TAX INFORMATION BULLETIN

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For full details of how binding rulings work, see our information booklet *Adjudication & Rulings – a guide to Binding Rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin* Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

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CHARITABLE ORGANISATIONS AND FRINGE BENEFIT TAX (FBT)

PUBLIC RULING – BR Pub 00/08

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 97/6, published in *Tax Information Bulletin* Vol 9, No 5 (May 1997), but its period of application is from 1 July 1999 to 30 June 2004. For clarification purposes, some minor changes have also been made. BR Pub 97/6 applied to FBT periods commencing after 30 June 1997 and ending before 1 July 1999.

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

Taxation Law

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

This Ruling applies in respect of paragraph (m) of section CI 1 of the Act.

The Arrangement to which this Ruling applies

The Arrangement is the provision of a non-monetary benefit by a charitable organisation to an employee of that organisation.

In this Ruling, the term "charitable organisation" has the meaning that it has in the Act for the purposes of the FBT rules. That is, in relation to any quarter or (where FBT is payable on an income year basis under section ND 4) any income year, any society, institution, association, organisation, trust, or fund (not being a local authority, a public authority, or a university) to which, in the quarter or income year, section KC 5(1) applies.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- For the purposes of the proviso to section CI 1(m), a non-monetary benefit which is provided to an employee of a charitable organisation *is not* received by that employee in relation to the carrying on of a business by the charitable organisation if the employee receives the benefit in the course of an activity of the charitable organisation which involves carrying out any of the organisation's charitable, benevolent, philanthropic or cultural purposes, even if income is received by the organisation in the course of carrying out that activity.
- For the purposes of the proviso to section CI 1(m), a non-monetary benefit which is provided to an employee of a charitable organisation *is* received by that employee in relation to the carrying on of a business by the charitable organisation if the employee receives the benefit in the course of an activity which both:
  - cannot be characterised as carrying out any of the organisation's charitable, benevolent, philanthropic or cultural purposes; and
  - constitutes a profession, a trade, a manufacture, or an undertaking which is carried on for pecuniary profit (even if that profit is to be applied solely for the purposes of the charitable organisation).

The period for which this Ruling applies

This Ruling will apply for the period from 1 July 1999 to 30 June 2004.

This Ruling is signed by me on the 14th day of August 2000.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 00/08

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 00/08 ("the Ruling").

Background

The charitable organisation exemption from fringe benefit tax (FBT) does not apply to any benefit that is provided by a charitable organisation to an employee in the course of the employee's employment in a business activity of the charitable organisation.

The issue is whether the FBT exemption applies to benefits provided by charitable organisations that carry on their charitable objects in a business-like manner, and which have a record and expectation of making surpluses of income over expenditure.

Legislation

Section CI 1 defines the term "fringe benefit" for the purposes of the FBT rules. The relevant parts of that section, for the purposes of the Ruling, state:

> In the FBT rules, "fringe benefit", in relation to an employee and to any quarter or (where fringe benefit tax is payable on an income year basis under section ND 4) income year, means any benefit that consists of -
>
> (a) The private use or enjoyment, in relation to the employee ... of a motor vehicle ...
>
> (b) The availability for the private use or enjoyment of the employee ... of a motor vehicle ...
>
> (c) Any loan that is owing, by the employee,...
>
> (d) Any subsidised transport:
>
> (e) ... any contribution to any sick, accident, or death benefit fund ...
>
> (f) ... any specified insurance premium or any contribution to any insurance fund of a friendly society:
>
> (g) Any contribution in relation to an employer of an employee, to any superannuation scheme:
>
> (h) Any benefit of any other kind whatever,... being, as the case may be, private use or enjoyment, availability for private use or enjoyment, a loan, subsidised transport, a contribution to a fund referred to in paragraph (e), a specified insurance premium or a contribution to an insurance fund of a friendly society, a contribution to a superannuation scheme, or a benefit that is used, enjoyed, or received, whether directly or indirectly, in relation to, in the course of, or by virtue of the employment of the employee (whether that employment will occur, is occurring, or has occurred) and which is provided or granted by the employer of the employee; but does not include -
>
> ...
>
> **(m) Any benefit that, in any quarter or (where fringe benefit tax is payable on an income year basis under section ND 4) any income year, is provided or granted by or on behalf of an employer, being a charitable organisation, to an employee of the employer:**
>
> **Provided that this paragraph shall not apply to any such benefit to the extent that the benefit is used, enjoyed, or received, whether directly or indirectly, primarily and principally in relation to, in the course of, or by virtue of, any employment, in relation to the employee, that consists of any activity or activities performed by the employee in the carrying on, by the employer, of a business**: [Emphasis added]

"Business" is defined in section OB 1 as including any profession, trade, manufacture, or undertaking carried on for pecuniary profit.

"Charitable organisation" is defined for the purposes of the FBT rules as:

> ... any society, institution, association, organisation, trust, or fund (not being a local authority, a public authority, or a university) to which ... section KC 5(1) applies.

Section KC 5(1) applies to certain named institutions (paragraphs (ae) to (bv)), and, more generally, to:

> (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):

"Charitable purpose" is defined in section OB 1 as including:

> ... every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community:

The Act does not define "benevolent, philanthropic, or cultural purposes".

Application of the legislation

The charitable organisation exemption from FBT contained in paragraph (m) of section CI 1 only applies to the extent that the employee does not receive the benefit in the course of the organisation carrying on a business. The Ruling addresses the issue of when a charitable organisation will and will not be carrying on a business for the purposes of the charitable organisation exemption from FBT.

"Business" is defined in section OB 1 as including "any profession, trade, manufacture, or undertaking **carried on for pecuniary profit**". [Emphasis added]

The Court of Appeal in *Grieve v CIR* (1984) 6 NZTC 61,682 considered that underlying the Act's definition of "business" and the use of the word in the context of a taxation statute, is the fundamental notion of the exercise of an activity in an organised and coherent way that is directed to an end result—the making of pecuniary profits. The Court said that the existence of a business activity is determined on the basis of the nature of the activity and whether the taxpayer has the intention of making a pecuniary profit in carrying out that activity. The Court stated, at page 61,691:

> Statements by the taxpayer as to his intentions are of course relevant but actions will often speak louder than words. Amongst the matters which may properly be considered in that inquiry are the nature of the activity, the period over which it is engaged in, the scale of operations and the volume of transactions, the commitment of time, money and effort, the pattern of activity, and the financial results.

Many charitable organisations engage in activities on a continuous and ongoing basis, commit time, money and effort to those activities and conduct a large volume of transactions, and so will have these characteristics of a business.

The issue is therefore whether a charitable organisation that budgets for and has a record of making surpluses of income over expenditure, has the intention of making a profit. If it is carried on for profit, it will be a "business" for the purposes of the Income Tax Act.

English cases have held that the fact that a charity makes a profit does not mean that it is carried on "for profit". In *Trustees of the National Deposit Friendly Society v Skegness UDC* [1958] 2 All ER 601, the House of Lords found that a charity's objects are to advance the charitable purposes for which it is established. If profit-making is not one of its purposes, but is only a means of achieving those purposes, the charity is not carried on "for profit". In *Customs and Excise Commissioners v Bell Concord Educational Trust Ltd* [1989] 2 All ER 217, the Court held that the question of whether or not an organisation is carried on "for profit" must be answered by reference to the objects for which that organisation is established, as contained in its constitution, and not by reference to the budgeting policy of that organisation.

Thus, a charitable organisation that carries on its activities in a business-like manner and which has the intention and record of making surpluses, is not carried on "for profit", unless the organisation's constitution states that one of its purposes is to make a profit. As such organisations are not carried on "for pecuniary profit", they are not carrying on a "business" for the purposes of the Income Tax Act and the FBT exemption.

The Commissioner considers that Parliament did not intend the word "business" in the proviso to paragraph (m) of section CI 1 to include any charitable organisation which operates in a business-like manner and which intends to make surpluses. Such an interpretation would mean that most successful charitable organisations, in carrying on their charitable, benevolent, philanthropic, or cultural purposes, would be carrying on businesses for the purposes of the Income Tax Act and so would be subject to FBT in respect of benefits they provide to their employees. The proviso to the exemption contained in paragraph (m) would apply to most charitable organisations, making them subject to FBT and the exemption from FBT contained in paragraph (m) would generally not apply. Only those charitable organisations that could show that they did not operate in a business-like manner, or did not intend to make surpluses, either in the short or long-term, would not be carrying on a business and would be exempt from FBT. The Commissioner considers that this wide interpretation of the word "business" in the proviso to paragraph (m) of section CI 1 is not correct.

Instead, the Commissioner considers that the proviso to paragraph (m) of section CI 1 only applies to business activities which are carried on by charitable organisations but which are not, themselves, charitable, benevolent, philanthropic, or cultural activities. Such business activities may be conducted to assist the achievement of charitable purposes and the income produced by them may be applied to the charitable purpose. However, the business activities that the proviso applies to are not the intrinsically charitable, benevolent, philanthropic, or cultural activities of the organisation.

A distinction between the charitable (running and administering a charity, and providing charitable services) and the non-charitable purposes of a charity was drawn in *Oxfam v City of Birmingham District Council* [1975] 2 All ER 289.

That case concerned section 40 of the United Kingdom General Rate Act 1967 that applied to premises or hereditaments that were occupied by a charity and **wholly or mainly used for charitable purposes**. The House of Lords considered whether Oxfam's gift shops were on premises wholly or mainly used for charitable purposes. The House of Lords found that, although the gift shops were used for purposes that indirectly related to the achievement of the objects of the charity (selling donated goods to raise money for the charity), the premises were not wholly or mainly used for charitable purposes.

In reaching this conclusion, the House of Lords drew a line between the use of premises for purposes which are the charitable purposes of the charity and the use of premises for purposes which, though purposes of the charity, are not charitable purposes. Lord Cross said (at page 293):

> The wording of s 40(1) of the 1967 Act shows that the Legislature did not consider that the mere fact that a hereditament in question is occupied by a charity justifies any relief from rates. That is only justified if the hereditament is being used for the 'charitable purposes' of the charity. So the first question which arises is: what are the 'charitable purposes' of a charity as distinct from its other purposes? The answer must be, I think, those purposes or objects the pursuit of which make it a charity - that is to say in this case the relief of poverty, suffering and distress.

Oxfam identifies the fact that a charitable organisation can carry out both charitable and non-charitable activities. However, not all of the "non-charitable" activities carried on by a charitable organisation will constitute business activities. Only benefits provided to employees of a charitable organisation in relation to the carrying on of a business by or on behalf of the organisation will be subject to FBT.

The distinction between an organisation carrying out the functions for which the organisation was established and an organisation carrying on a business was examined in *Port Chalmers Waterfront Workers Union v CIR; New Zealand Waterfront Workers Union v CIR* (1995) 17 NZTC 12,059 (High Court); *CIR v Port Chalmers Waterfront Workers Union* (1996) 17 NZTC 12,523 (Court of Appeal). That case concerned section 61(23) of the Income Tax Act 1976. Section 61(23) (section CB 4(1)(a) of the Income Tax Act 1994) provides an exemption from income tax for the income of a friendly society, except so far as that income is derived from **business** carried on beyond the circle of its membership.

In *Port Chalmers,* the High Court drew a distinction between a friendly society carrying on a business as a trading organisation and a friendly society discharging its functions as a friendly society. It said that where the friendly society is discharging its functions as a friendly society, it is not carrying on a business even though it may conduct transactions that have a commercial flavour. This distinction was accepted by the Court of Appeal.

The Ruling interprets paragraph (m) of section CI 1 as drawing a similar distinction as that drawn in *Port Chalmers* between the activities of a charitable organisation which discharge the purposes for which the organisation was established (the discharging of its charitable, benevolent, or philanthropic objects) and the charitable organisation carrying on a business as a trading organisation. A charitable organisation is not carrying on a business for the purposes of paragraph (m) when it discharges its charitable objects, even though it may discharge those purposes in a business-like manner.

The effect of the Ruling is that the activities involved in carrying out the charitable objects of a charitable organisation, or directly facilitating the carrying out of the charitable objects (such as fundraising or administrative or clerical activities) will not be treated as being business activities for the purposes of paragraph (m). However, trading activities carried on to raise funds for the charity, which are not themselves the charitable purposes of the charity, will be treated as business activities of the charitable organisation if they satisfy the "business" test set out in the Income Tax Act, ie if those activities are carried on for the purpose of making a pecuniary profit.

Thus, when a charitable organisation's employees are engaged in carrying out the charitable purposes of the organisation, any benefits provided to them are not provided in the course of employment in a business activity of the organisation. The benefits will therefore be exempt from FBT under paragraph (m) of section CI 1.

However, when a charitable organisation's employees are engaged in activities of the organisation which are not in themselves charitable **and** which constitute business activities of the organisation, any benefits provided to them will be provided in the course of employment in a business activity of the organisation. These benefits will not be exempt from FBT under paragraph (m).

An employee may be employed by a charitable organisation in a range of activities, some of which relate to the carrying out of the organisation's charitable purposes or other non-business activities of the organisation and some of which are non-charitable business activities. Such an employee may receive benefits from the organisation in connection with both the business and non-business types of activities. Section CI 1(m) exempts benefits provided to employees of charitable organisations from FBT except **to the extent that** the benefit is received **principally or primarily** in relation to the employee's employment in a business carried on by the charitable organisation.

The phrase "to the extent that" does not, in this instance, mean that the benefit should be apportioned. In other contexts, it has been held that the words provide for the possibility of apportionment. However, in section CI 1(m) Parliament has also used the phrase "primarily and principally". This use of "primarily and principally" is inconsistent with the concept of apportionment; rather the phrase means that where the requirement is for the most part true for that element, the section is satisfied completely. There is no need for an apportionment and, consequently, in the context of section CI 1(m), the phrase "to the extent that" is to be interpreted as meaning "where".

Thus, a benefit provided to an employee who engages in both the business and non-business activities of a charitable organisation will only be subject to FBT if the employee receives that benefit principally and primarily in relation to the carrying out of the organisation's business activities. In other cases the benefit will remain exempt from FBT. As a guide, the Commissioner considers that an employee will receive a benefit principally and primarily in relation to their employment in a business activity of the organisation where:

- the benefit arises primarily in connection with such a business activity, rather than in connection with a non-business activity, or
- the benefit arises equally in connection with both the business and non-business activities carried out by the employee, but the employee is predominantly employed in the business activities of the employer.

Note that the Ruling does not apply to employers that are local authorities, public authorities, or universities. These organisations are excluded from the definition of "charitable organisation" for the purposes of the FBT rules, so the charitable organisation exemption contained in paragraph (m) of section CI 1 does not apply to them. Fringe benefits provided by these organisations will be subject to FBT unless some other exemption applies to them.

Examples

It will be a question of fact in each case whether the particular activities of a charitable organisation are activities that are not the inherently charitable activities which the organisation was established to carry out and are also activities which constitute a business for the purposes of the Income Tax Act. The following activities are examples of activities likely to be characterised as not being business activities of the charitable organisation (and, hence, any benefits provided to employees of the organisation in connection with these activities will be exempt from FBT). Note that this is not intended to be an exhaustive list of such activities:

- Activities **directly** related to carrying out the objects of the charity, but which also have an income component. For example:
  - A school or polytechnic established to provide education that charges fees for the provision of the educational services.
  - An organisation established to provide assistance to a disabled or disadvantaged group that provides services to those people for payment (eg residential accommodation services in return for board).
  - An organisation established to provide relief and assistance to the poor that runs a secondhand shop in order to provide affordable goods to that group.
- Appeals for funds for the charity's purposes.
- Passive investment and management of the funds of the charity, as long as the charitable organisation does not carry on a business of fund investment.
- Administration of the above activities.

An activity that is carried on by the charitable organisation that does not involve the organisation carrying out its charitable objects, but which involves the sale of goods or services for valuable and adequate consideration on a similar basis to business enterprises carried out by private individuals and with a view to making a profit, is likely to constitute the organisation carrying on a business. Any benefits provided to employees in connection with such an activity will be subject to FBT under the proviso to paragraph (m).

Example 1

A charitable trust has the principal purpose of providing education through a private school. The trust is a charitable organisation for the purposes of the FBT rules, as it is not carried on for the private pecuniary profit of any individual and its funds are applied wholly or principally for charitable purposes (the advancement of education) within New Zealand. The trust charges tuition fees and has had surpluses of income over expenditure for the last three income years. It provides a car to its school principal for work and private use.

The trust is not liable for FBT on the benefit arising from the private use or availability for private use of the car provided to the principal. This is because the benefit is provided by a charitable organisation to an employee who is employed in respect of the charitable organisation carrying out its charitable objects. The employee is not employed in a separate business activity carried on by the school.

Example 2

A company conducts a farming business on land adjacent to the school. All the shares in the company are held for the benefit of the school charitable trust referred to in Example 1, and the company's constitution provides that the assets and profits of the farming business must be applied exclusively to the promotion of the objects of the school charitable trust.

The company provides a car to its farm manager for his work and personal use. The company is liable for FBT on the benefit arising from the provision of the car to the farm manager, because the farm manager receives the benefit in relation to his employment in a business (the farm) carried on by the company.

Example 3

The same facts as in Example 2, except in this case the farming operation is carried out by the company, in a business-like manner, for the purpose of the practical component of the school's agricultural courses. In this situation the farming operation relates to the carrying on of the educational charitable objects of the school and the availability of the car for private use by the farm manager is not subject to FBT.

Example 4

A polytechnic charitable organisation offers a course on working in the hospitality industry. As part of that course the polytechnic operates a restaurant where the students gain experience in preparing food and waiting on tables. The restaurant is open to the public and patrons pay for their meals.

The polytechnic provides the hospitality course supervisor with a van for restaurant use. The van is also available for the supervisor's private use. The supervisor is employed in carrying out the polytechnic's charitable purpose of providing education to the students in the hospitality course. Because of this, the van is not provided in relation to the supervisor's employment in a business carried on by the polytechnic and its availability for private use is not a benefit that is subject to FBT.

Example 5

A polytechnic runs a cafeteria that is open to students and the general public. The cafeteria is not operated as part of any polytechnic course. The cafeteria is an activity of the polytechnic that cannot be characterised as carrying out the polytechnic's charitable purposes of providing education. Further, it is a commercial trading activity carried on with the intention of making a profit. The cafeteria is therefore a business run by the polytechnic.

The polytechnic employs a person to prepare food for the cafeteria. Once a week, this employee is also employed by the polytechnic to provide instruction in the hospitality course run by the polytechnic. The employee therefore is employed in both the business operations (the cafeteria) and the charitable activities (providing education in the hospitality course) of the polytechnic.

The polytechnic pays for the employee's membership to an off-campus fitness centre. This benefit arises because of the employee's employment with the polytechnic, and does not specifically arise in relation to either her employment in the cafeteria or her employment in the hospitality course. However, because the employee's employment in the cafeteria takes up 80% of her time, the benefit arises principally and primarily in relation to her employment in a business activity of the polytechnic. The benefit is therefore not exempt from FBT under paragraph (m) of section CI 1 and will be subject to FBT.

DIRECTORS' FEES AND GST

PUBLIC RULING – BR Pub 00/09

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 6(3)(b), 8, and 57(2)(b).

The Arrangement to which this Ruling applies

The Arrangement is the engagement, occupation, or employment as a director of a company. The engagement may either be by direct contract between the director and the company for whom the person acts as a director, or by a third party appointing, or agreeing to provide, a director to a company.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- If a natural person is engaged as a director and the services are not undertaken as part of carrying on the person's own taxable activity, the engagement will be excluded from the term "taxable activity" due to the application of section 6(3)(b). The proviso does not apply as the services are not supplied as part of carrying on the person's taxable activity:
- If a natural person is engaged as a director as part of carrying on his or her taxable activity, the proviso to section 6(3)(b) will apply and the services will be deemed to be supplied in the course or furtherance of that taxable activity. If the person is registered for GST or is liable to be registered for GST, the person will be required to account for GST on the fees received for the supply of the directorship services:
- If a natural person is contracted by a third party to take up an engagement as a director of a company and the person has not accepted the directorship as part of carrying on a taxable activity:
  - the engagement of the natural person as a director will be excluded from the term "taxable activity" due to the application of section 6(3)(b). The proviso does not apply as the services are not supplied as part of carrying on the person's taxable activity;
  - the provision by the third party of the services of the natural person director does not fall within the provisions of section 6(3)(b), as the third party has not been engaged as a director of a company. If the third party is registered for GST or is liable to be registered for GST, that third party will be required to account for GST on the fees received for the supply of the person's services as a director of the company:
- If a natural person is contracted by a third party to take up an engagement as a director of a company and the engagement is part of carrying on the person's taxable activity:
  - the engagement of the natural person director will fall within the proviso to section 6(3)(b) and the services will be deemed to be supplied in the course or furtherance of the taxable activity;
  - the provision by the third party of the services of the director does not fall within the provisions of section 6(3)(b), as the third party is not engaged as a director of a company. If the third party is registered for GST or is liable to be registered for GST, that third party will be required to account for GST on the fees received for the supply of the person's services as a director of the company:
- If an employee, as part of his or her employment, is engaged as a director of a third party company by way of a contract between his or her employer and the third party company:
  - the engagement of the employee will fall within the provisions of section 6(3)(b) and is therefore excluded from the term "taxable activity". The proviso to the section does not apply as the services are not supplied as part of carrying on a taxable activity of

the employee;

- the provision by the employer of the services of a director does not fall within the provisions of section 6(3)(b), as the employer is not engaged as a director of a company. If the employer is registered for GST or is liable to be registered for GST, that employer will be required to account for GST on the fees received for the supply of the employee's services as a director of the company:

- If an employee is engaged by a third party company to be a director of that company, where: the employee is required to account to the employer for the directors fees received; there is no contract between the employer company and the third party company; and where the employee does not undertake the services as part of carrying on his or her own taxable activity:
  - the engagement as director will be excluded from the term "taxable activity" due to the application of section 6(3)(b). The proviso does not apply as the services are not supplied as part of carrying on the person's taxable activity;
  - if the employer is registered for GST or is liable to be registered for GST, the employer is required to account for GST on the consideration received for the supply of services to the employee, i.e. permitting the employee to be a director.
- If a partner in a partnership accepts an engagement as a director of a company as part of the partnership's business:
  - the activity of the partner, in accepting the engagement as a director, falls within the provisions of section 6(3)(b) and is therefore excluded from the term "taxable activity". The proviso to the section does not apply as, although the partner may be carrying on the taxable activity of the partnership, the services are deemed to be supplied by the partnership in terms of section 57(2)(b);
  - the provision by the partnership of the services of the director does not fall within the provisions of section 6(3)(b), as the partnership is not engaged as a director of a company. The partnership will be required to account for GST on the fees received for the supply of the partner's services as a director of the company as it is considered to be part of the normal taxable activity of the partnership.

The period for which this Ruling applies

This Ruling will apply to supplies made within the period 1 April 2000 to 31 March 2005.

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

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 00/09

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 00/09 ("the Ruling").

Background

Section 6 defines the term "taxable activity" for the purposes of the Act. Under section 6(1), a person conducts a taxable activity when all of the following characteristics are present:

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

Section 6(3) provides certain exclusions from the term "taxable activity". Under section 6(3)(b), the activities of a salary and wage earner, or of a person in receipt of directors' fees, are excluded from the term.

Under the proviso to section 6(3)(b), if a person, in carrying on a taxable activity, accepts any office, any services supplied by that person in holding that office are deemed to be supplied in the course or furtherance of that taxable activity. Therefore, if a GST-registered sole trader takes on a company directorship in carrying on a taxable activity, the proviso applies and GST is chargeable on the directors' fees paid.

Public Information Bulletin (*PIB*) 164 issued in August 1987 contained an item titled "GST on Directors' Fees". The item concerned the circumstances in which directors' fees did and did not attract GST. The item listed indicators that could be used in identifying the correct GST treatment to be applied to directors' fees. These indicators were:

1. Directors' fees paid to directors personally, and retained by them.

   Not subject to GST—excluded from the meaning of taxable activity by section 6(3)(b).

2. Directors' fees paid to directors personally, but applied by them to their partnership or business income, where the partnership or business is a registered person.

   Subject to GST—subject to the proviso to section 6(3)(b).

3. Directors' fees paid directly to director's partnership or company, where that partnership or company is a registered person.

   Subject to GST—a normal taxable supply.

In July 1988 the Department issued *PIB* 175 containing, at page 26, a further item "GST on Directors' Fees", restricting the policy set down in *PIB* 164. The item advised that the proviso to section 6(3)(b) applies only to a sole trader, eg an accountant (being a registered person) who, in carrying on his or her taxable activity, is appointed a director of a company. The statement said that directors' fees paid to a partner in a partnership or to a shareholder, director, or employee of another company are not therefore subject to GST. The reason given for this interpretation was that, in terms of the Companies Act 1955, a director could only be a natural person. Therefore, directors' fees either paid to directors on behalf of their companies or partnerships, or paid directly to the company or partnership for directorship services carried out by their employees or partners, do not attract GST under this policy.

Inland Revenue published an interpretation statement in *Tax Information Bulletin* Vol 8, No 4 (September 1996) on "Tax deductions from directors' fees paid to GST-registered persons". This interpretation statement is also relevant to the subject matter of this Ruling, even though it deals with tax deductions under the Income Tax Act 1994. The statement says, at page 3, that if an employee is acting as a director of a company on behalf of another company, the directors' fees paid are for services rendered by the employer company. Regulation 4(2) of the Income Tax (Withholding Payments) Regulations 1979 ("the Regulations") states that payments for work done or services rendered by a company are not withholding payments. Therefore, tax deductions are not required to be made from the payments. Similarly, if a company pays directors' fees to a partnership account in return for the partner performing partnership services, the fees are business income of the partners and the Commissioner will not require tax deductions to be made under section NC 13 of the Income Tax Act 1994. Therefore, if it is the company or partnership that is providing the services of its employee or partner as a director, the question arises as to whether GST should be charged on these services as they would normally be supplied in the course or furtherance of a taxable activity of the company or partnership.

This Ruling replaces the policy items on "GST on Directors' Fees" contained in *PIBs* 164 and 175.

Legislation

The definition of the term "person" is contained in section 2(1) of the Act and states:

> includes a company, an unincorporated body of persons, a public authority, and a local authority

Section 2 also contains the definition of "registered person" being:

> … a person who is registered or is liable to be registered under this Act.

Section 6 states:

> (1) For the purposes of this Act, the term "taxable activity" means -
>
> (a) Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:
>
> (b) Without limiting the generality of paragraph (a) of this subsection, the activities of any public authority or any local authority.
>
> (2) Anything done in connection with the commencement or termination of a taxable activity shall be deemed to be carried out in the course or furtherance of that taxable activity.
>
> (3) Notwithstanding anything in subsections (1) and (2) of this section, for the purposes of this Act the term "taxable activity" shall not include, in relation to any person, -
>
> (a) Being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or
>
> (aa) Not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby; or
>
> (b) Any engagement, occupation, or employment under any contract of service or as a director of a company:
>
> Provided that where any person, in carrying on any taxable activity, accepts any office, any services supplied by that person as the holder of that office shall be **deemed to be supplied in the course or furtherance of that taxable activity; or …** (Emphasis added)

Section 8(1), dealing with the imposition of goods and services tax, 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 57, dealing with unincorporated bodies, states:

> (1) For the purposes of this section -
>
> "Body" means an unincorporated body of persons; and includes -
>
> (a) A partnership:
>
> (b) A joint venture:
>
> (c) The trustees of a trust:
>
> "Member" means a partner, a joint venturer, a trustee, or a member of any body:
>
> "Partnership" and "partner" have the same meanings as in the Partnership Act 1908.
>
> (2) Where a body that carries on any taxable activity is registered pursuant to this Act, -
>
> (a) The members of that body shall not themselves be registered or liable to be registered under this Act in relation to the carrying on of that taxable activity; and
>
> **(b) Any supply of goods and services made in the course of carrying on that taxable activity shall be deemed for the purposes of this Act to be supplied by that body, and shall be deemed not to be made by any member of that body; and**
>
> … (Emphasis added)

Section 151(3) of the Companies Act 1993 states:

> A person that is not a natural person cannot be a director of a company.

Application of the Legislation

Section 8(1) provides that GST is charged on the supply (but not an exempt supply) in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person.

Therefore, one of the determining features in ascertaining whether there is a liability to account for GST, is the existence of a "taxable activity". Another determining feature is whether the person is a "registered person".

Section 6(1) defines a "taxable activity" as an activity that is carried on continuously or regularly, and involves or is intended to involve the supply of goods and services to another person for a consideration. The section also includes within the term "taxable activity" the activities of any public or local authority.

Under section 6(2), anything done in connection with the commencement or termination of a taxable activity is deemed to be carried out in the course or furtherance of that taxable activity.

Paragraphs (a), (aa), (b), (c), and (d) of section 6(3) exclude from the term "taxable activity" such activities as hobbies, employment under a contract of service and engagement as a director of a company, certain Government-type and local authority appointments, and the making of exempt supplies.

The proviso to paragraph (b) states that if a person, in carrying on a taxable activity, accepts any office, services supplied by that person in holding that office are deemed to be supplied in the course or furtherance of that taxable activity. Therefore, if a person is carrying on a taxable activity, and accepts an engagement as a company director in carrying on **that** taxable activity, the proviso will apply.

If it is established that a taxable activity is in existence after applying section 6, the question of whether the person is liable to account for GST will depend on the application of the remaining criteria set down in section 8. One of these criteria is whether the person is a "registered person", ie whether the person is registered for GST or is liable to be registered for GST, which includes whether the taxable activity threshold amount in section 51 has been satisfied.

Section 57(2)(b) provides that where a partnership carries on a taxable activity, any supply of goods and services made as part of carrying on that taxable activity is deemed to be supplied by the partnership and not by any of the partners.

Section 151(3) of the Companies Act 1993 provides that only a natural person can be a director of a company.

The following scenarios illustrate how section 6(3)(b) is applied to a person engaged as a director of a company to determine the existence of a taxable activity. It is important to note that the Ruling itself deals specifically with section 6(3)(b). If it is established that an activity does not fall within the exclusion from a "taxable activity" set down in that section, the remaining criteria under section 8 must be applied in order to determine the existence of a liability to account for GST.

Note that it is the contractual relationship between the parties, founded on a genuine basis, that determines the GST treatment of the relevant transactions (*Wilson & Horton v CIR* (1995) 17 NZTC 12,325).

A. Personal capacity

A natural person is engaged as a director of a company in that person's personal capacity and not as part of carrying on any taxable activity.

The activity of this person falls within the provisions of section 6(3)(b) in that it involves a person who is engaged as a director of a company. The activity is therefore excluded from the term "taxable activity". The proviso does not apply, as the person has not accepted the engagement as part of carrying on a taxable activity.

B. Carrying on a taxable activity

A natural person is engaged as a director of a company as part of carrying on that person's taxable activity.

The activity of this person falls within the provisions of section 6(3)(b) in that it involves a person who is engaged as a director of a company. The activity is therefore *prima facie* excluded from the term "taxable activity". However, as the person has accepted the engagement as part of carrying on a taxable activity, the proviso deems the services to be supplied in the course or furtherance of that taxable activity. If the person is registered for GST or is liable to be registered for GST, the person will be required to account for GST on the fees received for the supply of the directorship services.

C. Person contracted as a company director

A natural person is contracted by a third party to take up an engagement as a director of a company. The person is not undertaking the directorship as part of carrying on any taxable activity. The third party invoices the company for its services in providing it with a director.

The engagement of the person as a director of a company is excluded from the term "taxable activity" under section 6(3)(b). The proviso to the section does not apply as the services are not supplied as part of carrying on the person's taxable activity. The provision by the third party of the services of the director does not fall within the provisions of section 6(3)(b), as the third party is not engaged as a director of a company. Provided the third party is registered for GST or is liable to be registered for GST, that party will be required to account for GST on the fees received for the supply of the services of the person as a director of the company.

D. Person contracted as a company director in carrying on a taxable activity

A natural person, as part of carrying on a taxable activity, is contracted by a third party to take up an engagement as a director of a company. The third party invoices the company for providing the services of the director, who in turn invoices the third party for his or her services.

The engagement of the person as a director of a company is *prima facie* excluded from the term "taxable activity" under section 6(3)(b). However, as the person has accepted the engagement as part of carrying on a taxable activity, the proviso to the section deems the directorship services to be supplied in the course or furtherance of that taxable activity. The natural person's liability for GST will therefore

depend on satisfying the remaining requirements of section 8. The provision by the third party of the services of the director does not fall within the provisions of section 6(3)(b) as the third party is not engaged as a director of a company. Provided the third party is registered for GST or is liable to be registered for GST, that party will be required to account for GST on the fees received for the supply of the person's directorship services.

E. Employee engaged as director

An employee of an employer is engaged as a director of a third party company as part of the person's employment duties.

The engagement of this person as a director of a company is excluded from the term "taxable activity" under section 6(3)(b). The proviso to the section does not apply as the person has not accepted the directorship as part of carrying on a taxable activity—the person is merely carrying out employment duties. The provisions of section 6(3)(b) do not apply to the employer who is supplying the services of its employee as the employer is not engaged as a director of a company. Provided the employer is registered for GST or is liable to be registered for GST, that party will be required to account for GST on the fees received for the supply of the services of the person as a director of the company.

F. Employee required to pay over directors' fees to employer

Sometimes an employee is permitted to accept directorships of third party companies provided the employee accounts to the employer for the fees received. This might occur with family companies. In this type of scenario there would not be a contract between the employer and the third party company.

In this situation, the engagement of the person as a director of a company is excluded from the term "taxable activity" under section 6(3)(b). The proviso to the section does not apply as the person has not accepted the directorship as part of carrying on a taxable activity. The employer company, provided it is registered for GST or liable to be registered for GST, will be required to account for GST on the supply of services to the employee. These services could best be described as allowing the employee to undertake directorship duties in work time or permitting the employee to be a director.

G. Partner in a partnership engaged as a director

A partner in a partnership accepts an engagement as a director of a company as part of the partnership's business.

The engagement of this person as a director of a company is excluded from the term "taxable activity" under section 6(3)(b). The proviso to the section does not apply as, although the partner may be carrying on the taxable activity of the partnership, the services are deemed to be supplied by the partnership in terms of section 57(2)(b). Therefore, the partner is not required to account for GST on the supply of the directorship services. Section 6(3)(b) does not apply in the case of the partnership as the partnership is not engaged as a director of a company. The partnership supplies the services of one of its partners to the company as part of its taxable activity. The partnership will therefore be required to account for GST on the fees received for the supply of the partner's directorship services.

Examples

Example 1

Taxpayer A, who is not registered for GST, is a partner in a firm of chartered accountants. Company B engages taxpayer A as a director, and pays him fees for his services. Taxpayer A's appointment as a director is not connected with his involvement in the partnership nor has he accepted the directorship as part of carrying on a taxable activity. He retains the fees, having received them in his personal capacity.

Taxpayer A is engaged as a director of a company, an activity that is excluded from the term "taxable activity" by section 6(3)(b). The proviso to the section does not apply, as taxpayer A is not providing directorship services as part of carrying on a taxable activity. Taxpayer A is not required to account for GST on the fees received for directorship services.

Example 2

Taxpayer B is a human resources consultant in business on her own. She is registered for GST. She accepts a company directorship as part of carrying on her taxable activity, and receives fees for her services.

Taxpayer B's engagement as a director is *prima facie* excluded from the term "taxable activity" in terms of section 6(3)(b). However, as she has accepted the engagement as part of carrying on her taxable activity, the proviso to the section deems the directorship services to be supplied in the course or furtherance of her taxable activity. She should therefore account for GST on the fees she is paid.

Example 3

A GST-registered financial management company supplies the services of one of its specialist employees as a director of another company. Directors' fees are paid to the company for the services provided.

The engagement of the employee as a director is excluded from the term "taxable activity" under section 6(3)(b). The proviso does not apply as the employee has not accepted the office as part of carrying on a taxable activity. Therefore, the employee is not required to account for GST on the supply of the directorship services. Section 6(3)(b) does not apply to the activity of the management company as that company is not engaged as a company director. The fees are paid in consideration of the management company providing the services of one of its employees to the other company. This is a supply in the course or furtherance of a taxable activity of the management company and that company will be required to account for GST on the fees received for this supply.

Example 4

A partner of a GST-registered legal partnership is elected onto the board of directors of a client company as a representative of the partnership. The partnership is providing legal advice to the company, which in turn pays fees into the partnership's account.

The engagement of the partner as a director of a company falls within the provisions of section 6(3)(b) and is therefore excluded from the term "taxable activity". The proviso to the section does not apply as, although the partner may be carrying on the taxable activity of the partnership, the services are deemed to be supplied by the partnership in terms of section 57(2)(b). Therefore, the partner is not required to account for GST on the supply of the directorship services. The provisions of section 6(3)(b) do not apply to the partnership as it is not engaged as a director of a company.

The partnership will therefore be required to account for GST on the fees it receives from the company.

Example 5

A GST-registered accountant in business on his own is contracted by a consulting firm to take up an engagement as a director of a company with the object of monitoring the company's financial systems.

The engagement of the accountant as a director of a company is excluded from the term "taxable activity" under section 6(3)(b). However, as the person has accepted the engagement as part of carrying on his taxable activity, the proviso to the section deems the directorship services to be supplied in the course or furtherance of his taxable activity. The accountant will therefore be required to account for GST on the fees he receives in respect of these services. The provision by the consulting firm of the services of the accountant does not fall within the provisions of section 6(3)(b) as the firm is not engaged as a director of a company. Provided the consulting firm is registered for GST or is liable to be registered for GST, it will be required to account for GST on the fees received for the supply of the directorship services of the accountant.

Example 6

Company A agrees to one of its employees taking up a directorship position with Company X on the proviso that the employee hands over the directors' fees payable to the employee by Company X. There is no contract between Company A and Company X.

The engagement of the employee as a director is excluded from the term "taxable activity" under section 6(3)(b). The proviso does not apply as the employee has not accepted the office as part of carrying on a taxable activity. Therefore, the employee is not required to account for GST on the supply of the directorship services. If Company A is registered for GST or is liable to be registered for GST, it is required to account for GST on the supply of services, ie permitting the employee to be a director of Company X.

PRODUCT RULING – BR PRD 00/07

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 Deutsche Bank AG.

Taxation Laws

This Ruling applies in respect of the following Taxation Laws:

- Sections HH 3(2), HK (1), BG 1 and the definitions of "beneficiary income" and "taxable distribution" in section OB 1 of the Income Tax Act 1994 (the "Income Tax Act").
- Sections 3 and 14(a) of the Goods and Services Tax Act 1985 (the "GST Act").

The Arrangement to which this Ruling applies

The Arrangement is the offering by Deutsche Bank AG, a company incorporated in Germany, of an investment product, called "SELECT", to its clients. Under each SELECT Contract, Deutsche Bank AG acting as a custodian will accept funds from a client (the "Client") which will be invested in securities, referred to as "Authorised Investments". The Client will receive an agreed return subject to the terms governing the SELECT Contract. The Arrangement is governed by two agreements - the Secure Look-Through Enhanced Customised Transaction Master Agreement (the "Master Agreement") and the Secure Look-Through Enhanced Customised Transaction Custody Agreement (the "Custody Agreement"). Further details of the Arrangement are set out in the paragraphs below.

The Master Agreement

1. The parties to the Master Agreement are the Client, Deutsche Bank AG ("DBAG") (acting through its New Zealand branch), and Deutsche New Zealand Limited (the "Manager"). The Master Agreement provides that from time to time the parties may enter into transactions pursuant to which the Client may request the Manager to buy Authorised Investments as agent for the Client. These may be "Series 1 Authorised Investments" (generally DBAG, Government, Statutory Corporation and Bank securities) or "Series 2 Authorised Investments" (generally DBAG, Government, Statutory Corporation, Bank and other securities). However the categories may be otherwise agreed between the parties. Each such transaction will constitute a SELECT Contract.

2. The Master Agreement requires that the Client enters into the Custody Agreement, which provides that Deutsche Bank AG is to be the custodian (the "Custodian") of the Authorised Investments. This Agreement is discussed below.

3. References in this Ruling to "DBAG" are a reference to Deutsche Bank AG acting in its personal capacity pursuant to the Master Agreement, unless otherwise specified. References to the "Custodian" are a reference to Deutsche Bank AG acting as Custodian pursuant to the Custody Agreement. From an internal perspective and for internal reporting and accounting purposes, Deutsche Bank AG will undertake its duties and obligations that arise pursuant to the Master and Custody Agreements in a manner consistent with the separate capacities that those agreements give rise to.

4. The Authorised Investments for each SELECT Contract are initially acquired from DBAG. In order to purchase these initial Authorised Investments, the Client will pay to the Custodian the "Client Payment Amount". This consists of the funds provided by the Client for the acquisition of the initial Authorised Investments which the Client will direct the Custodian to pay to DBAG.

5. Payment obligations under a SELECT Contract involve a "netting" approach. If the Client's agreed contractual return is less than the amount actually derived from the Authorised Investments, the Client is required to pay DBAG the difference. Conversely, if the agreed contractual return is greater than the amount derived, DBAG is required to pay the difference to the Client. The formula for this is included in the Master Agreement and is to be calculated by DBAG. It requires calculating the "Amount Due" and subtracting the "DBAG Payment Amount" where:

(i) The Amount Due is the total amount (including interest, principal and other amounts) due to the Client under the Authorised Investments held under the relevant SELECT Contract, notwithstanding that the amount actually received by the Custodian may be less than the total amount due; and

(ii) The DBAG Payment Amount is the amount payable on the relevant Payment Date as specified in the relevant confirmation of the SELECT Contract.

6. The Manager has wide powers to deal with and act in respect of the Authorised Investments. To this end, the Client directs the Custodian to act on any instructions given by the Manager. Any profits or losses derived from dealings with the Authorised Investments by the Manager are for the account of DBAG.

7. DBAG and the Manager have only the duties in respect of the Authorised Investments that are expressly provided for in the Master Agreement. The main obligations of DBAG in respect of the SELECT Contracts are:

(i) To deliver a confirmation of a SELECT Contract to the Client on the Client entering into that SELECT Contract;

(ii) To provide the initial Authorised Investments, and to accept the Client Payment Amount from the Custodian as payment for these securities;

(iii) To deliver to the Custodian all Authorised Investments purchased on behalf of the Client;

(iv) To make payments to the Client when required, and to calculate such payments;

(v) To ensure only "Authorised Investments" as defined in the Master Agreement are purchased by the Manager;

(vi) To ensure that at the time of purchase the Authorised Investments are securities which have at least a Standard & Poor's rating of BBB- or better;

(vii) To pay default interest in relation to each amount due and payable by it to the Client or the Manager but unpaid at the due date for payment;

(viii) To ensure that the Authorised Investments under each SELECT Contract have a face value of not less than the amount specified in the confirmation of the SELECT Contract;

(ix) To act in good faith and have regard to the interests of the Client;

(x) Where requested by the Client, to provide a report detailing the particulars of the Authorised Investments held on behalf of the Client;

(xi) Where requested by the Client, to repurchase a SELECT Contract (the sale being arranged and effected by the Manager);

(xii) To notify the Client if a "termination event" occurs;

(xiii) Where a termination event only affects some of the Authorised Investments under a SELECT Contract, to amend the terms of that SELECT Contract as required; and

(xiv) Not to deal with its rights or obligations under the Master Agreement without the written consent of the other party.

8. Where an "automatic termination event" occurs, there is deemed to be a sale of the affected Authorised Investments to DBAG on that date.

The Custody Agreement

9. The Custody Agreement is entered into between the Client and Deutsche Bank AG (the "Custodian") (acting through its New Zealand branch). The Agreement appoints the Custodian to hold each SELECT Portfolio as "bare trustee and custodian" for the benefit of the Client. Beneficial ownership of the SELECT Portfolios is retained by the Client.

10. The SELECT Portfolios comprise the Client Payment Amount, the securities purchased as Authorised Investments and held on behalf of the Client in respect of a SELECT Contract, and any money or interest received in respect of these securities.

11. The Custodian has only the duties, rights, powers and discretions in respect of the SELECT Portfolios as set out in the Custody Agreement. Namely:

(a) the Custodian shall not deal with any part of any SELECT Portfolio except in accordance with the directions of the Client;

(b) the Custodian shall act at all times in good faith towards and have regard to the interests of the Client; and

(c) the Custodian shall provide the following services:

(i) hold each SELECT Portfolio in safe custody;

(ii) keep each SELECT Portfolio separate from each other SELECT Portfolio and not mix the portfolio with the assets of the Custodian;

(iii) maintain records which enable the Authorised Investments allocated to a SELECT Contract to be identified;

(iv) hold legal title to any Authorised Investments or money forming part of a SELECT Portfolio as bare trustee for the benefit of the Client;

(v) pay the Client Payment Amount to DBAG in payment of the purchase price of the initial Authorised Investments acquired from DBAG (the Client irrevocably and unconditionally directs the Custodian to do this);

(vi) account to the Client on each Payment Date relating to a SELECT Contract for any interest, principal or other amount actually received by the Custodian in respect of Authorised Investments under that SELECT Contract;

(vii) account to the Client as and when required under the terms of the Custody Agreement for the net proceeds of sale of any Authorised Investments held by the Custodian under a SELECT Contract;

(viii) deduct from any amount payable by the Custodian to the Client any amount owing by the Client to DBAG in respect of the SELECT Contract and pay it to DBAG (the Client irrevocably and unconditionally directs the Custodian to do this);

(ix) make payments to DBAG when required (the Client irrevocably and unconditionally directs the Custodian to do this);

(x) act on any instructions from the Manager in relation to the delivery of Authorised Investments to enable the Manager to exercise the power of acquisition, disposal or exchange, as if those instructions had been given to the Custodian by the Client directly (the Client irrevocably and unconditionally directs the Custodian to do this);

(xi) if directed by the Client, transfer the whole of a SELECT Portfolio held by the Custodian under a SELECT Contract to an entity nominated by the Client;

(xii) credit all money and other amounts received by the Custodian in respect of the Authorised Investments to the Custodian's account with DBAG (the Client irrevocably and unconditionally directs the Custodian to do this); and

(xiii) execute all documents and assurances and do all acts which are necessary, desirable or incidental to the exercise of its powers and obligations described in the Custody Agreement.

Assumptions made by the Commissioner

This Ruling is made subject to the following assumptions:

a) The Clients entering into the SELECT Contracts are *sui juris*.

b) The Custodian may not buy, sell, or otherwise deal with the SELECT Portfolios, otherwise than at the express direction of the Client or pursuant to clause 3.2 of the Custody Agreement.

How the Taxation Laws apply to the Arrangement

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

- Gross income arising from or related to the Authorised Investments of a Client held by the Custodian under the Custody Agreement will be derived by that Client in terms of section BD 1 of the Income Tax Act, and will not be derived by the Custodian, as the arrangement whereby the Custodian holds legal title to the Authorised Investments on behalf of the Clients will constitute a bare trust.
- For the purposes of sections HH 3(2) and HK 1 of the Income Tax Act, the Custodian will not derive an amount from the Authorised Investments that is "beneficiary income" or a "taxable distribution" (as those terms are defined in section OB 1 of the Income Tax Act) for which a trustee is liable to tax as agent of the beneficiary as the arrangement whereby the Custodian holds legal title to the Authorised Investments on behalf of the Clients will constitute a bare trust.
- Section BG 1 of the Income Tax Act does not apply to negate or vary the conclusions outlined above.
- Supplies made by the Custodian as specified in the Custody Agreement and outlined in paragraph 11(c), with the exception of the payment by the Custodian to DBAG of any amounts owing by the Client in accordance with the Master Agreement (subparagraph (viii)), are exempt from goods and services tax under section 14(a) of the GST Act.

The period for which this Ruling applies

This Ruling will apply for the period from 13 July 2000 to 12 July 2003.

This Ruling is signed by me on the 13th day of July 2000.

John Mora

Assistant General Manager (Adjudication & Rulings)

NEW LEGISLATION

DOUBLE TAX AGREEMENT WITH RUSSIA PROGRESSING

The double tax agreement between New Zealand and the Russian Federation moved a step closer to realisation with the signing of the agreement by both countries in Wellington on 5 September 2000. The agreement is expected to help reduce the costs of New Zealanders doing business in Russia, by reducing tax impediments to cross-border trade and investment.

The double tax agreement with Russia will not enter into force until each country has completed its domestic procedures for giving legal effect to the signed agreement. In New Zealand, this involves an Order in Council, although a more complex procedure applies in Russia. It is expected that the agreement will enter into force in time for the double tax agreement to apply from 1 January 2001 for New Zealand withholding tax, and from the 2001–2002 income year for all other New Zealand income tax.

The main features of the agreement are:

- New Zealanders will pay non-resident withholding tax of no more than 15% for dividends derived from Russia, 10% for interest, and 10% for royalties.
- The profits of New Zealand businesses will generally be exempt in Russia if the business is of a temporary nature.
- Mobile activities, such as consultancy, building and construction sites, installation and assembly projects, and natural resource exploration and exploitation, must be conducted in Russia for more than 12 months before Russia can tax the income.
- Income from professional services can be taxed in Russia only if the person performing the services is present for more than 183 days or has a fixed base there.
- New Zealand employees working in Russia will generally not be taxed by Russia unless they spend more than 183 days there.
- Profits from insurance, coastal shipping, domestic air transport and real property (including agriculture and forestry) can be taxed in the country in which they are situated, even if the activity is of a temporary nature.
- Pensions paid by the government of either state can be taxed in both states (although in the case of the state of residence of the recipient, the taxing right is limited to 50% of the amount of the pension. All other pensions and annuities are to be taxed solely by the state of residence.
- Certain forms of discriminatory tax treatment between non-residents by either tax authority are prohibited.

Russians living or carrying on a business in New Zealand will enjoy similar benefits.

The full text of the double tax agreement is available on the website of the Policy Advice Division of Inland Revenue at

www.taxpolicy.ird.govt.nz

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.

ASSETS UNDER CONSTRUCTION – DEPRECIATION

Introduction

This interpretation statement sets out the Commissioner's view on whether assets still under construction constitute "depreciable property", as defined in section OB 1 of the Income Tax Act 1994, and if so, how the allowable deduction for depreciation is to be determined under subpart EG.

In determining whether or not an asset still under construction can be depreciated for tax purposes, several criteria must be satisfied. Firstly, section EG 1(1) requires that the property in question must be owned by the taxpayer and must constitute "depreciable property", as that term is defined in section OB 1. Secondly, the property must be used or available for use for some purpose by the taxpayer (section EG 2(1)). These criteria will be considered in this statement. As well, the method for calculating the deduction allowed for depreciation under section EG 2(1) will be addressed.

Legislation

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

Section OB 1 defines the term "depreciable property" as:

> In this Act, unless the context otherwise requires,–
>
> **"Depreciable property"**, in relation to any taxpayer,–
>
> (a) Means any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons–
>
> (i) In deriving gross income; or
>
> (ii) In carrying on a business for the purpose of deriving gross income; but
>
> (b) Does not include–
>
> (i) Trading stock of the taxpayer:
>
> (ii) Land (excluding buildings and other fixtures and such improvements as are listed in Schedule 16):
>
> (iii) Financial arrangements:
>
> (iv) Intangible property other than depreciable intangible property:
>
> (v) Property which the taxpayer has elected to treat as low value property under section EG 16:
>
> (vi) Property the cost of which is allowed as a deduction under any of sections BD 2(1)(b)(i) and (ii), DJ 6, DJ 11, DL 6, DM 1, DO 3, DO 6, DO 7, DZ 1, DZ 3, EO 5, EZ 5, and EZ 6, or by virtue of an amortisation or other similar deduction allowed under any section of this Act such as sections DJ 9, DL 2, DO 4, DO 5, and EO 2, other than sections EG 1 to EG 15 and section EG 18:
>
> (vii) Property which will not, in respect of the taxpayer, decline in value as a result of any right of the taxpayer to receive compensation for any decline in value on disposition of that property:
>
> (viii) Property the cost of which was or is allowed as a deduction in any income year to any other taxpayer under any of sections DO 3, DZ 2, DZ 3 and DZ 4 of this Act (or any of sections 127, 127A and 128 of the Income Tax Act 1976 or sections 119, 119D and 119G of the Land and Income Tax Act 1954):
>
> (ix) Property that the taxpayer elects under section EG 16A to treat as not depreciable:

Section EG 1(1) allows a deduction for depreciation:

> Subject to this Act, a taxpayer is allowed a deduction in an income year for an amount on account of depreciation for any depreciable property owned by that taxpayer at any time during that income year.

Section EG 2 prescribes the formula for calculating the allowable deduction for depreciation:

> **(1)** Subject to this Act and to subsection (2), the deduction allowed to a taxpayer for any income year on account of depreciation under section EG 1 for any depreciable property shall be the smallest of the following amounts:
>
> (a) In the case of property that is not schedule depreciable property, an amount calculated in accordance with the following formula:

$$a \times b \times {}^{c}/_{12}$$

where–

a is the annual depreciation rate (expressed as a decimal) applicable in that income year to such property and to the depreciation method used by the taxpayer in respect of the property; and

b is–

(i) In any case where the diminishing value method is being used, the adjusted tax value of the property at the end of the income year before any deduction for depreciation in that income year has been made; and

(ii) In any case where the straight-line method is being used, the cost of the property to the taxpayer (excluding any expenditure of the taxpayer allowed as a deduction under any provision of this Act other than sections EG 1 to EG 15 and EG 18); and

c is the number of whole or part calendar months in the income year in which the property is owned by the taxpayer and used or available for use for any purpose by the taxpayer:

(b) In the case of schedule depreciable property, an amount calculated in accordance with the following formula:

$$a \times b \times {}^{c}/_{365}$$

where–

a is the annual depreciation rate (expressed as a decimal) applicable in that income year to the property and to the depreciation method used by the taxpayer in respect of the property; and

b is–

(i) In any case where the diminishing value method is being used, the adjusted tax value of the property at the end of the income year before any deduction for depreciation in that income year has been made; and

(ii) In any case where the straight-line method is being used, the cost of the property to the taxpayer; and

c is the number of whole or part days in the income year in which the property is owned by the taxpayer and is used or available for use for the purposes of deriving gross income or in carrying on a business for the purposes of deriving gross income:

(c) The adjusted tax value of the property at the end of the income year immediately before the deduction of any amount on account of depreciation for that income year:

(d) Where the property is a motor vehicle to which section DH 1(3) applies, an amount calculated in accordance with the following formula:

$$d \times e$$

where–

d is the amount of the deduction calculated in accordance with paragraph (a) of this subsection in respect of the motor vehicle; and

e is the proportion of business use to total use of the vehicle for the income year (expressed as a decimal) calculated in accordance with sections DH 2 to DH 4:

(e) where–

(i) The property is, at any time during the income year, not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income; and

(ii) Any use other than in deriving gross income or in carrying on a business for the purpose of deriving gross income is not subject to fringe benefit tax under this Act; and

(iii) The property is not a motor vehicle to which section DH 1(3) applies,–

an amount calculated in accordance with the following formula:

$$d \times {}^{f}/_{g}$$

where–

d is the amount of the deduction calculated under paragraph (a) of this subsection in respect of the property; and

f is the number of days or other appropriate units of measurement (whether relating to time, distance, or otherwise) in the income year (or in such lesser period as that property was owned by the taxpayer in that income year), being days or other appropriate units of measurement for which–

(i) The property was physically used or operated to produce gross income or in carrying on a business for the purpose of producing gross income; or

(ii) Fringe benefit tax was payable in respect of the use of the property; or

(iii) The property was not physically used or operated for any purpose whatever but was available for the purpose set out in subparagraph (i); and

g is the total number of days or other units of measurement (being the same units of time or other measurement as are used in item f) for which the depreciable property was used or available for use for any purpose in the income year (or in such lesser period as the property was owned by the taxpayer in that income year).

…

2(2A) In this section and in section EG 16, if at any time an asset owned by a taxpayer is temporarily under repair or under inspection, and if immediately before that time the asset was used or available for use by the taxpayer in deriving gross income, or in carrying on a business for the purpose of deriving gross income, the asset is to be regarded as available for use for either purpose during the period of repair or inspection.

Application of the legislation

Depreciable property

Before any asset can be depreciated, section EG 1(1) requires it to constitute "depreciable property" owned by the taxpayer. The term "depreciable property" is defined in section OB 1. According to this definition, an asset under construction by a taxpayer becomes depreciable property of that taxpayer when it is in such

a state that it may reasonably be expected in normal circumstances to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Thus, before calculating the depreciation deduction allowable under section EG 2(1), three criteria must be met. Firstly, the asset under construction must constitute "property". Secondly, it must be owned by the taxpayer. Thirdly, it must reasonably be expected under normal circumstances to decline in value while used or available for use in deriving gross income, or in carrying on a business for the purpose of deriving gross income. These three criteria will be considered in turn.

Property

Firstly, the assets under construction must constitute "property". The term "property" is not defined in the Act for the purposes of subpart EG (except that it includes consents granted in or after the 1996–1997 income year under the Resource Management Act 1991) (definition of "property" in section OB 1). The ordinary meaning of the term, as defined in the *Concise Oxford Dictionary of Current English,* 8th ed., is as follows:

> **1 a** something owned; a possession, esp. a house, land, etc. **b** *Law* the right to possession, use, etc. **c** possessions collectively, esp. real estate …

This gives a wide meaning to the term, with the two aspects of ownership or right to possession being similarly recognised in law, depending on the context in which the term is used. For example, *Stroud's Judicial Dictionary of Words and Phrases*, 5th ed., (London: Sweet & Maxwell Limited, 1986), at page 2,057, states:

> "Property" is the generic term for all that a person has dominion over. Its two leading divisions are (1) real, and (2) personal; …

Butterworths New Zealand Law Dictionary, 4th ed., (Wellington: Butterworths of New Zealand Ltd, 1995) similarly states:

> **property 1.** A thing owned, that over which title is exercised, whether tangible or intangible, real or personal. **2.** A title to or right of ownership in goods or other property.

In order to determine the meaning of "property", as that term is used in the definition of "depreciable property", it is necessary to consider the context in which the term is used. As Nicholls LJ stated at page 953 of *Kirby (Inspector of Taxes) v Thorn EMI plc* [1988] 2 All ER 947:

> "Property" is not a term of art, but takes its meaning from its context and from its collocation in the document or Act of Parliament in which it is found and from the mischief with which that Act or document is intended to deal: see Lord Porter in *Nokes v Doncaster Amalgamated Collieries Ltd* [1940] 3 All ER 549 at 574 …

Applying the ordinary meaning of "property" to the definition of "depreciable property" in section OB 1, the term is used in the phrase "property of that taxpayer". In its ordinary meaning, then, this connotes an item that is owned by the taxpayer or which the taxpayer has the right to possess and use. In the light of the wording of section EG 1(1), however, depreciable property not owned by the taxpayer will not qualify for a depreciation deduction.

Hence, in the context in which it is used in the definition of "depreciable property" and in section EG 1(1), an asset under construction will constitute "property" according to its ordinary meaning provided it is a possession of the taxpayer; something which the taxpayer owns and has the right to use as desired. The concept of "property" being a thing that the taxpayer owns also fits with the legal sense of the term.

Owned by the taxpayer

Secondly, as noted above when considering the term "property", the property consisting of assets under construction must be owned by the taxpayer in order to qualify for a depreciation deduction under section EG 1(1). An interpretation statement on the issue of the Commissioner's view of what constitutes being "owned or acquired" is being prepared for future publication.

Declining in value

Thirdly, the assets under construction must reasonably be expected to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. Since a decline in value must reasonably be expected, the asset will generally have a limited useful life and an asset expected to retain its value or to appreciate in value over time will not meet this criterion. For example, an original work of art will not generally constitute depreciable property since it would not be expected, in normal circumstances, to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income (see the item on this issue in *Tax Information Bulletin*, Vol 10, No 9 (September 1998) at page 12).

Additionally, it is considered that in order to meet this criterion the whole or some part of the asset under construction must be **able** to be used in deriving gross income or in carrying on a business for the purpose of deriving gross income. That is, the whole or part of the asset, as the case may be, must be in such a state that a person, at the point in time that a depreciation deduction is sought, **could** use it in deriving gross income or in carrying on a business for the purpose of deriving gross income. Actual use in deriving gross income or in carrying on a business for this purpose is not necessary to meet this criterion, given that the

wording of the definition specifically includes property merely available for use. Nevertheless, whether the property is used, or merely available for use, in deriving gross income or in carrying on a business for the purpose of deriving gross income, it is necessary for the property to be able to be used for this purpose.

Example 1 – raw materials

Z Limited wishes to build a piece of machinery to use in its manufacturing business. It purchased all the component material in December 1998, but did not complete the machine until June 1999. At no time before its completion was the machine able to be used in deriving gross income or in carrying on a business for the purpose of deriving gross income.

No depreciable property exists until June 1999 when the machine is completed since, before completion, it could not be used in deriving gross income or in carrying on a business for the purpose of deriving gross income. Thus, since no depreciable property existed until June 1999, depreciation deductions will not be allowed before this time.

Depreciation calculation

Having determined that an asset under construction constitutes depreciable property, the deduction allowed for depreciation is calculated under section EG 2(1). This section details various formulæ in limbs (a) to (e) with the deduction allowed being the smaller of the values calculated under these limbs.

Unlike the definition of "depreciable property", the formulæ in section EG 2(1) focus on the use or availability for use **by the taxpayer**. This is an important distinction. Whereas it is conceivable that any piece of equipment, say, could meet the definition of "depreciable property", no depreciation will be allowed unless **the taxpayer** will use it or has it available for use. Thus, the better view of the wording of the formulæ in section EG 2(1) is that it favours the interpretation that a deduction for depreciation is only allowed when the "depreciable property" is in a state which **the taxpayer** uses it, or intends to use it for some purpose (ie it is available for such use). This is considered further when looking at incomplete assets.

For non-schedule depreciable property, limb (a) of section EG 2(1) gives the maximum amount allowed to the taxpayer as a deduction. Limb (a) states that the depreciation deduction allowed to the taxpayer is equal to the annual depreciation rate for the asset being depreciated, multiplied by the cost or adjusted tax value of the depreciable property (depending on whether the straight-line or diminishing value method is used). The value so obtained is then multiplied by the proportion of the income year (in months) that the depreciable property was owned by the taxpayer and used or available for use for **any** purpose by the taxpayer.

This limb (or limb (b) in the case of schedule depreciable property) will apply in the case of assets whose construction is complete **and** which are wholly used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income.

In this regard, under section EG 2(2A), temporary unavailability of depreciable property, while being repaired or inspected, is treated as a time when the property is being used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income, provided that immediately before this time the depreciable property was so used or available for use.

It follows that, given that the repair of an asset will often be delayed until appropriate personnel are available to repair it, the legislative intent of section EG 2(2A) is that the provision would also apply when a damaged asset is awaiting repair, provided that immediately before the time the asset was damaged, it was used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. This is because the asset would have been inspected after the damage occurred in order to ascertain the extent of the damage and the repair needed.

However, in the context of section EG 2(2A), the word "repair" does not apply to reconstruction or the like. "Repair", as a revenue concept versus a capital one, has been considered in the courts in the context of allowable deductions for income tax purposes. The better view of the use of the term "repair" in section EG 2(2A) is one that fits with the type of work, the cost of which would be an allowable deduction under section BD 2.

Example 2 – temporary unavailability

Y Limited has built itself a new $2 million factory, completing the construction in April 1999. The depreciation rate for the building is 1% per annum. The company did not shift its business into the new factory until July 1999, and in the meantime the factory stood empty. In June 1999, massive flooding caused damage to the empty factory, making it unusable until repairs were carried out at the end of that month. The company wishes to calculate the deduction allowed for depreciation for the income year ended 31 March 2000.

Since the factory was available for use in deriving gross income, or in carrying on a business for the purpose of deriving gross income, immediately before the flood damage occurred, section EG 2(2A) deems the time that it was unavailable while awaiting repair and being repaired, as a time when the property was being used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Hence, after its completion, the factory was at all times during the income year, either used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. Therefore, limb (a) of section EG 2(1) provides for a deduction for depreciation for the year ended 31 March 2000 of:

$$0.01 \times 2{,}000{,}000 \times {}^{12}/_{12} = \$20{,}000$$

If the depreciable property is not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, and any other use is not subject to fringe benefit tax, limb (e) will generally apply. The two exceptions are motor vehicles subject to section DH 1(3), which will be subject to limb (d), and schedule depreciable property where limb (b) provides the formula for apportionment.

Limb (e) limits the deduction allowed for depreciation by apportioning the amount calculated under limb (a). The apportionment is calculated by determining the time, or other appropriate unit of measurement, in which:

- the property is physically used in deriving gross income or in carrying on a business for the purpose of deriving gross income; or
- fringe benefit tax is payable on its use; or
- the property is not physically used for any purpose, but is available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income,

expressed as a fraction of the total time (or other appropriate unit of measurement) that the property is used or available for use for **any** purpose **by the taxpayer**.

Regarding assets under construction, in two situations the asset will not be wholly used for deriving gross income or in carrying on a business for the purpose of deriving gross income:

- the asset is complete, but not wholly used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income; or
- the asset is not yet complete, but nevertheless constitutes depreciable property, ie a part of the asset is capable of being used in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Asset complete but not wholly used or available for use

If an asset is complete, but is not being wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, a straightforward application of the formula in limb (e) is required, with the unit of measurement used being dependent upon the type of asset in consideration.

Example 3 – completed asset not wholly used for deriving gross income

X, a sole trader, has built a $120,000 house for renting out, completing it on 21 June 1999. The depreciation rate for the house is 2% SL per annum. However, although the owner advertised the availability of the house from the time of its completion until the end of September 1999, he was unable to find a tenant. From 1 October 1999, the owner allowed a refugee family to live in it at no cost for a fixed period of seven months. On 30 April 2000, the refugee family shifted out and a rent-paying tenant shifted in.

The owner wishes to calculate the depreciation deduction allowed for the income year ended 31 March 2000.

As the house was used or available for use from its completion on 21 June 1999, the amount calculated under limb (a) of section EG 2(1), is:

$$0.02 \times 120{,}000 \times {}^{10}/_{12} = \$2{,}000$$

While the house was occupied by the refugee family at no cost, it was not used nor available for use by X in deriving gross income or in carrying on a business for the purpose of deriving gross income. Therefore, an apportionment is required under limb (e) of section EG 2(1). The apportionment will be calculated according to the number of days that the house was available for use in deriving gross income (22 June 1999 to 30 September 1999, inclusive) expressed as a ratio of the number of days in the income year that it was used or available for use for any purpose (22 June 1999 to 31 March 2000, inclusive), giving a deduction of:

$$2{,}000 \times {}^{101}/_{284} = \$711.27$$

Asset incomplete but a part is capable of use

An issue arises where an asset's construction is not yet complete, but a part is capable of being used by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income.

In this situation, as emphasised at the beginning of this discussion on the calculation of depreciation, the use or availability for use of the completed part, which will determine the depreciation deduction allowed, must be that of the taxpayer in question. Because a part of a yet-to-be-completed asset is capable of some use, or could be used by some other person in deriving gross income, does not mean that any deduction is allowed under section EG 2.

Bearing this in mind, in this situation the application of limb (e) is also appropriate, since the incomplete asset cannot be wholly used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income (sublimb (i)). However, it is acknowledged that the specific wording of the formula in the limb creates some difficulties in applying it to such a situation.

This can be seen from item "f" of the formula, which envisages that the depreciable property will be **wholly** used by the taxpayer but for only **some** of the time, or for only **some** of the distance travelled, etc. In the case of an incomplete asset, but where a part is capable of being used by the taxpayer, it is only that **part** which will be used—the whole cannot be used because it has yet to be completed. However, since the incomplete asset constitutes property owned by the taxpayer that had a cost, and is being used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, it is considered that in such a situation a court would interpret the wording of the formula broadly in order to allow a depreciation deduction.

Therefore, in order to apply the formula to the case of an asset under construction, where a part is used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, it is necessary to apportion the depreciation deduction allowed under limb (a) by comparing the completed part to the whole asset to be constructed. While the wording of the formula is not ideal to effect this comparison, it is considered that a court would adopt an apportionment reflecting the cost of that part of the asset that is capable of being used by the taxpayer in deriving gross income or in carrying on a business for this purpose (and is not used for another purpose), expressed as a ratio of the cost to date of the asset being constructed.

Such an approach is consistent with the statutory interpretation principles outlined by Lord Donovan in *Mangin v CIR* [1971] NZLR 591 at page 594:

> Thirdly, the object of the construction of a statute being to ascertain the will of the Legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.

In this regard, the legislative intent of section EG 2(1) was to apportion the deduction for depreciation allowed under limb (a) when depreciable property was not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income. Except for specific types of property (eg schedule depreciable property and motor vehicles), no other limb of section EG 2(1) allows for such an apportionment except for limb (e). Therefore, it is considered that limb (e) was intended by legislature to deal with all other situations where the depreciable property was not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income. An apportionment by way of a cost comparison gives a fair result that a court would be likely to adopt.

It is acknowledged that this approach requires the costs between the complete and incomplete parts to be apportioned. In some instances it will be possible to directly attribute certain expenditure to the complete or incomplete parts, as the case may be. For example, wallpapering and carpeting the completed ground floor of a building is directly attributable to that part, whereas a lift servicing the upper floors is directly attributable to those floors and not attributable to a completed ground floor.

In other situations, it is necessary to apportion costs between the complete and incomplete portions. For example, since the foundations of a five-storey building equally support all floors, the cost of the foundations could be apportioned equally across the five floors. Whether certain expenditure should be apportioned equally or not, however, will depend on the particular facts. For example, where the painting costs of the exterior of a four-storey building need to be apportioned, and the ground floor is twice the height of each of the other floors, an equal apportionment would not be appropriate since twice as much paint and painting time would be needed for the ground floor. In these circumstances, an appropriate apportionment of the expenditure on paint and painting would be $^{2}/_{5}$ for the ground floor and $^{3}/_{5}$ for the remainder.

Example 4 – incomplete asset partly available for use

W Limited is building a 10-storey office block to be depreciated at 1% per annum. In July 1999, the bottom floor was completed and available for leasing out as retail space. The space was duly leased in September 1999. The remaining floors were not completed until May 2000, with no part able to be used before that time in deriving gross income or in carrying on a business for the purpose of deriving gross income. The company wishes to calculate the depreciation deduction allowed for the income year ended 31 March 2000.

At 31 March 2000, a total of $5 million has been spent on the building. Of this total, $650,000 has been spent fitting out the bottom floor. A further $500,000 has been incurred on installing the lift. All other expenditure is considered to be attributable to each floor equally.

Following completion of the bottom floor (July 1999), the Commissioner considers that the better interpretation of the law is that the entire office block constitutes depreciable property since it was property owned by the company, which was able to be used by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, and which would reasonably be expected in normal circumstances to decline in value while so used or available for use. Hence, subject to section EG 2(1), a deduction for depreciation will be allowed.

The amount calculated under limb (a) of section EG 2(1) for the income year ended 31 March 2000 is:

$$0.01 \times 5{,}000{,}000 \times {}^{9}/_{12} = \$37{,}500$$

Under limb (e) of section EG 2(1), this amount is apportioned according to the cost of the bottom floor as a proportion of the total cost to date for the building. The cost of the bottom floor is as follows:

Fitting out the floor	650,000
Lift (considered to be attributable to the upper floors only)	–
All other costs (${}^{1}/_{10}$ x (5,000,000 – 650,000 – 500,000))	385,000
	$1,035,000

Applying the formula in limb (e) of section EG 2(1) gives a deduction of:

$$37{,}500 \times {}^{1{,}035{,}000}/_{5{,}000{,}000} = \$7{,}762.50$$

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.

WHETHER TAXPAYER WAS INVOLVED IN A TAX AVOIDANCE ARRANGEMENT

Case: *BNZ Investments Ltd v CIR*

Decision date: 10 July 2000

Act: Income Tax Act 1976

Keywords: *Tax avoidance*

Facts

BNZ Investments Limited ("BNZI") entered into four transactions in 1989. Each of them involved subscription in $100 million worth of redeemable preference shares ("RPS") in special purpose companies. These shares had a fixed, predetermined dividend payable and were to be redeemed for value at the end of the transaction. But because dividends were tax-exempt between companies at that time, BNZI paid no tax on them.

The special-purpose companies used the proceeds from the share subscription to invest (through a series of transactions and other special purpose companies) in interest-bearing deposits overseas. By a series of "downstream" transactions, the interest flows were transferred across the border back to the New Zealand special purpose companies without having been taxed, thereby enabling these companies to pay the stipulated dividend to BNZI. So BNZI received a substantial benefit in the form of greater tax-free dividends.

In 1995 Inland Revenue assessed the dividend receipts to BNZI under the general anti-avoidance section (then section 99 Income Tax Act 1976). The taxpayer challenged the correctness of that assessment, and proceedings were filed in the Wellington High Court in 1997.

The issues were:

1. What was the relevant arrangement?
2. If the relevant arrangement included BNZI:
   - 2.1 Was there no avoidance because a company in the structure resident in New Zealand raised a tax liability?
   - 2.2 Whether each structure had more than an incidental purpose or effect of avoidance?
3. If BNZI was not party to a tax avoidance arrangement, whether a tax avoidance arrangement existed from which it obtained a tax advantage, which could be taxed?
4. If BNZI obtained a tax advantage from a tax avoidance arrangement, what was the size of the tax advantage?
5. Whether interest is chargeable on any tax properly assessed?

Decision

McGechan J held on the first issue that there was no arrangement in terms of section 99(1) which included BNZI. To be a party to an arrangement one must have conscious (albeit, perhaps, only tacit) involvement in it. To suspect, or to have grounds for suspicion, or even to know, do not of themselves predicate involvement in a "contract, agreement, plan or understanding".

On the second issue, had it been necessary to decide, in respect of two of the four transactions, a downstream entity in each was liable to tax under the accruals rules, so there could have been no tax avoidance. Seemingly, these two transactions were not tax avoidance transactions for additional reasons, independent of the conclusion that a downstream entity was taxable. The reasons for this involve a distinguishing of this situation from the leading tax avoidance judgment *Challenge Corporation Limited v CIR* [1986] 2 NZLR 513. McGechan J found that the individual steps in the arrangement had tax consequences under the Act and carried individually and collectively the necessary alterations to financial position. Money was paid out and the entities carried risks as to returns and repayment. As he put it, "[t]here were risks. In contrast to the Challenge Group, [the downstream entities] did 'risk' and did 'spend' although (unless one takes in payments under the tax indemnities as a result of the Commissioner's subsequent actions) [they] did not 'lose'. [The downstream entities] carried real indemnity risks."

In respect of the other two transactions, they were tax avoidance transactions. But, as stated above, BNZI was not a party to them, so this finding was irrelevant.

On the third issue, McGechan J considered that, as he had found that BNZI was not a party, the issue did not arise.

On the fourth issue, had it been an issue, the Commissioner's reconstruction was excessive.

On the last issue, if it had been relevant, use-of-money interest was chargeable.

CORRECT METHOD OF APPEALING CHALLENGE-BASED DECISIONS OF TRA

Case:	*CIR v Lesley Dick and Bruce Grierson*
Decision date:	3 August 2000
Act:	Taxation Review Authorities Act 1994 (TRA Act)

Summary

The CIR was successful in his interlocutory application to file a Notice of Appeal.

Facts

This was an appeal from *Case T50* and *Case U7*.

The Commissioner commenced his appeal in the High Court using a Case on Appeal. This was standard for appeal objection-based decisions of the TRA under section 26 TRA Act.

However, there was no clear procedure for appealing challenge-based decisions of the TRA under section 26A of the TRA Act. Further it was not clear whether Part IX or Part X of the High Court Rules applied to the Commissioner's appeal (there being contradictory statements from different judges in the cases). In the absence of a clear procedure the Commissioner prepared a case on appeal.

The taxpayer trustees sought to strike out the appeal on the basis that the wrong procedure had been used and that it was frivolous and vexatious.

Decision

Glazebrook J found the Commissioner's case on appeal was the inappropriate way to proceed for challenges. She considered that the procedure at section 26 of the TRA Act could not be used for section 26A of the TRA Act.

She held that there was a clear procedure set out in Part X of the High Court Rules for appeals under any enactment. This procedure requires a Notice of Appeal to be filed in the appropriate registry of the High Court and the service of the Notice on the Registrar or appropriate officer of the tribunal by which the decision was made—see Rule 703.

However, Glazebrook J allowed the Commissioner time to file such a Notice of Appeal out of time relying on Rule 705(1) of the High Court Rules and the High Court's inherent jurisdiction.

She dismissed as baseless the taxpayers' attempt to strike out the appeal considering that the Notice was "an absolute right of appeal under section 26A and no leave to appeal is required. As such a Court should be very reluctant to strike out an appeal".

REGULAR FEATURES

DUE DATES REMINDER

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)

- *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

FBT return and payment due

31 GST return and payment due

November 2000

6 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

7 Provisional tax instalments due for people and organisations with a March balance date

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

30 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

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