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ADVERTISING SPACE AND ADVERTISING TIME SUPPLIED TO NON-RESIDENTS – GST TREATMENT

PUBLIC RULING – BR Pub 00/06

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 96/10, published in *Tax Information Bulletin* Vol 8, No 8 (November 1996), but its period of application is from 1 December 1999 to 30 November 2004. Some formatting changes have also been made. BR Pub 96/10 applied up until 30 November 1999.

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

Taxation Laws

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

This Ruling applies in respect of section 11(2)(e).

The Arrangement to which this Ruling applies

The Arrangement is the contractual supply of advertising space in a publication, or the supply of advertising time on radio or television (or other broadcasting service), by a GST registered person for and to a non-resident person who is outside New Zealand at the time the services are performed.

For the purposes of this Ruling the supply of advertising space or advertising time means the service of communicating an advertising message, and includes all steps involved in providing this service by the supplier of the advertising space or time.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The contractually supplied service of providing advertising space in a publication or advertising time on radio or television (or other broadcasting service), for and to a non-resident who is outside New Zealand at the time the service is performed, is not supplied "directly in connection with" any land (or improvement thereto) or moveable personal property situated in New Zealand. Section 11(2)(e) will apply to zero-rate the supply of services, provided that all the other requirements of section 11(2)(e) are satisfied.

The period for which this Ruling applies

This Ruling will apply for the period from 1 December 1999 to 30 November 2004.

This Ruling is signed by me on the 17th day of July 2000.

John Mora

Assistant General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 00/06

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 00/06 ("this Ruling").

The subject matter covered in this Ruling was previously dealt with by BR Pub 96/10 that appeared in *TIB* Vol 8, No 8 (November 1996), at page 13. This Ruling applies for the period from 1 December 1999 to 30 November 2004.

Background

In July 1994, the High Court delivered its judgment in *Wilson & Horton v CIR* (1994) 16 NZTC 11,221. The case dealt with the circumstances in which a newspaper publisher should account for GST on the services of placing advertisements for non-resident clients. The High Court held that:

- to qualify for zero-rating under section 11(2)(e), services must be provided "contractually to" and "beneficially for" a non-resident person. If a New Zealand resident receives the benefit of the advertising services, the services are not zero-rated; and
- the provision of advertising space and related services is not supplied directly in connection with the subject matter of the advertisements.

Wilson & Horton appealed this decision to the Court of Appeal (*Wilson & Horton* v *CIR* (1995) 17 NZTC 12,325). The Court of Appeal held in favour of the taxpayer, and concluded that the supply of advertising space in New Zealand by Wilson & Horton to non-resident clients is zero-rated under section 11(2)(e), irrespective of whether a New Zealand resident also benefits from the supply. The Commissioner did not appeal this decision.

Legislation

Section 11(2)(e) zero-rates a supply of services when:

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

Sections 11(2A) and 11(2B) deal with services that are supplied to non-residents but are received by persons in New Zealand. The sections state:

> (2A) Subsection (2)(e) does not apply to a supply of services under an agreement that is entered into, whether directly or indirectly, with a person (person A) who is not resident in New Zealand if-
>
> (a) The performance of the services is, or it is reasonably foreseeable at the time the agreement is entered into that the performance of the services will be, received in New Zealand by another person (person B), including-
>
> (i) An employee of person A; or
>
> (ii) If person A is a company, a director of the company; and
>
> (b) It is reasonably foreseeable, at the time the agreement is entered into, that person B will not receive the performance of the services in the course of making taxable or exempt supplies.
>
> (2B) For the purpose of subsection (2)(e) and (2fa), 'outside New Zealand', for a company or an unincorporated body that is not resident, includes a minor presence in New Zealand, or a presence that is not effectively connected with the supply.

Section 60 sets out the GST agency provisions. Section 60(2) states:

> Subject to this section, for the purposes of this Act, where any registered person makes a taxable supply of goods and services to an agent who is acting on behalf of another person who is the principal for the purposes of that supply, that supply shall be deemed to be made to that principal and not to that agent:…

Court of Appeal decision

The Court of Appeal held that the supply of the publication of advertisements by Wilson & Horton to non-resident clients qualified for zero-rating under section 11(2)(e), irrespective of whether a New Zealand resident obtains a benefit from the supply.

"For and to"

The Court of Appeal rejected the High Court's interpretation of "for" in section 11(2)(e), as meaning "beneficially for". The Court of Appeal questioned whether this "benefit" test was workable. The Court noted that many parties may potentially benefit from an advertisement placed by a non-resident, and that it was unlikely that the legislature would have intended a wide group of possible beneficiaries of a service to determine the GST treatment of the service.

In discussing the "for and to" wording in section 11(2)(e), the Court of Appeal examined the possible meanings of "for" that may have been intended by the legislature and rejected the Commissioner's interpretation of "for" as meaning "beneficially for".

The Court concluded that "for" in section 11(2)(e) was used for emphasis only. Justice Richardson noted that legislative drafters often convey emphasis through the use of a combination of words and said that (at 12,330):

> I am inclined to think that the framers of s11(2)(e) employed both expressions to convey emphasis and perhaps to bring out the intent that the contract must be genuine and so the services must be supplied under that contract to and for the other contracting party.

As a matter of statutory interpretation, the Court said that section 11(2)(e) would have been worded quite differently if the intent had been to preclude zero-rating, unless a non-resident recipient of a supply was the only person who could benefit from the services supplied.

Justice Penlington considered that this result was consistent with one of the underlying themes of zero-rating—the preservation of New Zealand's competitiveness in world trade. It was also recognised that if advertised merchandise is sold in New Zealand, GST will be imposed on the sale at that time.

"Directly in connection with"

The Court of Appeal did not discuss whether the supply was made directly in connection with land or moveable personal property in New Zealand for the purposes of section 11(2)(e). The High Court had accepted that the supply of advertising space in a newspaper was not "directly in connection with" the subject matter of the advertising. During the Court of Appeal hearing, the potential argument that the services are supplied directly in connection with the newspapers themselves was also raised.

However, the Court of Appeal did not allow the Commissioner to introduce this new line of reasoning, as it would have changed the basis upon which the assessment was made and objected to. The publishing industry has asked the Commissioner to clarify the application of the "directly in connection with" exclusion in section 11(2)(e) in this context.

Application of the Legislation

The key features of section 11(2)(e) are the phrases "for and to" and "directly in connection with".

"For and to"

The Commissioner accepts the Court of Appeal's interpretation of "for and to" in *Wilson & Horton* for the purposes of section 11(2)(e). In this context, "for and to" is a composite phrase. "For" simply emphasises "to" and does not connote any requirement that services must be provided for the exclusive benefit of the recipient of the supply. If services are supplied pursuant to a contract with a non-resident and are for that non-resident, section 11(2)(e) will apply to zero-rate the supply regardless of any other benefits also arising to a New Zealand resident (provided that the other requirements of the section are satisfied).

The Court of Appeal's interpretation of "for and to" is not restricted to the supply of advertising space in a newspaper. It also applies to the supply of advertising space in all forms of publication and to the supply of advertising time on radio or television (or other broadcasting service).

This Ruling discusses the application of section 11(2)(e) to the supply of advertising space in publications, such as newspapers and magazines. The Ruling also covers the supply of advertising time on radio and television, or by way of any other broadcasting service, eg the internet. For the purposes of the Ruling, the supply of advertising space or advertising time means the service of communicating an advertising message, and includes all steps involved in providing this service by the supplier of the advertising space or time.

"Directly in connection with"

A supply of services to a non-resident will not be zero-rated under section 11(2)(e) if the services are supplied "directly in connection with" any land (or improvement to the land) or moveable personal property (other than choses in action and goods which are referred to in section 11(2)(ca)) situated in New Zealand at the time the services are performed. The Court of Appeal in *Wilson & Horton* did not discuss the meaning of "directly in connection with" in section 11(2)(e), nor resolve whether advertising space is supplied directly in connection with the newspapers in which advertisements are placed.

Case law

The determination of whether or not services are supplied "directly in connection with" land or moveable personal property depends on the circumstances in which the services are supplied. In *Case E84* (1982) 5 NZTC 59,441, Bathgate DJ considered the meaning of the phrase "in connection with" (note that the word "directly" was not used) in the context of section 165 of the Income Tax Act 1976 (section DJ 5 of the Income Tax Act 1994) and noted (at 59,444 and 59,446):

> It may be that only an empirical and common sense approach to the interpretation of the words can be applied in each particular case to determine where, if at all, the line should be drawn to allow or not allow expenditure 'in connection with' an assessment. However I believe that a narrow interpretation of the words '… any expenditure … in connection with … the assessment …' is the correct interpretation …
>
> …

> It is a matter of degree whether, on the interpretation of a particular statute, there is a sufficient relationship between subject and object to come within the words "in connection with" or not. It is clear that no hard and fast rule can be or should be applied to the interpretation of the words "in connection with". Each case depends on its own facts and the particular statute under consideration.

In the context of GST, the meaning of "directly in connection with" for the purposes of section 11(2)(a), prior to its amendment in 1988, has been judicially considered by the High Court in *Auckland Regional Authority v CIR* (1994) 16 NZTC 11,080 and the Taxation Review Authority (TRA) in *Case P78* (1992) 14 NZTC 4,532. Before amendment, section 11(2)(a) provided for zero-rating of services supplied "directly in connection with" transportation. The High Court and TRA cases concerned the application of section 11(2)(a) to various charges (landing dues, international terminal charges, and rubbish disposal charges) levied on overseas airlines.

The High Court and the TRA adopted similar interpretations of the words "directly in connection with" under section 11(2)(a). The *Auckland Regional Authority* case summarises the reasoning of the TRA in *Case P78* (at 11,084):

> There, the Taxation Review Authority, Judge Barber, held that "airport dues" were zero-rated for GST because passengers cannot realistically be transported to New Zealand by air unless a plane lands and parks on the tarmac; that charges for those services can be regarded as provided for international passengers who are in a sense "outside New Zealand" until they pass through customs. The services are fundamental to and directly connected with the transportation of passengers;

The High Court and the TRA focus on whether a supply of services is fundamental or integral to transportation to determine whether the "directly in connection with" test in section 11(2)(a) is satisfied. This reasoning is not strictly relevant for the purposes of interpreting "directly in connection with" in section 11(2)(e). This is because the focus of section 11(2)(a) was on services directly connected with transportation services, and the identification of a direct connection between a service and another service, and a service and an item of property, involves different considerations.

However, the TRA has recently applied the proviso to section 11(2)(e) and considered the words "directly in connection with" in *Case S88* (1996) 17 NZTC 7,551. The objector in *Case S88* purchased motor vehicles from its non-resident parent company and then sold the vehicles to independent dealers, who onsold them to the public. The parent company provided a contractual warranty to the objector. The objector agreed with the dealers that if a vehicle was repaired under warranty the objector would reimburse the dealer. The objector would then register a claim with the parent company under the warranty and receive payment pursuant to that claim.

The TRA was required to consider whether the repair services provided by the objector pursuant to its contract with the non-resident parent were zero-rated under section 11(2)(e). The TRA concluded that section 11(2)(e) could not apply to zero-rate this supply as the services were supplied "directly in connection with" moveable personal property (the vehicles) situated in New Zealand at the time the services were provided. Although the TRA did not examine the meaning of "directly in connection with" in great detail, it did state (at 7,558):

> The moveable personal property in question is the repaired vehicle. There is a direct relationship or connection between the service of the repairs and the vehicle. Accordingly, the said "proviso" to s 11(2)(e) must apply to the facts of this case and prevent the objectors from relying on the zero-rating provisions of s 11(2)(e). The repair service could not be performed but for the existence of the vehicle.

[Please note that *Case S88* is currently under appeal by the taxpayer.]

The High Court in *Malololailai Interval Holidays New Zealand Ltd v CIR* (1997) 18 NZTC 13,137 also considered the words "directly in connection with" in the context of section 11(2)(b).

In *Case T54* (1998) 18 NZTC 8,410, the TRA considered whether the supply of video services for Japanese honeymoon couples to a Japanese company was zero-rated under section 11(2)(e).

The decisions in both of these cases are consistent with the cases mentioned above.

Therefore, the case law discussing "in connection with" and "directly in connection with" indicates that the interpretation of the test will be dictated by the particular context involved. The Commissioner considers that the "directly in connection with" proviso in section 11(2)(e) should be interpreted narrowly (Judge Bathgate's words from *Case E84* quoted above support this), and that there must be a clear and direct relationship with moveable personal property or land in New Zealand before a supply will be standard-rated. This is consistent with the approach of the TRA in *Case S88* in identifying on the facts of that particular case, a "direct relationship or connection" between the repair services and the vehicles under repair.

Advertising space and advertising time

The supply of advertising space in a publication is the supply of the service of communicating an advertising message, involving all the steps required to achieve communication of the advertisement. This service is not supplied directly in connection with the **subject matter of the advertisement**. In the words of the High Court in *Wilson & Horton v CIR* (1994) 16 NZTC 11,221 (at 11,224):

> The supply of space and services rendered by Wilson & Horton are directly connected with the advertising but not with the goods advertised. The goods are, as it were, at least one step removed from the services supplied by the newspaper proprietor.

The Commissioner agrees with this view. There is no direct relationship or connection between the provision of advertising space and the subject matter of the advertisement. The same reasoning also applies to the supply of advertising space in all types of publication as well as advertising time on radio or television (or other broadcasting service). The supply of advertising space or time in these media cannot be described as "directly in connection with" the advertised commodity.

Similarly, when advertising space is supplied in a publication, the services are not supplied directly in connection with the **publication** in which the advertisements are published. The High Court judgment in *Wilson & Horton* concluded that the provision of advertising space was supplied directly in connection with (if anything) the advertising itself. The advertised goods were considered to be at least one step removed from the services. The Commissioner considers the same logic applies in respect of a newspaper or other publication. The service of communicating an advertising message is directly connected with that message and not the publication. The publication is at least one step removed from the service and is merely the medium in which the advertising message is publicised. Accordingly, the service is not supplied directly in connection with the publication produced by the publishers.

Consequently, the supply of advertising space in either a publication or by way of broadcast will be treated in the same way for GST purposes. The supply will qualify for zero-rating, provided that the services are supplied for and to a non-resident who is outside New Zealand at the time the services are performed.

Supplies through agents

The application of section 60(2) may also need to be considered to determine whether a supply is zero-rated under section 11(2)(e). Section 60(2) deems a taxable supply of goods and services made by a registered person to an agent who is acting on behalf of a principal, to be a supply made to the principal.

Therefore, if a supply of advertising space or time is made to a New Zealand resident person who is acting as an agent for a non-resident principal, section 60(2) deems the supply to be made to the non-resident principal and not the resident agent. Section 11(2)(e) will apply to zero-rate the supply of services, provided that all the other requirements of section 11(2)(e) are satisfied. A common example of this is where a resident advertising agency acts as an agent for a non-resident person in purchasing advertising space or time in New Zealand.

Conversely, if a supply is made to a non-resident person who is acting as an agent for a New Zealand resident in relation to the supply, section 11(2)(e) will not apply to zero-rate the supply even if the criteria in section 11(2)(e) are otherwise satisfied. The supply will be deemed to be made to the resident principal and it will not be for and to a non-resident person.

Section 11(2A)

Section 11(2A) was introduced to deal with situations where services are provided to non-residents and persons in New Zealand receive the performance of these services. An example is where New Zealand educational institutions contract with non-residents to provide education for the non-resident's children in New Zealand. The section operates to ensure supplies of this type are standard rated for GST purposes.

Section 11(2A) will not affect the provision of advertising services to non-residents in the circumstances covered by the arrangement described in this Ruling. The performance of these services is **not** received in New Zealand by other persons.

Examples

For the purposes of these examples, it is assumed that:

- a person referred to as a resident is a "resident" as defined in section 2 of the Goods and Services Tax Act 1985. The converse applies to non-residents, and
- if the services are supplied to a non-resident, the non-resident is outside New Zealand at the time of performance of the services.

Example 1

A UK resident manufacturing company contacts a New Zealand magazine publisher and books advertising space for a newly developed product. The UK company has a GST-registered subsidiary in New Zealand that sells the advertised product.

The supply of advertising space by the magazine publisher to the UK manufacturer is zero-rated under section 11(2)(e). This is because:

- The publisher supplies the services contractually for and to a non-resident. The fact that the New Zealand resident subsidiary potentially may benefit from the supply through increased sales does not preclude zero-rating.
- The services are not supplied directly in connection with either the products for sale in New Zealand, or the magazines in which the advertisements are shown.

Example 2

A US resident distributor of soft drinks contracts for the supply of radio time on a national radio station in New Zealand. The soft drinks are available from all chains of supermarkets throughout New Zealand.

The supply of radio time by the New Zealand radio station to the US distributor is zero-rated under section 11(2)(e). This is because:

- The radio station supplies its services contractually for and to a non-resident. The fact that New Zealand resident retailers throughout New Zealand may potentially benefit from the supply through increased sales does not preclude zero-rating.
- The services are not supplied directly in connection with the products for sale in New Zealand.

Example 3

An Australian computer distributor plans to advertise its product range in New Zealand. The computers will be available through all major computer distributors in New Zealand. The Australian company contacts a New Zealand resident advertising agency to arrange an advertising campaign. The agency, acting in the capacity as agent for the Australian company, purchases air time on a New Zealand resident television channel.

The supply of air time by the television station to the Australian company is zero-rated under section 11(2)(e). This is because:

- The television channel supplies the air time services contractually for and to a non-resident. Section 60(2) deems the supply to be made to the Australian company, as principal. The New Zealand resident advertising agency receives the supply as agent only.
- The fact that New Zealand resident distributors may potentially benefit from the supply through increased sales does not preclude zero-rating.

The services are not supplied directly in connection with the products for sale in New Zealand.

DEBT FACTORING ARRANGEMENTS AND GST

PUBLIC RULING - BR Pub 00/07

This is a Public Ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

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

This Ruling applies in respect of sections 8(1), 20(3), and 26(1).

The Arrangement to which this Ruling applies

The Arrangement is the sale, by a GST registered person (the "Assignor") on an invoice basis, to a third party ("the Factor"), on a recourse or non-recourse basis, of an outstanding debt at a price less than the debt's face value.

Debt factoring on a non-recourse basis means that the Factor has no claim back to the Assignor if the debts sold to him or her become doubtful or uncollectable (that is, the Factor assumes all of the risk). In contrast, debt factoring on a recourse basis means that the Factor has some form of claim back to the Assignor if the debts sold to him or her prove to be doubtful or uncollectable, for example under a put option at the transfer price.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The difference between the face value of the debt and the price received from the Factor is not a bad debt for the purposes of section 26. Accordingly, section 26 has no application and the registered person cannot claim an output tax deduction under section 20(3)(a)(iii); and
- If a portion of a debt is written-off before it is sold to the Factor, then whether this write-off meets the requirements of section 26(1) depends on whether the amount written off was "bad" according to the conventional tests (outlined in public ruling BR Pub 00/03, entitled "Bad debts – writing off debts as bad for GST and income tax purposes").

The period for which this Ruling applies

This Ruling will apply to taxable periods commencing on or after 1 August 2000 to 31 July 2005.

This Ruling is signed by me on the 19th day of July 2000.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 00/07

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 00/07 ("the Ruling").

Background

Sections 20(3)(a)(iii) and 26 of the Goods and Services Tax Act 1985 ("the Act") allow a registered person to make a deduction from output tax if the registered person has made a taxable supply, returned output tax in respect of that taxable supply, and subsequently written off as a bad debt all or part of the debt.

If a registered person factors (sells) a debt owing for less than its face value to a third party ("the Factor"), the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount written off as a bad debt.

This issue was previously dealt with in *PIB* No 164 (August 1987) at page 27 under the heading "GST and debt collection agencies – debt factoring" and in Technical Rulings paragraph 104.9.4 under an identical heading. Those statements concluded that if a registered person accounting for GST on an invoice basis subsequently sold a debt for less than its face value, the Commissioner would allow the registered person a bad debt deduction under section 26 for the difference between the debt's face value and the sale proceeds. The inference being that the difference between the two amounts was a bad debt.

Barber DJ in *Case T27* (1997) 18 NZTC 8,188 reached a different conclusion from that set out in *PIB* No 164 and Technical Rulings paragraph 104.9.4. In particular, the Taxation Review Authority ("TRA") concluded that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt.

The Ruling confirms that the Commissioner accepts the view of Barber DJ in *Case T27*. In particular, it is now the Commissioner's view that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt. Accordingly, section 26 has no application, and a registered person cannot claim a deduction from output tax under section 20(3)(a)(iii).

The Ruling changes and supersedes the earlier policy set out in *PIB* No 164 and Technical Rulings paragraph 104.9.4.

This issue only arises in respect of taxpayers registered for GST on an invoice basis, because taxpayers registered for GST on a payments basis are only required to return, as output tax, any payment received. However, it is noted that the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill includes an amendment to section 26 which, if enacted, will establish parity between the two GST accounting bases. Under the amendment, a registered person who sells a debt to a third party must pay tax on the remaining book value of the debt on the date that the debt is sold if the registered person accounts for tax payable on a payments basis.

Legislation

Section 8(1) states:

> Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

Section 9(1) states:

> Subject to this Act, for the purposes of this Act a supply of goods and services shall be deemed to take place at the earlier of the time an invoice is issued by the supplier or the recipient or the time any payment is received by the supplier, in respect of that supply.

Section 20 states:

> (1) In respect of each taxable period every registered person shall calculate the amount of tax payable by that registered person in accordance with the provisions of this section.
>
> …
>
> (3) Subject to this section**,** in calculating the amount of tax payable in respect of each taxable period, there shall be deducted from the amount of output tax of a registered person attributable to the taxable period-
>
> (a) In the case of a registered person who is required to account for tax payable on an invoice basis pursuant to section 19 of this Act, the amount of input tax-
>
> (i) In relation to the supply of goods and services (not being a supply of secondhand goods to which paragraph (c) of the definition of the term "input tax" in section 2(1) of this Act applies), made to that registered person during that taxable period:
>
> (ia) In relation to the supply of secondhand goods to which paragraph (c) of the definition of the term "input tax" in section 2(1) of this Act applies, to the extent that a payment in respect of that supply has been made during that taxable period:
>
> (ii) Invoiced or paid, whichever is the earlier, pursuant to section 12 of this Act during that taxable period:

(iii) Calculated in accordance with section 25(2)(b) or section 25(5) or section 26 of this Act; and

(b) In the case of a registered person who is required to account for tax payable on a payments basis or a hybrid basis pursuant to section 19 of this Act, the amount of input tax-

(i) In relation to the supply of goods and services made to that registered person, being a supply of goods and services which is deemed to take place pursuant to section 9(1) or section 9(3)(a) or section 9(3)(aa) or section 9(6) of this Act, to the extent that a payment in respect of that supply has been made during the taxable period:

(ii) Paid pursuant to section 12 of this Act during that taxable period:

(iii) In relation to the supply of goods and services made during that taxable period to that registered person, not being a supply of goods and services to which subparagraph (i) of this paragraph applies:

(iv) Calculated in accordance with section 25(2)(b) or section 25(5) of this Act, to the extent that a payment has been made in respect of that amount, or section 26 of this Act; …

The provision relating to bad debts is in section 26, which states:

(1) Where a registered person-

(a) Has made a taxable supply for consideration in money; and

(b) Has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and

(c) Has written off as a bad debt the whole or part of the consideration not paid to that person,-

that registered person shall make a deduction under section 20(3) of this Act of that portion of the amount of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

…

Section 3(1) defines "financial services" as follows:

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

(a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise):

(b) The issue, payment, collection, or transfer of ownership of a cheque or letter of credit:

(c) The issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security:

(d) The issue, allotment, or transfer of ownership of an equity security or a participatory security:

(e) Underwriting or sub-underwriting the issue of an equity security, debt security, or participatory security:

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

(g) The renewal or variation of a debt security, equity security, participatory security, or credit contract:

(h) The provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, or in respect of the activities specified in paragraphs (b) to (g) of this subsection:

(i) The provision, or transfer of ownership, of a life insurance contract or the provision of re-insurance in respect of any such contract:

(j) The provision, or transfer of ownership, of an interest in a superannuation scheme, or the management of a superannuation scheme:

(k) The provision or assignment of a futures contract through a futures exchange:

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

(l) Agreeing to do, or arranging, any of the activities specified in paragraphs (a) to (ka) of this subsection, other than advising thereon.

Application of the Legislation

Under section 26, a registered person can make a deduction under section 20(3)(a)(iii) if that person has:

- made a taxable supply for consideration, and
- furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under the Act, and
- written off as a bad debt the whole or part of the consideration not paid to that person.

The amount that may be deducted is that portion of the amount of GST charged as the amount written off bears to the total consideration for the supply. If the supply is the supply of goods under a hire purchase agreement, the first proviso to section 26 limits the deduction to the portion of the amount written off as the cash price bears to the total amount payable under the hire purchase agreement.

Further, section 26 does not apply to a registered person accounting on a payments basis under section 19 or 19A, unless either section 9(2)(b) (door to door sales) or section 9(3)(b) (hire purchase agreements) applies to the supply.

Section 26 only applies when the registered person has already accounted for GST on a supply and subsequently "Has written off as a bad debt the whole or part of the consideration not paid to that person".

If a registered person factors a debt owing for less than its face value, the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount "written off as a bad debt".

The Commissioner believes that the difference between the face value of the debt and the amount received from the Factor cannot be an amount written off as a bad debt under section 26. Rather than being a bad debt, the discount from face value is simply a result of the process of agreeing the consideration for the debts that is acceptable to both the Assignor and the Factor. The reasons for this view are:

1. Cases considering the meaning of bad debt focus on whether the creditor can recover the outstanding amounts owing. That is, a bad debt arises when the creditor is unable or unlikely to recover the debt owing. If the creditor could recover the full amount owing but chooses not to (as in a debt factoring situation), any "loss" suffered by the creditor is not due to a bad debt.

2. Cases also indicate that for an amount to be written off as a bad debt, a debt must exist at the time the debt is written off. If a registered person factors a debt, no further debt exists between the registered person and debtor, and no amount can be written off as a bad debt.

In considering the second of these factors, with regard to recourse debt factoring arrangements (where the Factor has some form of claim back to the Assignor if he or she is unable to collect some of the debts purchased), it is the Commissioner's view that when a debt is sold by the Assignor on a recourse basis, the title to the debt passes to the Factor unless the Factor exercises a recourse option or right. Therefore, until the recourse is exercised and the debt is transferred back, a bad debt deduction is not available under section 26(1), as after the sale there is no debt owed to the Assignor.

However, if the Factor exercises an option or right to transfer some portion of the debt back to the Assignor after the sale then, once this has occurred, a debt exists that is owed to the Assignor that may be able to be written off by the Assignor. Whether it can be written off depends on the application of the ordinary tests for determining whether a debt is bad as noted below, under the heading "Whether the creditor can recover the amount owing".

Whether the creditor can recover the amount owing

The term "bad debt" is not defined in the Act. However, in *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 Tompkins J discussed the meaning of bad debt in the context of the Income Tax Act. He stated at page 12,269:

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

Case N69 (1991) 13 NZTC 3,541 also discusses the meaning of bad debt. In that case the taxpayer was a private limited liability company carrying on the business as a timber merchant. Following the receipt of a letter from one of the company's debtors, the managing director realised that there was no likelihood of recovery of a debt owing and that the debt should be written off. The taxpayer physically wrote the appropriate entries into the journal and books of the company in May 1988 to write off the debt as at 31 March 1988. The taxpayer claimed a bad debt deduction for the income year ending 31 March 1988, but this was disallowed by the TRA on the basis that the relevant journal entries had not been made by 31 March 1988. The TRA (Barber DJ) discussed the meaning of bad debt and at page 3,548 stated:

> Naturally, the debts in question must be "bad" to be written off as bad in terms of sec 106(1)(b). This is a question of fact. Generally, an application of that criterion will not be difficult as the debtor will be insolvent. However, the debtor does not need to be insolvent for the debt to be bad. It is only necessary that there be a bona fide assessment that the debtor is unlikely to make payment of the debt. If there is a clear understanding or arrangement that there be long term credit, and if the taxpayer believes that the terms of the credit will be met, then the debt cannot be treated as bad because it is merely a situation of deferred payment. In my view, as well as the need for the writing off to be made bona fide, the circumstances must indicate to a reasonable and prudent business person, that, on the balance of probability, the debt is unlikely to be recovered. This is an objective test.

As is evident from the quotations above, different wording is used by the High Court in *Budget Rent A Car* and the TRA in *Case N69* to describe the test of when a debt can be written off as bad. To summarise these differences, in *Budget Rent A Car* the words used were "**no reasonable likelihood**" that the debt (or part of the debt) would be recovered, whereas in *Case N69* the words used were that "**on the balance of probability, the debt is unlikely to be repaid**".

The wording used in *Case N69* may appear to include two standards into the test. That is, that the debt will not be repaid "on the balance of probabilities" and that the debt is "unlikely" to be repaid. These standards are potentially conflicting as the first of them provides a lower standard than the second.

However, the Commissioner considers that the test provided by Barber DJ in *Case N69* requires that for a debt to be written off as bad it must be unlikely to be repaid. This is clear from his Honour's statement at page 3,548 of the judgment:

> Even if the executives had come to a formal business decision or assessment by 31 March 1988 that the debts *were unlikely to be recovered and therefore should be written off as bad debts*… [Emphasis added]

Furthermore, the Commissioner considers that the words "no reasonable likelihood" and "unlikely" have the same meaning. Therefore, on this basis the Commissioner regards the decisions in *Budget Rent A Car* and *Case N69* as applying the same test, and both cases as authority for the conclusion that a reasonably prudent commercial person must determine that there is no reasonable likelihood of recovering a debt before it can be written off as bad.

The Commissioner prefers the wording used in *Budget Rent A Car* as this is the higher authority and this wording is supported by the way in which the High Court applied the test in *Graham* v *Commissioner of Inland Revenue* (1995) 17 NZTC 12,107. Also adopting this wording removes the risk of misinterpreting the wording of the test in *Case N69* as meaning that a debt can be written off as bad if, on the balance of probabilities, it will not be repaid.

The emphasis of the discussion above is on the **inability** of the debtor to pay due to the debtor's financial position. To reiterate, in order for a debt to be bad, the creditor must have sufficient information to enable a reasonably prudent business person to form the view that there is no reasonable likelihood that the debt will be paid.

Case T27 specifically considered the issue in respect of section 26 and debt factoring arrangements.

In *Case T27* the taxpayer sought a bad debt deduction for the difference between the amount invoiced and amount received from a debt factor, on the basis that the difference was a bad debt. The TRA determined that the debt was not a bad debt, but in actual fact a "good debt". At page 8,192 the TRA stated:

> A pivotal submission for the objector is that the discounts it allows the franchiser are bad debts which it may write off as such and, hence, claim an input tax refund for GST purposes under s 26(1) and s 20(3) of the Act. It is also pivotal to the objector's case that it has been factoring the hireage debts to its franchiser and that such process has constituted the writing off of bad debts regarding the discount.
>
> It seems to me that the provision of such a discount could not possibly constitute the incurring of a bad debt by the objector. The essence of the arrangement between the objector and the franchiser is that the hireage debt from the customer is a *good* debt, but that the objector prefers early payment of that debt and to avoid the administration process and normal risks of its recovery.

Moreover, at page 8,194 the TRA reaffirmed its view that such a debt could not be bad. The TRA stated:

> There were submissions by counsel as to whether a bad debt exists for the purposes of s 26(1) including references to case law. Counsel particularly referred to my decision in *Case N69* (1991) 13 NZTC 3,541 where I considered the wording of s 106(1)(b)(iii) of the Income Tax Act 1976 relating to the deductibility of bad debts for income tax purposes. There, I emphasised that a bad debt deduction was only available if the debt was in fact "bad" and had been actually written off. The present case is not a situation where there could be any sensible assessment that the debts (assigned by the objector to the franchiser) were, in any particular sense, bad or uncollectable or unlikely to be paid. Accordingly, the provisions of s 26(1)(c) of the Act are irrelevant to the issues before me. I appreciate that, in terms of my views in *Case N69*, the objector in the present case had made appropriate journal entries to write off the discounts as bad debts and had, no doubt, done so in good faith, but that was a quite erroneous procedure because, on any objective test, the debts were not bad.

Consistent with *Budget Rent A Car* and *Case N69*, the TRA appears to take the view that, where a creditor chooses to sell a perfectly collectable debt for below its face value, no bad debt can arise. In no way can such a debt be regarded as bad or uncollectable or unlikely to be paid. Accordingly, any difference between the face value of the debt and amount actually received is due to factors other than the debt being a bad debt.

In summary, when assessing whether a bad debt exists, the cases indicate that a debt is bad when a reasonably prudent business person would have concluded, based on the information available about the debtor's ability to repay the debt, that there is no reasonable likelihood that the debt will be paid. In the absence of such a circumstance, if a registered person chooses to sell a debt for below its face value, no bad debt exists and no deduction is available under section 20(3)(a)(iii).

Finally in this regard, in response to submissions received on the first draft of the Ruling, it is useful to clarify that, in the Commissioner's view, when a portion of debt is written-off on the basis of experience of the collectability of similar types of debts, without investigating the likelihood of each debtor repaying the debt, the requirements of section 26(1) have not been met. This is because case law establishes that, to write-off a debt as bad under section 26(1), reasonable steps must be taken to determine whether that particular debt owed by that particular debtor is likely to be paid (*Case P53* (1992) 14 NZTC 4370 and *Budget Rent A Car* v *C of IR* (1995) 17 NZTC 12263).

Writing-off a portion of debt on this basis involves seeking a deduction for the provision for doubtful debts. As noted in BR Pub 00/03, the GST Act does not allow a deduction for the provision for doubtful debts.

Must a debt be in existence at the time it is written off?

Case law also indicates that before an amount can be written off as a bad debt, a bad debt must be in existence at the time the amount is written off.

In *Budget Rent A Car* the taxpayer company carried on business in New Zealand as a motor vehicle rental company. A sum of money ($2,767,695.48) was owed to it by an Australian company (BRACS). In May 1989, BRACS developed financial problems and was purchased by a consortium. In July 1990, Budget Rent A Car ("Budget") entered a deed of covenant with BRACS and covenanted that it would not bring any proceedings against or prove in the liquidation of BRACS for any claim Budget might have. The debt, however, remained outstanding.

In November 1990, Budget's directors wrote off the debt owing by BRACS and claimed a bad debt deduction for the amount. The Commissioner argued that there was no bad debt and no bad debt deduction was allowed. In particular, the Commissioner argued that for there to be a bad debt, there must at the time of the write-off be a debt in existence. As any debt due by BRACS to Budget had been remitted or extinguished by the deed of covenant, no debt thereafter existed and none could be written off. Accepting the Commissioner's argument in this respect Tompkins J stated at page 12,267:

> I accept Mr Wood's submission that for a taxpayer to be entitled to deduct from its assessable income the amount of a bad debt written off, there must at the time of the write off be a debt in existence. If a debt has been effectively released, the effect is to extinguish it or put an end to its existence. Thereafter there cannot be a write off of that debt for tax purposes. This accords with the view expressed by Owen J in *Point v FC of T* 70 ACT 4021; (1970) 1 ATR 577 at ATC p 4023; ATR p 580. …
>
> The issue therefore becomes whether the parties, when they entered into the deed of covenant and in particular cl 2.1, intended to extinguish the debt. In accordance with the normal canons of contractual interpretation, this is to be determined having regard to the words the parties used, viewed in the light of the surrounding circumstances.

However, on the facts Tompkins J found that a debt did exist, and allowed Budget a bad debt deduction. The following Australian case illustrates a similar point.

In *GE Crane Sales Pty Ltd v FC of T* 71 ATC 4268 the High Court of Australia considered a claim by the taxpayer to write off certain bad debts. The Court held that it could not do so because the taxpayer was not a creditor in respect of these debts. Whereas some payment had been accepted in full satisfaction of a debt owing, the taxpayer's rights to recover the balance had been extinguished and it could not claim to write off as a bad debt the balance of the amount. Menzies J at page 4,272 expressed the opinion that a taxpayer cannot write off as a bad debt an amount that is no longer a debt. Moreover, at page 4,272 he stated:

> I have therefore come to the conclusion, both as to the factored debts which were extinguished and those in which the appellant gave up any beneficial interest which it had to the receiver and manager under the scheme of arrangement, that sec. 63 does not apply because at the time the writing off occurred there did not exist, in any sense, debts owing to the appellant. To write off as bad debts amounts which are owing but which cannot be recovered is a sensible commercial exercise and one to which taxation significance is naturally enough given, but to write off a non-existent debt as a bad debt is hardly sensible commercially and, in my opinion, to do so has no significance for the purposes of sec. 63 …

Section 26 requires that the registered person "Has written off as a bad debt the whole or part of the consideration not paid to that person". Both *Budget Rent A Car* and *G E Crane Sales Pty Ltd* indicate that before a debt can be written off a debt must be in existence at the time the debt is written off. Although these cases were determined in an income tax context, the wording of section 26 makes them no less applicable for GST purposes. Accordingly, for section 26 to apply, the registered person must be able to show that at the time of writing off the debt, a debt was then in existence.

In terms of non-recourse debt factoring, at the time the debt is sold, the debt between the registered person and debtor is extinguished and replaced with a separate and distinct debt between the Factor and debtor. In such situations no debt exists at the time the amount is written off, which will be after sale of the debt. Therefore, after the sale of the debt to the Factor, no further debt exists and according to both *Budget Rent A Car Ltd* and *G E Crane Sales Pty Ltd* no amount can be written off as a bad debt.

In terms of recourse debt factoring arrangements (where the Factor has some form of claim back to the Assignor if he or she is unable to collect some of the debts purchased) when a debt is sold by the Assignor on a recourse basis, the title to the debt passes to the Factor unless the Factor exercises a recourse option or right by which the debt can be transferred back to the Assignor. Therefore, after the sale of the debt to the Factor (until the recourse is exercised and the debt is transferred back) no further debt exists, and according to both *Budget Rent A Car Ltd* and *G E Crane Sales Pty Ltd* no amount can be written off as a bad debt.

However, if the Factor exercises an option or right to transfer some portion of the debt back to the Assignor after the sale then, once this has occurred, a debt exists that is owed to the Assignor that may be able to be written off by the Assignor. Whether it can be written off depends on the application of the ordinary tests for determining whether a debt is bad as noted above, under the heading "Whether the creditor can recover the amount owing".

Writing off the debt before sale to the Factor

Several submissions received on the first draft of the Ruling noted that the issue of whether the discount to the Factor might be written off as a bad debt under section 26(1) would not arise if this amount were written off prior to the sale of the debt to the Factor.

The Commissioner agrees that this is the case. If a portion of a debt is written off before it is sold to the Factor, then whether the debt is written off as bad according to the requirements in section 26(1) depends on the application of the tests outlined in Public Ruling BR Pub 00/03 entitled "Bad debts – writing off debts as bad for GST and income tax purposes", see *Tax Information Bulletin* Vol 12, No 5 (May 2000) at page 5.

PRODUCT RULING - BR PRD 00/06

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by The Royal New Zealand College of General Practitioners ("the College").

Taxation Laws

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

This Ruling applies in respect of sections CD 5 and CB 9(d) of the Act.

The Arrangement to which this Ruling applies

The Arrangement is the monthly payments made by the College to individual doctors ("Registrars"), for the Registrars' participation in an annual 40 week Intensive Clinical Training Course ("the Course"), on terms and conditions that are materially the same as those contained in the following three documents:

- Terms and Conditions of Registrars 1998: the terms and conditions to be agreed between the College and all Registrars enrolled in the Intensive Clinical Training Course of the General Practice Vocational Training Programme.
- Letter of Appointment of Registrar: The letter supplied to the Registrar, by the College, as an agreement of the respective obligations of each party.
- Intensive Clinical Training Year Handbook 1998: The detailed handbook of terms, conditions, obligations and syllabus of the Intensive Clinical Training Course.

Further details of the Arrangement are set out in the paragraphs below.

1. The College was formed in 1974, and obtained a Royal Charter in 1979. The mission of the College is to improve the health of all New Zealanders through the provision of high-quality general practice care.

2. The Constitutional Objectives of the College are:

   (a) To promote in all ways the highest standards in general practice in New Zealand;

   (b) To take a caring interest in the welfare of its members and their families;

   (c) To sustain and improve the professional competence of members of the medical profession who are engaged in general practice in New Zealand;

   (d) To inform the general public in New Zealand in relation to general practice;

   (e) To encourage and assist in the provision of a high standard of teaching and training for all undergraduate medical students in the field of general practice in New Zealand.

   (f) To encourage, strengthen, and engage in vocational training for general practice;

   (g) To encourage and provide for the training of future teachers of general practice;

   (h) To conduct, direct, encourage, support or provide for continuing education of general practitioners;

   (i) To conduct, direct, encourage, support or provide for research in matters relating to general practice;

   (j) To publish and encourage publication of journals, reports and treatises on matters relating to general practice and allied subjects;

   (k) To study environmental damage and advise on its effect on human health.

3. The College runs a General Practice Vocational Training Programme ("GPVTP") created from the objectives of the College and based on the College's commitment to maintaining and supporting standards of excellence among general practitioners. It is viewed as a significant part of a comprehensive cycle of vocational and professional education provided by the College and results in a Member of the Royal New Zealand College of General Practitioners ("MRNZCGP") qualification.

4. The Course is a 40 week practice-based training course established by the College as one part of its GPVTP. This Course is placed at 'year nine' of a doctor's standard educational path to gaining the MRNZCGP qualification. The GPVTP is regarded as encompassing years' seven to eleven of this 'path'.

5. It is stated by the College (page 8 of the Intensive Clinical Training Year Handbook 1998) the general aims of the Course are to:

    - Improve the health of New Zealanders through the provision of a GPVTP which achieves a level of competence sufficient to maintain independent general practice;
    - Promote high standards of general practice in New Zealand by ensuring those entering general practice are vocationally trained;
    - Ensure registrars understand the principles of general practice;
    - Develop and foster a group of general practice teachers and teaching practices; and
    - Foster an understanding of general practice within the medical profession and primary care purchasers.

6. The Course involves various aspects of training that a Registrar is to complete. Essentially, a Registrar is assigned to a 'teaching practice'. Each teaching practice is a general practice medical centre for which the College has contracted with a general practitioner to be the Registrar's teacher. The general practitioner teacher holds vocational registration and is paid by the College under the separate contract.

7. The standard Course week for a Registrar under the Course is broken up as follows:

    - 8 half days per week attendance at the teaching practice to which they are assigned, consisting of:
        - Patient contact. The conditions in respect of this are that a Registrar is to participate in between 5 and 13 patient consultations per half day. In the early weeks of the attachment, to relieve possible pressure on a Registrar, each consultation is to be for a generous period of 20-30 minutes.
        - The Registrar having at least three hours of direct contact time with the teacher per week, to include discussion, observation, review and feedback. It is essential that there be a minimum of a one hour and 30 minute uninterrupted block between the teacher and the Registrar per week.
    - 2 half days attending seminars and workshops that are provided and organised by the College.
        - Registrars are required to 'satisfactorily' attend and participate in these seminars and workshops.
        - Registrars are responsible for organising/presenting part of the programme within these seminars and workshops.

8. A Registrar does not receive any payment from the teacher, but receives monthly payments from the College allocated from the funding the College receives from the Clinical Training Agency ("CTA"). The 1998 level of the payments is as follows, being paid monthly during the period of the Course:

For the Forty Week Course		Annualised (before tax)
1.	$27,551.53	$35,817
2.	$29,027.69	$37,736

9. The level of payment is dependent on the level of prior medical experience of a Registrar. However these amounts are set at a level to provide for the Registrar's maintenance of their standard of living and not at the level for a doctor with similar experience in appropriate employment.

10. A doctor who wishes to attend the Course as a Registrar applies to the College at the appropriate time. From the total number of applicants, the College undertakes a selection process to accept only the number of Registrars for which it has funding for.

11. The criteria by which Registrars are selected are merit-based; the College taking the perspective of selecting Registrars who will benefit the community in the long term. These criteria include:

- The intention to enter general practice;
- Experience in various areas of medicine;
- A demonstrated commitment to general practice addressing priority health areas;
- A demonstrated commitment to general practice addressing rural health issues;
- A demonstrated commitment to general practice addressing Maori health issues; and
- A demonstrated commitment to teaching medical students and colleagues.

12. The College initiates an agreement with each individual doctor that is to be agreed before the doctor becomes a Registrar in the Course.

13. The letter of appointment that the College offers to the Registrar refers to the "Terms and Conditions of Employment" and also the obligations contained in the "Registrar Handbook", which are to form part of their agreement and be met by the Registrar.

14. The obligations contained in this Handbook include (among others):

- That the Registrar satisfactorily attend, and participate in, 80% of the seminars and workshops,
- That the Registrar complete the 'attachment' to teaching practices, and the assessments thereon;
- That the Registrar be involved in patient contact, by having 5 to 13 consultations with patients per half day.
- That the Registrar has review sessions with the attachment teacher each day.

15. In exchange for agreeing to undertake the above and undertaking it, the Registrars receive from the College the monthly payments which are intended to maintain the Registrars whilst attending the Course.

16. The College Council is responsible for setting the educational philosophy and mission statement for its general practice education programme.

17. With regards to the Course content, the College has developed a curriculum for general practice training in consultation with College Members and Fellows and with the CTA to ensure that Government health priority areas are reflected in the educational programmes.

18. The College determines, in consultation with its Registrars, the methods of delivery for its programme for Stage I. The content of seminars and workshops is based on the syllabus for the Course and the specific learning needs of Registrars. The College determines the structure of the programme also. Materials for the programme are provided by the College and are purchased from the funding provided by the CTA. Seminars and workshops are held on premises hired by the College for that purpose.

19. The College is responsible for setting the Primex examination (sat at the end of the Course) and, in doing so, sets the standards for entry into Stage II and ultimately for vocational registration. The College also determines the structure and timing of the teaching programme. Furthermore the College determines the outputs of Registrars in terms of assignments, research projects, presentations and other learning activities.

20. The College selects teachers to the programme who meet a number of specific criteria. These include holding general registration with the Medical Council, being a Fellow of the College, and being assessed by the Regional Director as being competent and able to provide excellent education to a trainee. These teachers are employed by the College to provide teaching within the calendar year of the programme. All teachers must undertake ongoing professional development activities whilst they remain a teacher.

21. Regional directors (employed by the College) are responsible for maintaining contact with teachers during the programme and resolving any difficulties that may arise. They do so primarily through teacher meetings and practice visits. The regional directors are kept informed by teachers on the progress of Registrars.

22. The College devotes the majority of its resources (staff, funding and other assets) to the administration and running of the GPVTP and the continuing education of doctors in general practice. Over 50% of the College's total income and expenditure for the year ended March 1998 were directly attributable to the GPVTP alone.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

- The monthly payments made to the Registrars under the Arrangement are not grants made under regulations made under section 193 of the Education Act 1964, section 303 of the Education Act 1989, or any enactment in substitution for those sections.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the condition stated above, the Taxation Laws apply to the Arrangement as follows:

- The monthly payments made to the Registrars under the Arrangement are exempt income under section CB 9(d).

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 January 1998 to 31 December 2003.

This Ruling is signed by me on the 29th day of May 2000.

John Mora

Assistant General Manager (Adjudication & Rulings)

This Product Ruling has considered the income tax status of payments made under the Intensive Clinical Training Programme only. Registrars who are, or have been, receiving family assistance are advised that any payments received under the Programme may affect the level of family assistance entitlement. Registrars are advised to contact their tax agents if they require further advice on this issue.

Registrars should also note that this Product Ruling is applicable from 1 January 1998 and are advised to contact their agents to determine the impact on their 1998 and/or 1999 tax returns.

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.

WEBSITE EXPENDITURE - DEDUCTIBILITY

Section BD 2, Income Tax Act 1994 – Allowable deductions

A taxpayer has asked how he should treat expenditure incurred in creating a website to be used by him in deriving gross income. (The same considerations could also apply if the taxpayer had contracted another person to create the website for him.)

A website is a collection of web pages or web files. "Web" is an abbreviation for the "World Wide Web", the graphical part of the Internet. A web page is created using different programming languages (such as hypertext markup programming language ("HTML")). The use of programming code such as HTML enables web pages to have a number of features, such as video files, sound files, and links to other sites. A web browser interprets the code for graphical interface with a user's computer. A web page is transferred to a user's computer via the hypertext transfer protocol ("HTTP"). A website resides on an HTTP server.

A website's development has a number of steps (that can be undertaken in any order), including acquiring a domain name—the site's Internet address. The site needs to be designed and programmed. A website owner may wish to register the site with different Internet search engines, and to embed search strings in the site. The owner will also need to rent space on a web server.

The domain name of the website is generally acquired for a modest sum (less than $200). However, in some cases acquiring the domain name may require substantial expenditure. Expenditure incurred in acquiring a domain name is capital expenditure and non-deductible. In terms of the applicable capital/revenue tests established by the courts, such expenditure is of a one-off nature, gives rise to an enduring benefit, gives rise to an identifiable asset, and is part of the business structure of a taxpayer. A domain name is not "depreciable intangible property" as defined in section OB 1, and listed in Schedule 17, of the Act. As such, the expenditure incurred in acquiring the domain name is also not depreciable.

The HTML or other programming that makes up the website is an asset, being a computer software program. The costs incurred in creating the website are appropriately categorised as capital expenditure. In terms of the applicable capital/revenue tests established by the courts, such expenditure:

- is of a one-off nature
- gives rise to an enduring benefit
- is part of the business structure of a taxpayer.

As a capital asset, the costs of creating the website must be capitalised and may be depreciated. To be depreciable, the software must be used in deriving gross income. Consistent with other computer software, it may be depreciated at a rate of 40% diminishing value or 30% straight line.

This approach (of capitalising expenditure and depreciating it) is consistent with the views expressed by a number of commentators. In an accounting context the view that capitalisation and amortisation is appropriate has been expressed by Dr Rachel Baskerville in "Web Sites – Lame Ducks or Golden Geese" *Chartered Accountants Journal* (March 2000, page 62) and by Craig Fisher in "Accounting for Web-sites" *Accounting, Corporate and Tax Alert* (Issue 93, 5 June 2000, paragraph 200). The approach of capitalising and depreciating is also consistent with the draft Australian Tax Office ruling TR2000/D6.

Ongoing costs of updating or adding to the information on a website are of a revenue nature, and are deductible when incurred if they meet the general test of deductibility in section BD 2(1). It is a matter of degree as to whether expenditure is updating and maintaining a website, and hence revenue, or a reconstruction or functional improvement to a website, which would be capital. It is difficult to give general guidance on the distinction, as was noted (in a different context) by the Privy Council in *Auckland Gas Co Ltd v CIR* (unreported, PC Appeal 32 of 1999, judgment 14 June 2000).

However, some examples can be given as to the distinction between the two categories in the context of websites.

Maintenance of a website would include the following:

- updating the content of a web page
- adding content to a web page
- correcting minor errors or bugs in a website, and
- minor style or format changes relating to matters such as font types, font sizes, colours and so on.

An upgrade of a website would include the following:

- adding new features to a website, such as adding a sales capability with credit card processing features
- adding extra pages to the website
- upgrading the version of the software used in the website, and
- completely changing the layout and functions of the website sufficient to be a reconstruction.

These examples are consistent with the distinction between maintenance and upgrade in the Commissioner's existing computer software policy statement ("Income Tax Treatment of Computer Software" in *Tax Information Bulletin* Vol 4, No 10 (May 1993)). The examples also reflect the fact that a website may start out as a very simple website with few features, and yet may be upgraded over time to be a complex e-commerce site with advanced features such as the ability to purchase goods and services online, with online credit card processing capability. Just as the general capital/revenue principles apply to the original website (and the capital classification of that), any upgrade which adds new functions is also subject to those general principles and will also be on capital account.

The cost of renting space on an HTTP server is deductible, assuming the general test of deductibility is met. The annual renewal fee for registration of a domain name is also deductible. Such costs are of a revenue nature, because they are ongoing in the nature of a servicing charge, and are analogous to expenditure incurred in renting space in a building or in hiring goods.

REAL ESTATE SALE AND PURCHASE – GST APPORTIONMENTS OF INCOME AND EXPENDITURE

Section 2(1), Goods and Services Tax Act 1985 – definition of "consideration"

We have been asked if the Goods and Services Tax (GST) treatment of local authority rates apportionments on the sale and purchase of real estate, outlined in Public Ruling BR Pub 99/8, also applies to other income or expenditure that is similarly apportioned.

Public Ruling BR Pub 99/8 published in *TIB* Vol 11, No 11 (December 1999), with a minor correction in *TIB* Vol 12, No 2 (February 2000), sets out the GST treatment of local authority rates apportioned at the time of settlement on the sale and purchase of real estate. The Commissioner's view is that rates apportionments form part of the consideration for the supply of real estate and, where the transaction is subject to GST, should be taken into account in calculating the applicable GST.

If other expenditure (such as insurance) or income (such as commercial rental) is apportioned at settlement, these apportionments should be treated in a manner consistent with Public Ruling BR Pub 99/8. Provided the apportionment is determined on a contractual basis between the vendor and purchaser at the time of settlement, the apportionment will form part of the "consideration" of the supply of the real estate. For the reasons set out in Public Ruling BR Pub 99/8, the GST consequences will depend on whether the vendor and/or purchaser are GST-registered persons and whether the transaction forms part of a taxable activity.

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.

GST TREATMENT OF SUMS RECEIVED BY TAXPAYER FROM PARENT COMPANY UNDER WARRANTY AGREEMENT

Case: *CIR v Suzuki New Zealand Limited*

Decision date: 18 July 2000

Act: Goods and Services Tax Act 1985

Summary

McGechan J held both TRA findings were correct. In the result, the assessments stand.

Facts

Suzuki New Zealand ("SNZ") purchases Suzuki motor vehicles from Suzuki Motor Corporation ("SMC") which is the Japanese parent company. The terms of the sale and purchase agreement include a provision under which SMC warrants the goods to SNZ. The warranty is in respect of parts and labour for up to one year from the date the vehicle is sold to any particular customer. The beneficiary of the warranty is SNZ.

Once the Suzuki products arrive in NZ, they are sold to independent dealers. The dealers then sell to the public. Each vehicle is sold with a warranty provided by SNZ. This warranty is separate from the warranty agreement between SMC and SNZ. SNZ has an agreement with each dealer that if the dealer repairs a vehicle covered by the warranty provided by SNZ the dealer will be paid by SNZ at standard rates for the work. The warranty provided by SNZ covers any repairs specified in the agreement which are necessary within a period of three years after the purchase of the Suzuki product. The work is generally done by the same dealer who sold the vehicle to the customer.

SNZ contracts with the eventual purchaser of vehicles to provide the retail warranty. The dealers are authorised to offer the warranty to the purchasers.

When a customer has a problem with a vehicle, the customer normally returns it to a dealer, who assesses the vehicle to determine whether it is covered by the warranty. If they consider the repairs will cost more than $250, authority from SNZ to begin work is needed. The dealer repairs the vehicle free of charge to the customer. The dealer seeks payment from SNZ, who pays according to their agreement. The dealer accounts for output tax on the payment from SNZ and SNZ claims an input tax credit. SNZ may only then, after the repairs have been completed, approach SMC under the warranty between SMC and SNZ. If SMC is satisfied it is liable, it pays SNZ under the terms of the agreement between them.

The dispute is focused on the GST treatment of sums received by SNZ from SMC Japan. No issues arise in respect of the warranty payments from SNZ to dealers.

Decision

Whether SNZ supplied repair services to SMC Japan

On the first issue, concerning whether SNZ made a supply of repair services to SMC, the taxpayer argued the payments were not for repair services and the particular documentation should be interpreted as a mere obligation by SMC to pay compensation for defects.

McGechan J held that on the facts, including the documentation and the established practice, the true position was that payments were not necessarily either payments under the warranty, as the taxpayer contended, nor payments for repair services as the CIR contended, but were a mixture of both. The Court said the supply of repair services was an integral component of the situation which brought about the SMC payments, bringing the supply within the definition of consideration. There was a clear nexus. The payment if not "in respect of" was certainly in "response to" those repair services.

Whether repair services zero-rated under s 11(2(c)

The second leg of the first issue concerned whether the repair services were zero-rated or standard-rated. Quite simply the Court had no doubt repair services were carried out on cars in New Zealand, so the supply could not be zero-rated.

Whether payments by SMC Japan to SNZ were consideration for repairs by SNZ to customers

The second issue concerned whether payments by SMC Japan were "consideration" for repairs by SNZ to the customers. The CIR relied on this as an alternative argument, which had already failed before the TRA.

McGechan J accepted SNZ did carry out repairs via dealer agents for customers, but noted that was not all SNZ did. It also carried out repairs for SMC under the SMC warranty arrangements. Although SMC would want to see customers satisfied, the Court was unable to accept SMC was paying SNZ to supply repairs.

It paid SNZ because that was required under its warranty agreement, not for the repair work itself. It was not "in respect of" or "in response to" or as "an inducement for" the repair work carried out for the customer. Thus the payments by SMC were not in consideration of repair services by SNZ to customers. They were repairs carried out by SNZ for SMC itself.

REGULAR FEATURES

DUE DATES REMINDER

September 2000

5 Employer monthly schedule: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer monthly schedule* (*IR 348*) due

Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer deductions* (*IR 345*) or (*IR 346*) form and payment due

20 Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer deductions* (*IR 345*) or (*IR 346*) form and payment due

Employer deductions and Employer monthly schedule: **small employers** (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions* (*IR 345*) or (*IR 346*) form and payment due
- *Employer monthly schedule* (*IR 348*) due

29 GST return and payment due

October 2000

5 Employer monthly schedule: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer monthly schedule (IR 348*) due

Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer deductions* (*IR 345*) or (*IR 346*) form and payment due

20 Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

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Employer deductions and Employer monthly schedule: **small employers** (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions* (*IR 345*) or (*IR 346*) form and payment due
- *Employer monthly schedule (IR 348*) due

FBT return and payment due

31 GST return and payment due

These dates are taken from Inland Revenue's Smart business tax due date calendar 2000–2001

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

This page shows the draft public binding rulings, interpretation statements, standard practice statements, and other items that we now have available for your review. You can get a copy and give us your comments in these ways:

By post: Tick the drafts you want below, fill in your name and address, and return this page to the address below. We'll send you the drafts by return post. Please send any comments *in writing, to the address below*. We don't have facilities to deal with your comments by phone or at our other offices.

By internet: Visit **www.ird.govt.nz/rulings/**
Under the Adjudication & Rulings heading, click on "Drafts out for comment" to get to "The Consultation Process". Below that heading, click on the drafts that interest you. You can return your comments by the internet.

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