum to be paid was equal to the cash price plus 11% interest per annum, and the taxpayer included in assessable income returned for each year only the instalments received or receivable in that year. The Court held that for tax purposes a trader's income is derived when it is earned, even though not received. The "profit emerging" method was considered inappropriate and the full cash price of the stock was considered earned and therefore derived during the year of the sale contract. Gibbs J stated at page 4,160:

> I agree that for taxation, as well as for business purposes, income of a trading business is derived when it is earned and the receipt of what is earned is not necessary to bring the proceeds of sale into account ... The method adopted should be that which is "calculated to give a substantially correct reflex of the taxpayer's true income: *Carden's case*."

In delivering the majority judgment, Menzies J stated, at pages 4,158 and 4,159:

> It is implicit in the foregoing provisions that the proceeds of any sale of stock in the ordinary course of business will be brought into account in the year in which it is sold ... In a system of annual accounting, ordinary business considerations would indicate that what becomes owing to a company for trading stock sold during a year should, in some way, be brought into account to balance the reduction of trading stock which the transaction affects. Any other method of accounting would lead to a misrepresentation of the trader's financial position.
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> ...
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> Acceptance of the taxpayer's contention [that income was derived only when instalments were due and receivable] would, of course, largely destroy the accepted basis for the taxation of most trading and business concerns.

The general principle that income is derived when it is earned, and that such time will be when there is an entitlement to payment or a legally enforceable debt, was also recently applied in *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685. In that case, Goddard J held that the taxpayer's income was derived at the contemporaneous point in time the electricity was supplied by the taxpayer and consumed by its customers. This was because (on the facts) her Honour found that the income had been earned, and the taxpayer had a legal entitlement to payment – regardless of the fact that no invoice had been rendered.

Sales of land

Although land is not trading stock as defined (or subject to the Sale of Goods Act) it is worth noting that the same general principles in relation to derivation apply to the sale of land, or where the contract is otherwise an executory contract. However, although the applicable derivation principles are the same for land as for other property, the exact timing of when income is earned and a legally enforceable debt arises may be different. The difference will arise where the contract has an executory nature, and the vendor is not legally entitled to sue for the purchase price until after settlement.

Cases that discuss the date of "sale" indicate that a sale of land occurs when a contract becomes unconditional (assuming there is no express intention of the parties that can be ascertained) – the same as for any other property or goods. However, the case of *Gasparin v FCT* (1994) 94 ATC 4,280 specifically addressed the question of when income from the sale of the land was "derived". In delivering the judgment of the Full Federal Court, von Doussa J concluded that ordinary derivation principles applied, but a legally enforceable debt did not arise until the date of settlement and conveyance (when the executory contract was executed). Before this date, the vendor merely had a right to sue for specific performance of the contract, but not for the debt itself.

His Honour stated that there was no difference between the sale of land or other executory contracts, and the sale of retail goods, in terms of the principles that apply to the question of derivation for tax purposes. He was satisfied that income is derived when it is earned and a debt is due, according to ordinary principles. The difference in the timing of derivation that occurred for the land in that case, compared to a sale of other goods, was caused by the fact that title did not pass to the purchaser, and there was no legal right for the vendor to sue for a debt prior to the settlement/conveyance. Because that was the only point at which a legal debt arose, derivation did not occur until that time.

In delivering the decision of the Court, von Doussa J stated:

> I am unable to agree that there is no difference in the present case from a department store sale of articles on 30 day terms. In that example there has been a delivery of the articles sold. The contract of sale is no longer executory. A debt has accrued due; the debtor has become subject to an obligation to pay a sum certain in money even though the debt may not be payable forthwith: c.f. *Carden*.
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> ...
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> In the present case such a matching will occur if it is held that that trading stock is not disposed of for the purposes of the Act until there is under a transaction for the sale of land both a loss of "dispositive power" and the accrual to the trader of debt due by the purchaser.
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> ...
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> The allotments in question remain registered in the name of the vendors until settlement. Until then the vendors have not lost all dispositive power and had not ceased to have any proprietary interest in the land. ... Prior to settlement, under the contracts of sale the purchasers undoubtedly acquired interests in equity and rights to specific performance but the vendors did not become bare trustees for the purchasers.
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> ...
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> In my opinion it should be held that the joint venturers derived income from the sale of the allotments of land which comprised the trading stock not when the contracts became unconditional but at settlement when a debt accrued due from each purchaser to the joint venturers. The critical consideration is for the time when the debt arose. It should also be held that each allotment remained trading stock on hand until settlement, that being the point in time in a transaction for the sale of land under a contract of sale in the terms of those before the court when the vendor finally uses all dispositive power, and the contingency that the sale will not proceed to completion disappears.

Von Doussa J also pointed out that his conclusions were consistent with judicial "sign posts" on derivation principles, such as *Barratt v FCT* (1992) 92 ATC 4,275, *Farnsworth v FCT* (1949) 78 CLR 504, *Henderson v FCT* (1970) 70 ATC 4,016 and *FCT v Australian Gas Light Co* (1983) 83 ATC 4,800.

It must be remembered however, that the facts of each case need to be examined, rather than assuming all executory contracts will automatically result in derivation occurring on settlement. This is because the key differences identified by von Doussa J between ordinary goods and land sales, were the facts that property/title did not pass until settlement, and a legally enforceable debt did not occur until settlement. If the facts of a case clearly show an earlier debt (rather than being able to sue for specific performance) and/or passing of property, the time of derivation will be earlier. This possible distinction is well expressed by Salmon J *in Ruddenklau v Charlesworth* (1925) NZLR 161 where he stated:

> The general rule, however, that in an executory contract for the sale of land the vendor cannot sue for the price is excluded whenever a contrary intention is shown by the express terms of the contract. And it seems established by authority that a contrary intention is sufficiently shown in all cases in which by the express terms of the contract the purchase money or any part thereof is made payable on a fixed day, not being the day for completion of the contract by conveyance. In all such cases the purchase money or any part thereof becomes, on the day so fixed for its payment, a debt immediately recoverable by the vendor irrespective of the question whether a conveyance has been executed and notwithstanding the fact that the purchaser

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may have repudiated his contract. Notwithstanding such repudiation the vendor is not bound to sue for damages or specific performance, but may recover the agreed purchase money.

When stock is "sold or otherwise disposed of"

The question of when stock is "sold or otherwise disposed of" becomes important when considering section FB 3, where stock is sold along with other assets of the business. This is a different question to when income is "derived".

Sale of Goods Act 1908

The phrase "sold or otherwise disposed of", as used in section FB 3, is not specifically defined for the purposes of the Income Tax Act 1994, but some guidance is provided by case law and the Sale of Goods Act 1908 ("SGA"), which indicate that a sale of goods occurs when property in those goods passes to the purchaser.

Although section 2 of the SGA states that "'contract of sale' includes an agreement to sell as well as a sale", section 3 of that Act recognises a distinction between a "contract of sale of goods" and an "agreement to sell". There is a "contract of sale of goods" when a seller agrees to transfer property in the goods for a consideration called the "price". A sale is effected once the property in the goods is transferred from the seller to the buyer. In contrast, there is an "agreement to sell" when the transfer of property in the goods is to take place either at some future time or is subject to the fulfilment of some condition. A sale is effected either when the time elapses or the conditions are fulfilled.

When property passes depends on whether the goods are specific or unascertained. The term "unascertained goods" is not defined in the SGA, but *Butterworths Commercial Law in New Zealand* (Borrowdale 3 ed, Butterworths) states at Chapter 12.3:

> ...it is clear that unascertained goods are goods which are not identified and agreed on at all. Unascertained goods become ascertained goods once they are identified and agreed on in accordance with the contract.

Under section 18 of the SGA, no property is transferred in unascertained goods unless and until the goods are ascertained. Goods may be unascertained because they are generic goods sold by description (*Re Gold Corp Exchange Ltd* [1994] 3 NZLR 385) or because they are not yet severed from part of a larger bulk (*Re Wait* [1927] 1 Ch 606).

Specific goods are defined in section 2(1) of the SGA as "goods identified and agreed on at the time a contract of sale is made".

(a) The timing when the parties agree

Section 19(1) and (2) of the SGA provide that property in specific goods is transferred from the seller to the buyer at such time as the parties to the contract intended to be transferred, and that when ascertaining the intention of the parties regard should be had to the terms of the contract, the conduct of the parties, and the circumstances of the case. Accordingly, any explicit intention of the parties as to when property in the goods passes will be recognised as the date the sale occurs.

(b) The timing when the parties' agreement is not evident

However, in situations where the parties have either not formed an intention as to when property shall pass, or have not clearly expressed their intention, section 20 of the SGA sets out five rules for determining the moment when the property in the goods will be deemed to have passed from a seller to the buyer. Which rule applies depends upon such factors as whether the contract is for the sale of specific or unascertained goods, or the seller is bound to do something to the goods. For the purposes of this discussion, rule 1 in section 20 is considered the most relevant (and common). Section 20 states:

> Unless a different intention appears, the following are rules for ascertaining the intention of the parties as to the time at which the property in the goods is to pass to the buyer:
>
> Rule 1. Where there is an unconditional contract for the sale of specific goods, in a deliverable state, the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment or the time of delivery, or both, is postponed.
>
> Rule 2. Where there is a contract for the sale of specific goods, and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done, and the buyer has notice thereof.
>
> Rule 3. Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test, or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done, and the buyer has notice thereof.
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> Rule 4. Where goods are delivered to the buyer on approval, or "on sale or return" or other similar terms, the property therein passes to the buyer –
>
> (a) When he signifies his approval or acceptance to the seller, or does any other act adopting the transaction:
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> (b) If he does not signify his approval or acceptance to the seller, but retains the goods without giving notice of rejection then, if a time has been fixed for the return of the goods, on the expiration of such time, and if no time has been fixed, on the expiration of a reasonable time. What is a reasonable time is a question of fact.
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> Rule 5. (1) Where there is a contract for the sale of unascertained or future goods by description, and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made.
>
> (2) Where, in pursuance of the contract, the seller delivers the goods to the buyer, or to a carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract.

Date of sale for section FB 3

The general principle is therefore that the date of sale occurs when property in the goods passes. When an express intention of the parties can be ascertained as to when property passes, that will be the date of sale. If no intention is expressed or can be ascertained, the date of sale will be ascertained according to the statutory rules/presumptions contained in section 20 of the SGA, (commonly the date an unconditional contract exists). This general approach has also been upheld in tax cases.

Case law

While there is no New Zealand case law on the effect of the SGA on section FB 3, the Australian Commonwealth Taxation Board of Review referred to the Australian Sale of Goods Act when deciding in *Case 18* (1946) 12 CTBR 120 that property had been disposed of by way of sale when the contract became unconditional. The issue in *Case 18* was whether the taxpayer's property had for the purposes of section 36(1) of the Australian Income Tax Assessment Act 1936 been "disposed of by sale or otherwise howsoever...". The Chairman of the Board of Review noted in relation to the sale of goods at page 125:

> The ownership of the goods will be transferred by the contract itself (in which case, the contract is the sale) if the parties express that intention but where the parties form no intention as to the time when the property is to pass, or fail to express their intention, the time when the property passes is determined by certain statutory presumptions. Of these presumptions the only one which deems the property in the goods to pass when the contract is made arises where there is an unconditional contract for the sale of specific goods in a deliverable state. In view of these principles (...and most which are embodied in the Sale of Goods Act) it appears to me to be quite clear that the property in the goods which were included in the assets which where the subject of the contract under consideration did not pass from the taxpayer to the purchasers until 25 August 1943, when the last of the three necessary consents was given.

The similarity of the SGA legislation in Australia and New Zealand (reflecting their common UK origins), coupled with the fact that the trading stock provisions in the Australian Income Tax Assessment Act 1936 are very similar both in their treatment of trading stock and the wording in section 36(1), are factors which make *Case 18* strong authority in New Zealand on this particular issue.

A similar result was arrived at in the context of when a sale of land had taken place, in *Mills v CIR* (1985) 7 NZTC 5,025 when the High Court held that for a sale of land to take place there must be an unconditional agreement for the sale of the land. This principle was also upheld in *Case K60* (1988) 10 NZTC 487.

In *Hansen v CIR* [1972] NZLR 193, the Court considered the precursor to section FB 4 and whether the Commissioner could calculate the value of stock sold along with the other assets of the business, regardless of an overall price having been agreed to by the parties in relation to the stock value. Of interest to this discussion, the Court gave effect to the intentions of the parties in relation to when property in the livestock passed. In that case, prior to settlement the purchaser was not permitted to shear the sheep which were the stock of the business, and as such there was an implied lack of property in the sheep until that date. The Court concluded that settlement date was the appropriate date to value the sheep for the purposes of calculating their sale price, as that was clearly the date the parties intended property in the sheep to pass to the purchaser, and so that was the date on which they were sold.

Whilst the SGA determines when there is a sale of **personal** property in New Zealand, the same principles have been applied to **real** property in the above cases. Accordingly, for the purposes of section FB 3 trading stock is "sold or otherwise disposed of" when property in the goods passes. This will occur when the parties intend property to pass, where an express intention can be ascertained. If no intention can be ascertained, the statutory presumptions contained in Rules 1 to 5 of section 20 of the Sale of Goods Act will determine when property passes, and therefore when a sale or other disposition occurs.

When a contract is unconditional

As Rule 1 will often be relevant, it is important to understand when a contract becomes unconditional.

An unconditional contract is a contract that is not subject to a condition precedent. The contract may still be subject to a condition subsequent, but this will not prevent the contract from being unconditional. "Condition precedent" is a legal term for those conditions in a contract which suspend a contract until a specified event has occurred. A common example of a condition precedent is a contract that is subject to finance. In other words, the contract will be suspended until the buyer has advised the seller that he or she has obtained the necessary finance.

A "condition precedent" is to be contrasted with a "condition subsequent", which is a condition which can either bring a binding contract to an end (either totally or only partially) or entitle a party to damages. A common example of a condition subsequent is a contract that entitles a buyer to return dairy cattle if they prove not to be eczema free or sound on delivery. An unconditional contract can still be subject to conditions subsequent.

Qualified accruals rules

The ruling does not consider any potential operation of the qualified accruals rules where the arrangement attracts the operation of those provisions.

This may occur when settlement is scheduled to take place more than 63 days from the date an agreement for sale and purchase is entered into, or if there is a trade credit debt permitting payment more than 63 days after the supply of the trading stock or date of a periodic invoice. In either case the arrangement will not be a "excepted financial arrangement".

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If the qualified accruals rules do apply, the approach in the ruling will apply in relation to the consideration that is effectively attributed by the Act to the property sold (as distinct from any deemed financial arrangement income or expenditure that arises by virtue of section EH 1).

Examples

Example 1

A customer enters a sporting goods store and purchases a tennis racquet, which comes with a 30 day money-back guarantee if not completely satisfied. The customer pays by cheque.

The income from the sale is derived by the store in terms of section CD 3 on the day the customer enters the store and purchases the tennis racquet. The tennis racquet is sold in the ordinary course of business, and at that point the income has been earned (and therefore derived), regardless of whether the cheque is subsequently dishonoured or the customer returns at a later date seeking a refund under the guarantee.

Example 2

A motor vehicle dealer and purchaser sign a sale and purchase agreement for the sale of a motor vehicle on 12 March, which permits the customer to take delivery of the car that day, on payment of a 25% deposit. The contract provides that risk passes to the purchaser on delivery of the car, but property does not pass until payment of the balance of the purchase price, which occurs one month later.

The income from the sale is derived in terms of section CD 3 on 12 March, as it is a sale of trading stock in the ordinary course of business, and on that day the income has been earned and a legally enforceable debt has arisen when the purchaser took delivery of the car.

Example 3

On 20 May, Vendor and Purchaser enter into an agreement for the sale and purchase of a herd of dairy cattle, and a deposit is paid. The agreement states that the balance of the purchase price shall be paid on the day of delivery/settlement, and that property in the cattle passes on that day. The agreement is subject to the buyer confirming finance on or before 15 June.

The vendor is entitled to continue milking the herd (and retain any proceeds) until the stock is delivered. Both parties have a 31 May balance date.

The vendor culls 20% of her herd each year, so it is the within the vendor's usual business to sell individual herds of cattle, and she is left with other herds to continue her business operations.

The purchaser confirms on 3 June that finance has been arranged. The contract becomes unconditional on 3 June. Payment is made and possession given and taken on 20 June.

Section CD 3 applies, as the sale is made in the ordinary course of business, and for the purposes of section CD 3 the income is derived on 20 June. That is when the income is earned, the contract is no longer executory, and a legally enforceable debt first arises.

This example illustrates the difference that is possible between the date of "derivation" and the date of "sale". If this had not been a sale made in the ordinary course of business, the fact that the agreement explicitly stated that property in the goods passes on settlement would have resulted in the same date of 20 June being the date of sale. However, if there had been no express intention of the parties evident as to when property in the cattle passed (either by virtue of the agreement itself or the circumstances of the case/conduct of the parties), the date of sale for the purposes of section FB 3 would have been 3 June, when the contract became unconditional.

(Unless Rule 4 or 5 of the Sale of Goods Act 1908 applied, due to a delivery on an approval basis, or the goods being unascertained and sold by description.)

Example 4

Vendor and Purchaser enter into an agreement for the sale and purchase of a plot of land and a herd of cattle on 15 April. The sale is subject to the buyer confirming finance on or before 20 May, with payment of the balance and possession being given on 19 June. Finance is confirmed on 20 May. The contract became unconditional on 20 May and payment is made and possession given and taken on 19 June. Both parties have a 31 May balance date. **There is no clear indication in the contract as to when property in the goods passes.**

For the purposes of section FB 3, the cattle were sold on 20 May, when the contract became unconditional, as there is no express intention of the parties as to when property in the goods is to pass, and Rule 1 of the Sale of Goods Act applies.

If the contract also stated that the cattle could be returned within 7 days if they were not eczema-free on delivery, and the purchaser signified later that same day that the cattle were pronounced eczema-free and would not be returned, the date of sale will differ. The existence of such a condition in the contract is a condition subsequent (rather than a condition precedent), and accordingly the contract is not **conditional** upon the cattle being eczema-free, and there is no alteration of the date the contract became unconditional. However, it does mean that the cattle are delivered on "sale or return" (or similar) terms, as envisaged by Rule 4 of the Sale of Goods Act. This means the date of sale will be 19 June, when the purchaser signifies his approval and retention of the cattle.

If the parties had included an explicit clause in the original contract described above (without the "sale or return" terms) that delivery did not occur and property did not pass until payment was made in full, this intent would be recognised, and the sale would be considered to have been made, for the purposes of section FB 3, on 19 June.

Example 5

A customer orders a photocopier from his regular office equipment supplier, by way of mail order from a catalogue description. The order is posted on 12 September, and received by the vendor on 15 September. A photocopier is taken from the stock warehouse and shipped on 20 September, with delivery to the customer taking place the next day. The standard terms of sale are that goods are sent FOB (which, for the purposes of this example, are taken to mean that risk, title, and property in the goods pass when the goods are put onto the delivery truck), and the photocopier is delivered with an invoice indicating the terms of payment.

As this sale is made in the ordinary course of operating an office equipment business, the gross income from the sale is subject to tax under section CD 3. The income is "derived" on 20 September, when the stock is shipped, and it can be said that the income has been earned and a debt become due and enforceable under the terms of the sale.

If the sale contract conditions were that the goods are delivered COD (and clearly indicated that risk, title, and property in the goods did not pass until delivery), the income would be "derived" on 21 September. In such a situation, no debt is enforceable until delivery occurs.

If the order was for a bulk supply of photocopiers and facsimile machines sold by a vendor who was ceasing trade in electrical office appliances, section FB 3 would apply and the time of "sale" is what is relevant. Such an order is for generic items which are unascertained goods at the time the order is made. The goods do not become specific goods until such time as the particular photocopiers are identified, and it is possible to say that such items are the customer's. In the absence of any differing clear contractual intention, this would occur on 20 September, which is when the items are appropriated to the contract, property passes and the sale occurs.

Tertiary student association fees

Public ruling BR Pub 99/1

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 95/8 which was published in TIB Volume Seven, No.6, December 1995, but its period of application is from 1 April 1999 to 31 March 2002 and some formatting changes have been made. BR Pub 95/8 applies up until 31 March 1999.

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

Taxation Laws

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

This Ruling applies in respect of section KC 5 of the Act.

The Arrangement to which this Ruling applies

The Arrangement is the payment by a student at a tertiary institution, of a single tertiary student association fee as a membership fee to that tertiary student association.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The payment of a single fee to the tertiary student association to become a member of the student association is not a gift for the purposes of section KC 5(4). The student is not entitled to a rebate under section KC 5.

The period for which this ruling applies

This Ruling will apply for the period 1 April 1999 to 31 March 2002.

This Ruling is signed by me on the 11th day of January 1999.

Martin Smith
General Manager (Adjudication & Rulings)

Commentary on public ruling BR Pub 99/1

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in public ruling BR Pub 99/1 ("the Ruling").

Background

If the recipient has charitable status, section KC 5 of the Income Tax Act 1994 ("the Act") provides a rebate for the donor of a gift of money in certain circumstances.

If a student pays a single fee to a student association to become a member of that association, the association has charitable status, and the fee as a whole confers some rights on members, the issue is whether the fee is a "gift".

The subject matter was previously dealt with in public ruling BR Pub 95/8 that expires on 31 March 1999. This public ruling replaces BR Pub 95/8 on 1 April 1999. The previous ruling concluded that if a student pays a single

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fee to the student association to become a member of the student association, and the fee as a whole confers some rights on members, the payment is not a gift for the purposes of section KC 5(4). As the payment of the fee is not a gift, the student is not entitled to a rebate under section KC 5.

Legislation

Section KC 5 states:

(1) In the assessment of every taxpayer, other than an absentee or a company or a public authority or a Maori authority or an unincorporated body, or a trustee assessable and liable for income tax under sections HH 3 to HH 6, HK 14, and HZ 2, there shall be allowed as a rebate of income tax the amount of any gift (not being a testamentary gift) of money of $5 or more made by the taxpayer in the income year to any of the following societies, institutions, associations, organisations, trusts, or funds (being in each case a society, an institution, an association, an organisation, a trust, or a fund in New Zealand), namely:

(aa) A society, institution, association, organisation, or trust which is not carried on for the private pecuniary profit of any individual and the funds of which are, in the opinion of the Commissioner, applied wholly or principally to any charitable, benevolent, philanthropic, or cultural purposes within New Zealand:

(ab) A public institution maintained exclusively for any one or more of the purposes within New Zealand specified in paragraph (aa):

(ac) A fund established and maintained exclusively for the purpose of providing money for any one or more of the purposes within New Zealand specified in paragraph (aa), by a society, institution, association, organisation, or trust which is not carried on for the private pecuniary profit of any individual:

(ad) A public fund established and maintained exclusively for the purpose of providing money for any one or more of the purposes within New Zealand specified in paragraph (aa):

(ae) - (bt) [A list of organisations]

(2) The rebates provided for in this section shall not, in the case of any taxpayer, in any income year exceed in the aggregate the smaller of -

(a) 33 1/3% of the aggregate of all gifts described in subsection (1):

(b) $500.

(3) No rebate shall be allowed under this section in respect of any gift unless the taxpayer furnishes to the Commissioner in support of the taxpayer's claim for the rebate a receipt evidencing to the satisfaction of the Commissioner the making of the gift by the taxpayer.

(4) In this section, "gift" includes a subscription paid to a society, institution, association, organisation, trust, or fund, only if the Commissioner is satisfied that the subscription does not confer any rights arising from membership in that or any other society, institution, association, organisation, trust, or fund.

Application of legislation

Under section KC 5, a taxpayer other than an absentee, company, public authority, Maori authority, unincorporated body, or trustee liable for income tax (sections HH 3 to HH 6, HK 14, HZ 2), can claim a rebate if that person:

- makes a gift (not being a testamentary gift) of money of $5 or more;
- to any of the organisations listed in s KC 5(1) or any special appeal fund allowed by the Commissioner; and
- the recipient in the opinion of the Commissioner applies the funds for a charitable purpose; and
- the taxpayer furnishes to the Commissioner a receipt evidencing the making of the gift by the taxpayer to the recipient.

Furthermore, if a subscription is paid by the taxpayer to any organisation listed in section KC 5(4), the Commissioner must be satisfied that the subscription does not confer any rights arising from membership in that or any other society, institution, association, organisation, trust, or fund.

The payment of a single fee to a student association to become a member of the student association is not a "gift" under section KC 5, as the fee as a whole confers some rights on members. As the payment of the fee is not a gift, the student is not entitled to a rebate under section KC 5. There are two reasons for this view:

1. Payments of student association fees are not "gifts" in the ordinary meaning of that word, as payment is not voluntary, and benefits may arise from the payment.
2. Section KC 5(4) expands the meaning of "gift" for the purposes of section KC 5. A subscription will only qualify as a "gift" for the purposes of section KC 5 if the payer receives no rights to do anything, receive anything, or to have access to anything in return for the payment of the subscription. If any rights are conferred by any part of the subscription, section KC 5 does not apply, and no rebate is available.

The meaning of the term "gift"

In *Mills v Dowdall* [1983] NZLR 154, (in the Court of Appeal) the nature of a gift was referred to by Cooke J who said:

in general a gift is something truly gratuitous, although it is possible that nominal or very small considerations may not prevent transactions from being classed as gifts for some purposes: see *20 Halsbury's Laws of England* .

In the same case, Richardson J said that at common law, the term "gift" refers to:

a transaction where the owner of property conveys the ownership of that property to another without consideration.

Similar views were expressed in *Federal Commissioner of Taxation v McPhail* [1966] 117 CLR 111, (known as "the *McPhail* rule") where the Court held that a "gift" has the following attributes:

- The property transferred was transferred voluntarily and not as the result of a contractual obligation to transfer it; and
- The transferor by way of return received no advantage of a material nature.

A similar view was taken by the Federal Court of Australia in *Klopper & Anor v FC of T* [1997] ATC 4186, which applied *Cyprus Mines Corporation v FC of T* 78 ATC 4468, and made reference to the *McPhail* rule. In *Klopper & Anor v FC of T* the taxpayers made donations to the Australian Sports Aid Foundation (ASAF). The Oceanic Racing Club of Australia received funds from ASAF that it credited to an account belonging to the taxpayers. The Court held that the donations made by the taxpayers were not gifts. It could not be said that the payments were free from contractual obligation and voluntary. It could not be said that the taxpayers received no advantage of a material character as a result of making the donations.

The Australian Administrative Appeals Tribunal also referred to the *McPhail* rule in *Hodges v FC of T* [1997] ATC 2158 and *Australian Dairy Corporation v FC of T* [1998] ATC 2059. In both cases, as there was an element of benefaction, it could not be said that a "gift" was made.

Payments of student association fees are not "gifts" in the ordinary meaning of that word, as payment is not voluntary and benefits may arise from the payment.

The definition of gift in section KC 5(4)

Section KC 5(4) expands the meaning of "gift" for the purposes of section KC 5, to include subscriptions paid to a society, institution, association, organisation, trust, or fund, if the Commissioner is satisfied that the subscription does not confer any rights arising from membership in that or any other society, institution, association, organisation, trust, or fund.

It is arguable whether student association fees are subscriptions. There are many definitions of "subscription", some of which are wide enough to include student association fees.

In *Case M128* (1990) 12 NZTC 2,825 payments to a school for camp fees, a school trip, stationery, and a manual were not gifts. They conferred rights on the pupil. The Taxation Review Authority ("Authority") noted that the Commissioner had allowed school activity fees as a deduction because they came within the expanded definition of "gift". Other fees that conferred a right were not allowed as a deduction. The Authority did not comment on what the definition of a subscription was.

However, assuming that the fees paid are a subscription, the fees will only be a "gift" for the purposes of section KC 5(4), and will only qualify for a rebate, if the Commissioner is satisfied that the payment does not confer any rights on the payer. A subscription will only qualify as a "gift" for the purposes of section KC 5 if the payer receives no rights to do anything, receive anything, or to have access to anything in return for the payment of the subscription. Thus, the payment of a subscription is in the nature of a donation because the payer does not get any direct rights in return for the payment. The requirement that the subscription confers no rights does not contain any words of apportionment (such as "to the extent to which"). It is absolute in its terms. Accordingly, if any rights are conferred by any part of the subscription, section KC 5 does not apply and no rebate is available.

The provision refers only to rights being conferred: the rights do not have to be exercised or enjoyed by the taxpayer.

In *Case J76* (1987) 9 NZTC 1,451, a taxpayer paid the fees of a number of disadvantaged children at a school which qualified as a charitable institution. The Authority held that the payments were not gifts, as the payment of the fees meant that the school had a contractual duty to educate the children. The Authority quoted the expanded definition of gift, but did not discuss either the definition of "subscription", or whether the payments were a subscription (and thus covered by the extended definition of gift). The case was decided in terms of whether the fees paid were a "gift" in the ordinary meaning of the word.

Students attending tertiary institutions pay a sum for membership of a student association or union. Being a member commonly gives rights to benefits from the student association and other organisations, such as:

- Access to advice, welfare, and counselling services.
- Liaison services between students and teaching staff.
- Access to newsletters and other information.
- Facilities on campus, such as the library, health facilities, sports and recreation facilities.
- Student discounts on various goods and services.

In addition, it could also be argued that the payment of the student association fee is one of a number of payments a student must make, and things a student must do, in order to qualify for enrolment at a tertiary institution. If the student association fee (or a substitute payment to a charity of the student's choice) is not paid, the student does not qualify for enrolment. The payment of the student association fee, therefore, confers a further right on students – the right to enrolment if the other conditions of enrolment are met. Similarly, payments to the student association (together with payment of other fees and meeting terms) give students the right to attend university and sit examinations.

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The student makes his or her payment to the student association, not to any other body which may later be allotted funds by the student association (for example, trust funds, hardship funds). The payment to the student association is a payment that confers rights on the student.

Compulsory student membership is incorporated into statute in section 229 of the Education Act 1989. Under this section a University Council has the power to impose and collect student association membership fees from its students. This section remains unchanged at present. However, section 3 of the Voluntary Student Membership Bill 1997 intends to repeal section 229 and introduce voluntary student association membership.

If the Bill is enacted it will not change the tax treatment of student association membership fees under section KC 5. A voluntary payment of student membership fees to a student association would fail to meet the requirements of section KC 5(4). That is, the payment would give rise to rights that the student could claim. At a minimum this would include the right to vote at an AGM and receive an annual newsletter. If the student receives any rights from the payment of that fee, section KC 5 does not apply, and no rebate is available. Any legislative change that makes tertiary student membership voluntary would therefore not alter the tax treatment of student association fees under section KC 5.

For the reasons outlined above, section KC 5 does not apply if the payment of a student association fee confers any rights. In these circumstances, no rebate is available.

Example

A student enrols at a Polytech. He pays the student association fees, and is able to use the gym facilities, counselling services, and the subsidised health care programme. The student association has charitable status.

As the payment of the student association fees confers certain rights on the student, the payment does not qualify for a rebate as a donation to the student association.

However, if a person who is not a student makes a donation to the student association at the Polytech and no rights are conferred because of the payment, a gift is made and a rebate is allowed.

Product ruling BR Prd 98/79 withdrawn

1. This is a notice of withdrawal of a product ruling made under section 91FJ of the Tax Administration Act 1994.
2. Product ruling 98/79 is hereby withdrawn, due to an error in the formula at page 3 of the ruling.
3. Product ruling 98/79 related to the deductibility of interest payments incurred as a result of borrowings made in order to pay a dividend. It applied for the period 31 July 1998 to 31 July 2001. Notice of its making appeared in the *New Zealand Gazette* of 3 December 1998. It is withdrawn on and from 21 January 1999.

Martin Smith
General Manager (Adjudication & Rulings)

Legislation and determinations

This section of the TIB covers items such as recent tax legislation, accrual and depreciation determinations, livestock values and changes in FBT and GST interest rates.

Accident Insurance Act 1998 – tax implications

Features of new accident insurance cover

The Accident Insurance Act 1998, which opens the accident compensation scheme to competition, became law on 19 December 1998. Accident insurance cover remains compulsory, comprehensive, 24 hour and no fault, but employers, self-employed people and private domestic workers are now able to choose their insurance provider. Minimum compensation entitlements are set in law and are similar to those available now.

By 1 July 1999, all employers must have purchased a single accident insurance contract from a private insurance provider to cover their employees' work accidents. Self-employed people can purchase work and non-work accident cover privately, or choose to remain with the ACC. Private domestic workers can purchase work accident cover privately or choose to remain with the ACC; their non-work accidents continue to be covered by the ACC.

Employees' non-work accidents continue to be covered by the ACC, and they will continue to pay earner premium to Inland Revenue.

The ACC will continue to manage the non-competitive accounts. These include the earners', non-earners', motor vehicle and medical misadventure accounts.

A state owned enterprise is being established to compete with private insurers on a commercial basis. It will be subject to the same entry requirements and regulations as other competing insurers, and will be subject to income tax.

A Regulator will be established within the Department of Labour to ensure that employers purchase insurance. The Regulator will have access to information from insurers and Inland Revenue.

To fund the "tail" of outstanding claims, a residual claims levy will be paid annually by employers, private domestic workers and those self-employed people with liable earnings. Self-employed people will also pay an earners' account levy. Inland Revenue will collect these levies on behalf of the ACC, beginning in the 1999 tax returns. The levies will use the same administrative procedure and due dates as currently apply to the collection of the ACC premiums.

The legislation provides that the ACC is responsible for collecting any ACC premiums owed by employers, self-employed people and private domestic workers for the period 1 April 1998 to 30 June 1999.

Consequential tax legislation changes

A number of changes to tax legislation result from changes enacted in the Accident Insurance Act 1998. They are contained in Schedule 6A of the Accident Insurance Act 1998, and explained in this article. The major changes relate to:

- the tax treatment of insurers who provide cover for work-related accidents
- the tax treatment of these insurers' reserves
- the fringe benefit tax consequences of premiums paid by employers
- the taxation of compensation payments.

The amendments to tax legislation apply from 19 December 1998.

People can currently purchase insurance cover in excess of that provided under the ACC scheme. If this cover provided compensation for loss of earnings and was not calculated by reference to those earnings, the proceeds were exempt from tax and the premium was not deductible for tax purposes.

Compensation for loss of earnings as a result of accidents that occur after 1 July 1999 which are covered by the Accident Insurance Act 1998 will be subject to tax. Premiums for this cover will be deductible.

Premiums and levies imposed under the Act

Levies to fund the "tail"

Until recently, the ACC was funded on a pay-as-you-go basis, meaning only enough premium was collected each year to pay the costs of claims in that particular year. As a result, there is a "tail" of past claims, amounting to $3.9 billion in the employers' account. Employers, private domestic workers and the self-employed will remain responsible for this cost.

Starting with the 1999 returns, Inland Revenue will collect two new levies to fund the tail:

(a) Residual claims levy

With effect from the 1998-99 income year, all employers, private domestic workers and those self-employed with liable earnings will pay a "residual claims levy". This will fund the ongoing cost of work injury claims made before 1 July 1999 and non-work claims made before 1 July 1992.

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Employers will calculate their levy annually in their IR 68A return and pay it by 31 May. Self-employed people will calculate the levy in their IR 3 return and pay it by their terminal tax date (either 7 February or 7 April). For companies with shareholder employees who receive non-deducted salaries, the levy will be calculated on the company's IR 4 return and payable by the company's terminal tax date.

The levy:

- will be risk-rated using the same industry classifications as at present
- will not be experience-rated
- will be liable for GST (Employers or self-employed people who are registered for GST will be able to claim the GST as an input tax credit on their GST return.)
- will be tax deductible for income tax purposes
- will be subject to the generic income tax compliance and penalties legislation
- will be payable annually for up to 15 years, although the legislation does allow for the levies to be collected over a shorter time frame
- will be payable by new employers, new private domestic workers and newly self-employed people.

(b) Earners' Account Levy

Self-employed people and employees will also pay an earners' account levy from the 1998-99 income year. This funds the ongoing cost of non-work accidents that occurred between 1 July 1992 and 1 July 1999.

Self-employed people will calculate the levy in their IR 3 tax return and pay it on their terminal tax date (either 7 February or 7 April).

For self-employed people, the levy:

- will not be risk-rated or experience-rated
- will be liable for GST (Self-employed people who are registered for GST will be able to claim the GST as an input tax credit on their GST return.)
- will be tax deductible for income tax purposes
- will be subject to the generic income tax compliance and penalties legislation
- will be payable annually for up to 15 years, although the legislation does allow for the levies to be collected over a shorter time frame
- will be payable by newly self-employed people.

For employees, the levy is included in the earner premium which is deducted from their salary or wages at the same time as tax is deducted. Inland Revenue will continue to collect earner premium from employees and IR 56 taxpayers as part of PAYE deductions, from overseas income earners in the IR 3 return, and from shareholder employees via PAYE deductions or in the IR 4 return. Employees will pay the levy for up to 15 years, although legislation does allow for the levy to be collected over a shorter timeframe.

ACC premiums owed for period 1 April 1998 to 30 June 1999

The legislation provides that the ACC is responsible for collecting:

- employer premium from employers, self-employed taxpayers and private domestic workers for the 1998-99 income year and the period 1 April 1999 to 30 June 1999; and/or
- earner premium for self-employed people for the 1998-99 income year and the period 1 April 1999 to 30 June 1999.

Summary: payment of premiums and levies

	1997-98 income year	1998-99 income year and 1 April to 30 June 1999	1 July 1999 onwards
Premuims	payable to IRD	ACC's responsibility	payable to private insurer or ACC
Levies to fund tail		Payable to IRD	Payable to IRD

Taxation of insurers

Insurers who provide cover for work-related accidents under the Accident Insurance Act will be subject to the general insurance tax rules.

At present, the income derived by a friendly society (except so far as it is derived from business carried on beyond the circle of its membership) or a trustee in trust for a sick, accident, or death benefit fund has been exempt income for income tax purposes. To provide consistency of tax treatment for all entities competing in the accident insurance business, income derived by a friendly society or a trustee from a company which is registered under the Accident Insurance Act 1998 to provide insurance cover is not considered exempt income under the Income Tax Act. To provide for this outcome, section CB 4(1)(a) of the Income Tax Act (non-profit bodies and charities exempt income) has been amended to exclude the income of a company registered under the Accident Insurance Act 1998 from being exempt income of a friendly society.

Section CB 5(1)(i) of the Income Tax Act 1994 (certain pensions, benefits and other compensation exempt) has been amended to ensure that amounts derived by a trustee in trust for any sick, accident, or death benefit fund from any company registered under section 166 of the Accident Insurance Act 1998 and under the control of that trustee is not exempt income. The exemption for dividends in section CB 10(2) has also been amended to provide that dividends derived by a friendly society or a sick, accident, or death benefit fund are not exempt income if they are derived from a company registered under section 201 of the Accident Insurance Act 1998 which is under the control of the society or trustee of the fund. Whether a friendly society or sick, accident, or death benefit fund is under the control of the society or trustee is determined in accordance with section OD 1 of the Income Tax Act 1994.

The ACC is required to set up a wholly owned subsidiary company to provide claims management and network services to the ACC and possibly to other insurers. To ensure that the subsidiary competes on the same footing as other claims management companies, it will be subject to the same tax rules that apply to other companies. However, an amendment has been made to section ME 1(2) of the Income Tax Act 1994 to ensure that it does not establish an imputation credit account.

Taxation of compensation payments

Currently, income-related compensation for loss of earnings or loss of potential earnings capacity paid to an injured person or their spouse or dependants is subject to income tax. Other forms of compensation that are a reimbursement of costs or compensation not related to earnings are not subject to income tax.

The Income Tax Act 1994 has been amended to extend this treatment to compensation paid under the Accident Insurance Act 1998.

Compensation paid under the new Accident Insurance Act

A new paragraph (ba) has been inserted into section CC 1 of the Income Tax Act 1994. It provides that the following forms of compensation, provided under the Accident Insurance Act 1998, are included in gross income:

- weekly compensation paid to earners, self-employed people, shareholder employees and employees who have ceased employment but have continued their cover under the Accident Insurance Act 1998
- weekly compensation for loss of potential earnings capacity
- weekly compensation paid to the surviving spouse
- weekly compensation paid to a child or other dependants
- compensation for loss of earnings under a top-up insurance policy for work-related accidents as provided for in section 188 of the Accident Insurance Act 1998.

To ensure these forms of compensation are taxable, amendments have also been made to sections CB 5(1)(g) and (h) of the Income Tax Act. These amendments ensure that any compensation payments for work-related accidents paid under the Accident Insurance Act 1998 are not exempt income if they are paid by a friendly society, sick, accident, or death benefit fund or from a personal sickness or accident policy of insurance.

Currently, compensation paid to employees or a self-employed person for loss of earnings owing to an accident is taxable if calculated by reference to those earnings. Compensation that is not calculated by reference to those earnings is exempt from tax. Compensation paid under the Accident Insurance Act 1998 to employees or self-employed people for loss of earnings will be subject to tax regardless of whether the compensation is calculated by reference to those earnings. This includes payments made in excess of the statutory minimum set out in that Act.

The definition of salary or wages in section OB 1 of the Income Tax Act 1994 has been amended to include these forms of compensation. They will be subject to PAYE deductions at source.

The employer will continue to pay the first week's compensation when an employee suffers a work-related accident. This payment will be salary or wages for tax purposes and will be subject to PAYE deductions.

If the ACC or an insurer recovers any compensation that has been paid in error or has been overpaid, the recovered compensation is not included in gross income.

Exempt income

A number of forms of compensation are provided under the Accident Insurance Act 1998 that are exempt from income tax. Section CB 5(1) of the Income Tax Act 1994 (exempt pensions, benefits and other compensation) has been amended to insert a new paragraph (q) that provides the following forms of compensation are exempt income:

- funeral grant
- survivor's grant
- child care payments
- an independence allowance
- payments for treatment or rehabilitation.

Fringe benefit tax

Currently, premiums paid by an employer to the ACC for work-related cover are not subject to fringe benefit tax (FBT). This treatment will continue for premiums paid to purchase insurance under the Accident Insurance Act 1998. To provide for this the meaning of "fringe benefit" in section CI 1 has been amended by inserting a new paragraph (ja).

At present, if an employer takes out an insurance policy for work-related accidents to "top up" the compensation provided by the ACC, the premiums are exempt from FBT provided the compensation payable under the policy is monetary remuneration. A new paragraph (ja) has been inserted into section CI 1 of the Income Tax Act 1994 to ensure that premiums paid for cover from 1 July 1999 for work-related accidents under contracts to "top up" compensation (in excess of the minimum payable under the Accident Insurance Act 1998) will be exempt from FBT.

If an employer purchases insurance cover for employees' non-work accidents, the insurance premium will continue to be liable for FBT.

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Goods and services tax

Two minor amendments have been made to the Goods and Services Tax Act 1985 (the GST Act) to extend the current GST treatment for indemnity payments paid by the ACC to indemnity payments paid under the Accident Insurance Act 1998.

Sections 5(13) and 20(3)(d)(v) of the GST Act, which deal with the meaning of the term "supply" in relation to indemnity payments and the deductions from output tax respectively, have been consequentially amended. They now include a reference to the Accident Insurance Act 1998 after the references to the Accident Rehabilitation and Compensation Insurance Act 1992.

Insurers' outstanding claims reserves

Section DK 5 has been inserted into the Income Tax Act 1994 and applies to the outstanding claims reserve of insurers for insurance business written under the Accident Insurance Act 1998. This section provides for a present value approach to valuing the reserve. If the reserves for financial reporting purposes meet certain requirements, the same basis can be used for tax purposes.

The net income or loss of the insurer must take into account the value of the outstanding claims reserve at the beginning of the income year as an allowable deduction and the value at the end of the income year as gross income. The value of the opening reserve must also be the same as the prior year's closing reserve.

The value of the reserve at the end of the income year is to be the amount calculated by an actuary and adopted by the insurer for financial reporting purposes. If the reserve has not been determined on this basis, the Commissioner of Inland Revenue can seek the advice of the Government Actuary or any other actuary to determine the amount of the reserve.

The amount of the reserve must have regard to generally accepted accounting practice, generally accepted actuarial practice and the present value of expected future payments.

The result is that in calculating the outstanding claims reserve, future costs of administering and settling claims incurred and other factors, such as prudential margins, can be taken into account, where this is consistent with accounting and actuarial practice. A present-value approach to valuing the reserve is considered to result in a more accurate measure of an insurer's income in relation to accident insurance. The relevant professional bodies are currently developing accounting and actuarial standards.

"Outstanding claims" has been defined for the purpose of this section as the claims made or expected to be made with the insurer in respect of insured events that have occurred on or before the end of that income year and have not yet been settled. It also includes an estimate of claims that have been incurred but not reported to the insurer before the end of that income year.

Timing of deductions for premiums and levies

Section ED 1 of the Income Tax Act 1994 (year in which ACC levies and premiums are deductible) currently provides that earner premium and employer premium imposed under the Accident Rehabilitation and Compensation Insurance Act 1992 are deductible when they become due and payable by the taxpayer.

The Accident Insurance Act 1998 inserts a new section ED 1A. The new section provides that the levies collected by Inland Revenue and premiums collected by the ACC under the Accident Insurance Act are deductible in the year in which they become due and payable by the taxpayer. The levies and premium are:

- earners' account levy
- residual claims levy
- premium payable to the ACC for the 1998-99 income year and for the three months April to June 1999
- contributions to the insolvent insurers fund
- levies to meet the costs of the Regulator
- levies or penalties paid to the non-compliers fund.

At present, premiums paid by self-employed taxpayers and private domestic workers to the ACC for work-related accident cover are deductible when they became due and payable by the taxpayer. Premiums paid to the ACC for cover for work-related accidents from 1 July 1999 onwards will be "accrual expenditure" and dealt with under section EF 1.

Information matching

Sections 370 and 371 of the Accident Insurance Act 1998 provide for the transfer of information from Inland Revenue to the Regulator to enable the Regulator to:

- issue insurance numbers to employers
- identify those employers who are not complying with their obligation to purchase insurance cover for their employees' work-related accidents
- calculate the penalty to be imposed on non-complying employers.

Inland Revenue will supply the Regulator with a list of all employers, stating each employer's name, address, Inland Revenue number and the date they started or ceased employing. This transfer will occur on an on-going basis. The Regulator will compare the information with information provided by insurers on who has an accident insurance contract. If satisfied that an employer has not complied with the requirements to insure, the Regulator will request that Inland Revenue supply the non-complying employer's earnings level and industry classification. The Regulator will use this information to calculate the penalty for failure to insure.

These matching provisions comply with the requirements of Part X of the Privacy Act 1993.

Maintaining secrecy

Section 81 of the Tax Administration Act 1994 has been amended to ensure that officers of the Inland Revenue Department maintain secrecy of all matters in relation to the Accident Insurance Act 1998 and disclose information only for the purpose of implementing the Accident Insurance Act 1998.

A new paragraph (fa) has been inserted into section 81(4) of the Tax Administration Act 1994. It enables the Commissioner to disclose to employees or agents of the Regulator any information they are authorised by the Regulator to receive and which is provided for the purposes of sections 370 and 371 of the Accident Insurance Act 1998.

Section 86 (other persons to maintain secrecy) of the Tax Administration Act 1994 requires employees or agents of the Regulator to maintain secrecy in relation to information received by them from Inland Revenue. Before they gain access to that information they must certify that they have read and understood the secrecy requirements of section 86.

The Regulator will retain the certificates that are signed by their employees or other persons appointed by them.

Anyone who fails to maintain secrecy commits an offence under the Tax Administration Act 1994, and if convicted could be liable to either a term of imprisonment of up to six months, a maximum fine of $15,000, or both.

Definition of full-time earner

The transitional tax allowance provides a rebate for people whose income is under $9,880 and who are in full-time employment. Section KC 3(3) of the Income Tax Act 1994 defines “full-time earner” as a person who:

- engages in remunerative work for at least 20 hours per week; or
- would have been engaged in remunerative work for that number of hours but for being incapacitated owing to sickness or an accident for which earnings related compensation is payable.

The definition of “full-time earner” has been amended to provide that it is met if the Commissioner considers that a person would have been in full-time employment but for suffering personal injury within the meaning of section 13 of the Accident Insurance Act 1998 for which compensation is payable under that Act.

Application of Tax Administration Act 1994

Section 316(4) of the Accident Insurance Act 1998 provides that, if the Commissioner is acting as agent for the ACC for the collection of premiums, the provisions of the Tax Administration Act 1994 will apply to the collection of premiums under the Accident Insurance Act 1998.

Section 309 of the Accident Insurance Act 1998 provides that the residual claims levy, earners’ account levy and the motor vehicle account levy are, for the purposes of the Accident Insurance Act 1998, treated as if they were premiums. The combination of sections 316 and 309 ensures that the provisions of the Tax Administration Act 1998 (interest and penalty provisions) apply to the collection of the earners’ account levy and the residual claims levy – but not to the motor vehicle account levy.

Other amendments

A number of other amendments have been made to sections of the Income Tax Act 1994 and the Tax Administration Act 1994 to include:

- after references to the Accident Rehabilitation and Compensation Insurance Act 1992, references to the Accident Insurance Act 1998; and
- after references to the Corporation, references to the Manager.

Transitional process

From the 1998-99 income year, Inland Revenue will collect the residual claims levy and the earners’ account levy. It will continue to collect the premium arrears for all years before 1998-99.

The legislation provides that the ACC is responsible for collecting any ACC premiums owed by employers, self-employed persons and private domestic workers for the period 1 April 1998 to 30 June 1999.

Taxpayers who have a balance date between 1 October and 31 March (inclusive) and file their IR 3 or IR 4 tax return before 1 April 1999 will calculate their ACC liability for the 1998-99 income year based on premiums, instead of levies. Inland Revenue will use the liable earnings figure and classification code on the return to calculate the levies payable, and then advise the taxpayer of the reassessment. ACC is responsible for the collection of any premium owed.

Summary and common questions continued on page 20

Accident Insurance Act 1998 – summary and common questions and answers

The table below summarises the changes to the treatment of compensation payments and premiums that have resulted from the Accident Insurance Act 1998.

Situation	Current treatment	New treatment
Personal accident insurance premiums paid by employers to cover employee work-related injuries.	Deductible to the employer.	Deductible to the employer.
Personal accident insurance premiums paid by employers to cover employees against non-work-related injuries.	Deductible to the employer, but liable for fringe benefit tax.	Deductible to the employer, but liable for fringe benefit tax.
Medical benefits paid or provided by the insurer.	Non-taxable to the recipient.	Non-taxable to the recipient.
Compensation paid to employees or a self-employed person for loss of earnings resulting from an accident.	Taxable to the recipient if calculated by reference to those earnings. Not taxable to the recipient if not calculated by reference to those earnings.	Taxable irrespective of whether or not it is calculated by reference to loss of earnings.
Income-related compensation for loss of earnings, loss of potential earning capacity payable under ARCI or the AI Act.	Taxable	Taxable
Premiums paid to ACC for work accident cover.	Deductible by employers and self-employed. Not subject to fringe benefit tax.	Deductible by employers and self-employed. Not subject to fringe benefit tax.
Persons in receipt of earnings-related compensation for more than three months.	Not eligible for the independent family tax credit if receive compensation for more than three months.	Not eligible for the independent family tax credit if receive compensation for more than three months.
Earner premiums paid by self-employed persons.	Deductible	Deductible
Earner premiums paid by employees.	Not deductible	Not deductible
Statutory entitlements for child care payments, costs of treatment or rehabilitation, independence allowance, funeral grant, survivors grant.	Exempt from tax	Exempt from tax

Tax policy

Q Will current tax-exempt entities continue to be exempt under the new regime?

A Friendly societies that provide accident compensation under the Accident Insurance Act 1998 will be subject to the same tax treatment on this business as other insurers.

Q Will accident insurance premiums be deductible for income tax purposes?

A Current income tax treatment remains. Employers and self-employed people will be able to deduct their insurance premium and levies for income tax purposes.

Employers – residual claims levy

Q Will my residual claims levy be liable for GST?

A Yes. If you are registered for GST you will be able to claim the GST as an input tax credit on your GST return.

Q Will my residual claims levy be deductible for income tax purposes?

A Yes.

Q How will I calculate and pay my residual claims levy?

A Your levy will be calculated annually on your IR 68A return and payable to Inland Revenue on 31 May. If you have shareholder-employees who receive a salary that has not had PAYE deducted during the year, your residual claims levy will be calculated on your IR 4 and payable on your terminal tax date.

Q Will there be a penalty for late filing or late payment?

A Yes. The residual claims levy is subject to the same interest and penalties provisions as those that apply to income tax.

Q Will the residual claims levy be risk-rated?
A Yes. It will use the same industry classifications as at present.

Q How long will I be paying the residual claims levy for?
A The residual claims levy will be payable annually for up to 15 years.

Q On what income will I pay the residual claims levy?
A On your liable earnings, as is currently used to calculate the ACC premiums.

Q I'm a new employer. Will I have to pay the residual claims levy?
A Yes.

Q Will I be paying my insurance premium to Inland Revenue?
A No. You will make this payment directly to the insurer of your choice.

Self-employed – residual claims levy and earners' account levy

Q How will I calculate and pay my levies?
A Your levies will be calculated annually using the liable earnings on your IR 3 and will be payable to Inland Revenue on your terminal tax date.

Q Will there be a penalty for late filing or late payment?
A Yes. You are subject to the same interest and penalties provisions as those that apply to income tax.

Q Will my levies be liable for GST?
A Yes. If you are registered for GST you will be able to claim the GST as an input tax credit in your GST return.

Q Will my levies be deductible for income tax purposes?
A Yes.

Q Will the residual claims levy be risk-rated?
A Yes. It will use the same industry classifications as at present.

Q Will the earners' account levy be risk-rated?
A No. Non-work accidents are not risk-rated.

Q How long will I be paying the levies for?
A The levies will be payable annually for up to 15 years.

Q On what income will I calculate the levies?
A On your liable earnings, as is currently used to calculate the ACC premiums.

Q I'm newly self-employed. Will I have to pay the levies?
A Yes.

Q Will I be paying my insurance premium to Inland Revenue?
A No. You will make this payment directly to the insurer of your choice.

Q If I choose to stay with the ACC for my accident insurance cover, will I pay my insurance premiums to Inland Revenue?
A No, the ACC will collect premiums for their insurance cover. Inland Revenue will collect only the residual claims levy and the earners' account levy.

Employees

Q I'm an employee. What do I have to pay?
A You won't need to do anything different. Your non-work accidents will continue to be covered by the ACC, so your earner premium will still be deducted from your salary and wages as part of your PAYE deductions. Your employer will be purchasing cover for your work-related accidents.

Shareholder-employees

Q I'm a shareholder-employee. Do I have to pay a levy or levies?
A No, the company as your employer will pay the residual claims levy on the company's IR 4 return. You will continue to pay earner premium (including the earners' account levy) on your shareholder-employee income and be covered by the ACC for non-work accidents, as at present.

IR 56 taxpayers

(Part-time private domestic worker, embassy staff, Deep Freeze personnel, overseas company representatives)

Q As a private domestic worker, what am I liable for under the new regime?
A You will pay a premium to the insurer of your choice (including the ACC) to cover your work accidents and a residual claims levy to Inland Revenue as agent for the ACC. Your non-work accidents will continue to be covered by the ACC, so you will continue to deduct earner premium (including earners' account levy) from your salary and wages as part of your PAYE deductions.

Q As an overseas company representative, embassy staff member or Deep Freeze worker, what am I liable for under the new regime?
A Your non-work accidents will continue to be covered by the ACC, so your earner premium will still be deducted with your PAYE tax from your wages. You are not liable for the residual claims levy. Your work accidents will be covered by the ACC.

Further information

For further information on the accident compensation changes, visit the Department of Labour's special website http://www.tochoose.govt.nz, or call their freephone – 0800TOCHOOSE. In February, all affected taxpayers will receive a comprehensive booklet on the changes, which has been prepared by the Department of Labour.

Disputes procedures: TRA regulations and High Court rules

New Taxation Review Authorities regulations

New Taxation Review Authorities Regulations were notified in the *NZ Gazette* of 22 December 1998.

The new regulations replace the Taxation Review Authority Regulations 1994 (S.R. 1994/41). They introduce procedural and associated measures required to implement in the jurisdiction of Taxation Review Authorities the tax disputes procedures enacted in 1996.

The new regulations contain procedural requirements associated with:

- the existing objection proceedings
- the Authorities' small claims jurisdiction for challenges involving tax in dispute not exceeding $15,000
- the procedures for commencing and conducting challenges.

They also provide for:

- Authorities' holding of directions hearings in challenge proceedings in both the small claims and general jurisdictions
- the manner in which objections proceedings and challenges may be set down for hearing
- the manner in which reports of proceedings may be published
- the non-precedential nature of decisions in the small claims jurisdiction
- filing fees of $50 for challenges begun in the small claims jurisdiction and $100 for those in the general jurisdiction.

The regulations came into force on 19 January 1999.

Challenges to tax assessments and the High Court rules

The Government's 1994 consultative document *Resolving tax disputes: proposed procedures* invited submissions on the most appropriate procedure to be followed in taxpayer-initiated litigation brought to challenge tax assessments. The consultative document indicated that an amendment to the High Court Rules would be sought in order to introduce to those rules a separate part containing all rules associated with the commencement and conduct of taxpayer-initiated challenges to assessments.

Because the Rules Committee prefers to see the one general procedure used where possible in all proceedings, Inland Revenue has decided not to proceed with the proposal at this time. The Committee will review the situation if it appears the existing procedure creates difficulties in the tax context.

Student loan scheme – interest rates and repayment threshold for 1999-2000

On 16 December 1998 the Ministers of Education and Revenue announced the interest rates and the repayment threshold for the student loan scheme for the year commencing 1 April 1999.

The total interest rate will be 7.0 percent. This is made up of the base interest rate of 5.3 percent and the interest adjustment rate of 1.7 percent.

The repayment threshold for the 1999-2000 income year will remain at $14,716.

Interpretation statements

This section of the TIB contains interpretation statements issued by the Commissioner of Inland Revenue. These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation 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 the assessment we consider that the earlier advice is not consistent with the law.

Lease renewals and extensions

Section 29, Stamp and Cheque Duties Act 1971

Summary

This interpretation statement sets out the Commissioner's view on the application of section 29 of the Stamp and Cheque Duties Act 1971. In particular, it focuses on the application of section 29 to instruments of extension and renewal of lease, as it is in this area that difficulties in interpreting the section have arisen. This interpretation statement replaces the relevant parts of the Commissioner's statement published in Tax Information Bulletin Volume Six, No.2 (August 1994), at pages 2 and 3.

Under section 29, if an instrument increases the rental payable under any lease, stamp duty will be computed on that instrument only to the extent of the increase.

In order for an instrument to be dutiable under section 29, a particular lease must already exist at the time an instrument increasing or agreeing to increase the rental is executed, and the instrument must be executed "during the term of the lease". Therefore, if an instrument is executed after the term of a lease has expired, section 29 will not apply and any such instrument will be dutiable under section 26 of the Stamp and Cheque Duties Act 1971.

If an instrument is executed to vary the term of a lease so that the lease is extended to cover a further period, effectively a new lease is created and the instrument will be dutiable under section 26. This will be the case whether or not there is a corresponding increase in rental.

If the term of a lease is renewed, effectively a new lease is granted following the termination of the earlier lease. This means that when a lease is renewed and the rental payable under the lease is increased, section 29 will not apply and the instrument evidencing the renewal will be dutiable under section 26.

If the term of a lease is varied by way of a memorandum of extension in Form L of the Second Schedule to the Land Transfer Act 1952, effectively a new lease is created and consequently the instrument will be dutiable under section 26 of the Stamp and Cheque Duties Act 1971.

If an option to extend the term of an unregistered lease is exercised unilaterally and the rental payable under the lease is increased, the instrument will be dutiable under section 29. Where on the other hand an option to extend the term of an unregistered lease is exercised bilaterally and the rental payable under the lease is increased, effectively the parties are varying the term of the lease and accordingly the instrument will be dutiable under section 26.

Legislation

All legislative references in this item are to the Stamp and Cheque Duties Act 1971 unless otherwise stated.

Section 26 states:

(1) Stamp duty payable on a lease shall be a lease duty computed -

- (a) At the rate of 40c for each $100, and for such amount as may be less than $100, of -
  - (i) The maximum rent that is or may become payable under the lease in any year; or
  - (ii) If the lease is for a term of less than 1 year, the maximum rent that is or may become payable for that term; and
- (b) At the rate of $1 for each $100 and for such amount as may be less than $100, of any premium, fine, or other consideration whatsoever other than rent, payable under the lease.

(2) If any lease is granted without consideration, or for a consideration that in the opinion of the Commissioner is inadequate, lease duty shall be computed on the value of the lessee's interest under the lease, determined in accordance with Part III of this Act, at the rate of $1 for each $100, and for such amount as may be less than $100, of that value, to the extent that the lease is without consideration or the consideration for the lease is inadequate.

Section 29 states:

Notwithstanding anything in section 26 of this Act, lease duty shall be computed on every instrument whereby the rent or other consideration, or the value of the lessee's interest, under any lease is increased or agreed to be increased during the term of the lease as if the instrument were a new lease for a consideration equivalent to the increase in rent or other consideration, or the increase in the value of the lessee's interest.

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Section 8 states:

For the purposes of this Act, the term "lease" means any instrument whereby at law or in equity -

(a) Any leasehold interest in land; or

(b) Any easement over land -

is created or agreed to be created; and includes any instrument by which the rent, consideration, or the value of the lessee's interest in any lease is increased or agreed to be increased.

Section 3 states:

For the purposes of this Act, the term "instrument" includes every writing, whether executed in New Zealand or elsewhere, affecting -

(a) Any property situated in New Zealand; or

(b) Any property situated or to be situated on the continental shelf beyond the territorial limits of New Zealand, but that pursuant to the Continental Shelf Act 1964 would or will be deemed to have taken place in New Zealand, -

but does not include a will or other instrument operating only by way of a testamentary disposition, or a bill of exchange.

Section 116 of the Land Transfer Act 1952 states:

(1) The term of any lease may from time to time be extended by a memorandum of extension in Form L in the Second Schedule to this Act signed by the lessor and lessee for the time being and registered before the expiry of the then current term of the lease.

(2) Subject to the provisions of this section, the memorandum of extension shall have the same effect as if it were a memorandum of lease for the extended term subject to the same covenants, conditions, and restrictions, with the necessary modification, as are contained or implied in the lease. Upon the registration of the memorandum of extension the estate of the lessee thereunder shall be deemed to be subject to all encumbrances, liens, and interests to which the lease is subject at the time of registration of the memorandum of extension. For the purposes of this subsection all references in any Act or in any agreement, deed, instrument, notice, or other document whatsoever to the lease or to the estate of the lessee thereunder shall, unless inconsistent with the context or with the provisions of this section, be deemed to be references to the lease as varied by the memorandum of extension or to the estate of the lessee thereunder, as the case may be.

(3) The covenants, conditions, and restrictions contained or implied in the lease may be expressly varied, negatived, or added to by the memorandum of extension.

...

(4) Notwithstanding that the term of the lease is not extended, the covenants, conditions, and restrictions contained or implied in any lease may be expressly varied, negatived, or added to by a memorandum of variation in the said Form L (with the necessary modifications) signed by the lessor and the lessee for the time being and registered before the expiry of the then current term of the lease.

(5) The memorandum of extension or memorandum of variation may be registered in the same manner as the original lease:

Provided that, notwithstanding anything to the contrary in section 66 hereof, a memorial of a memorandum of extension or memorandum of variation of any lease in respect of which a certificate of title has been issued under that section shall be entered on all relevant instruments and on that certificate of title, which shall have full validity and effect during the extended term.

(6) If the land affected by the memorandum of extension or memorandum of variation is at the time of the registration of the memorandum subject to any mortgage, the memorandum shall not be binding on the mortgagee unless he has consented thereto in writing on the memorandum.

Application of the legislation

Section 26(1) imposes stamp duty on leases of commercial land and buildings. Stamp duty is payable at the rate of 40 cents per $100 (or part thereof) on the maximum rent that is payable or may become payable under the terms of the lease in any year. If the lease is for a term that is less than a year, stamp duty is payable on the maximum rent that is payable or may become payable over the term of the lease.

Prima facie, every instrument that falls within the section 8 definition of lease is dutiable pursuant to section 26 at the specified rate.

Under section 29, if an instrument increases the rent or other consideration, or the value of the lessee's interest, under any lease stamp duty will only be computed on that instrument to the extent that there is an increase in rent or other consideration or there is an increase in the value of the lessee's interest.

Example 1 – rental increased at some point during the term of the lease

C Ltd leases a commercial building from D Ltd for a ten-year period from 1 December 1998 at an annual rental of $50,000 per annum. Lease duty of $200 is paid. Under the lease, the rental is to be reviewed after five years by agreement, and if no agreement can be reached, by arbitration. By way of an instrument dated 24 December 2003, the rental is increased to $75,000 per annum.

The lease provides that the rental payable is to be increased at a specified date in the future, and an instrument effecting this increase has been executed. In this situation section 29 will apply and stamp duty of $100 will be payable on the instrument.

The use of the words "under any lease" in section 29 indicate that in order for an instrument to be dutiable under the section, a particular lease must already be in existence at the time an instrument increasing or agreeing to increase the rent or other consideration, or the value of the lessee's interest is executed. This indicates that instruments will not be dutiable under section 29 if:

- a lease is entered into for the first time; or
- during the term of a lease a new lease is agreed upon and entered into (including occasions where by operation of law an instrument effects a new demise).

In these situations it cannot be said that the instrument is entered into under "any lease" (meaning the specific lease in question), as a new lease is, in effect, created. Any such lease will be a fresh demise, dutiable under section 26.

The wording of section 29 also indicates that in order for the provision to apply, the instrument increasing or agreeing to increase the rent or other consideration, or the value of the lessee's interest, under any lease must be executed "during the term of the lease". Therefore, if an instrument is executed after the term of a lease has expired, section 29 will not apply and any such instrument will be dutiable under section 26.

Example 2 - entering into a lease

F Ltd enters into an agreement to lease a commercial building from S Ltd for a four-year period from 1 December 1998, at an annual rental of $50,000 per annum.

Stamp duty of $200 is paid under section 26(1). A new lease has been entered into between the parties, there is no existing lease and therefore section 29 has no application.

Example 3 - lease expires, new lease agreed

H Ltd enters into an agreement to lease a commercial building from L Ltd for a four-year period from 1 December 1998 at an annual rental of $50,000 per annum. Lease duty of $200 is paid under section 26(1).

On 31 March 2003 the parties agree to enter into a new lease for a further four-year term, and further lease duty of $200 is paid under section 26(1).

The existing lease entered into on 1 December 1998 expired on 1 December 2002. Therefore, section 29 does not apply – it applies only if an instrument is entered into under an existing lease. In this instance the lease has expired and the parties have entered into a new lease.

Varying the terms of a lease

The parties to a lease may wish to vary their existing rights under the lease so as to extend or renew its term, or alternatively to introduce an option to renew or extend the term of the lease at some time in the future.

In *Re Savile Settled Estates, Savile v Savile* [1931] All ER 556, the plaintiff granted two leases, both for a period of 60 years. The plaintiff later sought to vary both leases by substituting a term of 100 years from the date when the leases took effect. Maugham J stated at page 557:

> I think there is no doubt that the law, as stated in Halsbury's Laws of England, 2nd Ed., vol. 20, p.271, para. 303, is that any arrangement between the landlord and tenant which operates as a fresh demise will work as a surrender of the old tenancy...
>
> ...
>
> I should add that, in my opinion, an alteration of an existing lease, so that it will operate for a term extending beyond the original term, can only operate in law as a surrender of the old lease and a grant of a new one…

In *Baker v Merckel* [1960] 1 QB 657, by a lease under seal in 1947, the lessor demised premises to the lessee for a term of seven years from 1 November 1946, at a yearly rent of £150. A supplemental deed made between the lessor and the lessee in March 1949, and endorsed on the lease provided that: "if the tenant shall give notice ... to the landlord before Nov 1, 1952, of such his desire the within written lease thereupon shall read, construed and take effect as though the term thereby granted was for a period of eleven years from Nov 1, 1946...". In 1951 the lessee assigned the lease and option to the first assignee, who in turn assigned it in the same year. In 1952 the second assignee exercised the option to extend the term of the lease, and subsequently in that year assigned it to the last assignee, who in 1957 gave up possession owing rent and being in default on the repairing covenant. The lessor brought an action against the original lessee claiming rent and damages for breach of covenant. Sellers LJ at pages 669-670 said:

> [T]he supplemental deed of March, 1949, had the effect in law of supplanting the original lease by a new one, the terms of which were derived from reading the two documents together. The effect is to include the option as if it had been in the original lease. There was therefore, whilst the lessor and lessee were in direct contractual relationship, a contractual right by unilateral action of the lessee to enlarge the term from seven to eleven years and to vary by the same action the provisions as to painting of the outside of the premises.
>
> ...what was done in 1949 was not a mere agreement for the future; it was the granting and obtaining by mutual agreement of a right which the lessee could at his option exercise and which at once became an enforceable part of the contract. The agreement itself did not enlarge the original term, but it provided that it might be extended without any further consent of the lessor and was therefore a substantial alteration of a character to which the rule applies.
>
> Whilst the agreement for the option was consensual and in law effected a new lease, the exercise of the option ... was unilateral ... Here the notice had the effect of enlarging the demise, of its own force. It was in fulfilment of and in accordance with the agreement and not inconsistent with it or a variation of it. No new bargain was struck in 1952. That which had been agreed as permissible became effective.

Pearce LJ at pages 671-672 said:

> I think it would be wrong to hold that the demise was unaffected by the option until its exercise in 1952.
>
> ...
>
> It is not easy on the authorities to avoid the implication of a surrender and fresh grant where such a change is made in the term, viz., a variation of a term of seven years with an option for a further four years.

In *O F Gamble Pty Ltd v Whitemore Pty Ltd* (1990) 2 WAR 327, Commissioner Anderson QC made the following relevant comments at pages 332-334:

> Any variation having the effect of extending the term of a lease is, as I have observed, held to work a surrender and fresh grant.

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In *Baker v Merckel* [1960] 1 QB 657, it was held that the insertion into a lease by supplemental deed of an option to extend the demise from seven years to eleven years had the same effect. It had the effect of supplanting the existing lease by a new one. It was not necessary for the option actually to be exercised. The mere insertion, by variation, of an option to extend, sufficiently changed the estate to bring the doctrine of surrender and fresh grant into operation.

Counsel for the defendant pointed out the distinction between the facts of *Baker v Merckel* and the facts of the instant case. In the instant case, the option does not provide for the enlargement of the existing term; but, instead provides that the lessee can "require the lessor ... to grant to the lessee a new lease of the property for a further term of eight years ... on the same terms and conditions...". The point of distinction is that in *Baker v Merckel* the option was to extend the existing demise, whereas in the instant case the option is for the grant of a new lease. This seems to be a very fine distinction.

...

In my opinion, a demise with a covenant of renewal is an estate or interest in the land that is different from a demise containing no covenant of renewal, and this is so regardless of whether the covenant of renewal is in a form which provides for the enlargement of the existing term, or is in a form which provides for the grant of a new lease. I would therefore hold that the introduction into a lease by deed of variation of an option of renewal works a surrender of the old lease by operation of law and a grant of a new lease.

...

It is true that, when an option of renewal is exercised, the position is that there is a new lease, a new demise. Plainly, that new lease or new demise does not come into existence until the option is exercised; but that is not to say that if the option of renewal is introduced by variation, the variation is not also effective to create a new lease.

In *Jenkin R Lewis & Son Ltd v Kerman* [1971] Ch 477, the question to be decided was whether a document between the lessee and the landlord in 1961 increasing the rent, and/or a similar deed between the two parties in 1968 had the effect of creating a new contract of tenancy between those persons, and consequently a surrender and cesser of the 1941 contract of tenancy.

The Court found that a mere agreement between landlord and tenant for an increase in rent did not necessarily result in a surrender of the existing tenancy and the creation of a new one. Delivering the judgment of the court, Russell LJ stated at page 496:

It is not possible simply to convert the existing estate in land into a different estate by adding more years to it, and even if the parties use words which indicate that this is what they wished to achieve the law will achieve the result at which they are aiming in the only way in which it can, namely by implying a fresh lease for the longer period and a surrender of the old lease: see *In re Savile Settled Estates* [1931] 2 Ch 210; *Baker v Merckel* [1960] 1 QB 657.

On the basis of the above discussion it is evident that:

- Any arrangement between the lessee and lessor which operates as a fresh demise will work as a surrender of the old tenancy.
- Some terms of a lease can only be varied by an instrument which operates as a surrender and regrant, e.g. the lengthening of the term of a lease.

On this basis it is evident that if an instrument is executed varying the term of a lease so that the lease is extended to cover a further term, the lease will be dutiable under section 26. This will be the case whether or not there is a corresponding increase in the rental or other consideration, or the value of the lessee's interest in the lease.

Example 4 – parties agree to vary the terms of the lease so as to extend its term

K Ltd leases a commercial building from B Ltd on 1 December 1993 for a term of three years at a rental of $100,000 per year. Lease duty of $400 is payable.

On 30 October 1996 the parties enter into negotiations and decide to vary the lease and extend its term for another 3 years, increasing the rent payable to $150,000.

The variation of a lease so that its term is lengthened operates as a surrender and regrant by operation of law. On this basis lease duty is assessable pursuant to section 26, and stamp duty of $600 is payable on the new lease.

Renewals and extensions of lease generally

Many leases include a provision granting the lessee a right to extend the term of a lease or to renew the lease for a further term or terms at the end of the current term. This right may be presented as a covenant on the part of the lessor to grant a further term or terms, or as an option to renew or extend the lease in favour of the lessee. Alternatively, the parties to a lease may wish to renew or extend a lease by varying their existing rights under a lease during the term of the lease or after the lease has expired.

A distinction between an "extension" of a lease and a "renewal" of a lease is generally accepted, albeit that it is sometimes difficult to determine.

In *Brooke v Clarke*, 1B & Ald. 399, the Court considered the term "extension" at page 399:

"Extension", is a term properly used for the purposes of enlarging, or giving further duration to, any existing right, but does not import the re-vesting of an expired right; that would not be an 'extension' but a 're-creation".

In *Muller v Trafford* [1901] 1 Ch. 62, the Court found that a covenant by an under-lessee with his sub-lessee to grant an "extension" of the latter's term on the under-lessee obtaining a further term from the freeholder, "is not a covenant to renew".

In *Regor Estates v Wright* [1951] 1 KB 689, the Court found that a "renewal of a tenancy" meant an agreement for a fresh tenancy following on the termination of the earlier one.

In *Green v Wilson & Horton* (1983) 2 NZCPR 94, Savage J at page 102 said:

I think it is clear that a renewal of a lease for more than three years, which in effect is **the grant of a new lease**, is required to be in writing and thus comes within s.2(1)(b) Contracts Enforcement Act 1956.

And later at page 103:

A further difficulty that would lie in the way of the plaintiff is that for a lessee to take advantage of a right of renewal, **which is in effect an option to a new lease**...

Halsbury's Laws of England (4th ed. reissue (1994) vol 27(1), para 467) states:

Where a lease contains an option to renew the lease the exercise of the option will ordinarily involve the creation of a new lease, and as regards the new lease there will be no privity of contract between the landlord and the original lessee under the old lease which contained the option to renew: however, the right given to a tenant may be simply to extend the term, in which case privity of the contract will endure between the parties, even during the extended term.

Halsbury's indicates that where a lease contains a renewal option, the exercise of the option will not ordinarily constitute the extension of the original lease's term.

In *Brooker's Land Law* Volume 2, Ch 11, Leases, at 11-125:

A preliminary question, which may be of importance, is the construction of the lease provision to determine whether the lessee has been granted an option to renew the lease, **meaning to be granted a new lease** on the same or substantially the same terms as the expiring term, or alternatively, **an option to *extend* the present lease term for a further period.**

Woodfall, *Landlord and Tenant*, Release 38 at page 18/3 states that:

Sometimes a lease contains an option to extend the term rather than an option to renew it. The grant of a lease pursuant to **an option to renew creates a new interest, whereas the extension of the term keeps the old term in being** with the consequence that the original tenant is bound by the extension, even where the option is exercised by an assignee. *Baker v Merckel* [1960] 1 QB 657.

The following points can be taken from the above discussion:

- The "renewal" of a lease, in its ordinary sense, implies the granting of a new lease following on from the termination of an earlier lease.
- The "extension" of a lease, in its ordinary sense, implies a continuation of the old lease for a further period, but does not import the re-vesting of an expired right.

If it is unclear as to the nature of a further term contemplated, it will be necessary to look at "the true construction of the respective rights and obligations as expressed in the relevant documentation - Per Henry J in *Sina Holdings Ltd v Westpac Banking Corporation* [1996] 1 NZLR 1 at page 5.

Renewals of lease – application to the Stamp and Cheque Duties Act 1971

The "renewal" of a lease, in its ordinary sense, implies the granting of a new lease following on the termination of an earlier lease. On this basis, if a lease is renewed as well as the rental being increased, section 29 will not apply and the instrument evidencing the renewal will be dutiable under section 26.

Example 5 – option to renew a lease

M Ltd leases a commercial building from G Ltd on 1 December 1993 for a term of ten years at a rental of $50,000 per year. The lease contains an option to renew the lease for a period of 5 years. Lease duty of $200 is payable.

In June 2003, M Ltd exercises its right to renew the lease for a further five years and the rental is increased to $70,000 per year.

In this situation stamp duty of $280 is payable under section 26(1). The renewal of a lease constitutes the surrender of the lease followed by the regrant of a new lease. Therefore, section 29 will not apply.

Extensions of lease – application to the Stamp and Cheque Duties Act 1971

The word "extension", when used in its proper and usual sense in connection with a lease, means a prolongation of the previous leasehold estate. This could be seen as supporting the view that when an option to extend a lease is exercised it is merely a continuation of the existing lease, and therefore stamp duty on the instrument evidencing the extension is assessable under section 29.

However, there are a number of ways the terms of a lease could potentially be extended which could influence the application of section 29, dependent on whether the lease is registered or unregistered.

Registered leases

If a lease is registered under the Land Transfer Act 1952 (LTA), the parties may agree to extend the term of the lease by way of memorandum of extension under section 116 of that Act.

Under section 116 of the LTA, the term of a registered lease may be extended by the registration of a memorandum of extension in Form L in the Second Schedule to the Act. The use of Form L is mandatory, and the memorandum of extension must be signed by the lessee and lessor. The memorandum of extension must be filed before the expiry of the current term of the lease.

Section 116(2) of the LTA stipulates that upon registration of the memorandum of extension the memorandum shall have the same effect as if it were a memorandum of lease for the extended term subject to the same terms and conditions contained or implied in the lease. Under this section, all references in any Act or in any agreement,

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deed, instrument, notice, or other document are deemed to refer to the lease as varied by the memorandum of extension.

The wording of section 116 of the LTA is clear that a memorandum of extension must stand on its own terms and conditions rather than on those of the previous lease. The memorandum of extension is treated as having the same effect as a memorandum of lease, and references to the lease are deemed to refer to the lease as varied by the memorandum of extension.

As discussed previously, some terms of a lease can be varied only by an instrument which operates as a surrender and regrant, e.g. when the term of a lease is lengthened. Under section 116 of the LTA, the length of term of the premises demised is clearly being altered: the parties are entering into a bilateral arrangement whereby the terms of their lease are materially varied.

On this basis, if the term of a lease is varied by way of a memorandum of extension in Form L of the Second Schedule to the LTA, the effect is that a new lease is created and accordingly the instrument will be dutiable under section 26 of the Stamp and Cheque Duties Act. Section 29 will not apply, as the extension (by way of variation) constitutes a new lease and section 29 applies only to instruments increasing the rental payable under an existing lease.

This view is supported by comments made in *Law of Stamp Duty in New Zealand*, 3rd ed., where Adams states at page 186 that:

> *Stamp duty on extension of leases* – An extension of a lease – e.g., one executed in the form prescribed by s.116 of the Land Transfer Act 1952 – is liable to the same duty as a lease, for it is in fact a fresh demise…

Example 6 – parties agree to vary the terms of the lease so as to extend its term

A Ltd leases a commercial building from B Ltd on 1 December 1993 for a term of three years at a rental of $100,000 per year. A condition of the lease provides that the parties may agree to extend the term of the lease for a further 3 years at some time in the future. Lease duty of $400 is payable.

On 30 October 1996 the parties enter into negotiations and decide to extend the term of the lease for another 3 years and increase the rent payable to $150,000 under section 116 of the LTA.

Lease duty of $600 is payable on the new lease. The extension of the term of a lease under section 116 of the LTA operates as a surrender and regrant by operation of law. On this basis lease duty is assessable under section 26 of the Stamp and Cheque Duties Act 1971.

Unregistered leases

If a lease is not registered for the purposes of the LTA, the lease may be extended or varied by deed executed by both landlord and tenant. Extensions of equitable leases may be effected by deed or written agreement. The parties may agree before the end of the term to the extension, or alternatively the lease may not contain an option to extend the term of the lease and the parties may agree before the end of the term to vary the terms of the lease so as to extend its term.

The application of section 29 to the situation where an instrument merely realising a right that is already available under an existing lease is executed is not clear. It is apparent, for example, that there will be situations when a lessee may have an option, to be exercised bilaterally or unilaterally, to extend the term of a lease. If such an option is taken up, is a new leasehold interest created or is the term of the old lease merely increased? This is relevant in so far as section 29 relates to instruments whereby the rent or other consideration, or the value of the lessee's interest, under any lease is increased or agreed to be increased during the term of the lease.

In *Baker v Merckel* an option to extend the term of a lease was exercised unilaterally. The Court in that case found that the original variation of the lease was consensual and in law effected a new lease. The new lease which was to be gathered from reading the original lease and the supplemental deed, required nothing more than the option to be exercised by way of a unilateral act, and therefore the exercise of the option was merely an extension of the current lease rather than the creation of a new lease: that creation took place when the earlier lease was created. The Court drew a distinction between a consensual act varying the terms of a lease and a unilateral act arising out of and in accordance with the terms of a lease. Sellers LJ at page 670:

> Whilst the agreement for the option was consensual and in law effected a new lease, the exercise of the option ... was unilateral ... Here the notice had the effect of enlarging the demise, of its own force. It was in fulfilment of and in accordance with the agreement and not inconsistent with it or a variation of it. No new bargain was struck in 1952. That which had been agreed as permissible became effective.

Baker v Merckel supports the view that a distinction can be drawn between a consensual act varying the terms of a lease which amounts to the surrender and regrant of a lease, and a unilateral act arising out of and in accordance with the terms of a lease which has the effect of extending the existing lease's term.

On this basis, if an option to extend the term of an unregistered lease is exercised unilaterally, section 29 is of potential application in assessing duty on any increase in rental.

Until an option is exercised, it can only be said to offer a future possibility that the lease will be extended. If the parties to a lease decide to exercise the option, they are in effect agreeing to a consensual variation of the terms of the lease and accordingly a fresh demise is created. This situation is to be distinguished from that where a lease contains an option to extend the term of the lease by virtue of a party's unilateral act without any element of bargain. As a result of the unilateral act there is an enlarging of the existing demise.

Example 7 – option to extend the term of lease

By deed dated 1 December 1993, K Ltd leases a commercial building from J Ltd for a term of two years at a rental of $100,000 per year. Lease duty of $400 is payable. Under a condition of the lease, the lessee may extend the term of the lease for a further year, before its expiry, by notifying the lessor of that intention. In that event the rent for that year will be increased to $150,000.

Before the expiry of the lease, the lessee exercises the option to extend the lease for a further year. The exercise of an option to extend the term of a lease implies the continuation of the existing lease, and accordingly duty is assessable under section 29. Duty of $200 is payable.

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.

Advertising agencies: placement and creative services supplied to non-residents

Section 11(2)(e), Goods and Services Tax Act 1985 – Services provided for and to persons not resident in New Zealand

In November 1996 Inland Revenue published public ruling BR Pub 96/10 – *GST: advertising space and advertising time sold to non-residents* – (TIB Volume Eight, No.8, pages 13-17). That ruling and its commentary discussed the supply of advertising space and advertising time on radio and television, by a GST registered person to a non-resident person who is outside New Zealand at the time the services are performed.

A taxpayer has asked whether zero-rating would apply to:

- services that are required to create an advertisement for a non-resident
- placement services provided to a non-resident.

The ruling itself says that the supply of advertising space or advertising time means the service of communicating an advertising message, including all steps involved in providing the service by the supplier of the advertising space or time. However, the ruling does not mention advertising agencies that supply creative and placement services, and deals only with the supplier of the advertising media.

This item explains Inland Revenue's view of how section 11(2)(e) applies and, in particular, whether the "directly in connection with" test is satisfied in the case of creative and placement services when these advertising services are supplied to non-residents.

Section 11(2)(e) states:

> (2) Where, but for this section, a supply of services would be charged with tax under section 8 of this Act, any such supply shall be charged at the rate of zero percent where - ...
>
> (e) The services are supplied for and to a person who is not resident in New Zealand and who is outside New Zealand at the time the services are performed, not being services which are supplied directly in connection with-
>
> (i) Land or any improvement thereto situated inside New Zealand; or
>
> (ii) Moveable personal property (other than choses in action, and other than goods to which paragraph (ca) of this subsection applies) situated inside New Zealand at the time the services are performed; -
>
> and not being services which are the acceptance of an obligation to refrain from carrying on any taxable activity, to the extent that the conduct of that activity would have occurred within New Zealand;...

Creative services are simply services supplied that create the advertisement itself. The creation of an advertisement involves ascertaining the client's general aspirations, defining the required product image, identifying potential market targets, identifying suitable advertising media and formats, and focusing more specifically on the generation of ideas, themes and concepts which best link these. After evaluation and discussion with clients, a specific advertising product is finally developed and submitted to the client for approval.

Placement services cover the "where and when" of advertising, and are services provided by agents in giving their advice on placing advertisements with the appropriate media. This may involve the detailed planning of an advertising campaign, and negotiating and arranging the placement of advertisements with broadcasters and mass circulation publishers.

The Commissioner's view is that placement services may be zero-rated, provided the other requirements of section 11(2)(e) are satisfied, i.e. the services are supplied contractually for and to a non-resident who is outside New Zealand at the time the services are performed. It is considered that placement services are in the same category as other services such as the provision of advertising space which, according to Hillyer J in his decision in *Wilson & Horton v CIR* (1994) 16 NZTC 11,221 at 11,224, are supplied directly in connection with an advertisement but not directly in connection with whatever goods or services are advertised. Placement services will always satisfy the requirement of section 11(2)(e) that the services are not to be supplied directly in connection with land or moveable personal property situated in New Zealand.

With creative services the situation is more complicated. Since the finished advertisement does not yet exist while creative services are being performed, it arguably follows from the reasoning in *Wilson & Horton* that creative services should be considered to be directly connected with the subject matter of the advertisement.

However, the Commissioner's view is that although the finished advertisement may not exist, it will nevertheless exist in a conceptual or embryonic form while the creative services are being performed. Although the developing advertisement may be said to have an imaginary or intellectual existence, it would not be so elusive or insubstantial as to be said to have no existence at all for the purposes of the Act. Accordingly, there will always be something intervening between the creative services and the subject matter of the advertisement. On the basis of the "one step removed" test applied in *Wilson & Horton*, creative services and the advertisement's subject matter (i.e. the goods and/or services being advertised) may truly be said not to be directly connected with one another.

In summary, creative services and placement services supplied to non-residents who are outside New Zealand at the time the services are performed will qualify for zero-rating, regardless of whether or not the goods to be advertised are situated inside 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'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.

Gas pipe replacement – whether capital or revenue expenditure

Case: CIR v Auckland Gas Company Limited

Decision date: 15 December 1998

Act: Income Tax Act 1976 – section 104 & 108

Keywords: capital v revenue expenditure

Summary

This was an appeal by the Commissioner from the High Court. The Court of Appeal allowed the Commissioner's appeal, finding that AGC's expenditure was of a capital nature.

Facts

Auckland Gas Company Limited ("AGC") is in the business of gas distribution. Since mid 1980s AGC has been inserting polyethelene pipe into its existing cast iron and steel mains and services. AGC claimed deductions for the expenditure incurred on the basis that the expenditure constitutes a "repair" under section 104 of the Income Tax Act 1976

Decision

The Court of Appeal found that the PE insertion in its nature and scale could not realistically be regarded as a mere repair, but held that the High Court had rightly proceeded on the basis that the asset was the whole of the AGC network.

The Court of Appeal held that if the taxpayer was faced with a costly maintenance bill but elects to rebuild the asset in question in a different way which results in a substantial change in its character, the cost cannot be written off for tax purposes as if it were merely an expenditure or maintenance work which was not actually done – even if what was spent may have been less than the cost of maintenance.

Their Honours held that the pipe substitution programme was from its inception projected beyond the income years in question. Furthermore the Court held that the taxpayer could not, by artificially treating portions of an overall program done in separate income years as separate works, deny the reality or minimise the extent of what had been effected

The Court of Appeal held that under section 108 the changes effected to AGC's network were fairly categorised as alterations. They were modifications to the network and did not amount to a replacement of substantially the whole even if the Commissioner's figure of 70% was accepted. However their Honours held that AGC's valuation evidence failed to establish that what was done had not increased that capital value (market of economic value) of the network or had done so by less than the cost. AGC failed because it had not produced the requisite before of after valuations. In any event the Court held that AGC's valuation evidence failed to establish AGC's case.

Auckland Gas Company Limited has appealed the Court of Appeal ruling to the Privy Council.

Costs awards in tax court cases

Case: Auckland Gas Company Limited v CIR – costs decision

Decision date: 15 December 1998

Act: Income Tax Act 1976

Keywords: Costs to the respondent

Facts

The costs appeal was argued before the result of the substantive appeal was know. The Commissioner succeeded in the substantive appeal and therefore the case is to be remitted to the High Court for finalisation of costs.

Decision

The Court of Appeal held that in relation to appeals, the High Court may award such costs to or against either party as it thinks just. In relation to the first instance hearings in the High Court the same costs jurisdiction and rules (s 51G of the Judicature Act and r 436) apply to tax cases as they do to civil cases generally.

Their Honours stated that although the right to challenge assessments for tax is central to the functioning of the tax system, so too, are the principles underlying ss 6 and 6A. Those principles are designed to protect the integrity of the tax system in an environment where the Commissioner is required to operate within limited resources in the care and management of all the functions committed to the Commissioner's charge. Accordingly, the Court of Appeal held that it does not follow that there is a special and different approach to costs awards in High Court tax litigation than applies generally in civil cases.

In that regard both the taxpayer and the Commissioner operating under the care and management responsibilities imposed by ss 6 and 6A are entitled to make sensible litigation, including settlement, decisions. The Court of Appeal held that although the Commissioner's functions as spelt out in the 1995 amendment, based on the Report of the Organisational Review, must be taken into account and place the Commissioner in a somewhat different category from a private person, for litigation purposes there is no cause to read the legislation as placing any substantial or undue inhibition on his or her powers in this regard.

The Court of Appeal held that the general principles governing the discretionary award of costs in civil cases including the relevance of the scale (r 48) are equally applicable to tax cases and can readily accommodate any special factors that may be present in a particular case, e.g. test case implication, particularly small or large sums at stake, and any particular circumstances of the taxpayer or of the litigation itself.

Power cable undergrounding – revenue or capital

Case: Poverty Bay Electric Power Board v CIR

Decision date: 15 December 1998

Act: Income Tax Act 1976 – section 108

Keywords: Capital expenditure or revenue expenditure, repairs, alterations

Summary

This was an appeal by the Objector from the High Court. The Court of Appeal dismissed the Objector's appeal, finding that the expenditure was of a capital nature.

Facts

Poverty Bay Electric Power Board ("PBEPB") is an electricity supplier. They supply electricity from the East Coast to south of Gisborne.

PBEPB replaced urban overhead power lines in its area with underground cables and claimed a deduction for revenue expenditure of $422,658 in respect of 14 of the sites.

The Commissioner disagreed and assessments were issued on the basis that the expenditure was capital in nature.

Issues

1. Whether the expenditure was a revenue expenditure qualifying for deductibility as a "repair" or whether it was capital expenditure.

If capital expenditure:

2. Whether the second proviso to s 108(1) of the Act was a " stand-alone " provision permitting the deduction of certain capital expenditure within the limits therein prescribed.
3. Whether the expenditure was on " alterations " to the system, and if so:
4. Whether those alterations increased the " capital value" of the asset so altered, or did so by an amount less than the cost of the alterations.

Decision

The Court of Appeal found that the work overall on the undergrounding programme was so substantial and was intended to produce such a different and operationally superior asset for the board that it is impossible to regard it as anything but a capital improvement.

On the second and third issues, the Court of Appeal found that the second proviso allows a deduction of the cost of alterations of a capital nature, and on the facts, the changes made to sections of the cable is fairly described as "alterations".

On the fourth issue, the Court was satisfied on the evidence that there was an appropriate basis for the High Court's decision that the capital value of the urban reticulation had been increased by at least the cost of the works. As that view was open on the evidence, the Court was not prepared to disturb it.

Farm land supplied by trusts – whether taxable activity for GST

Case: CIR v John Humphry Bayly & Ors

Decision date: 9 December 1998

Act: Goods and Services Tax Act 1985

Keywords: taxable activity, farm land, lease

Summary

The trusts were found to be liable to GST in this instance and the Commissioner's appeal was allowed.

Facts

This case involved five land-owning trusts. Three sets of trustees owned the Tangihau Station. Two further sets of trustees owned the Cricklewood and Tahanui Stations. Approximately thirty years ago the owners of the stations entered into separate partnership deeds. Under those deeds the stations were placed at the use and occupation of the partnership for the term of the partnership (approximately 30 years). The deeds provided that the interests in the land were not partnership assets.

The partnerships were required to pay all rates and taxes and the landowners were to receive a share of partnership profits. One of the five trusts, which engaged in an unrelated activity, was registered for GST purposes; otherwise the trusts were not registered persons.

On 6 May 1992 the trusts which owned the Tangihau Station sold it to a family company. On 30 October 1992 the trusts which owned the Cricklewood and Tahanui Stations sold them to a family partnership.

The purchasers of the land registered for GST and claimed an input tax credit on the transactions. The Commissioner assessed the vendor trusts for GST on the land sales. The trusts objected.

The Taxation Review Authority upheld the Commissioner's assessments, deeming the trusts to be registered persons who were engaged in the taxable activity of supplying the use and occupation of farmland to the relevant farming partnership and also concluding that they had met the necessary registration threshold.

Tompkins J in the High Court overturned the Taxation Review Authority's decision. His Honour found that the deeds in each case were contractual licences as opposed to leases. His Honour held that once the trustees executed the deed they were not involved in any activity and were not required to do anything as owners. Accordingly, the trustees were not carrying on a taxable activity and were not liable for GST on the sale of their lands.

Decision

The Court of Appeal addressed first the question of whether the trustees were engaged in a taxable activity. The Court of Appeal stated that the character and incidents of the legal arrangements in question could be ascertained only by their surrounding circumstances. The label which should be attached (lease or licence) was not decisive in determining whether or not the provider of land and livestock was carrying on a taxable activity. Rather it was a matter of examining the clauses of the deeds in question in their context.

The Court of Appeal examined the rights and responsibilities of each of the trusts to the partnerships in return for the supply of land. The different deeds relating to the separate stations gave differing rights and the Court of Appeal noted these.

For the sake of brevity a brief sample of those rights are recorded here. The trustees were entitled to monitor the performance of the continuing obligations of the farming partnership to maintain and farm the property. They were entitled to monitor the partnership's obligations to pay rates and taxes. They had continuing obligations to give the partnership quiet enjoyment of the property.

The Court of Appeal concluded that Tompkins J's view that the trustees' role was entirely passive was incorrect. The Court of Appeal affirmed Judge Barber's view that the trustees were carrying on a taxable activity.

In relation to the consideration issue the Court of Appeal stated that where the supplier and the recipient are associated persons the consideration in money for the supply is deemed to be the open market value of that supply (section 10(3) of the GST Act 1985). The Court of Appeal found that in the present case it was common ground that in each instance the provision of interest in the land by the trusts was worth well over $30,000 per annum.

Due dates reminder

February 1999

5 Large employers: PAYE deductions and deduction schedules for period ended 31 January 1999 due.

7 Provisional tax and/or Student Loan interim repayments: first 2000 instalment due for taxpayers with October balance dates.

Second 1999 instalment due for taxpayers with June balance dates.

Third 1999 instalment due for taxpayers with February balance dates.

1998 end of year payments due (income tax, Student Loans, ACC premiums) for taxpayers with balance dates in period March-September.

(We will accept payments received or posted on Monday 8 February 1999 as in time for 7 February.)

QCET payment due for companies with balance dates in period March-September, if election is to be effective from the 1999 year.

20 Large employers: PAYE deductions and deduction schedules for period ended 15 February 1999 due.

Small employers: PAYE deductions and deduction schedules for period ended 31 January 1999 due.

Gaming machine duty return and payment for month ended 31 January 1999 due.

RWT on interest deducted during January 1999 due for monthly payers.

RWT on dividends deducted during January 1999 due.

Non-resident withholding tax (or approved issuer levy) deducted during January 1999 due.

(We will accept payments received or posted on Monday 21 February 1999 as in time for 20 February.)

26 GST return and payment for period ended 31 January 1999 due.

March 1999

5 Large employers: PAYE deductions and deduction schedules for period ended 28 February 1999 due.

7 Provisional tax and/or Student Loan interim repayments: first 2000 instalment due for taxpayers with November balance dates.

Second 1999 instalment due for taxpayers with July balance dates.

Third 1999 instalment due for taxpayers with March balance dates.

(We will accept payments received or posted on Monday 8 March 1999 as in time for 7 March.)

20 Large employers: PAYE deductions and deduction schedules for period ended 15 March 1999 due.

Small employers: PAYE deductions and deduction schedules for period ended 28 February 1999 due.

Gaming machine duty return and payment for month ended 28 February 1999 due.

RWT on interest deducted during February 1999 due for monthly payers.

RWT on dividends deducted during February 1999 due.

Non-resident withholding tax (or approved issuer levy) deducted during February 1999 due.

(We will accept payments received or posted on Monday 22 March 1999 as in time for 20 March.)

31 GST return and payment for period ended 28 February 1999 due.

Non-resident Student Loan repayments - fourth instalment of 1999 non-resident assessment due.

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