TAX INFORMATION BULLETIN

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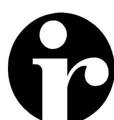

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REGISTRATIONS FOR THE TIB MAILING LIST FROM 1 – 30 NOVEMBER 2000

A number of TIB mailing list forms for the period 1 – 30 November 2000 have been mislaid. Anyone who submitted a form during that period and wants to find out whether they have been successfully added to the mailing list can phone 04 576-4992.

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We sincerely apologise for any inconvenience that this may cause readers.

NEW LEGISLATION

TAXATION (GST AND MISCELLANEOUS PROVISIONS) ACT 2000 00/39

TAXATION (ANNUAL RATES OF INCOME TAX 2000–2001) ACT 2000 00/40

The Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill was introduced into Parliament on 16 May 2000. The main legislation resulting from the bill's passage through Parliament was enacted as the following Acts of Parliament on 10 October 2000:

- Taxation (GST and Miscellaneous Provisions) Act 2000 00/39
- Taxation (Annual Rates of Income Tax 2000–2001) Act 2000 00/40

Most of the new legislation is devoted to wide-ranging changes to GST arising from the continuing Government review of the tax. Also introduced are two pieces of anti-avoidance legislation and further tax simplification measures. Other changes include reduction of the incremental late payment penalty and extension of relief provisions to all taxes. The legislation also confirms the income tax rates for the 2000–2001 year.

GST

CHANGES TO THE GOODS AND SERVICES TAX ACT 1985

Introduction

A number of changes have been made to the Goods and Services Tax Act 1985 (GST Act) as a result of the continuing Government review of the Act. The aim of the changes is to resolve problems, anomalies and inadequacies in the GST Act that have been identified over recent years. The basic policy objectives underlying the GST Act have not changed.

The amendments are intended to improve the administration and application of the GST Act and make it more workable.

Background

Most of the changes resulting from this legislation were first proposed in the Government discussion document *GST: A Review*, released in March 1999. The amendments are a mixture of base maintenance, compliance cost reduction and remedial measures. Unless indicated otherwise, they apply from 10 October 2000, the date on which the new legislation was enacted.

Developments since 1 October 1986, when the goods and services tax (GST) first applied to the supply of goods and services in New Zealand, made it timely to review the tax. A number of issues suggested that the original policy intent of the legislation was either not being achieved, or was ambiguous and needed reform. The opportunity was also taken to review the extent to which GST imposed compliance costs on registered persons and how these costs could be reduced.

The aim of the amendments outlined here was to resolve certain problems that had been identified. The wider policy objectives underlying the GST Act have not changed and remain valid. The Government view remains that the objective of a broad-based, single rate tax is still fundamentally sound and the changes to the Act are consistent with this objective.

Key features

The registration threshold

The threshold over which people are required to register for GST has been raised from $30,000 to $40,000 a year, with effect from 1 October 2000.

Adjustments for changes in use

Adjustments to output tax

A registered person is allowed an input tax credit for GST paid on purchases used for the principal purpose of making taxable supplies. These purchases may not be used 100% of the time to make taxable supplies. When goods and services are used privately or used to make exempt supplies the Act requires registered persons to make an adjustment. The adjustment reflects the consumption of the goods and services resulting from the change in application. In the past these adjustments had to be made in each taxable period that the asset was owned to reflect the changes in use. This often resulted in high compliance costs for small amounts of revenue.

The amendments allow registered persons the option to calculate GST for private or exempt use on:

- a one-off basis
- an annual basis
- a period-by-period basis.

If the one-off basis is chosen, further adjustments are required if at any time the application of the goods or services changes by 20% or more.

Adjustments to input tax

If goods and services are acquired for private or exempt use, an input tax credit is not available for the GST paid on acquisition. If those goods and services are then applied for the purpose of making taxable supplies, registered persons must make an adjustment to reflect the taxable use using one of the following methods:

- the annual basis
- the period-by-period basis, or
- in limited circumstances, the one-off basis.

A one-off adjustment is allowed provided that the value of the goods and services is less than $18,000 (including GST). In relation to assets with a cost of $18,000 or more used entirely for taxable purposes, taxpayers may apply to the Commissioner to make a one-off adjustment. Before the Commissioner approves such an adjustment the taxpayer will have to satisfy a number of statutory criteria, including that one-off adjustments are also made for taxable to non-taxable changes in use.

Input tax credits for changes in use of imported goods

Amendments to section 21(5) (now sections 21E – 21G) remove any ability to claim an input tax credit when an asset that was previously outside the GST base and had not been used in making taxable supplies, starts to be used in New Zealand to make taxable supplies. The amendments reflect the policy intent that a credit should only be available when GST has been paid and not previously deducted.

The amendment applies from 1 October 1986, subject to a savings provision for claims agreed to by the Commissioner before the introduction of the Taxation (GST and Miscellaneous Provisions) Bill on 16 May 2000. The savings provision will apply to:

- input tax credit claims that the Commissioner has paid or agreed to pay before 16 May 2000, and
- claims of which the Commissioner has not been specifically notified other than by inclusion in a GST return filed before 16 May 2000.

The secondhand goods input tax credit

If a registered person acquires secondhand goods from a non-registered, non-associated person an input tax credit is allowed equal to one-ninth of the consideration paid to acquire the goods. Previously, the credit in transactions between associates was equal to the lesser of one-ninth of the actual consideration, or the market value of the goods.

An amendment now limits the credit in relation to supplies of secondhand goods between associated parties to the lesser of:

- the GST component (if any) of the purchase price that the vendor paid when the goods were originally acquired, or
- one-ninth of the consideration paid for the supply of the goods, or
- one-ninth of the market value of the goods.

The amendment removes the incentive to enter into transactions with the primary intent of claiming the credit.

Deregistration

Registered persons may apply to deregister if their taxable activity ceases or the value of their taxable supplies falls below the registration threshold. Any goods and services forming part of the assets on hand at the time of deregistration are deemed to be supplied as part of the taxable activity.

GST was previously payable on the lesser of the cost or open market value of assets held by the registered person immediately before opting out of the GST base. However, this created an anomaly between assets sold immediately before deregistration and assets sold after deregistration. If the person values the assets held at deregistration at cost, a lower GST liability arises in relation to assets that have appreciated in value. Therefore, GST must now be paid on the basis of the market value of goods and services retained on deregistration.

Goods and services retained at the time of deregistration that were acquired before 1 October 1986, the date GST first came into effect, will continue to be valued at the lower of cost or open market value.

Deferred settlements

Deferring the date of settlement can allow registered persons to create a timing advantage in a transaction where the parties are on different bases of accounting for GST. A purchaser on the invoice basis is able to claim an immediate input tax credit but a vendor on the payments basis is able to defer the payment of GST until payment is received.

An amendment requires GST to be returned on an invoice basis for any supply exceeding $225,000 (including GST) in value. Agreements where settlement is required within one year are, however, excluded from the requirement to account on an invoice basis.

To prevent registered persons from entering into arrangements to avoid the $225,000 threshold by splitting a supply of goods or services into a number of transactions, the Commissioner has a discretion to require the registered person to account for those transactions on an invoice basis.

Definition of "associated persons"

Amendments have been made to the definition of "associated persons" that both widen and narrow the categories of person between whom there is a significant degree of connection. The amendments include in the definition (among other things) certain relationships with trustees and relationships in the nature of marriage. On the other hand, there is a narrower "relatives" test and an increase in the required level of association between individuals and companies.

Definition of "input tax"

The definition of "input tax" has been amended in relation to imported goods. An input tax credit is now available for GST paid at the border if the goods are "applied" for the principal purpose of making taxable supplies as well as being "acquired" for such purposes. An input tax credit is not available for freight-forwarders or other parties in New Zealand that merely facilitate the import and delivery of goods.

The general anti-avoidance provision

The general anti-avoidance provision has been amended to follow more closely the general anti-avoidance provisions of the Income Tax Act 1994, sections BG 1 and GB 1. This will improve consistency in the application of the general anti-avoidance legislation in the two Acts and will allow a similar analysis and application of case law when determining whether avoidance has occurred.

Application dates

Unless otherwise stated, the amendments apply on or after 10 October 2000.

Section references

Unless otherwise stated, section references in this commentary are to the GST Act.

DEFINITION OF "ASSOCIATED PERSONS"

Section 2A

Introduction

New section 2A inserts a new definition of "associated persons" into the GST Act. The new definition addresses a number of deficiencies in the previous definition.

Background

The definition of "associated persons" is important in the GST Act because it is used in a number of specific anti-avoidance provisions. For example, it appears in the rule in section 10(3) countering supplies made to associated persons at an under-value to minimise output tax and the rules limiting input tax credits for sales of secondhand goods between associated persons. These anti-avoidance provisions recognise that transactions between related persons are more likely to be influenced by non-arm's length considerations than in the case of transactions between other persons.

The previous definition of "associated persons" for GST purposes was largely based on the definition in section OD 8(4) of the Income Tax Act relating to land transactions. This definition was deficient because it did not treat as associated certain categories of persons between whom there was a significant degree of connection, such as a trustee and a settlor of a trust and persons in a relationship in the nature of marriage. The previous definition also had inadequate nominee "look-through" rules. In some cases the definition was too wide—for example, it had an interest threshold of only 10% in the test for determining whether a company and an individual are associated.

Key features

The following persons are associated under the new definition of "associated persons":

- two companies controlled by the same persons
- a company and a person other than a company (typically an individual) who holds a 25% or greater interest in the company
- two persons who are relatives by blood (to the second degree of relationship), marriage (including relationships in the nature of marriage, that is, de facto spouses) or adoption
- a partnership and any partner in the partnership
- a partnership and a person who is associated with a partner in the partnership
- a trustee of a trust and a person who has benefited or is eligible to benefit under the trust (except if the trustee is a charitable or non-profit body)
- a trustee of a trust and a settlor of the trust
- trustees of two trusts that have a common settlor, and
- two persons who are each associated with a third person. (This is referred to as the universal tripartite test—it is explained in more detail later.)

Changes from previous definition

The main differences between the new definition of associated persons and the previous definition are as follows:

- The interest threshold for determining whether a company and an individual are associated has been raised from 10% to 25%.
- More effective "look-through" rules have been introduced for the purpose of determining whether two companies or a company and an individual are associated (the aggregation rule).
- The associated persons test for relatives extends only to the second degree of relationship instead of the fourth degree, as the previous definition did. (The new test is based on paragraph (b) of the definition of "relative" in section OB 1 of the Income Tax Act 1994.)
- The associated persons test for relatives includes people in a relationship in the nature of marriage.
- A new test associating a trustee of a trust and a settlor of that trust has been introduced.
- A new test has been introduced that associates a trustee of a trust and a trustee of another trust if there is a common settlor of both trusts.
- The universal tripartite test has been introduced. (The previous definition contained a limited version of the tripartite test that required one of the three persons to be a company—this requirement has been removed under the new test.)

Analysis

Voting and market value interests

The tests for determining whether two companies, or a company and an individual, are associated, incorporate the voting and market value interest concepts contained in sections OD 3 and OD 4 of the Income Tax Act 1994.

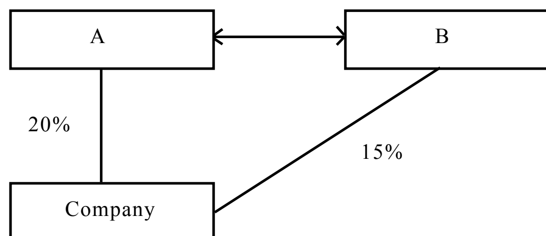
This means that the corporate look-through rules in sections OD 3(3)(d) and OD 4(3)(d) apply. The interests of an individual in a company include interests held directly in the company and indirect interests in the company held through interposed companies.

The voting and market value interest tests also contain their own nominee look-through rules in sections OD 3(3)(b) and OD 4(3)(b), which provide that anything held by a nominee for a person is deemed to be held by that person and not by the nominee.

Aggregation rule

For the purpose of determining whether two companies, or a company and an individual, are associated, interests held by any person in a company must be aggregated with interests held by associates of that person.

The aggregation rule is designed to prevent the tests for associating two companies, or a company and an individual, from being circumvented by the fragmentation of interests among associated persons, resulting in the interest thresholds (50% or 25%) not being reached. Consider the following example of relatives holding interests in a company:



Without the aggregation rule, neither A nor B would be associated with the company under the company–individual test because their interests do not reach the required 25% threshold. However, under the aggregation rule both sister A and sister B would be associated with the company. For the purpose of determining whether A is associated with the company, she is treated as holding B's 15% interest in the company, which when aggregated with her own 20% interest, means that A is treated as holding a 35% interest and, therefore, is associated with the company. Similarly, B is treated under the aggregation rule as holding A's 20% interest in the company, which when aggregated with her own 15% interest also makes the company and B associated persons.

It is important to note that the aggregation rule is applied afresh to each sister in the example.

As well as aggregating the interests held directly by a person with interests held by associated persons, the aggregation rule would also aggregate interests held by mere nominees with interests held directly by that person. This is because interests held by nominees of a person would be covered by the trustee-beneficiary test in new section 2A(1)(f).

Definition of "settlor"

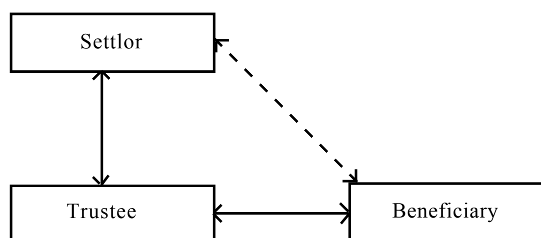
The trustee–settlor and two trustees (common settlor) tests in new section 2A(1)(g) and (h) employ the wide definition of "settlor" contained in section OB 1 of the Income Tax Act 1994.

Under that definition a settlor is defined, in short, to mean any person who provides goods or services to a trust for less than market value or acquires goods or services from a trust for greater than market value. This definition is wider than that under general trust law. It ensures that these associated persons tests cannot be circumvented by the transferor of the trust property arranging for someone else to settle the trust formally (including settling a nominal amount of property on that trust) and subsequently transferring the property to the trust. The definition of "settlor" is further extended by the provisions of section HH 1 of the Income Tax Act 1994.

Universal tripartite test

The universal tripartite test in new section 2A(1)(i) treats two persons as associated if each of them is associated with the same third person. This test is designed to prevent the other associated persons tests being circumvented by the interposition in arrangements of relatives, companies and trusts which are under the influence or control of the main protagonists.

An example of the test applying would be the following situation involving the settlor, trustee and a beneficiary of a trust, all of whom are individuals.



The settlor is associated with the trustee under the new settlor–trustee test (new section 2A(1)(g)) and the trustee is associated with the beneficiary under the trustee–beneficiary test (new section 2A(1)(f)). Accordingly, because of their common relationship with the trustee, the beneficiary and the settlor of the trust are associated under the universal tripartite test.

The universal tripartite test does not treat two individuals as associated if they are both associated with the same other person under the associated persons test for relatives in section 2A(1)(c). This restriction prevents the universal tripartite test from having the effect of associating relatives within the third or fourth degrees of a relationship, while the associated persons test for relatives itself extends only to the second degree of relationship.

For example, first cousins are within the fourth degree of relationship and are not, therefore, associated with each other under the test for relatives, which extends only to the second degree of relationship.

The universal tripartite test does not apply to associate first cousins who are both associated with the same third person (a grandparent) under the test for relatives.

DEFINITION OF "FINANCIAL SERVICES"

Section 3

Introduction

The broad policy underlying the definition of "financial services" is to encompass services provided under agreements involving the exchange of money or close substitutes for money, such as shares. In contrast, agreements that involve the supply of a commodity should generally be included in the GST base.

The amendments addressed areas where changes were needed to ensure that the intended scope of the definition and, therefore, the scope of the exemption, was achieved.

Key features

Section 3, the definition of "financial services", has been amended by:

- inserting new section 3(4)(b) to specifically exclude the activity of debt collection by third party agents from the definition
- inserting section 3(1)(kaa) to include financial options
- clarifying that non-deliverable futures contracts are exempt from GST
- clarifying that deliverable futures contracts are exempt if the underlying commodity being traded is exempt or involves the delivery of money, and
- inserting the requirement that futures contracts must be traded on a defined market or on arm's length terms for that supply to be an exempt supply under section 14 of the Act.

Analysis

Debt collection services

Debt collection services were previously treated as an exempt supply of financial services. This treatment of debt collection was the result of the insertion of paragraph (ka) into the definition of financial services in 1986. Paragraph (ka) included the collection of interest, dividends and principal in the definition. This provision was intended to clarify that the payment of dividends, principal and interest was exempt.

However, as section 3(1)(l) (agreeing or arranging a financial service) is subject to section 3(1)(ka), the collection of dividends, principal and interest became exempt, meaning that many of the services performed by debt collection agencies were exempt,[1] contrary to the original policy intent.

The supply of debt collection services by third parties is now a taxable supply, in line with the principle that a supply of services that is connected with a financial service but is not in itself the supply of a financial service should be taxable.[2]

New section 3(4)(b) excludes the provision of debt collection services from the definition of "financial services" unless the services are provided by the creditor in relation to a debt.

The amendment is aimed at taxing the activity of debt collecting as carried out by debt collection agencies and other third parties, not internalised collection functions undertaken by the holder or issuer of a financial instrument such as a bank.

Therefore, the activities of debt collection agencies and billpay agencies are now subject to GST.

Financial options

The buying and selling of financial options on recognised markets has been treated by taxpayers as an exempt activity under section 3(1)(k), which relates to futures contracts, since all that is being supplied is the right either to buy or sell a given amount of a specified commodity on a specified date. Technically, the nature of a financial option is distinct from a futures contract.

A financial option is the right to buy or sell, at a specified price during a specified timeframe, specified financial assets, such as equity securities or currency. Unlike the holder of a futures contract, the option-holder is not obliged to exercise the rights or obligations under the contract. This technical distinction between futures contracts and options is recognised under the accrual rules of the Income Tax Act 1994.

New section 3(1)(kaa) clarifies the treatment of financial options by specifically listing the provision of a financial option as a financial service.

Deliverable and non-deliverable futures contracts

Futures contracts fall into two categories:

- contracts that provide for the delivery of a commodity (deliverable contracts), and
- contracts that do not provide for the delivery of a commodity (non-deliverable contracts).

The former definition of "financial services" did not specify any distinction between deliverable and non-deliverable contracts. All that section 3(1)(k) required was that the futures contract be traded on a futures exchange.

When a futures contract is non-deliverable, all that is being traded is money and no underlying commodity is exchanged. A deliverable contract, in comparison, can involve the trade of an underlying commodity and is, therefore, equivalent to a contract for the supply of goods and services.

Non-deliverable contracts continue to be exempt from GST. However, deliverable contracts are exempt only if the supply of the underlying commodity would be exempt, or is the supply of money.

The previous requirement that a futures contract be traded though a futures exchange ensured that there was a genuine market in tradeable derivatives and that there were arm's length trading terms. The Act did not, however, define the term "futures exchange". As arm's length transactions occur outside derivatives markets, the reference to a futures exchange was arguably too restrictive. The reference has been removed from the Act and replaced with a requirement that futures contracts (both deliverable and non-deliverable) be traded on a defined market, or on arm's length terms.

Definitions

"Financial option"

A financial option is the right to buy or sell, at a specified price during a specified timeframe, specified financial assets such as equity securities or currency.

"Defined market"

The term "defined market" is not intended to be limited to specifically defined markets for the trading of futures, such as an "authorised futures exchange" under the Securities Amendment Act 1988. The term is broader, referring to any discernible or distinct market.

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[1] See *Public Information Bulletin* No 164 (August 1989), *Public Information Bulletin* No 168 (January 1988), and *Tax Information Bulletin* Vol 6 No 7 (December 1994).

[2] *Commissioner of Inland Revenue v Databank Systems Limited* (1990) 12 NZTC 7,227.

"Futures contract"

A futures contract is an agreement under which parties agree to buy commodities or other property at a specified future date at a specified price. The obligations under the contract can be, and usually are, satisfied other than by actual delivery of the commodities or property (by making cash payment or setting off futures contracts). A futures contract differs from an ordinary long-term purchase contract in that it is treated as a commodity in itself. A normal contract for the sale and purchase of property cannot itself be traded. Futures contracts fall into two categories, deliverable and non-deliverable.

"Deliverable futures contract"

A deliverable futures contract is a contract under which the delivery of the commodities or property that are the subject of the contract is contemplated. A deliverable futures contract will be treated as exempt only if it is supplied:

- on arm's-length terms, or
- on a defined market, and
- it provides for the delivery of money, or
- it provides for the delivery of a commodity, the supply of which (or the activity of supplying) is in itself exempt.

For example, the supply of a futures contract providing for the delivery of shares will be treated as exempt.

"Non-deliverable futures contract"

A non-deliverable futures contract is a contract under which the delivery of the commodity or property that is the subject of the contract is not contemplated. The supply of a non-deliverable futures contract on arm's-length terms, or on a defined market, is a financial service under section 3(1)(k) and is an exempt supply.

IMPORTERS ACTING AS AGENTS FOR NON-RESIDENTS

Sections 3A, 12(4)(c) and 60(7)

Introduction

New sections 3A and 60(7) make changes to the availability of input tax credits for GST imposed by the New Zealand Customs Services (Customs) when goods enter New Zealand for home consumption.

Background

Goods that are imported into New Zealand are subject to GST levied by Customs. In most instances a credit for this GST will be available if the goods were acquired for the principal purpose of making taxable supplies. However, if the person who imports the goods is an agent (meaning the goods are imported as part of the person's taxable activity, but not for the purpose of making taxable supplies) the position is less clear.

Key features

The amendments:

- extend the definition of "input tax" to allow an input tax credit for GST paid to Customs when the goods are "applied" for the principal purpose of making taxable supplies. This excludes agents involved merely in delivering goods so that they cannot obtain refunds of GST paid on those goods.
- provide, if the agent and principal agree, that the supply of the goods in New Zealand will be treated as made by the agent when the principal is a non-resident and is outside New Zealand. In these circumstances the agent will be liable for output tax but will be able to claim input tax in respect of taxable supplies made as agent.
- allow GST paid at the border to be recovered when goods are imported for the purposes of a taxable activity but cannot be used for such purposes.

Analysis

"Applied"

The definition of "input tax" has been amended to allow registered persons to claim an input tax credit for tax paid to Customs in situations when the goods may not have been acquired. For example, it was previously arguable that a branch of a non-resident entity would be unable to claim a credit for tax paid at the border, as the branch would not have "acquired" the goods for the principal purpose of making taxable supplies.

By using the word "applied", a credit will be available when a branch applies the goods for the principal purpose of making taxable supplies.

The word "applied" can be interpreted broadly. To clarify the interpretation of the term, the mere delivery of goods by an agent is excluded. In these circumstances goods can be applied in making taxable supplies but it is not appropriate to allow an input tax credit.

Agents for non-resident principals

Non-residents who wish to supply goods and services in New Zealand, but do not have, or wish to establish, a place of operation in New Zealand may contract the services of an agent to sell and distribute products. Although an agent may be used, the goods are still supplied by the non-resident and, depending on the value of the goods supplied in New Zealand, may not give rise to the appropriate GST treatment unless the non-resident registers for GST in New Zealand.

New section 60(7) makes the agent responsible for returning GST provided that:

- the agent is resident in New Zealand and registered for GST, and
- the principal and agent agree that the agent, not the principal, should be treated as making the relevant supplies.

If the provision applies, the supply of the goods will be deemed to be made by the agent. The agent will be liable for paying GST on the supply in New Zealand and will be entitled to an input tax credit for any GST paid at the border.

Goods imported but unable to be used in a taxable activity

Section 12(4)(c) permits a refund of GST imposed by the New Zealand Customs Service if there has been an error in calculating the tax. Previously, no refund was permitted if the taxpayer importing the goods did so for the purposes of carrying on a taxable activity. This rule prevented taxpayers from claiming an input tax credit and claiming a refund from Customs if the goods were faulty or tax had been levied in error. The exclusion was disadvantageous to taxpayers who imported for the purpose of carrying on their taxable activity but, for example, because of a fault in the goods, were unable to use the goods in their taxable activity. The legislation has been amended so that a refund of GST levied by Customs will be available unless the taxpayer is entitled to claim an input tax credit.

Example 1

A non-resident art gallery decides to exhibit artwork in New Zealand and arranges this through a New Zealand agent, who is also authorised to sell the artwork. The gallery does not intend to establish itself in New Zealand and does not want to incur the costs associated with returning GST.

Provided that the agent is registered for GST and resident in New Zealand, and the art gallery and the agent agree, new section 60(7) will treat the agent as the supplier of the artwork in New Zealand. This means the agent will be able to claim an input tax credit for any GST paid to bring the artwork into New Zealand and will be required to pay GST on sales of the artwork.

Example 2

An individual in New Zealand orders goods from an overseas supplier advertised through a catalogue. The order is received, along with fifty others, and is processed. The ordered goods are bulk consigned and sent to New Zealand. A third party handler in New Zealand receives the goods and breaks down the import into the constituent orders and posts the goods to the individuals who ordered them. The handler is registered for GST and charges the offshore supplier for the service.

The handler does not have proprietary rights to the goods but merely facilitates the delivery of the goods in New Zealand. Unless the handler acquires the goods, it will not be able to claim an input tax credit if it pays GST to uplift the goods from Customs. This is appropriate because the handler does not supply the goods in New Zealand. Although it is arguable that the GST levied at the border is incurred when applying the goods for the purpose of making taxable supplies to the offshore supplier, the goods are incidental to the services provided and cannot be said to be applied for the principal purpose of making taxable supplies.

THE SECONDHAND GOODS INPUT TAX CREDIT

Section 3A

Introduction

A registered person purchasing secondhand goods from an associated unregistered person was previously entitled to an input tax credit of one-ninth of the lower of the purchase price or the open market value of the asset. The credit allowed in these circumstances is now limited to the lower of:

- the GST component (if any) of the original cost to the supplier, or
- one-ninth of the purchase price, or
- one-ninth of the open market value.

This change will remove the potential for transactions to give rise to windfall gains of more than the amount of GST originally paid by the vendor by transferring appreciating assets to associates.

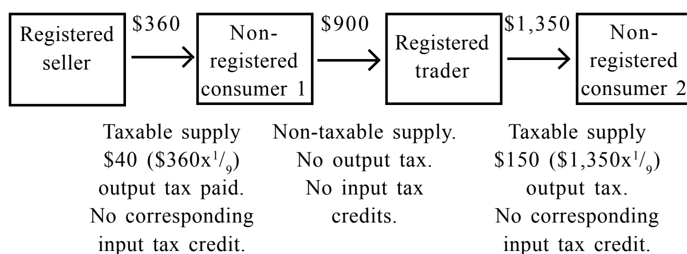
Background

If a registered person acquires new or secondhand goods from a registered person the GST component is shown on the tax invoice and can be claimed as an input tax credit.

An input tax credit is allowed to a registered person who acquires secondhand goods from a non-registered supplier, even though no GST is charged on that supply. This is intended to recognise the GST paid when the non-registered supplier acquired the goods. Allowing a credit avoids the double taxation that would arise on the resale of goods on which GST was charged when acquired by the non-registered supplier.

For example, the following diagram illustrates a situation where an appreciating asset has been purchased by a private consumer who subsequently on-sells the asset to a registered trader who also on-sells it. The total private consumption is $1,350. Ideally, net GST (output tax payable less input tax claimable) of $150 should be returned on this total.

If no offsetting input tax credit were allowed to the trader, the net GST returned would equal $190, which is an over-taxation of $40.



Allowing an input tax credit of $40 to the trader equal to the output tax paid by the first consumer (and returned by the registered seller) addresses this over-taxation.

If, however, the trader obtained an input tax credit for the $900 (as previously allowed) rather than the $360, there would be under-taxation of $60 (being the difference between one-ninth of $900 and one-ninth of $360).

Key features

The tax advantage that arises from allowing the credit on the basis of the cost or market value to the purchaser is addressed by limiting the input tax credit available in relation to supplies of secondhand goods between associated parties to the lesser of:

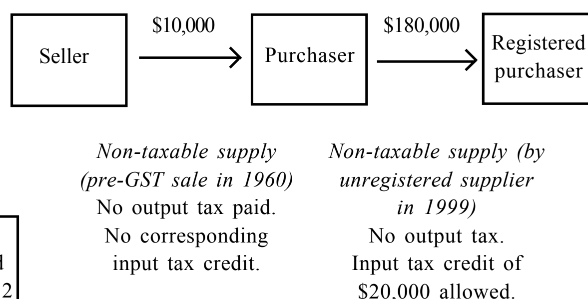
- the GST component (if any) of the original cost of the goods to the supplier, or
- one-ninth of the purchase price, or
- one-ninth of the open market value.

Analysis

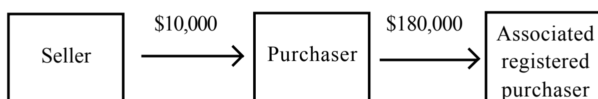
The input tax credit for secondhand goods previously resulted in registered purchasers claiming large GST refunds in relation to goods, particularly land, on which GST had not been paid by the seller, because, for example, the goods were acquired before the introduction of GST. Alternatively, the GST paid was significantly less than the credit that could be claimed. These credits were windfall gains to the registered purchaser rather than refunds of tax previously paid. This provided an incentive to sell secondhand goods to an associated person primarily to claim the input tax credit.

Example – asset acquired before GST

Goods acquired in 1960 and on-sold in 1999.



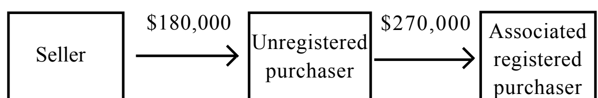
Goods acquired in 1960 and on-sold in 2001.



Non-taxable supply (pre-GST sale in 1960) No output tax paid. No input tax credit.	*Non-taxable supply (by unregistered supplier in 2001)* No output tax. No input tax credit.

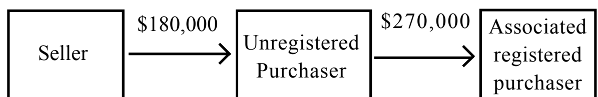
Example – asset acquired after GST

Goods acquired in 1990 and on-sold in 1999.



Taxable supply (by registered supplier in 1990) Output tax of $20,000 paid. No input tax credit.	*Non-taxable supply (by unregistered supplier in 1999)* No output tax. Input tax credit of $30,000 allowed.

Goods acquired in 1990 and on-sold in 2001.



Taxable supply (by registered supplier in 1990) Output tax of $20,000 paid. No input tax credit.	*Non-taxable supply (by unregistered supplier in 2001)* No output tax. Input tax credit of $20,000 allowed.

Relationship with new deregistration rules

Section 3A also determines the amount of the input tax credit allowed in circumstances where goods that are held at deregistration are subsequently sold to an associated person.

If the supplier, on deregistration, has paid output tax on the basis of the market value of the goods under section 10(7A), the input tax credit allowed to the associated registered purchaser will also be the lesser of:

- the amount of output tax paid by the supplier on deregistration, or
- one-ninth of the purchase price, or
- one-ninth of the market value of the supply.

If the supplier, on deregistration, has paid output tax on the basis of the lesser of the cost or market value of the goods under section 10(8), the input tax credit allowed to the associated registered purchaser will be the lesser of:

- the amount of output tax paid by the supplier on deregistration, or
- one-ninth of the purchase price, or
- one-ninth of the market value of the supply.

Example 1

In 1988 Retailer Ltd, a registered person, acquired an asset with a value of $25,000 (GST inclusive). The asset was used for the principal purpose of making taxable supplies, and Retailer Ltd claimed a credit of $2,500 (the rate of GST was 10% at that time). By mid-2000 Retailer Ltd decides to deregister. The market value of the asset at the time of deregistration is $6,750. If the asset is not sold before deregistration, Retailer Ltd will recognise a GST liability of $750.

If the asset were immediately sold to an associated person for $7,200 the secondhand goods input tax credit would be limited to the lower of the tax fraction of the:

- open market value of the asset on deregistration ($6,750)
- purchase price ($7,200), or
- open market value of the supply ($6,750).

In this case the open market value is lower, and the secondhand goods input tax credit would be limited to $750, which is equivalent to the amount of GST paid on deregistration.

Example 2

In 1978 Retailer Ltd, a registered person, acquired an asset with a value of $18,000. By mid-2000 Retailer Ltd decides to deregister. The market value of the asset has increased to $54,000. Retailer Ltd recognises GST of $2,000 (being the tax fraction of the lower of cost or the market value of the asset) on the asset at the time of deregistration.

If the asset were immediately sold to an associated person for $63,000 the secondhand goods input tax credit would be limited to the lower of the tax fraction of the:

- value of the deemed supply on deregistration ($18,000)
- purchase price ($63,000), or
- open market value of the supply ($54,000).

In this case the value of the deemed supply on deregistration is lower, and the secondhand goods input tax credit would be limited to $2,000. Again, this is the same amount as that paid by the vendor on deregistration.

TOKENS, STAMPS AND VOUCHERS

Sections 5(11D) to ***(11I) and 9(2A) and (2B)***

Introduction

New sections 5(11D) to (11I) replace sections 10(16) to (17A) in relation to supplies of tokens, stamps and vouchers, such as book tokens, record vouchers and phone cards. The supply is recognised when a token, stamp or voucher is issued. This removes difficulties with the former requirement to pay GST on the supply of goods and services when a token, stamp or voucher was progressively redeemed. In limited circumstances, however, the recognition of GST on redemption will continue.

Background

Previously, the GST consequences of supplying a token, stamp or voucher depended on whether or not it had a monetary face value. Section 10(16) disregarded the supply of a token, stamp or voucher (except postage stamps) with a monetary face value at the time of its sale. Therefore, GST was to be recognised at the time of redemption. If the consideration for the voucher exceeded its face value, the amount of the excess was required to be returned at the time of sale.

Section 10(17) provided that vouchers without a face value and postage stamps were subject to GST on sale. This approach ensured that double taxation did not arise—first when vouchers were sold, and then when they were redeemed for goods or services. However, compliance difficulties arose in relation to progressively redeemable vouchers with a face value, such as phone cards, since each time the voucher was used a GST liability arose.

New sections 5(11E) and (11F) provide that the issue of a token, stamp or voucher with a face value is treated as a supply, while the redemption of a voucher is not treated as a supply. This ensures double taxation does not arise, while reflecting that the supply of a voucher is to be treated in the same way as any other supply of goods and services. This also removes the difficulties with the requirement to pay GST on redemption.

In some instances, however, the supply of a voucher is not like an ordinary supply. For example, a person other than the one who issued the voucher may supply the goods and services specified in the voucher. Therefore section 5(11G) allows the redemption of a voucher with a face value to be treated as a supply. Section 9(2A) provides that the supply is treated as taking place at the time of redemption so that output tax is returned when the goods and services are supplied, rather than when the voucher is issued.

In all cases an input tax credit will be allowed to a registered person acquiring a voucher for the principal purpose of making taxable supplies at the time the voucher is issued.

The treatment of excess consideration remains unaffected—any consideration in excess of the face value must be returned when the voucher is issued. Similarly, GST in relation to the supply of a postage stamp and a voucher sold to a non-resident for services performed in New Zealand (being services to which section 11A(2) applies) must be recognised at the time of issue.

The legislation refers to the "issue" of a voucher to ensure that only registered persons who carry on a taxable activity of supplying goods and services specified in a voucher may choose when to recognise the GST. Sales of vouchers, as opposed to their issue, are treated in the same manner as other supplies of goods and services. There is no need, therefore, for the specific rules in section 5 to apply in these circumstances.

In order to recognise GST on redemption, a supplier must establish that it is not practical to return GST when a voucher is issued and that the supplier of the goods and services specified in the voucher has agreed that GST is to be returned on redemption. These criteria ensure that the redemption option is used to reduce compliance costs, rather than to defer the payment of output tax. They also ensure that output tax is not returned twice—once by the issuer on acquisition and again by the supplier on redemption.

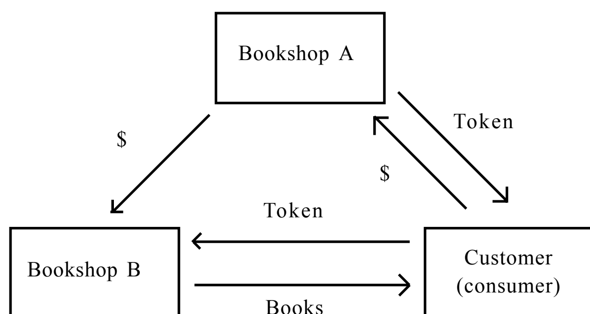
Key features

New sections 5(11D) to (11I) and 9(2A) and (2B) ensure that:

- The issue of a voucher is treated as a supply.
- The redemption of a voucher with a face value is not treated as a supply, unless:
  - it is not practical to return GST on the voucher at the time it is issued, and
  - the issuer of the voucher and the supplier or suppliers of the goods and services under the voucher agree that a supply will be recognised on redemption of the voucher.
- The option to recognise the supply of a voucher at redemption does not apply:
  - to the extent that the consideration given for the voucher exceeds its face value
  - to the supply of postage stamps, and
  - to the supply of a voucher to a non-resident for the supply of services performed in New Zealand (services to which section 11A(2) applies).

Example

Recognition on redemption



Bookshop A sells a book token. The customer redeems the token at an affiliated shop, Bookshop B, which supplies books to the customer. Bookshop A passes the consideration from the sale of the token to Bookshop B as reimbursement for the supply. This means that it is not practical for Bookshop A to recognise GST when the token is sold to the customer.

Bookshop A and Bookshop B agree that GST will be recognised by Bookshop B when the token is redeemed.

If the token were on-sold by the customer rather than being redeemed, GST would have to be returned by that person (if a registered person) at the time of sale, with an input tax credit having been allowed for acquisition of the voucher by that person. GST would still be payable by Bookshop B on redemption.

GENERAL INSURANCE

Section 5(13), 20(3)(d) and 20(3)(db)

Introduction

For GST purposes, supplies of general insurance services are treated as taxable supplies. The inherent difficulties in valuing such supplies are overcome by taxing the flows of money to and from insurance companies as follows:

General insurer – charges GST on premiums received, and

– claims input tax credits for insurance payments and costs of providing general insurance services.

Insured party – claims input tax credits on premiums paid (if GST-registered), and

– returns output tax (if GST-registered) on payments received from general insurers.

Background

Payments to third parties

Previously, if an insurer made a payment under an insured party's insurance contract to a GST-registered third party it could be argued that the insurer was entitled to an input tax credit, but neither the insured party nor the third party recipient would incur a corresponding output tax liability under section 5(13). If, however, the payment was made directly to the insured party, a corresponding output tax liability would arise.

For example, on 9 October 2000 Liable Company (L Co) sold defective goods to Victim Company (V Co). These goods caused damage to V Co's factory, for which L Co was liable. L Co has an insurance policy covering such liability. L Co's insurance company could either make a payment to settle any claim to L Co (which would be taxed under section 5(13)), or directly to V Co (which would, following the preceding argument, not be taxed).

Under section 5(13) as amended, V Co would be liable to GST on the payment.

Use of the term "taxable supply" in section 5(13)

The use of the term "taxable supply" in section 5(13) may previously have had the unintended effect of narrowing the application of the provision to insurance payments in circumstances where there was a direct relationship between the insurance payment and a particular supply made by the insured person.

For example, if a retailer's warehouse was destroyed as a result of arson, it could be argued that the loss was not incurred "in the course of making a taxable supply", as section 5(13) required. Although the retailer could claim input tax credits for the cost of the insurance policy, as they are costs incurred in the course or furtherance of a taxable activity, it might have been argued that there was no corresponding output tax liability on payments received in this situation.

The term "taxable supply" in section 5(13) has been changed to "taxable activity" to remove the possible narrowing effect of the former term.

Indemnity payments

Under previous sections 5(13) and 20(3)(d), if insurance payments were indemnity payments they gave rise to an input tax credit for general insurers and a corresponding output tax liability for registered recipients. On one interpretation, the terms "indemnify" and "indemnity" used in the legislation had a narrow meaning in this context, so that only payments under contracts that reimbursed the insured for any loss suffered in the value of an insured item were included. Following this line of argument, contingency insurance, such as sickness and personal accident insurance, would have fallen outside the ambit of the legislation. This meant that general insurers could not claim input tax credits in relation to these policies, even though they would be charging GST on premiums for them.

The potential for a narrow interpretation of "indemnify" and "indemnity" undermined the policy intent of treating general insurance as a taxable supply. The words "indemnify" and "indemnity" have, therefore, been removed to clarify that general insurers may claim input tax credits and to ensure that registered recipients are correspondingly taxed.

Subrogation payments

When settling a claim under a contract of insurance, an insurer may make a payment to an insured person and receive under that contract, the insured person's legal rights in relation to the insured item (for example, the right to sue a third party for negligence). If the insurer has claimed an input tax credit for the payment to the insured party, any amount the insurer recovers from the third party (a subrogation payment) as a result of exercising those rights, is intended to be taxable under section 5(13B). The registered party making the subrogation payment should be correspondingly entitled to an input tax credit.

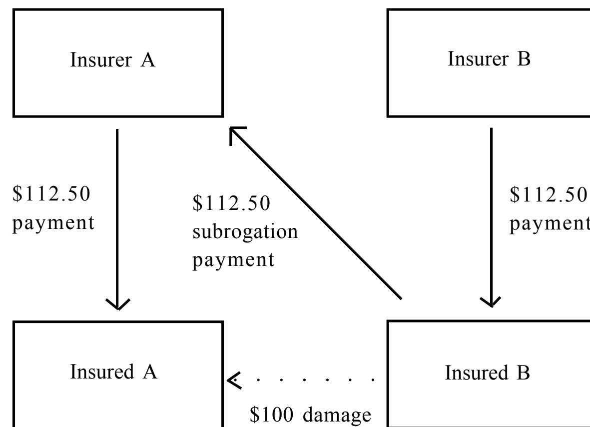
The amendments ensure that this is achieved by:

- clarifying that section 5(13) does not apply if section 5(13B) applies
- clarifying that section 5(13B) applies to deem the receipt of a subrogation payment by an insurer to be consideration for a supply of services by that insurer, where the insurer has been allowed an input tax credit for the payment in respect of which the subrogation payment is made, and
- allowing registered persons input tax credits for subrogation payments that are taxed under section 5(13B).

Example

Insured A has a contract of insurance with Insurer A covering it for any loss it may incur. Insured B has a contract of insurance with Insurer B covering it for any losses it may incur owing to negligent actions on its part. Insured A incurs a loss of $100 because of the negligent actions of Insured B.

Insurer A pays Insured A $112.50 under Insured A's contract of insurance (net $100 for both parties after input and output tax). Insurer A then takes action against Insured B to recover this amount. Insured B makes a subrogation payment to Insurer A of $112.50 (net $100 to both parties after input and output tax). Insurer B pays Insured B $112.50 under Insured B's negligence insurance policy (net $100 to both parties after input and output tax).



Payment	Sum	Output Tax	Input Tax	Net Amount
Insurer A to Insured A	$112.50	Insured A $12.50 [s 5(13)]	Insurer A $12.50 [s 20(3)(d)]	$100 to each party
Insured B to Insurer A	$112.50	Insurer A $12.50 [s 5(13B)]	Insured B $12.50 [s 20(3)(db)]	$100 to each party
Insurer B to Insured B	$112.50	Insured B $12.50 [s 5(13)]	Insurer B $12.50 [s 20(3)(d)]	$100 to each party

Key features

Amendments to sections 5 and 20 ensure that:

- A registered recipient of a payment under any contract of insurance is liable for output tax on the payment, whether or not the recipient is a party to the contract.
- Payments to registered recipients for losses incurred in the course or furtherance of a taxable activity (as opposed to a taxable supply) are taxed.
- General insurers can claim input tax credits for payments made under contingency policies and registered recipients of such payments are correspondingly taxed.
- There is no overlap between sections 5(13) (payments under contracts of insurance) and 5(13B) (receipt of subrogation payments).
- Subrogation payments received by an insurer are deemed to be consideration for a supply of services by that insurer, if the insurer has been allowed an input tax credit for the payment for which the subrogation payment is made.
- Registered persons making subrogation payments receive input tax credits for those payments.

TERMINATION OF A TAXABLE ACTIVITY

Sections 6, 15, 19A, 48A and 51

Introduction

The meaning of the term "taxable activity" has been clarified so that it applies to both a premature ending and a successful winding-up of a taxable activity.

Background

Section 6(2) provided that anything done in connection with the termination of a taxable activity is carried out in the course or furtherance of that activity. The new provision ensures that GST applies to supplies made in completing a taxable activity as well as to supplies made as part of normal trading activities. The completion of a taxable activity by a registered person is regarded as involving a taxable supply and a GST liability should arise accordingly.

In *Commissioner of Inland Revenue v Drummond and Ors*[3] the High Court found that the objectors' forestry activity had ceased earlier than planned for reasons outside the objectors' control. The Court suggested that an activity is terminated only when it has run its intended course. A supply made because of a premature conclusion of a business would be made on "cessation" of the activity rather than its "termination". This interpretation might have limited the application of section 6(2) to the completion of a taxable activity in the ordinary course of events.

Key feature

Section 6(2) has been amended to include within the definition of "taxable activity", anything done in connection with the beginning, ending or premature ending of a taxable activity.

A number of other consequential amendments have been made to sections 15, 19, 48 and 51 to reflect the change in wording.

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[3] (1998) 18 NZTC 13,745

LOCAL AUTHORITIES

Sections 9, 19A and 19AB of the Goods and Services Tax Act 1985

Introduction

Changes have been made to the way that local authorities account for GST. From 1 July 2001 local authorities will generally no longer be able to account for GST using the payments basis if their annual turnover exceeds $1.3 million. A local authority listed in an Order in Council will, however, be able to continue to use the payments basis.

The time of supply rules have been amended to clarify when a GST liability should be recognised in relation to rates charged by a local authority.

Background

Most registered persons are required to account for GST on the invoice basis of accounting—the earlier of when an invoice is issued or payment is received. Some exceptions apply, for compliance reasons, to registered persons with a low turnover and to non-profit bodies, who are able to account for GST as payment is received. Local authorities were also entitled to use the payments basis regardless of their annual turnover.

Until 1992 government departments were able to use the payments basis, but this ability was removed as part of reforms to move government departments' financial systems to accrual accounting. Similar reforms have occurred in the local government sector. Therefore, it is no longer appropriate to allow all local authorities to use the payments basis as it is unlikely that they will face high compliance costs in accounting for GST on an invoice basis. Only a few local authorities are adversely affected by the change.

As part of this reform, amendments have been made to clarify the time of supply in relation to local authority rates.

Key features

Local authorities will generally be required to account for GST using the invoice basis from 1 July 2001. However, a local authority listed in an Order in Council may continue to use the payments basis.

Section 9 has been amended to provide that the time of supply for local authority rates is the earlier of:

- the date of an instalment notice that requires payment of a rates instalment, or
- the due date of payment, or
- the date when payment is received.

Any notice that establishes an obligation to pay rates is considered to be an instalment notice, a particular type of tax invoice. Any notice that merely informs ratepayers of their future liability will not, however, trigger the time of supply.

Application date

The amendments to section 19A apply from 1 July 2001.

The new sections 19AB and 9(8) apply on and after 10 October 2000.

UPLIFT TO MARKET VALUE RULES

Sections 10(3) and 10(3A)

Introduction

Sections 10(3) and 10(3A), which provide that supplies made at an under-value between associated persons are treated as being made at market value for GST purposes, have been correctly targeted at supplies made to unregistered persons or persons making exempt supplies.

Background

Section 10(3) treats a supply made at an under-value between associated persons as being made at market value. Section 10(3A), however, prevents this rule applying if the recipient is a registered person who acquired that supply for the principal purpose of making taxable supplies and is entitled to an input tax deduction for that supply. The reason for this exclusion is that, if transactions between registered persons were required to be transacted at market value, any increase in output tax would be matched by an equivalent increase in input tax credits to the recipient. Therefore, requiring an uplift to market value would impose an unnecessary compliance cost for no revenue gain. Accordingly, sections 10(3) and 10(3A) are directed at supplies made at an under-value to unregistered persons or persons making exempt supplies.

The previous application of these sections created a number of problems that have now been addressed by the amendments:

- A gap in section 10(3) whereby the provision did not apply if the only consideration for a supply was non-monetary consideration that was less than the open market value of the supply.
- Circularity between section 10(3), which, because it requires an uplift to market value, may lift the supplier above the registration threshold, and section 10(3A), which provides that section 10(3) does not apply if the supply is between registered persons.
- Section 10(3A) did not cater adequately for certain types of registered recipients of supplies from associated persons. In particular, the requirement that the recipient be entitled to an input tax deduction in respect of the supply could be problematic.

  First, was when a supply not consisting of secondhand goods (for example, services or livestock) was made by an unregistered supplier to a registered recipient—no output tax would be charged on the supply, so no input tax deduction was available to the recipient. Second, when no consideration was charged for the supply, meaning that no input tax deduction would be available to the recipient. The application of the new restriction on secondhand goods input tax credits (new section (3A)) could also have been problematic in terms of section 10(3A) because, again, the registered recipient of the secondhand goods might not have been entitled to an input tax deduction.

Key features

The problems with the application of sections 10(3) and 10(3A) have been addressed by the following amendments, which ensure that the market value uplift rules for supplies between associated persons are correctly directed at supplies made to unregistered recipients or persons making exempt supplies:

- The gap in section 10(3) has been addressed by replacing the two references to “consideration in money” with references to “consideration”.
- The circularity between sections 10(3) and 10(3A) has been addressed by replacing the first reference to “registered person” with a reference to a “person”.
- The application of section 10(3A) to registered recipients (not making exempt supplies) has been broadened. Section 10(3A) still applies to the supply of goods and services, other than secondhand goods, made by an unregistered supplier to a registered recipient, if the registered recipient would have been entitled to an input tax deduction if the supplier had been registered and had complied with the requirements of the GST Act (such as supplying the recipient with a tax invoice). For the purpose of section 10(3A), all supplies to registered persons are treated as if they had been made for a consideration, and the restriction on secondhand goods input tax credits in new section 3A(3)(a) is treated as not applying.

CONSIDERATION FOR A SUPPLY UNDER A CREDIT CONTRACT

Section 10(5)

Introduction

A change has been made to the way that a supply of goods or services under a credit contract is valued, so that the consideration in money for such a supply is deemed to be the higher of the cash price, or the price the customer would have been charged but for the credit contract.

Background

The GST liability on a supply of goods or services that is made under a credit contract was previously calculated by reference only to the "cash price". The cash price is deemed under section 10(5) to be the consideration in money for the supply of goods and services under the credit contract and is meant to determine the consideration given by the purchaser for the non-credit portion of the credit contract. The term "cash price" is defined in the Credit Contracts Act 1981. The cash price is either:

- the lowest price for which anyone could have purchased the goods or services from the vendor on the basis that the customer paid the full price when the contract was entered into, or
- if there is no such price, the fair market value of the goods or services when the contract was made.

The use of the term "cash price" raises a number of problems including:

- The boundary with respect to determining the vendor is not clear—for example, whether it extends to any branches of that vendor in New Zealand or, depending on the price, branches overseas.
- The definition does not distinguish between classes of customers, such as retail and wholesale customers.
- Theoretical lowest prices could be used—for example, employees of the vendor may have the discretion to offer a maximum discount of, say, 30%. Even though this discount may never be given, it is theoretically the "lowest price" and therefore the cash price.

Key features

Section 10(5) has been amended so that the consideration in money for a supply of goods or services made under a credit contract is deemed to be the higher of the cash price or the price that customer would have been charged for those goods or services but for the credit contract.

Example

A sells a car to B for $7,000 under a credit contract. The car is advertised for sale at $5,000 for cash and $7,000 on credit. A gives a 10% discount to regular customers. This could give a cash price, under the Credit Contracts Act definition, of $4,500 for the sale of the car. B is not a regular customer, and if B had paid in cash, in full, A would have charged him $5,000 for the car. Under section 10(5), the consideration for the supply of the car is the higher of the cash price (potentially $4,500) and the price that B would have been charged for the car but for the credit contract ($5,000).

Therefore the consideration for the supply of the car is $5,000—A must return GST on this and if B was registered for GST and purchased the car for taxable purposes he would be entitled to an input tax credit for one-ninth of $5,000.

DEREGISTRATION

Sections 10(7A) and 10(8)

Introduction

Output tax payable on assets retained when a person ceases to be registered for GST purposes must now be based on market value rather than the previous basis of the lower of cost or market value. The latter basis continues to apply to assets purchased before the introduction of GST.

Background

GST is paid on assets held at the time a registered person deregisters because the registered person has, in effect, made a supply to themselves in their non-registered capacity. Before the amendment the registered person could elect to pay tax on the lower of cost or open market value of the assets retained. However, this election allowed scope for avoidance activity and allowed a more favourable treatment for retained assets sold after deregistration than for assets sold before deregistration.

Key features

Section 10(7A) has been inserted so that GST is paid on the open market value of assets held on deregistration. If, however, the assets were acquired before GST took effect on 1 October 1986, GST will continue to be charged on the basis of lower or cost of market under section 10(8).

EXPORTED GOODS AND SERVICES

Section 11, 11A, 11B

Introduction

Several amendments have been made to the GST treatment of exported goods and services and temporary imports.

Section 11 has also been restructured and split into three separate sections:

- section 11, zero-rated goods
- section 11A, zero-rated services, and
- section 11B, zero-rating of certain supplies by territorial authorities.

Background

Goods destroyed before export (section 11(1)(f))

The amendment allows goods that were destined to be exported to retain their zero-rated status if the goods are destroyed, die or cease to exist as a result of events outside the control of the exporter or purchaser. Previously, the goods would have had to be exported, or else lose their zero-rated status.

Exported aircraft (sections 11(1)(i), 11(7), 11(8) and 11(9))

The amendment allows the supply of an aircraft that can leave New Zealand under its own power to be zero-rated. Previously, zero-rating applied only to boats that were capable of leaving under their own power.

Supplies in relation to temporary imports (section 11A(1)(i))

The amendment zero-rates services supplied directly in connection with temporary imports. This removes the previous requirement that the services be provided to a non-resident. The amendment extends the application of the section to the supply of services to residents provided those services are supplied directly in connection with a temporary import. For example, repair services performed on a yacht visiting New Zealand under a temporary import entry would be zero-rated.

Exported information services (section 11A(1)(l))

Information that is supplied to a non-resident who is outside New Zealand can be zero-rated if the information has a direct connection with moveable property in New Zealand. In these circumstances the services should be regarded as being consumed offshore and should not be subject to New Zealand's GST.

For example, the provision to an offshore non-resident of testing services in relation to pharmaceutical samples in New Zealand would be zero-rated. Other services relating to personal property that involve the provision of information to non-residents (for example, the provision of certain legal services) would also be zero-rated.

Zero-rating does not apply if the performance of the services is received in New Zealand by another person (not being the person who contracted for the services) who does not make taxable or exempt supplies. For example, the provision of education services in New Zealand to the child of a non-resident parent is not zero-rated under this provision.

Zero-rating also does not apply to exported information relating to land in New Zealand, such as the supply to a non-resident of a New Zealand architect's plan for a building in New Zealand.

Example

Agricultural machinery is brought into New Zealand from Germany for testing. A New Zealand agricultural firm is contracted to carry out tests on the machinery in terms of durability, manoeuvrability, and efficiency. The goods are entered as temporary imports and a bond, equal to the amount of GST due on import, is paid to the New Zealand Customs Service. While in New Zealand the machinery is exhaustively tested to the point that it is written off. The information that is gathered from the testing is sent to the German manufacturer. The New Zealand firm is also required to prepare a report based on the data and make recommendations about design improvements to the machinery. Both the data and the report may be zero-rated under new section 11A(1)(l).

Services supplied in relation to exported goods (section 11A(1)(m))

Before the amendment, agency services supplied to a non-resident outside New Zealand in relation to goods that were destined for export could not be zero-rated.

The direct relationship the services had with the goods in New Zealand meant that the general exported services zero-rating provision (section 11(2)(e), now section 11A(1)(k)) could not apply. However, if the goods were acquired by the agent and then exported, the services could be incorporated into the price paid for the goods, and be zero-rated as part of the export of the goods. The amendment resolves this anomaly by zero-rating services supplied directly in connection with exported goods if the services are supplied to a non-resident who is outside New Zealand.

Example

A non-resident who is outside New Zealand purchases a crop duster from a New Zealand firm. The range of the aircraft means that it is not capable of leaving New Zealand under its own power. The New Zealand firm cannot zero-rate the supply under section 11(1)(i). However, this does not preclude sections 11(1)(a) – (e) from having effect. In this case, moving the aircraft to its overseas destination requires special packing. The overseas customer arranges the services of a specialist packer. The new section 11A(1)(m) allows the specialist to zero-rate the packing services to the non-resident, provided that the non-resident is outside New Zealand at the time the services are supplied (the packing specialist should hold sufficient evidence to show that the goods are in fact to be exported, such as an export entry).

Key features

- The new section 11(1)(f) allows goods that were to have been exported to retain their zero-rating status if those goods are destroyed, die or cease to exist in circumstances beyond the control of either the supplier or the recipient.
- The new section 11(1)(i) allows the supply of an aircraft that is capable of leaving New Zealand under its own power to be zero-rated provided that it leaves New Zealand within 60 days of the time the recipient takes physical possession.
- The new section 11A(1)(i) zero-rates services supplied directly in connection with temporary imports.
- The new section 11A(1)(l) zero-rates the supply of information to a non-resident who is outside New Zealand if the information has a direct connection with moveable personal property in New Zealand. This is subject to the requirement in section 11A(2) that another person (not being a person who makes taxable or exempt supplies) does not receive the performance of the services in New Zealand.
- The new section 11A(1)(m) zero-rates services that are supplied directly in connection with exported goods (under new sections 11(1)(a) to (e)) if those services are supplied to a non-resident who is outside New Zealand at the time the services are performed.

GOING CONCERNS

Section 11(1)(m)

Introduction

Minor amendments to the "going concern" provisions will remove uncertainties as to when the "going concern" test is to be applied, and the meaning of the term "going concern".

Background

The transfer of a taxable activity as a going concern is a zero-rated supply. A supply qualifies for zero-rating only if the vendor and purchaser agree in writing that the supply is of a going concern. This precludes the possibility of a vendor not paying output tax on the basis that the supply is of a going concern and a purchaser claiming an input tax credit on the basis that the supply is not of a going concern.

The policy intent of the "going concern" provisions was that the taxable activity must be received as, and be capable of being operated as, a going concern by the purchaser for the zero-rating provisions to apply. The taxable activity must be capable of seamless operation during its transfer, although it is not necessary that the purchaser, in fact, operate the taxable activity as a going concern after its transfer.

The amendment seeks to clarify the time at which a going concern must exist to enable the parties to reach agreement.

Key features

The "going concern" test has been amended to ensure that:

- The test for a "going concern" is applied at the time of supply.
- To qualify for zero-rating the parties must intend that the taxable activity be capable of being carried on by the recipient as a going concern at the time of transfer or settlement.

Analysis

The amendment provides that there must be a going concern at the "time of supply" (generally the earlier of invoice or payment). It also provides that the parties must intend that the taxable activity be capable of being carried on by the purchaser as a going concern at the time of transfer or settlement.

Therefore, to be zero-rated as the transfer of a going concern, the following must occur or exist:

- There must be a supply of a taxable activity, or part of a taxable activity that is capable of separate operation, to a registered person.
- There must be an agreement in writing between the supplier and the recipient that the supply is of a going concern.
- At the time of supply (under section 9, the earlier of invoice or payment), the taxable activity must be a going concern, as defined in section 2(1).
- Under the definition of "going concern" in section 2(1) there must be, in relation to the supplier and recipient, a situation in which:

  "(a) There is a supply of a taxable activity, or a part of a taxable activity where that part is capable of separate operation; and

  (b) All of the goods and services that are necessary for the continued operation of that taxable activity or that part of a taxable activity are supplied to the recipient; and

  (c) The supplier carries on, or is to carry on, that taxable activity or that part of a taxable activity up to the time of its transfer to the recipient."
- The supplier and the recipient must intend that the supply is of a taxable activity, or a part of a taxable activity where that part is capable of separate operation, that is capable of being carried on as a going concern by the recipient.

In most cases the agreement itself will provide the necessary evidence of an intention to transfer a going concern.

Examples

Not zero-rated

A owns a service station which comprises a petrol station and an attached panel-beating workshop. A decides to sell the petrol station to B.

The sale agreement between A and B provides that the business will be transferred to B and payment will be made in full on the signing of the sale agreement. The agreement transfers all of the assets of the petrol station (such as fittings, computer, cash register and office furnishings) to B. The agreement states that the business will be transferred as a going concern and the sale zero-rated for GST purposes.

The petrol pumps, signage and petrol tanks, however, are all owned by an oil company, X Inc, and are leased to A under a supply agreement which also secures A a supply of petrol for the petrol station. Once A has sold the petrol station the supply agreement terminates, and B has no existing supply agreement with X Inc or any other oil company.

At the time of supply (which is also the time of transfer in this situation) the business is not a going concern, as all of the necessary assets have not been transferred to B. The sale cannot, therefore, be zero-rated under section 11(1)(m). A is liable for output tax on the sale and B is entitled to an input tax credit on the purchase. (Note that if the requirements of section 78E are met, the consideration payable by B for the petrol station can be increased to take account of the mistaken zero-rating of the sale.)

Zero-rated

D owns E Co, a registered company in business as a boutique cricket bat-maker. D decides to retire, selling the business to F, who is also a registered person. F has no experience in the making of cricket bats, and intends to retool the workshop to make softball bats.

The sale agreement provides that all of the assets of E Co, including all intellectual property rights (for example, the brand name “E Bats”) and goodwill, will be transferred to F, and that the supply is of the business as a going concern and will be zero-rated. The agreement also provides that F will pay half of the purchase price upfront, and D will continue to operate the business until it is transferred to F, at which time the remainder of the purchase price will be paid.

Even though the cricket bat manufacturing business will not be carried on by the purchaser, this sale would be zero-rated under section 11(1)(m) as all of the requirements of section 11(1)(m) and the definition of “going concern” are met. There is an agreement in writing between the two parties that there is to be the transfer of a going concern, and at the time of supply, when the deposit is paid, E Co is a going concern. All that is necessary for the continued operation of the business has been transferred, and the business continued to be operated by D up until the time of transfer.

The agreement clearly shows that there is an intention to transfer a going concern. It is not relevant that F intends to switch to softball bat production and has no cricket bat-making abilities. If F chose, the business could still be operated by him as a going concern in the form in which it was transferred, for example, by employing a cricket bat-maker.

RESIDENTIAL ACCOMMODATION

Section 14

Introduction

An amendment has been made to section 14, which treats certain supplies as exempt from GST. The amendment exempts the supply of property by way of lease that is to be used for residential accommodation.

Background

The supply of residential accommodation in a dwelling is an exempt supply. However, the scope of the exemption did not appear to extend to the supply of residential property under a lease in circumstances where the lessee rather than the owner will lease the property to an individual as a private residence. Examples include the supply of property under a head lease or a series of separate leases.

It was arguable that the supply of residential property to a person under a head lease was not an exempt supply because the head lessee is unable to occupy the property. The amendment removes the distinction between supplies made in circumstances where the recipient is able to occupy the dwelling and where the recipient cannot. Therefore, both forms of supply will be exempt from GST.

Key features

New section 14(1)(cb) exempts the supply of property by way of lease that is to be used for the principal purpose of residential accommodation. It is likely that leases to which the exemption will apply will contain a permitted use clause, ensuring that the property is used for residential accommodation purposes. The exemption will not apply if the property is to be used by a registered person in carrying on a taxable activity. Therefore, if the property were used principally as business premises, the exemption would not apply. However, minor taxable use, such as use of a spare room for an office or study, would not affect the exempt treatment.

The exemption does not apply in relation to existing leases if the supplier and the recipient agree in writing that it will not apply and supplies already made under the lease have been treated as taxable supplies before 16 May 2000.

PENALTY INTEREST

Section 14

Introduction

An amendment has been made to section 14 to treat interest in the nature of a penalty imposed under a contract for goods or services as consideration for an exempt supply.

Background

If a purchaser fails to make payment under a contract the supplier may, if the contract permits, charge the purchaser interest for the use of the money to induce payment. The interest is generally called penalty interest or default interest.

The nature of penalty interest is indistinguishable from that of other forms of interest, which the Act exempts under section 3(1)(ka).

The provision of a credit contract[4] and certain services relating to credit contracts are within the definition of "financial services" and, therefore, exempt from GST. However, penalty interest charged under a contract does not necessarily make the contract a "credit contract", so penalty interest may be subject to GST when the underlying supply is taxable.

The amendment removes the technical distinction between certain penalty interest charged under credit contracts (and interest generally) and other forms of penalty interest.

Key features

New section 14(3) treats penalty interest imposed under a contract for goods or services as consideration for an exempt supply.

[4] As defined in the Credit Contracts Act 1981.

THE SIX-MONTHLY FILING PERIOD

Section 15A(1AA)

Introduction

The new section 15A(1AA) gives the Commissioner of Inland Revenue the discretion to allow a taxpayer who has been accounting for GST on a six-monthly basis to remain on that basis if the taxpayer's turnover exceeds $250,000.

Background

The GST Act gives taxpayers within the $250,000 threshold the option of filing every six months rather than every two months. This recognises that filing on a two-monthly basis may be onerous on taxpayers with a low-volume but high-value turnover, such as businesses with seasonal income.

Compliance costs may also be incurred if a taxpayer on a six-monthly filing basis starts to exceed the $250,000 threshold and is required to shift to the two-monthly filing basis.

In both instances the compliance costs can be high when balanced against the cash flow costs to the Government. The discretion of the Commissioner to allow six-monthly filing is intended to address these issues.

Key features

Section 15 has been amended to give the Commissioner the discretion on written application to allow taxpayers to remain on a six-monthly filing basis provided that the taxpayer can demonstrate:

- a history of accurate and timely filing and payment of GST
- good record keeping practices
- that the taxpayer had earlier filed on a six-monthly basis, and
- that the nature and volume of the supplies made by the taxpayer make six-monthly filing appropriate.

THRESHOLDS

Sections 19A, 24, and 51

Introduction

The registration, payments basis, and abbreviated invoice thresholds in the GST Act have all been increased.

Background

The registration threshold

The threshold that requires a person to register for GST has been increased from $30,000 to $40,000 (excluding GST) of supplies in a twelve-month period. The increase reflects movements in the purchasing power of the dollar since 1990, when the threshold was last increased, plus an amount for expected inflation for the next five to ten years.

The payments basis threshold

The threshold under which a registered person can elect to account for GST on a payments basis, rather than comply with the invoice basis of accounting for GST, has been increased to $1.3 million (including GST). The increase also reflects recent movements in the purchasing power of the dollar and expected inflation for the next five to ten years.

Tax invoices

The threshold under which an abbreviated tax invoice is acceptable to verify a taxpayer's input tax credit claim has been increased from $200 to $1,000 (including GST) to reduce compliance costs in relation to holding detailed tax invoices for small items of expenditure.

Key features

- The registration threshold in section 51 which requires a taxpayer to register for GST has been increased to $40,000.
- The threshold in section 19A under which a taxpayer can elect to account for GST on a payments basis has been increased to $1.3 million.
- The threshold in section 24 under which an abbreviated tax invoice can be issued has been increased to $1,000.

Application date

The amendments apply from 1 October 2000.

FAILURE TO ISSUE A TAX INVOICE

Section 143 of the Tax Administration Act 1994

Introduction

The penalty that can be imposed for failing to issue a tax invoice once one has been requested has been clarified.

Background

An amendment has been made to clarify the imposition of penalties in cases where a supplier fails to issue a tax invoice. Since GST was introduced it has been an offence for a registered person not to issue a tax invoice within 28 days of such a document being requested. The amendment makes it an explicit, absolute liability offence not to issue a tax invoice.

This offence carries with it, on conviction, a penalty of up to $4,000 for the first offence, $8,000 for the second offence, and $12,000 for the third and subsequent offences.

Key features

The failure by a registered person to issue a tax invoice within 28 days of one being requested is now an absolute liability offence under section 143 of the Tax Administration Act 1994.

DEFERRED SETTLEMENTS

Section 19D

Introduction

Amendments have been made to the application of section 19, which applies to taxpayers who use the payments basis of accounting for GST. The Act now requires output tax to be returned on an invoice basis for any supply for which the consideration exceeds $225,000 (including GST) unless settlement is required to be made within one year.

Background

The amendments address the GST advantage in certain transactions where the purchaser is on an invoice basis and able to obtain an immediate input tax credit, while the vendor is on the payments basis and able to significantly defer the payment of output tax on the supply. By deferring the date of settlement it is possible to gain a significant timing advantage in relation to such a transaction.

Key features

New section 19D requires a registered person who makes a supply of goods and services for a consideration of more than $225,000 (GST-inclusive) to account for that supply on an invoice basis.

The provision will not apply when the supply of goods or services is a "short-term agreement for the sale and purchase of property or services". This term is defined in section OB 1 of the Income Tax Act 1994, except that for GST purposes a short-term agreement will be one that does not exceed one year.

To prevent avoidance of the new threshold, the legislation has the effect of empowering the Commissioner to aggregate supplies if the Commissioner considers that the taxpayer is avoiding the application of new section 19D. The Commissioner's decision to use the aggregation rule will be based on an objective assessment on the facts as to whether the supply was deliberately broken down so as to avoid the $225,000 threshold.

ADJUSTMENTS FOR CHANGES IN USE

Sections 21 - 21I

Introduction

Several changes have been made to the requirement to make adjustments to input and output tax when a change in the use of goods or services occurs.

The main change is to give registered persons who acquired assets for the principal purpose of making taxable supplies, the option to pay output tax in respect of private or exempt use of such assets on a one-off or annual basis rather than in each taxable period.

Registered persons who acquire assets other than for the principal purpose of making taxable supplies will be allowed to claim input tax credits in respect of the use of such assets in making taxable supplies on an annual rather than a taxable period basis. If the asset is used entirely for taxable purposes a registered person may apply to the Commissioner for approval to make a single adjustment. In approving an application, the Commissioner will consider a number of criteria, which are explained below.

To clarify the application of the adjustments provisions, section 21 has been restructured as follows:

In relation to output tax adjustments, the following sections apply:

Section 21	Supplies of goods and services other than for making taxable supplies
Section 21A	Method of allocating between taxable and other supplies
Section 21B	Methods of allocation for replacement goods and services
Section 21C	Attribution of output tax
Section 21D	Attribution of output tax in contemplation of sale of goods and services

In relation to input tax adjustments, the following sections apply:

Section 21E	Application of section 21F
Section 21F	Deductions from output tax for goods and services applied for making taxable supplies
Section 21G	Timing of deduction under section 21F
Section 21H	Application to make single deduction under section 21F

Section 21I applies to adjustments for fringe benefit tax and income tax deductions for entertainment expenditure.

Background

A registered person may claim input tax credits for GST paid on goods and services acquired principally in making taxable supplies. Those goods and services may also be used in making other than taxable supplies. The Act deems the latter use to be a taxable supply by the registered person, and output tax is charged accordingly.

A registered person cannot claim input tax credits in relation to goods and services acquired principally for making other than taxable supplies. If those goods or services are also used for making taxable supplies the Act allows an input tax credit to reflect the latter use.

The objective behind requiring an adjustment for a change in use of goods and services from making taxable supplies to other than making taxable supplies, is to ensure that the consumption of the goods or services while they are applied for a non-taxable use is taxed. For example, the private use of goods and services acquired by a registered person for the principal purpose of making taxable supplies, represents a supply of goods or services to the registered person in his or her private capacity and, as such, should be subject to GST.

Key features

Output tax adjustments

- The allocation methods outlined in Inland Revenue's *GST guide (GST 375)* are now included in the legislation. Allocation should occur on the basis of actual use, but alternative methods may be used if they are fair and reasonable. The turnover method is also available to taxpayers making exempt supplies.
- Taxpayers now have the choice when making output tax adjustments to make adjustments in each taxable period or a single adjustment. If taxpayers elect to make one adjustment, additional adjustments will be required if the non-taxable use subsequently changes by twenty percent or more. Taxpayers will also have the choice to make adjustments annually.

- The dollar limit in the formula that determines when adjustments must be made for exempt use has been increased from $48,000 to $90,000. The exclusion from making adjustments for purchases connected with making exempt supplies now applies when the total value of the exempt supplies made by a registered person does not exceed the lesser of $90,000, or 5% of total turnover, in a 12-month period.
- Technical changes have been made to ensure that an output tax adjustment is made for any non-taxable use of goods and services acquired or produced as well as applied, for the principal purpose of making taxable supplies.
- Technical changes have been made to clarify the application of the provisions for dual or multiple use, not just a subsequent change in use.
- Technical changes have been made to ensure that fringe benefits provided to past employees are subject to GST.

Input tax adjustments

- The input tax credit allowed under the old section 21(5), now section 21F, applies only to goods and services on which GST has previously been charged. This change applies to transactions entered into from 1 October 1986 unless the Commissioner has agreed in writing to the input tax credit claim before 16 May 2000, or has not been notified of a claim, other than by way of inclusion in the registered person's return and, on this basis, has not queried the claim before 16 May 2000.
- Taxpayers will have the choice of making input tax adjustments for changes in use on a taxable period or annual basis.
- The threshold for one-off input tax adjustments for changes from non-taxable use to taxable use has increased to $18,000. In relation to assets that exceed $18,000 and are used entirely for taxable purposes, a taxpayer may apply to the Commissioner for approval to make a single deduction. To the extent that the taxable use changes to non-taxable use the taxpayer will be required to make a one-off output tax adjustment.

Application date

The majority of the amendments apply to supplies that are deemed to be made on and after 10 October 2000. As noted earlier, sections 21E and 21F(1) apply from 1 October 1986 except in circumstances (as outlined) where the Commissioner has approved a claim before 16 May 2000.

Detailed analysis

Section 21

Section 21 sets out the circumstances where it is necessary for a taxpayer to calculate the output tax that is due on goods and services applied for a purpose other than of making taxable supplies.

The section applies to:

- Changes in use (either actual or intended use) of post-GST assets—goods or services acquired or produced principally for taxable purposes but applied for a non-taxable purpose, for example, a computer acquired for use in a farming business and later used by the farmer's family solely to play computer games.
- Mixed use of post-GST assets—goods or services applied for both taxable and non-taxable purposes, for example, a computer used both for the farming business and unrelated university study.
- Changes in use of pre-GST assets—goods and services acquired or produced before 1 October 1986 for what would have been taxable purposes if acquired after 1 October 1986 and used for non-taxable purposes after 1 October 1986, unless the goods and services had already been entirely used for non-taxable purposes before that date and continued to be so used. For example, a computer that was acquired in 1980 for use in a farming business and used in 1987 by the farmer's family to play computer games.

  (The section will not apply if the family began to use the computer to play computer games in 1985 and from then on the computer is used for that purpose only.)
- Mixed use of pre-GST assets—goods and services acquired or produced before 1 October 1986 and applied for what would have been both taxable and non-taxable use if the use was on or after 1 October 1986, but applied for non-taxable purposes after 1 October 1986. For example, a computer that was acquired in 1980 for the farming business and personal banking which continues to be used for those purposes after 1 October 1986.

It is not necessary to calculate output tax where a supply is:

- the supply of services by an employee on or after 1 October 1986, or
- in relation to goods and services acquired before 1 October 1986 and no longer used for a principal purpose of making taxable supplies because of a change in the GST Act. This ensures that no output tax adjustment is required following a change in the GST Act in relation to goods and services for which an input tax credit was not allowed on acquisition. Therefore, no output tax adjustment is required following a legislative change to make a supply exempt (for example, in relation to the change making the provision of residential accommodation under a head lease exempt)—no input tax credits were allowed and no output tax is payable. This achieves the same effect as if supplies of the goods or services were always exempt.

A further exclusion from the operation of section 21 applies to goods and services that are applied for the purpose of making exempt supplies. (Note that supplies for a private purpose are not covered by this exclusion.) The dollar limit in the formula that determines when adjustments must be made for exempt use has increased from $48,000 to $90,000. Therefore, a taxpayer is not required to calculate the output tax due on any change in the use if, in any 12-month period (after the start of the taxable period in which the taxpayer would be obliged to calculate output tax), the value of all exempt supplies is less than the lesser of:

- $90,000, or
- 5% of the total consideration for all taxable and exempt supplies to be made in the twelve months.

Section 21A

New section 21A sets out the methods of allocating the application of goods or services to making taxable supplies and other supplies.

Actual use (or the "direct attribution" method)

This method of allocation requires the taxpayer to directly attribute the use of the goods and services to the extent that those goods and services were used for a purpose other than making taxable supplies.

Under this method the taxpayer should make every effort to determine the actual private or exempt use. In the case of a motor vehicle, taxpayers should keep a logbook to work out the taxable and non-taxable use of the asset. If part of a home is used for business purposes, the floor area used for these purposes should be taken as a percentage of the entire floor area of the house.

Turnover method

This method is available only in relation to the exempt use of goods or services. (Adjustments for private use cannot be calculated using this method of allocation.) The formula, as shown in the legislation, is:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period}}$$

The method is to be used in cases where the actual use method is too difficult to apply—for example, in the case of overhead expenses.

An alternative (or special) method

This method is available, provided that the Commissioner approves it, if the use of the method results in allocated amounts that are fair and reasonable in comparison with actual use.

No change in current IRD practice

There has been no change in the policy of allowing a variety of special methods to be used to allocate GST between taxable and exempt purposes.

Other methods of allocating GST that have previously been accepted will continue to be accepted. For example, interest income and expenses should be applied on a net basis in any form of turnover calculation, as is set out in the current *GST guide*.

No need to reapply for approval for current special methods.

If, before the change in legislation, a taxpayer has been using a special method to allocate goods and services acquired between taxable and exempt purposes, the taxpayer will not be required to apply to the Commissioner for approval provided:

- the allocation method has been used in previous GST returns and accepted by the Commissioner, and
- its results are fair and reasonable in the circumstances.

If a taxpayer fundamentally changes their allocation method, or there is a significant change in their business which might raise questions about the appropriateness of the method being used, they will need to obtain approval from the Commissioner. No approval will however be required for minor changes to an allocation method.

Binding rulings on GST issues

Section 91G of the Tax Administration Act 1994 states that "a binding ruling does not apply from the date a taxation law is repealed or amended to the extent that the repeal or amendment changes the way the taxation law applies in the ruling".

Public rulings

Following the changes to the GST legislation, public binding rulings on GST issues have been reviewed. None are affected by the changes.

Private and product rulings

Holders of current private or product rulings who wish to obtain certainty can apply for a status ruling. Other affected or interested parties are advised to refer to the new legislation, and to seek professional advice if necessary.

Section 21B

New section 21B applies to taxpayers who have elected to make a one-off adjustment. It provides supplementary rules for allocating output tax if goods and services are acquired for replacement, regardless of whether they have an existing pattern of use. If a taxpayer has elected to make a one-off adjustment, the pattern of use that has been established for the replaced asset during the 12 months before acquisition or production may be applied to the replacement asset to reflect the non-taxable application.

The adjustment must be made on the day that the replacement goods or services are acquired or produced.

If a pattern of use does not exist the taxpayer must estimate the degree of non-taxable use for which the goods and services will be applied and revise that provisional use 12 months after the date of purchase or production.

Section 21C

The new section 21C determines when a taxpayer is required to calculate the amount of output tax due as a result of applying goods and services for a non-taxable purpose.

A taxpayer is required to calculate output tax at one of the following times:

- in the first taxable period in which the goods and services are applied for a purpose other than that of making taxable supplies (a one-off adjustment). This adjustment is made at the time goods or services with mixed use are acquired or when a change in use first occurs, or
- in each taxable period in which the goods and services are applied for a purpose other than that of making taxable supplies (a period-by-period adjustment), or
- in each year in which the goods and services are applied for a purpose other than making taxable supplies (an annual adjustment). This adjustment is made in the taxable period that corresponds to the time when a calculation of taxable and non-taxable use has been made for income tax purposes (the earlier of when a return is due or has been filed).

A different method may be elected for different goods and services. However, once a method is selected the taxpayer will not be able to change the method without the Commissioner's approval. A taxpayer is not required to make a written application to the Commissioner seeking such approval, but must instead notify the Commissioner in the current return of a change in method to be adopted in the current and future GST returns. The method adopted would be subject to review by the Commissioner during audit.

Because the legislation gives taxpayers the choice of when to make an output tax adjustment, penalties will not be imposed if a person has failed to make adjustments in each taxable period. Non-compliance will be considered to have occurred only if no adjustments have been made for over a year since a change in use occurred.

After adopting the one-off adjustment method, the taxpayer will be required to reassess the adjustment if there is a subsequent variation of 20% or more in the non-taxable use. If non-taxable use decreases, an input tax credit will be allowed. If non-taxable use increases, output tax will be payable. If there is a reasonable chance that there will be a significant change in use, the taxpayer will need to keep continual records.

Subsection 3 reduces the output tax liability arising from a one-off or annual adjustment by any output tax attributed to earlier taxable periods for the goods and services in question. This is a transitional provision which applies when a one-off adjustment is made for the first time to ensure that over-taxation does not arise. If a taxpayer has already made one or more output tax adjustments in earlier taxable periods and wishes to make an adjustment on an annual or one-off basis, the earlier adjustments should be deducted from the first adjustment made on an annual basis or an adjustment on a one-off basis.

In all circumstances the value of a deemed supply is the lesser value of the cost of the goods and services or the open market value of the supply (section 10(8)).

Example

A builder purchases a ute for $20,000 (including GST) for business use as well as a second family vehicle. The ute is used entirely for business purposes during the week and is available to the family during the weekends. Therefore the extent of private use is approximately 29%.

The builder may choose to make GST adjustments to reflect the private use by using one of the following methods:

One-off adjustment

The ute does not have an established pattern of use so a provisional calculation of the private use is required at the time of its purchase. An output tax adjustment of one-ninth of 29% of $20,000, being $644.44, is required.

If, after 12 months it was established that the extent of private use declined during the past six months as the builder now works Saturdays as well during the week, the initial adjustment has overestimated the extent of private use. Recalculating the adjustment shows that the actual private use of the ute is 14% rather than the estimated 29%. Therefore the initial output tax adjustment should have been one-ninth of 14% x $20,000, or $311.11. In the next taxable period a reduction in the builder's output tax liability of $333.33 would offset the difference between estimated and actual use.

After 12 months from acquisition an actual pattern of use would have been established and no further adjustments are required unless the private use changes by 20% or more. For example, if the builder buys a van for the business and the ute is used only for private purposes an adjustment of one-ninth of 86% x $20,000, being $1,911.11, is required.

If the private use of the ute subsequently decreases to 70% an input tax adjustment of $666.66 is allowed.

Annual adjustments

In calculating allowable deductions for income tax purposes, the extent of private use also needs to be calculated. By referring to his logbook the builder has calculated that for the income year ending 31 March 2001 the ute has been used 30% for private purposes. He files his income tax return for that year on 6 July 2001. He files GST returns on a six-monthly basis. His taxable periods end in March and September. Therefore, for the GST return filed on 31 October 2001 he makes an output tax adjustment of one-ninth of 30% x $20,000 x 18%[5] ($120) in every second return.

If for the taxable period ending 31 March 2001 the builder had already made an output tax adjustment of, say, $60, that amount would be deducted from $120 to calculate the adjustment for the taxable period ending 30 September 2001 (of $60). The next annual adjustment will be made in the GST return filed on 31 October 2002.

Period-by-period adjustments

For the taxable periods ending 31 March 2001 and 30 September 2001 the actual extent of private use would need to be calculated at, say, 25% and the output tax adjustment would be calculated as:

$20,000 x 18%/2 x 25% = 450/9 = $50

Section 21D

This new section is an anti-avoidance provision allowing the Commissioner to disregard a deemed supply for a change from taxable to non-taxable use of goods and services if the Commissioner considers that the registered person is making the change in contemplation of the sale of the goods or services.

Taxpayers may choose to make one output tax adjustment to be valued at the lesser of the cost of the goods or services or the open market value of the deemed supply. In contrast, the value of a deemed supply on deregistration is the market value of any assets retained. It may be possible for vendors to reduce their GST liability by changing the use of an appreciating asset such as land from business use to private use immediately before sale, making a one-off adjustment for the deemed supply on the basis of cost and selling the assets free of GST. This section removes this opportunity.

Section 21E

New section 21E sets out the circumstances in which a taxpayer may claim an input tax credit for a change from non-taxable to taxable use under new section 21F. Section 21E will allow a taxpayer to make a deduction from output tax under section 21F provided that three tests are met.

- First, the goods and services used for taxable purposes must have been acquired after 1 October 1986 for the principal purpose other than that of taxable supplies.

  This reflects the policy to allow an input tax credit only when GST has been imposed.

  The rule also clarifies that the application of section 21F will not be precluded if the change of use is the result of the goods and services owned by a partner of a partnership being applied in the partnership activity provided that the partnership is using the goods and services for making taxable supplies.

[5] The annual depreciation rate.

- Second, the goods or services must have been subject to tax under section 8(1) or, in the case of imported goods, section 12(1). In respect of imported goods, the person claiming the input tax credit must be the person who imported the goods. This requirement removes the ability for someone who has not imported an asset to claim an input tax credit for a change in use.
- Third:
  - if the goods are secondhand they must have been both sold in New Zealand, and always situated in New Zealand (and therefore have had GST charged on their supply) or have been outside New Zealand but have had GST levied on their importation, and
  - the supply must not be a taxable supply (that is, GST has not been charged and section 21F would not therefore otherwise apply), and
  - the goods not have been supplied to another person who is the importer of the goods.

Again, these requirements ensure that a change in use input tax credit is available only if the importer does not qualify for an input tax credit for the GST paid on importation. An input tax credit is, however, available to other purchasers of secondhand goods who would have been entitled to an input tax credit but for the fact that the goods were not acquired for the principal purpose of making taxable supplies.

Section 21E(4) replicates the effect of the previous first proviso to section 21(5) and section 21(6) to ensure that an input tax credit is still available in relation to goods and services on which output tax has arisen from an earlier change in use or deregistration.

For example, a farmer acquires land for the principal purpose of making taxable supplies. The farmer subsequently retires, deregisters for GST purposes and pays output tax under section 5(3) on the deemed supply of the land. The farmer establishes a small bed and breakfast business on the farm and registers again for GST. Although the land was not acquired for the principal purpose of making non-taxable supplies, she is entitled to input tax credits for the taxable use under section 21E.

The new requirements for claiming an input tax credit adjustment will apply in relation to changes to taxable use from 1 October 1986 unless the Commissioner has agreed in writing to the input tax credit claim before 16 May 2000, or has not been notified of a claim, other than by way of inclusion in the registered person's return and, on this basis has not queried the claim before 16 May 2000.

Section 21F

New section 21F allows a taxpayer a deduction from output tax in the circumstances described in section 21E to the extent that the goods and services are applied for the purpose of making taxable supplies. The value of the deduction has not been changed and is the tax fraction (one-ninth) of the lesser of cost or open market value of the goods or services in question.

New section 21F does not apply to services supplied by employees.

New section 21F also provides for a one-off adjustment when the cost of the asset is less than $18,000 (including GST). This threshold has been increased from $10,000. A one-off adjustment may also be allowed on application to the Commissioner under section 21H.

Section 21G

New section 21G determines the time at which the calculation of the deduction from output tax must be made. The section allows the taxpayer two options: the deduction can be attributed on a period-by-period basis, or annually. As a transitional measure, if the annual basis is chosen, any previous input tax adjustments should be deducted from the first adjustment made on the annual basis.

Once a method of attribution is applied to the goods and services affected, the taxpayer cannot change the method of attribution without the Commissioner's approval. Again, a formal application procedure does not apply but a taxpayer must notify the Commissioner of the change in a return, which may be reviewed by the Commissioner during an audit.

Section 21H

Taxpayers may make one-off input tax adjustments in relation to changes in use of assets that cost $18,000 or less. For assets costing more than $18,000 taxpayers may only make adjustments on an annual or period-by-period basis.

In special circumstances, however, taxpayers may apply to the Commissioner for a one-off input tax adjustment in relation to 100% changes in use of goods and services that cost $18,000 or more.

The criteria to be applied by the Commissioner in approving a taxpayer's application for a one-off input tax adjustment are:

- Whether the taxpayer has previously made one-off input tax adjustments. This option is intended to apply to taxpayers who have (either before or after 10 October 2000) already made one-off input tax adjustments so as to reduce their compliance costs.

- Whether the taxpayer has elected to make one-off output tax adjustments for any previous changes from taxable use to non-taxable use (either before or after 10 October 2000). This criterion removes the tax advantages that might otherwise arise if taxpayers are only making output tax adjustments on a periodic basis yet claiming input tax adjustments on a one-off basis.
- Whether making period-by-period or annual adjustments is practical in the circumstances. If the extent of business use fluctuates during a year it will be more practical to make period-by-period or annual adjustments. Therefore it is intended that the one-off basis will apply in relation to assets with relatively constant ongoing taxable use.
- The nature of the goods or services. Goods and services to which a one-off adjustment should apply are those that are likely to be retained for a number of years, such as real property. Few compliance cost saving benefits would arise in relation to assets that are held only for a short time.

If the Commissioner approves a taxpayer's application for a one-off input tax adjustment and the taxable use changes to any non-taxable use, the taxpayer will be required to make a one-off output tax adjustment to the extent of the non-taxable use.

Applications should be made to local Inland Revenue Service Centres.

Example

A property management company purchases for $270,000 (including GST) an apartment building which it previously managed on behalf of a property developer and continues to receive rental income for three years. The residential rental market declines and the company then decides to convert all the apartments into office space.

The company applies to the Commissioner for a one-off input tax adjustment of $30,000 (being the GST component of the purchase price of the building).

The company has previously made one-off input tax adjustments and one-off output tax adjustments in relation to other changes in use of goods and services.

It is more practical to make a one-off adjustment because the overall use of the building will remain relatively static.

It is likely that the company will own the building for a number of years, and a one-off adjustment will provide compliance cost saving benefits.

The company satisfies the legislative criteria for exercise of the Commissioner's discretion and, therefore, would be permitted to make a one-off input tax adjustment. The adjustment may still be allowed even if a small part of the building were used for private purposes—for example, the company may use part of the office space for their own private storage.

Any increase in exempt use—for example, if some of the office space is rented as private residences—would require a one-off output tax adjustment.

Section 21I

New section 21I prescribes the GST consequences of providing fringe benefits and entertainment expenditure. The amendments redraft the application of adjustments created by the fringe benefit tax and entertainment expenditure rules. The amendments do not change existing policy or practice.

Fringe benefit tax

The supply of a fringe benefit under the Income Tax Act 1994 is deemed to be a supply of goods and services by the taxpayer in the course or furtherance of a taxable activity.

The section does not apply to the extent that:

- the person who receives or enjoys the benefit pays an amount for the fringe benefit, or
- the fringe benefit relates to an exempt supply, or
- the fringe benefit relates to a supply charged with GST at the rate of 0%, or
- the fringe benefit is deemed to be provided by a registered person in the course of making exempt supplies.

The time of supply for these adjustments arises when the taxpayer is liable for tax under the fringe benefit tax rules of the Income Tax Act 1994.[6] Section 10(7) determines the amount of GST that should be charged on the provision of a fringe benefit is equal to one-ninth of the value of the fringe benefit—the deemed consideration for the supply.

Entertainment expenditure

Section 21I deems a taxpayer to have made a supply when section DG 1 of the Income Tax Act applies in relation to expenditure on entertainment. The supply is equal to the deduction that is disallowed under section DG 1. The output tax that results from this adjustment should be calculated in the taxable period when a taxpayer calculates the amount denied as a deduction for income tax—being the earlier of the time the income tax return is due or is filed.

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[6] Refer sections ND 9, ND 10, ND 11, ND 13 or ND 14 of the Income Tax Act 1994.

FACTORED DEBTS

Sections 26 and 26A

Introduction

Two amendments have been made to section 26 in relation to the treatment of factored debts. The amendments are designed to create parity between the invoice and payments accounting bases and remove opportunities for recharacterising credit sales. Registered persons accounting for GST on a payments basis must pay GST on the remaining book value of a debt when it is factored.

The legislation has also been clarified in respect of debts that are factored on a recourse basis. The assignor may claim a bad debt adjustment if the debt becomes bad after it is returned to the assignor.

Background

Debt-factoring involves the sale of debt to a third party. The nature of such a transaction as a general rule means that it is an exempt supply.

When a taxpayer sold a debt it could have two different outcomes, depending on the basis of accounting the taxpayer used to recognise GST. If the taxpayer accounted for GST on a payments basis, GST was only recognised to the extent that payment had been received. Section 3(4), therefore, required the taxpayer to return GST on any amount received in respect of the assignment.

If the taxpayer accounted for sales on an accrual basis (that is, the invoice or hybrid basis) GST was recognised at the earlier time that payment was received or an invoice was issued. In most cases, any output tax liability on the assignment would have been recognised in an earlier taxable period.

The difference in tax treatment between the accounting bases meant that taxpayers on the payments basis enjoyed a relative tax advantage equal to one-ninth of any discount allowed when the debt was sold.

In the past Inland Revenue had a practice of allowing a bad debt adjustment for the discount on sale if a taxpayer accounted for GST on an accrual basis. This adjustment was allowed to create parity between the accounting bases. In *Case T27*,[7] which concerned the sale of debts from credit card sales, the Taxation Review Authority indicated that this practice was incorrect, since the debts in that case were good debts. Inland Revenue no longer follows this practice.[8]

Case T27 concerned only taxpayers on an accrual basis. Those accounting for GST on a payments basis were still able to receive a tax advantage by, in effect, recharacterising the taxable status of credit sales.

The amendments are directed, therefore, at creating the same tax outcome regardless of accounting basis.

Although the assignment of a debt at a discount does not give rise to any reduction in the GST liability, if a debt becomes bad at a later stage a deduction for that debt ought not to be always precluded. A bad debt deduction is not allowed if the debt has been assigned on a non-recourse basis and becomes bad in the hands of the assignee, since the debt does not relate to a taxable supply by the assignee. However, if the debt is assigned on a recourse basis and becomes bad after being returned to the assignor, a bad debt deduction should be available as the debt relates to a taxable supply by the assignor.

Key features

The new section 26A requires registered persons who account for GST on a payments basis to pay GST on the remaining book value of a debt when it is factored.

Section 26 has also been amended to allow registered persons an input tax credit when a factor exercises a right of recourse and the debt becomes bad after it is returned to the assignor.

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[7] (1997) 18 NZTC 8,188.

[8] *Tax Information Bulletin* Vol 10, No 5 (May 1998) pg 23.

UNINCORPORATED BODIES

Sections 42 and 57

Introduction

A number of changes have been made to the legislation relating to the recovery of an unincorporated body's GST debts and the extent of a member's liability for GST.

Background

Section 42 makes the Commissioner a preferred creditor in relation to GST that is unpaid at the time of bankruptcy, liquidation, or receivership. This ranking is appropriate because input tax credits in relation to a supply may be refunded to a purchaser regardless of whether the vendor pays output tax.

Section 57(3) provides that members of an unincorporated body are liable jointly and severally for all taxes payable by the body while they are members. The estate of a deceased member is severally liable for any unpaid liabilities of the member.

In some areas there is a lack of clarity or a limitation of the scope of the provisions. The amendments address these problems.

Definitions have been removed from section 57 and made applicable to the whole Act. This simplifies the legislation by reducing the number of cross-references in the Act.

Key features

- The preferential status of GST debts recoverable from individual members of an unincorporated body is confirmed.
- The preferential status for unpaid GST debts of an unincorporated body applies if the receiver is appointed other than by court order.
- The liability of a member of an unincorporated body for GST payable will extend beyond the period of membership, but only in respect of liabilities that arise during the period the person was a member.
- The existing requirement to provide written notification to the Commissioner will involve actual receipt of the notice by the Commissioner, and the change in membership will take effect from this date.

SPECIFIED AGENTS

Section 46, 55 and 58

Introduction

Amendments clarify the application of GST in circumstances where a specified agent carries on a taxable activity in the place of an incapacitated registered person.

Background

Section 58 provides that the specified agent of an incapacitated person personally carries on that person's taxable activity during an agency period. The specified agent has all the obligations and liabilities of a registered person carrying on the taxable activity. If the section did not exist, a person making taxable supplies on behalf of another might not be liable to account for GST.

An incapacitated person is defined "as a registered person who dies, or goes into liquidation or receivership or becomes bankrupt or incapacitated". A specified agent is defined as a "person carrying on a taxable activity as the agent, personal representative, liquidator or receiver of an incapacitated person".

In some areas there was a lack of clarity or a limitation of the scope of the provisions.

Key features

Section 58(1A) has been amended to include appointments of receivers to control only part of a taxable activity.

An agency period is deemed to terminate when the taxable activity is no longer carried on by a specified agent, whether a liquidator, receiver or both.

The new section 58(1C) ensures that input tax credits available to an incapacitated person but not claimed by that person in relation to pre-agency supplies can be claimed by the person's specified agent. This is subject to new subsections 46(7) – (9), that allow the Commissioner to set off pre-agency tax debts against pre-agency input tax credits claimed by specified agents.

A number of other amendments have been made to clarify that:

- Section 58(1A) overrides the application of section 5(2).
- A specified agent is not personally liable for any liability incurred on (as well as before) the date of commencement of the agency period.
- The appointment of a specified agent does not affect the membership of a group of registered persons.

GENERAL ANTI-AVOIDANCE PROVISION

Section 76

Introduction

A new general anti-avoidance provision, section 76, has been enacted. The new section 76 is based on the general anti-avoidance provisions contained in sections BG 1 and GB 1 of the Income Tax Act 1994.

Background

The former section 76 had a number of possible limitations to its potential application.

For example, in determining whether tax avoidance had occurred, the old section relied on the subjective test of the taxpayer's intention when entering into an arrangement. In many circumstances this is difficult to determine.

The former section was also possibly limited as a result of the requirement that "the application of the [GST] Act" was defeated. If an arrangement relied on the provisions in the GST Act so as to create a tax advantage it was arguable that the section could not be applied.

Having consistent general anti-avoidance provisions in the GST and Income Tax Acts is desirable as it allows a similar analysis to be used when considering the application of the provisions. Aligning the provisions also allows the case law dealing with the income tax provisions to be used to interpret the GST provisions.

Key features

The new section 76 applies to any arrangement that directly or indirectly has tax avoidance as:

- its purpose or effect, or
- one of its purposes or effects, whether or not another purpose or effect relates to business or family dealings, if the purpose or effect is not merely incidental.

A tax avoidance arrangement is void against the Commissioner for GST purposes. The Commissioner may adjust the amount of tax payable by, or the refund to, a registered person affected by the arrangement to counteract any tax advantage obtained by the person under the arrangement.

"Tax avoidance" has been defined to include:

- a reduction in the liability to pay tax
- a postponement in the liability to pay tax
- an increase in an entitlement to a refund
- an earlier entitlement to a refund
- a reduction in the consideration payable for a supply.

Examples

Secondhand goods

A owns a large tract of land (in his private capacity) worth $9 million, which he acquired in 1980. A wishes to transfer the land to his newly-formed property development company, B, which is registered for GST purposes. As A is a non-registered person and B is acquiring the land for a business purpose, B would be entitled to a secondhand goods input tax credit. However, as A and B are associated persons, the secondhand goods input tax credit B is entitled to, would be limited to the lesser of the GST component (if any) of the original cost to A of the land, one-ninth of the price B pays for the land, or one-ninth of the open market value of the land. Therefore, B would receive a zero input tax credit.

A decides to enlist the help of C, a non-associated, non-registered person, to manufacture a larger input tax credit entitlement. A sells the land to C for $9 million, and C immediately on-sells the land to B for $9 million. B now claims to be entitled to a full input tax credit for one-ninth of the open market value of the land, $1 million, as it has purchased it for a business purpose from a non-associated person.

A has structured the sale of the land in this way for the sole purpose of gaining a greater input tax credit than he would otherwise have been entitled to, and avoiding the associated persons valuation rule for the secondhand goods input tax credit. A purpose or effect (not being merely incidental) of this transaction is tax avoidance—an increase in an entitlement to a refund. Section 76 would apply to void this transaction for GST purposes, and the Commissioner would adjust the amount of tax refundable to B to zero under section 76(3).

Section 10(3)

D (a registered person) and E (a non-registered person) are in a de facto relationship. D wishes to transfer cameras out of his photography business to E. The cameras have a market value of $90,000, and if D sold the cameras directly to E he would have to return GST of $10,000 on the sale. This is because section 10(3) deems the value of a supply between associated persons to be the open market value of that supply.

Instead D sells the cameras to his friend F, who is a non-associated, non-registered person, for $18,000, and returns GST of $2,000 on the sale, on the understanding that F will immediately on-sell the cameras to E for $18,000.

D has structured the sale in this way to reduce his liability to pay GST on the supply of the cameras, by avoiding the associated persons valuation rule in section 10(3). A purpose or effect (not being merely incidental) of this transaction is tax avoidance—a reduction in the liability to pay tax. Section 76 would apply, therefore, to void this transaction for GST purposes, and the Commissioner would adjust the amount of tax payable by D to $10,000 under section 76(3).

OTHER POLICY CHANGES

DEDUCTIBILITY OF GROUP INVESTMENT FUND MANAGEMENT FEES

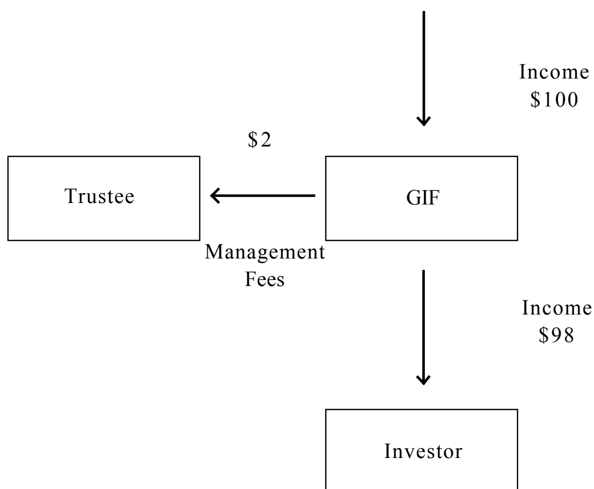
Section DI 3A, Income Tax Act 1994

Introduction

Group investment funds (GIFs) are now able to claim deductions for management fees paid to trustee companies on behalf of GIF investors, reducing compliance and administrative costs.

Background

Under section 32 of the Trustee Companies Act 1967, trustees of GIFs are prohibited from charging management fees to GIFs. Consequently, it has become industry practice for the GIFs' trust deeds to allow the trustee companies to charge the management fees directly to investors. GIFs deduct these fees from amounts due to investors and pay the management fees to the trustee companies on the investors' behalf . GIFs then distribute the net amount owed to investors. This can be shown simply as follows:



As it is the investors who incur the management fees, they should claim a deduction for those fees. However, that approach would impose significant compliance and administrative costs on the GIFs, their investors and Inland Revenue.

In order to reduce those costs, the law has been amended to allow GIFs to claim a deduction for management fees involved.

This is an interim measure. The Government has indicated that the Trustee Companies Act 1967 will be amended to allow trustee companies to charge management fees to GIFs. Until that amendment, the deduction provision ensures that GIFs are not disadvantaged for tax purposes by the current practice.

Key features

Section DI 3A of the Income Tax Act 1994 provides that management fees paid by GIFs to trustee companies on behalf of GIF investors may be claimed as a deduction by the GIF.

An equivalent provision is added to section 211A of the Income Tax Act 1976, to deal with the period from 1 April 1993 to 31 March 1995, before the Income Tax Act 1994 came into force.

Application date

The amendment applies from 1 April 1993.

DEDUCTIONS FOR 1998–1999 BASE PREMIUMS

Sections ED 1A and ED 6A, Income Tax Act 1994

Introduction

To ensure that deductions for the 1998–1999 accident insurance base premiums were not deferred beyond the year in which they were paid, an amendment has been made to provide that when the base premium was paid on or before a discount date, the deduction could be claimed on the discount date. An exception was when the employer and ACC reached an agreement on a due date that fell before the discount date. In these cases the deduction could be claimed on the due date.

Two minor ancillary amendments clarify that:

- Section ED 1A(3) did not apply to those base premiums.
- Interest paid under an instalment plan for payment of those base premiums is deductible on the date when the interest is applied, according to the relevant instalment plan.

Background

Under normal rules, base premiums payable under the Accident Insurance Act 1998 are deductible in the year in which the premium is due and payable. However, under the Accident Insurance (Payments of Base Premiums) Regulations 1999, some 1998–1999 base premiums were due and payable on 30 June 2000, although the regulations contained an incentive (by way of a discount) for payment within 30 days from the date of the invoice.

The effect was that, under normal rules, tax deductions for many of the 1998–1999 accident insurance base premiums would have been deferred until the year ending 31 March 2001—the year in which the date 30 June 2000 falls. This would have been the case even if payment were made before 31 March 2000.

To solve this problem, the Income Tax Act has been amended to provide that, generally, when the payments were made on or before the discount date, a deduction was claimed in the year in which the discount date fell. If payment was not made by the discount date, the deduction was allowed on the due date.

The introduction of the Bill containing this amendment, the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill, in May 2000 alerted taxpayers and their agents that the change was pending. As a result, most of those concerned claimed their deduction for 1998–1999 base premiums in the appropriate year.

Key features

Section ED 1A of the Income Tax Act 1994 has been amended to provide that:

- If a 1998–1999 base premium payment was made on or before a discount date, and the discount date was before the due date, the deduction for the base premium could be claimed in the income year in which the discount date falls.
- Subsection (3) did not apply to those base premiums.

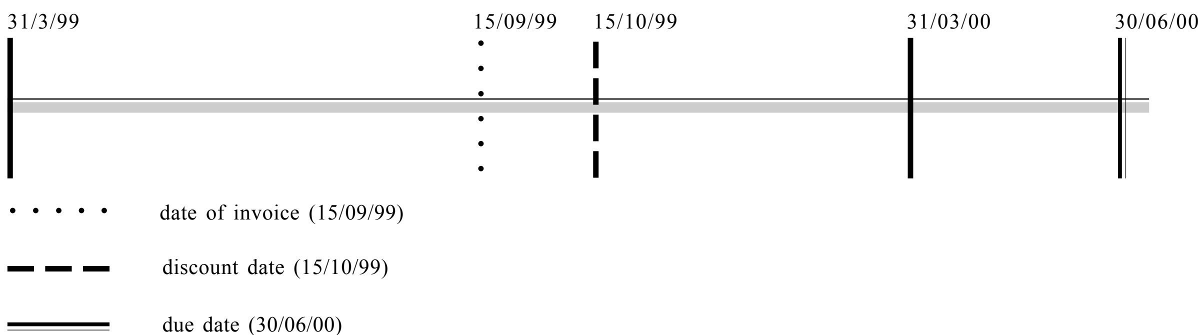
A new section ED 6A provides that interest paid under an instalment plan for payment of a 1998–1999 base premium is deductible on the date when the interest is applied, according to the relevant instalment plan.

Detailed analysis

Example 1 – the general rule

Although the due date for payment was 30 June 2000, employers generally paid the premium on the discount date, which in this example was 15 October 1999. The amendment allowed the employer to claim the deduction on that date. Therefore if the employer has a balance date of 31 March, the deduction could be claimed in the 1999–2000 income year.

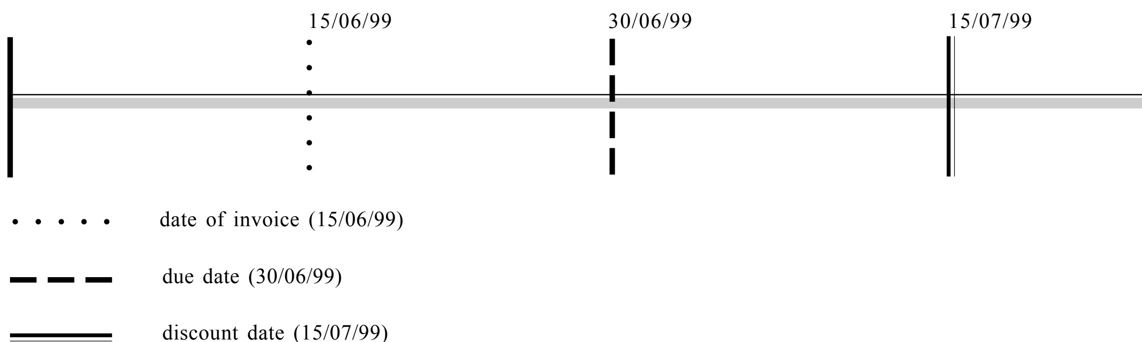
If payment was not made by the discount date, however, a deduction was allowed on the due date, 30 June 2000.



The general rule did not apply, however, when the ACC and the employer agreed to a due date that was before the discount date. Some employers requested that the due date be changed so that it fell within the income year in which the payment was made. The amendment ensures that if a due date was earlier than the discount date, the employer could claim the deduction on the due date.

Example 2 – ACC and employer set a new due date

In this example, because the due date was before the discount date, the deduction was claimed on the due date, 30 June 1999. An employer who has a 30 June balance date would have claimed the deduction in the 1998–1999 income year.



Minor ancillary amendments

Levies and premiums due on terminal tax date

ACC levies and premiums for self-employed persons are paid on the terminal tax date for income tax payments. Although the terminal tax date has been extended for taxpayers with tax agents and an extension of time for filing their income tax returns, the extension does not apply to payment of ACC levies.

Section ED 1A(3) of the Income Tax Act 1994 provides that ACC levies and premiums are due on 7 February each year. In theory, section ED 1A(3) is irrelevant to base premiums because they are never payable on the terminal tax date. Even so, payments of 1998–1999 base premiums due 30 days after an invoice was issued could have been caught by the words of the provision.

Therefore, subsection (3A) to section ED 1A provides that subsection (3) does not apply to 1998–1999 base premiums.

Interest on instalment plans

A further issue relates to daily interest paid under an instalment plan for 1998–1999 base premiums of $2,000 or more. Interest is calculated on the basis of 10% of the amount of premium remaining unpaid after 30 June 2000. The interest is applied at each relevant instalment date.

It was not entirely clear when the interest was deductible for tax purposes. For the sake of clarity, section ED 6A has been amended to provide that interest is deemed to be due and payable on the relevant instalment date when the interest is applied.

Application date

All of the amendments apply to 1998–1999 accident insurance base premiums.

GIFTS OF FINANCIAL ARRANGEMENTS

Sections EH 16(3) (Division 1) and EH 49(1) (Division 2), Income Tax Act 1994
Section 64 J(3), Income Tax Act 1976

The accrual rules have been amended to provide that financial arrangements transferred for nil or inadequate consideration will be treated as having been transferred at market price. This amendment will ensure that the transferor of a financial arrangement that is gifted will not receive a deduction under the accrual rules for the value of the financial arrangement.

Background

Following the decision of the Court of Appeal in *Auckland Harbour Board v CIR* in September 1999, the transferor of a financial arrangement that is gifted could receive a deduction under the accrual rules for the value of the financial arrangement. This result was unintended and is undesirable for two reasons:

- Such a deduction is inconsistent with the monetary limit placed on rebates and deductions for cash gifts.
- A deduction for gifts is inconsistent with the function of the base price adjustment mechanism and allows tax-planning opportunities.

Key features

Sections EH 16(3) (Division 1) and EH 49(1) (Division 2) have been amended to provide that all financial arrangements transferred for inadequate consideration will be treated as having been transferred by the transferor and acquired by the transferee at market price. Previously, the transfer was deemed to be at market price only when the transferor purchased the financial arrangement to sell or dispose of it, or the transferor's business included dealing in financial arrangements.

Section 64 J(3) of the Income Tax Act 1976 has been amended in the same way.

Application date

The amendment applies to all financial arrangements gifted since the implementation of the accrual rules (1986), unless a transferor has claimed a deduction in relation to the transfer in a tax return filed by 16 May 2000 (the date of introduction of the legislation). If the transferor has already claimed a deduction, the existing provisions will apply for both the transferor and the transferee.

FOREIGN TAX CREDITS – ANTI-AVOIDANCE PROVISIONS

Sections GB 1(2A) to (2C), LC 1A, LC 1(3A) to (3B), LC 3, and LC 13(b), Income Tax Act 1994

Introduction

Anti-avoidance amendments have been made to shore up the foreign tax credit rules against abuse. They deny a foreign tax credit and require disclosure, when an equivalent benefit is provided to the taxpayer or an associate, and put beyond doubt that the general anti-avoidance provisions are effective against tax avoidance arrangements that involve tax credits.

The amendments also allow for the update through Order in Council of the schedule of countries with abusive tax practices for which New Zealand provides only limited recognition of taxes paid. These measures supersede equivalent provisions in the Income Tax Amendment Bill 1994, which has since lapsed.

Background

The amendments strengthen the anti-avoidance provisions applying to foreign tax credits in the Income Tax Act 1994. Specific anti-avoidance provisions are generally easier to interpret and apply than the general anti-avoidance provisions (sections BG 1/GB 1) so their application is more certain. For this reason they are usually preferable to reliance on the general provisions, which are primarily intended to perform a backstop role. Similar measures are contained in regulation 1.901 of the United States Internal Revenue Code, which are designed to ensure that a credit is not allowed when the taxpayer has not incurred an actual economic loss. This regulation was considered necessary to stem avoidance in the United States and it is appropriate for New Zealand to have similar provisions.

Key features

- New subsections GB 1(2A) to (2C) of the Income Tax Act 1994 enable Inland Revenue to disallow tax credits in whole or in part, if the credits are part of an avoidance arrangement.
- New subsections LC 1(3A) to (3B) ensure that when a refund of foreign tax has been received either by taxpayers or their associates, a tax credit will not be allowed against New Zealand tax.
- Section LC 13(b) is amended to oblige taxpayers who are claiming tax credits for foreign tax paid, to disclose to Inland Revenue any refunds of foreign tax paid to them or an associate.
- Section LC 3 is amended to enable full recovery of any foreign tax credit allowed in New Zealand when the underlying foreign tax has been refunded.
- New Section LC 1A allows amendment to Schedule 6 by Order in Council, rather than legislative change. New Zealand does not allow tax credits for foreign taxes paid in countries listed in Schedule 6, as these countries have abusive tax practices. This will expedite the process by which countries can be added and taken off the list.

Application date

The amendments apply from 5 April 2000, the date of the Government's announcement on this legislation.

ATTRIBUTION OF INCOME

Sections CD 7, CF 6(1), DJ 19, EN 8, EO 6, GC 14B – GC 14E, MB 9A, ME 4(1)(ab), ME 4(2)(ab), ME 5(1)(ia), ME 5(2)(ba), OB 1 and OB 2, Income Tax Act 1994

Introduction

The new attribution rule is aimed at ensuring that individuals in specified situations have to pay the 39% tax rate in respect of the income over $60,000 a year that results from their personal effort. The 39% rate could be bypassed by interposing a company, trust or partnership between the individual and the entity that uses the personal services. Although an intermediary can be interposed for a variety of reasons, a common effect of doing so is a lower overall tax liability. In defined circumstances the rule will attribute income from personal effort to the individual who provides the personal services.

The attribution rule applies for income tax purposes only and does not have any impact on the commercial and/or legal consequences of transactions entered into by the interposed entity. The attribution rule can be avoided when the income from the services is paid as salary, partnership profits, beneficiary income or as dividends to the individual(s) who provided the services.

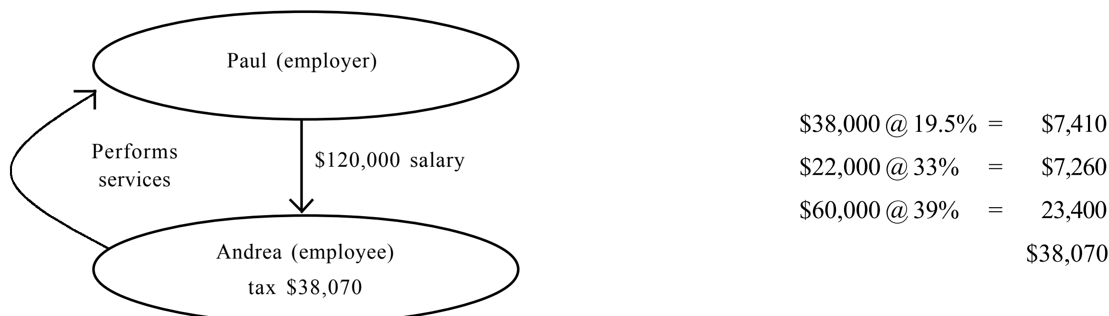
Background

The recent increase in the top personal tax rate to 39% provided an incentive for employees and contractors to arrange their affairs so that they avoided paying it. One of the responses was that simple avoidance schemes were targeted at people who would normally be regarded as employees.

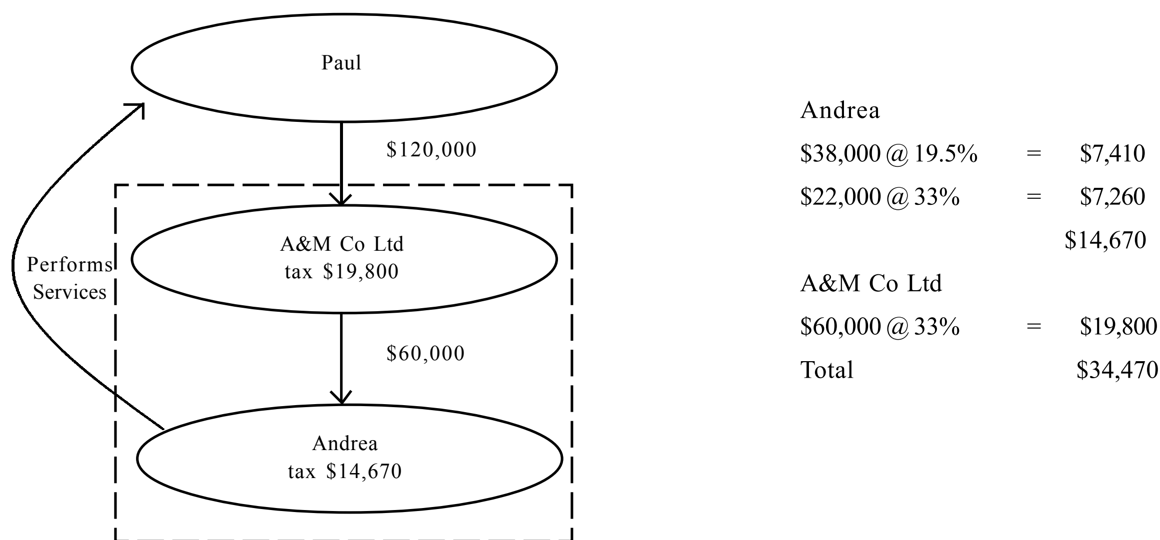
The legislation addresses this problem by providing explicit rules and follows the scheme of the proposal announced by the Government on 30 March 2000.

How The Schemes Work

In this simple example, Andrea is employed by Paul who pays her an annual salary of $120,000. Before 1 April 2000, Andrea's annual tax liability would be $34,470. However, with the top tax rate increasing to 39%, her annual tax liability after 1 April 2000 would increase to $38,070:



Andrea now has a greater incentive to structure her employment arrangement to reduce her tax liability. By forming and interposing a company, A&M Co Ltd, between herself and Paul, and drawing only $60,000 income from the company, the 39% tax rate could be avoided, and the total tax levied on the $120,000 income would remain at $34,470:



The attribution rule will operate to ensure that the full $120,000 income is attributed to Andrea, as the person who has performed the personal services giving rise to the income.

Key features

The main legislation is new sections GC 14B to GC 14E of the Income Tax Act 1994.

The attribution rule is generally intended to apply when:

- an person (person C) has structured his or her relationship
- so that an entity (person B) is between themselves
- and their service purchaser (person A)

if the result is that income is diverted, or alienated, to an associated person.

The effect of the attribution rule is, in defined circumstances, to attribute person B's net income from services to person C, the individual who personally provided the services.

The use of net income means that any deductible expenses incurred by person B will still be deductible.

The rule applies only when five key criteria are met:

- The person who personally provides the services, person C, and the interposed entity, person B, must be associated persons.
- At least 80% of the gross income from the services of person B must be derived from a single source, person A, or persons associated with A.
- At least 80% of the gross income from the services of person B must relate to the services personally provided by person C and related persons.
- Person C must have income over $60,000 after the application of the attribution rules.
- Substantial business assets are not a necessary part of the business structure that is used to derive the income from services.

Substantial business assets are defined as being depreciable assets whose cost is the lesser of $75,000 or 25% or more of gross income from services. Up to 20% private use is allowed.

The amount to be attributed is the lesser of person B's net income from services, or person B's net income, with allowance being made to reduce the amount by income distributed by person B to person C in the form of beneficiary or partner income, or as dividends.

If the intermediary is a company, losses transferred from other companies may not be used. Likewise, losses brought forward may not be used by a company or trust intermediary, except when the sole activity of the entity is the derivation of income from the provision of personal services.

The amount attributed will be deemed to be gross income of person C and a deductible expense of person B.

If person B is a company or a trust, special rules can apply with the objective of ensuring there is no double taxation.

If the amount that would otherwise be attributed under this rule is less than $5,000, the rule does not apply.

Application date

The attribution rule applies from the income year beginning 1 April 2000, to coincide with the date on which the 39% top personal tax rate took effect. Arrangements made before 1 April 2000 are subject to the rule.

Detailed analysis

The main provisions are new sections GC 14B to GC 14E:

- Section GC 14B defines the circumstances in which the rule will apply.
- Section GC 14C inserts definitions.
- Section GC 14D quantifies the amount to be attributed.
- Section GC 14E provides for the $5,000 minimum threshold.

Section GC 14B – the application

Subsection (1) sets out the general proposition that when person B provides services personally performed by person C, and persons B and C are associated, the attribution rule could apply.

The words "services are personally performed" indicate that a natural person performs the services.

Criteria to apply the rule

Subsection (2) sets out the criteria to be met before the rule applies:

- At least 80% of the gross income from services of person B must be derived from a single source, person A, or persons associated with A.
- At least 80% of the gross income from the services of person B must relate to the services personally provided by person C, and persons related (within the second degree of relationship) to person C.
- Person C's net income after the attribution rule applies is more than $60,000.
- Substantial business assets are not a necessary part of the business structure that is used to derive the income from services.

The 80% level is arbitrary, but has been set to provide a suitable balance between what might or might not otherwise be a genuine employer–employee situation.

Although this item refers to person C in the singular, if the attribution rule applies there could be more than one person C. For example, if a husband and wife jointly provide services that are subject to the attribution rule, income will be attributed to both of them.

Subsection (3) provides the rule does not apply when persons B and C are both non-resident or when the personal services are essential support for a product supplied by person B.

Section GC 14C – the definitions

The main definitions are:

"Associated persons"

Persons are associated for the purposes of the 80% of income from one source and associated persons test if they meet the criteria of sections OD 7 or OD 8(3). There are two exceptions to this:

- public authorities are not associated with each other for this rule, and
- when person C cannot reasonably be expected to know that the two persons are associated, the associated persons test does not apply.

"Income for the $60,000 test"

This income includes the value of fringe benefits provided to person C by any associated persons.

"Substantial business assets"

Subsections (6) to (9) provide a definition of "substantial business assets" as being depreciable property that costs the lesser of:

- $75,000, or
- 25% or more of gross income from services

so long as the property is used privately for 20% or less of total use.

This recognises that in most small enterprises there will usually be some private use. Private use is measured, as appropriate, as either:

- days in which fringe benefit tax is payable as a percentage of days the asset is leased or owned, or
- the proportion of operating expenditure that is non-deductible in relation to the total operating expenditure on the asset.

For this rule, "assets" includes assets subject to a hire purchase or specified or finance lease.

The substantial business assets test is designed to recognise that when substantial business assets are used there should also be a return on capital that does not relate to the services personally performed by person C. For example, the owner-driver of a petrol tanker should receive a return based on both assets employed and on labour provided.

Section GC 14D – the calculations

Person B may have more than one source of income. For example, the one entity may have a share dealing business and, as well, be providing professional accounting services to one user. On the assumption that the qualifying criteria are met in relation to the accounting services income, the issue then becomes a question of how much to attribute.

Clearly, one of the relevant amounts is the determination of the net income from the services. Equally clearly, using the preceding example, it is appropriate to ignore any net income from the share dealing activity. However, if the share dealing activity makes a loss for any one year, it is reasonable to allow the loss to reduce the services income for that year as in many cases this loss would be accessed and used anyway.

It also is appropriate to allow any losses brought forward if those losses arise only from the activity of selling personal services. It is envisaged that this will mainly be used for start-up costs when the start-up occurs at the end of a year.

Therefore section GC 14D(1) requires that the amount to be attributed is the lesser of:

- person B's net income from services (specifically, "calculated as if their only gross income were derived from personal services"), or
- person B's net income, or
- person B's net income reduced by losses brought forward when those losses relate to the activity of selling personal services.

The "net income from services" is after allowing for what are loosely termed "head office expenses"—the expenses of running the business, such as accounting and company office fees. It is calculated as the expenses person B would have incurred had the non-services gross income not been derived. In other words, the marginal costs of deriving the non-services gross income are the only costs that are "removed".

Subsection (2) qualifies the calculations when person B is the trustee of a trust or a partnership. If person B is a trustee, the calculations for person B must be completed as if the trust had not distributed any of its income to beneficiaries. If it is a partnership, person B is to be regarded as a taxpayer. Ordinarily partnerships do not have net income—rather, their income and expenditure are attributed to the partners.

Furthermore, subsection (3) provides that person B's net income from services allows that the monetary remuneration package paid to or on behalf of person C is an expense of deriving its "net income from services". This package includes wages and salary, directors fees, attributable fringe benefits provided and fringe benefit tax. This means that there is no need to apportion remuneration paid to the service provider.

In a similar fashion, subsection (4) provides that any amount to be attributed by person B is reduced:

- if person B is a trust, by the amount of any beneficiary income distributed to person C
- if person B is a partnership, by the amount of any partnership income received by person C
- if person B is a company, by the amount of dividends paid to person C during the year, or within six months afterwards, in respect of the year's income.

Although it is not possible to trace income through a company to a dividend paid to its owners, it will be acceptable, so long as the facts do not otherwise indicate, that the resolution declaring the dividend refers to the year's income to which it relates. Obviously, any other method that identifies the source of the dividend is also acceptable.

Any dividends paid by person B from the income before it was attributed will not be reversed as a result of applying this attribution rule.

If a partner provides administrative services to a partnership that is subject to the rule, subsection (5) provides that the amount to be attributed may be reduced by the market value of the services provided.

Subsection (6) provides that if the amount paid by person B to person C by way of beneficiary or partnership income, or by dividend, is greater than the amount to be attributed, the attribution rule does not apply.

There is a potential double tax issue in relation to trusts. Subsection (7) ensures that in practice this does not arise where the attribution rule applies.

Subsection (8) provides that if there is more than one person C in relation to a person B (for example, husband and wife have both provided services) the amount to be attributed must be fairly divided between them, based on the relative value of work they have performed. Although this is not likely to apply very often, any reasonable basis of apportionment will be acceptable.

Structures involving multiple entities

In relation to one person C there may be more than one person B. In this case the rule still works, however, because it considers each person B separately and focuses on those persons B that have net income. Each person B will have to consider whether the rule requires it to make an attribution of income.

Section GC 14E

This section provides the $5,000 minimum threshold. If the amount calculated under section GC 14C is less than $5,000, no attribution need be made. When, in relation to any one service provider (person C) there is more than one person B, the $5,000 threshold applies only once.

Double tax of companies

Amendments have been made to the imputation rules in an attempt to address the double taxation that arises when the intermediary is a company and the attribution rule applies. Although the company obtains a tax deduction for the amount attributed, it does not have any imputation credits to attach to this amount when it is distributed as a dividend.

An extra imputation credit at 33% of the amount attributed is allowed to prevent the double taxation that would otherwise occur when this income is paid as a dividend to the shareholders. Associated with this is a special rule to cancel this extra credit when the financial statements are adjusted to reflect the amount attributed. Amendments to sections ME 4 and ME 5 provide the extra credit and allow for it to be cancelled where appropriate.

This extra credit at 33% is not the complete answer, however. If the amount attributed was $100,000, imputation credits of $33,000 are provided by the amendment as it is currently stated. However, to fully impute the dividend (so as to prevent the double taxation effect) $49,250 of credits should attach to the $100,000 dividend. This anomaly will be corrected.

At this stage the only assurance that can be given is that the result will not be double tax. Any fix will apply to the 2000–2001 income year and is likely to be part of the first tax bill to be introduced next year.

Other changes

Sections CD 7, DJ 19, EN 8 and EO 6 are inserted to provide that any amount attributed is gross income of person C and an allowable deduction to person B respectively in the relevant income year. This has the effect of reducing person B's income by the amount attributed and also helps to prevent double tax.

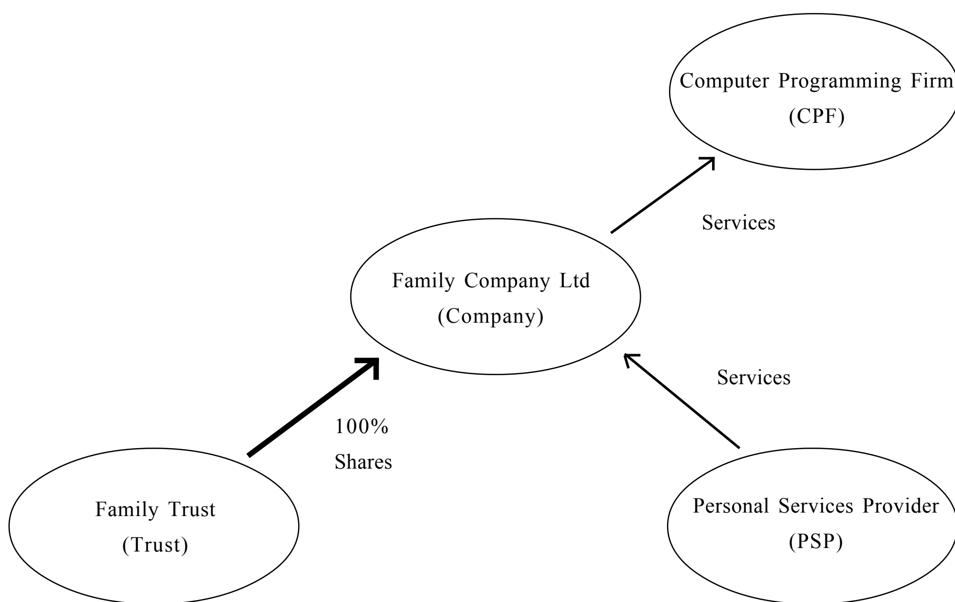
The section OB 1 definition of "relative" was extended to provide that for the purpose of the attribution rules the definition is generally limited to relatives of the first and second degrees of relationship.

The section OB 2 definition of "source deduction payment" was amended to ensure that amounts attributed are not source deductions, so they are not subject to tax at source. Rather, person C has to account for the income tax.

Section CF 6(1) was amended to require that dividend amounts for ascertaining the amount to be attributed include imputation credits.

New section MB 9A was inserted to allow transfers of provisional tax between the intermediary and the personal service provider, and vice versa, in circumstances where the attribution rule may apply. This was to ensure that taxpayers potentially affected by the attribution rule are not disadvantaged when the tax has been paid by one party but the income is borne by the other party. The word "may" was used to ensure that when taxpayers have acted in the presumption that the attribution applies, or it applies when they were not expecting it to, transfers of overpaid provisional tax are allowed.

Example 1: A company as the intermediary



Company, incorporated on 1 April 2000, undertakes two different activities in the year to 31 March 2001. First it provides computer programming services to CPF. For this it is paid $155,000. Company incurs $3,500 direct costs in relation to this. No assets are required to derive this income.

Second, Company has a computer hardware sales business. The net income for the year for this business is:

Gross income		$300,000
Less purchases		$200,000
		$100,000
Less Expenses		
General	$5,000	
Vehicle	$15,000	
Wages (non-related person)	$40,000	$60,000
Net income of this business		$40,000

PSP puts five hours a week into managing this business.

PSP draws an annual salary of $80,000. Company's administration costs (accounting and company office fees) are $1,500.

The net income for Company for the year to 31 March 2001 is:

Gross income from services		$155,000
Gross income from sales		$300,000
		$455,000
Less Expenses		
Administration	$1,500	
Costs (services income)	$3,500	
General (sales)	$5,000	
Purchases	$200,000	
Salary to PSP	$80,000	
Vehicle (sales)	$15,000	
Wages (sales)	$ 40,000	$345,000
Net taxable income		$110,000
Provisional Tax Paid by Company in the 2001 income year	$30,000	
PSP's income before attribution	$80,000	(salary)
PAYE deducted (because PSP is not a shareholder in Company, PAYE must be accounted for)	$22,470	
Dividend paid by Company to Trust on 31 March 2001 (fully imputed)	$50,000	plus credits

Result

The attribution rule cannot apply to the computer hardware sales business because this business does not provide services (section GC 14B). Even if it provided services that were essential support to the hardware sales the services would not be subject to the attribution rule (section GC 14B(3)(b)).

The attribution rule (sections GC 14B and GC 14C) will apply to the income Company derives from CPF if:

- PSP is associated with Trust.
- At least 80% of Company's service income is from one source—all of it is from CPF.
- At least 80% of Company's service income relates to services provided by PSP—all of Company's service income is derived from PSP's efforts.
- PSP has income over $60,000 after application of the attribution—this condition is met as PSP's income is at least $80,000.
- Substantial assets are not required—in this example the assets clearly are not substantial.

Thus all the tests are met.

The next step is to determine the amount to be attributed according to section GC 14D.

Services income		$155,000
Less Expenses		
Administration	$1,500	
Direct Costs	$3,500	
Wages to PSP	$80,000	$85,000
Amount to be attributed		$70,000

Note that all of the PSP's salary can be allocated against the service income, as can all the administration costs (section GC 14D(3)(a)).

This leaves Company with net taxable income after attribution of $40,000 ($110,000 less $70,000) (sections DJ 19 and EO 6).

Tax on this at 33% is $13,200. Thus Company has overpaid its provisional tax by $16,800. This overpayment can be transferred to PSP at the relevant provisional tax payment dates (section MB 9A).

Presuming this transfer is made, PSP's position is:

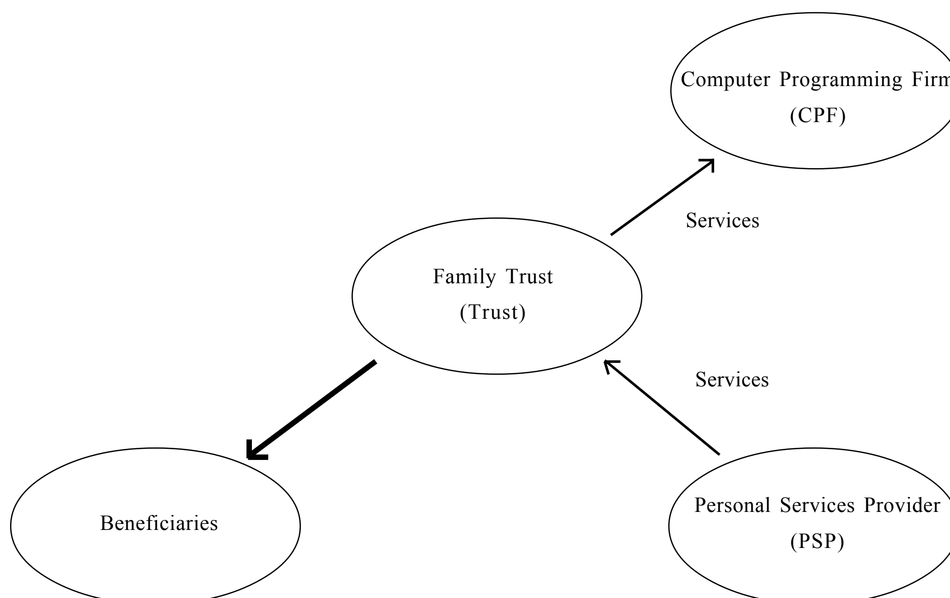
Salary		$80,000
Amount attributed (sections CD 7 and EM 8)		$70,000
Taxable Income		$150,000
Taxation thereon		$49,770
Less PAYE	$22,470	
Provisional tax transferred	$16,800	$39,270
Balance to pay		$10,500

Because PSP's RIT is below $30,000, she will not be subject to use-of-money interest.

Company receives an extra imputation credit of $23,100, being 33% of the amount attributed (sections ME 4(1)(ab) and ME 4(2)(ab)). Thus its ICA entries for the year to 31 March 2001 are:

Debit		Credit	
Provisional tax transferred	$16,800	Provisional tax paid	$30,000
Credits attached to dividend	$24,625	Extra credit	$23,100
	$41,425		$53,100
		Credit balance at 31/3/01	$11,675

Example 2: A trust as intermediary



This is based on example 1, with the same income and expenses from services, including PSP's $80,000 salary. However, there is no income from hardware sales.

Trust has paid $13,650 in provisional tax.

Trust equally allocates the income (all from services) to PSP's husband and their two children and, for the sake of this example, deducts tax from this at 19.5%.

It is then realised that the attribution rule applies.

Again the amount to be attributed is $70,000, in this case the pre-tax income of Trust (section GC 14D(1) and (3)(a)). This is calculated before the distribution to beneficiaries (section GC 14D(2)(a)).

Again the Trust receives a deduction of the amount attributed, leaving it with nil net income (before the distribution to the beneficiaries).

The beneficiaries' income is, therefore, also reduced to nil (section GC 14D(7)).

Trust's tax paid of $13,650 can then be transferred to PSP as at the dates it was paid.

REBATES PAID BY THE NEW ZEALAND DAIRY BOARD

Section HF 2, Income Tax Act 1994
Section 199A, Income Tax Act 1976

Introduction

A tax deduction will be allowed for all rebates paid by the New Zealand Dairy Board to co-operative dairy companies between the 1988–89 income year and the 2003–2004 income year. From the 2004–2005 income year, the total amount in rebate deductions claimed by the Dairy Board for the year cannot exceed its net income (taxable profits) for that year.

Background

The Dairy Industry Restructuring Act 1999 contained a tax provision allowing the Dairy Board to claim a deduction for all rebates paid to co-operative dairy companies from when it first became subject to tax, until the date it ceased to be a statutory producer board as part of the dairy industry reforms. A prerequisite of the Restructuring Act coming into force was that an approved dairy co-operative amalgamation occur before 1 September 2000. This amalgamation has not occurred.

The amendment allows this tax treatment of rebates paid by the Dairy Board to continue until the 2003–2004 income year, to allow the dairy industry time to work through the issues associated with restructuring. The provision relating to the tax treatment of rebates was intrinsically linked to the restructuring proposal contained in the Dairy Industry Restructuring Act, and it is appropriate that this link continue for a period of time to allow restructuring.

Key features

New section 199A of the Income Tax Act 1976 allows a deduction for all rebates paid by the Dairy Board to co-operative dairy companies for the income years 1988–1989 to 1994–1995 (both income years inclusive).

New section HF 2 of the Income Tax Act 1994:

- allows a deduction for all rebates paid by the Dairy Board to co-operative dairy companies for the income years 1995–1996 to 2003–2004 (both income years inclusive); and
- limits, from the 2004–2005 income year, the amount in deductions for rebates that the Dairy Board can claim to its net income (taxable profits) for that income year.

Application date

The amendments to the Income Tax Act 1976 allow a deduction for all rebates paid by the Dairy Board to co-operative dairy companies for the income years 1988–89 to 1994–95. The amendments to the Income Tax Act 1994 allow a deduction for all rebates paid by the Dairy Board to co-operative dairy companies for the income years 1995–1996 to 2003–2004. The limit on the amount the Dairy Board can claim in rebate deductions applies from the 2004–2005 income year.

TAX SIMPLIFICATION FOR WAGE AND SALARY EARNERS

Sections KC 5, KD 4, KD 5, KD 7, NC 17 and OB 1, Income Tax Act 1994
Sections 41A, 80B, 80C, 80F, 80H and 184A, Tax Administration Act 1994

Introduction

A number of policy changes and remedial amendments have been made to support the tax simplification measures enacted in 1998.

The main changes:

- allow family tax credits to be claimed in certain circumstances without providing IRD numbers or evidence of employment income
- allow rebates to be claimed early or late in special circumstances
- extend the deadline for claiming rebates in relation to the 1999–2000 income year to 31 December 2000
- make the return filing period for income statements consistent with other returns by agents, and
- give taxpayers who receive an income statement issued after the due date for tax, two months to review it before it becomes an assessment.

Background

Major tax simplification initiatives were enacted by the Taxation (Simplification and Other Remedial Matters) Act 1998, which removed the need for wage and salary taxpayers to file IR 5 returns. That legislation included changes to the process for claiming rebates for donations and payments for childcare and housekeeping.

These later amendments make a number of minor enhancements and remedial changes identified during the process of implementing the original simplification initiatives.

Key features

Family Assistance

Families with low employment income are entitled to tax credits. Three amendments to the Income Tax Act 1994 have made it simpler for families to apply for tax credits and increase the efficiency with which the credits are administered.

Children for whom family tax credits are claimed must have tax file numbers. This is a compliance measure designed to reduce the amount of information that recipients need to provide. However, in circumstances where the child in relation to whom the application is made has been given up for adoption or has died, that compliance cost benefit may be outweighed by the stress of payments being delayed until a tax file number has been provided.

Section KD 4(2A) is replaced for the 1999–2000 income year and again for the 2000–2001 and subsequent income years. These changes give Inland Revenue the power to accept birth certificates or other acceptable forms of identification to verify the existence of the child when processing claims at the end of the year. The newly acceptable forms of identification are intended to be consistent with the requirements under the child support rules. Section KD 5(2)(c) is also replaced and a new section KD 5(2AB) has been inserted to create the same effect for interim instalments of family tax credits.

Applicants for interim instalments of family tax credits are required to provide evidence of their income from employment to verify how much they earn. Inland Revenue already collects this information, for applicants with only wage and salary income, from employer monthly schedules. Therefore, the new section KD 5(2AA) removes the need to provide evidence of employment if the Commissioner already has that information.

Inland Revenue is required to provide a certificate showing the amount of interim payments of Family Assistance paid to IR 3 taxpayers by 20 April following the end of the year in which the payments are made. Since this requirement was enacted, Inland Revenue has designed administrative processes that provide the certificate to taxpayers, together with related documents, within a month of its being due. Therefore section KD 7(2A)(a) has been amended so that the certificate is now due on 20 May following the year in which the payments are made. The purpose of the delay is to prevent any confusion that might result from duplicating the information and to provide the necessary information to taxpayers at a more appropriate time.

The amendments support processes that began with the start of the 1999–2000 income year, and apply from that time.

Rebates

Tax agents who claim rebates for donations are required to send Inland Revenue receipts evidencing the payments. In practice, this has been difficult for agents who prefer to see the receipts and arrange for them to be retained. To simplify the new rebate claim process, the new section KC 5(3AA) of the Income Tax Act 1994 exempts agents from the need to return receipts evidencing donations. Instead, agents will be required to see the receipts, and the receipts must be retained for four years following the income year to which the claim relates.

To further simplify the rebate claim process, the definition of "tax" in section 184A(5) has been replaced so that rebates must be direct credited to a bank account.

Both these changes apply from when the new rebate claim process began.

New sections 41A(6AA) and (6AB) in the Tax Administration Act 1994 allow rebates for donations and payments for childcare and housekeeping to be claimed, in special circumstances, before or after the rebate claim period. Previously, early balance date and standard balance date taxpayers had to claim rebates between 1 April and 30 September following the income year in which the payments were made. This restriction significantly disadvantaged certain taxpayers, such as those who intended to leave the country before the end of the year.

Inland Revenue will process early and late rebate claims only under special circumstances. Those circumstances must be such that having to make their claim during the claim period would significantly disadvantage or inconvenience the taxpayer. Forgetting to claim within the claim period, or delaying it until an income tax return is filed under an extension of time arrangement, are not examples of special circumstances.

Taxpayers who will be eligible to claim a rebate early include:

- those who will be outside the country for most of the rebate claim period, and
- trustees of a deceased person's estate who wish to wind up the estate.

Rebates can be claimed late, for example, when a taxpayer has been:

- out of the country during most of the rebate claim period, or
- incapacitated for most of the rebate claim period.

In special circumstances rebates can be claimed early or late for payments and gifts made in the 1999–2000 and future income years.

Because the process to claim rebates is new, the rebate claim period for applications made in respect of the 1999–2000 income year has been temporarily extended by three months to 31 December 2000. Although most people who wanted to claim rebates would probably have done so by late September, the extension gives taxpayers and their agents more time to adapt to the new process. Section 41A has been amended to give effect to the temporary extension. The rebate claim period for subsequent years will be six months.

The reference to "rebates allowed" under section KF 1(2) and (3) has been removed from the definition of "refundable rebate" in section OB 1 of the Income Tax Act 1994 because it is redundant. This change is effective from 10 October 2000.

Due date for paying income tax

Taxpayers with agents are generally allowed to pay their income tax two months later than other taxpayers. When the tax simplification reforms were legislated, this extension was inadvertently omitted for taxpayers who receive an income statement. Section NC 17(2)(b) of the Income Tax Act 1994 has been replaced to make the return filing period for income statements consistent with other returns by agents. A new subsection (3) has been added to section NC 17 to prevent ambiguities arising about the separate application of paragraphs (a) and (b) in section NC 17(2).

Consequential amendments have been made to sections 80B, 80C, 80F and 80H of the Tax Administration Act 1994. The amendments apply from the 1999–2000 income year.

Income statements

Income statements become assessments of tax liability at the time that income tax is due. Although statements are generally expected to be issued well before the day that income tax is due, some may be issued after that date. Those statements were deemed to be assessments before taxpayers had a chance to review and correct them.

The new section 80H(6) of the Tax Administration Act 1994 prevents an income statement that is issued after the due date for tax from becoming an assessment until two months after it is issued.

This amendment is effective from the 1999–2000 income year.

RWT ON INTEREST PAID BY INLAND REVENUE

Section NF 1(3A), Income Tax Act 1994

Introduction

The law has been clarified to ensure that resident withholding tax on interest paid by Inland Revenue on overpayments of tax is correctly deducted.

Background

Resident withholding tax must be deducted from interest paid by Inland Revenue. If the underlying overpayment of tax is revised upwards, interest paid with respect to that overpayment is recalculated. Previously, the legislation was not clear about whether the resident withholding tax rules required tax to be deducted from both interest payments, which could have led to over-deduction of resident withholding tax.

Key feature

The new section NF 1(3A) requires Inland Revenue to take into account interest that has previously been calculated in relation to the same underlying overpayment.

Application date

The amendment applies from the 1999–2000 income year.

CONFIRMATION OF ANNUAL INCOME TAX RATES FOR 2000–2001

Schedule 1, Income Tax Act 1994

The income tax rates for the 2000–2001 income year have been confirmed as follows:

Policyholder income	33 cents for every $1 of schedular taxable income
Maori authorities	25 cents for every $1 of taxable income
Undistributed rents, royalties and interest of the Maori Trustee	25 cents for every $1 of taxable income
Companies, public authorities and local authorities	33 cents for every $1 of taxable income
Trustee income (including that of trustees of superannuation funds)	33 cents for every $1 of taxable income
Trustees of group investment funds	33 cents for every $1 of schedular taxable in respect of category A income
Taxable distributions from non-qualifying trusts	45 cents for every $1 of taxable distribution
Other taxpayers (including individuals)	
– Income not exceeding $38,000	19.5 cents for every $1 of taxable income
– Income exceeding $38,000 but not exceeding $60,000	33 cents for every $1 of taxable income
– Income exceeding $60,000	39 cents for every $1 of taxable income
Specified superannuation contribution withholding tax	39 cents for every $1 of the contribution where the employee has made an election under section NE 2AA
	33 cents for every $1 of contribution where no such election is made.

The rates apply for the 2000–2001 income year.

TAX SIMPLIFICATION FOR BUSINESSES

Sections 3, 139B, 176, 177 and 183C, Tax Administration Act 1994

Introduction

Three tax simplification measures have been introduced to help taxpayers meet their outstanding tax obligations.

- The incremental penalty for late payment of tax has been reduced.
- The grace period from use-of-money interest that follows the issue of a statement of account for overdue tax has been increased.
- The types of taxes that can be remitted or be paid under an instalment arrangement have been extended to apply to all taxes, and the processes for applying those relief provisions have been streamlined.

Background

The changes are in response to the concerns expressed during last year's inquiry into the powers and operations of Inland Revenue by Parliament's Finance and Expenditure Committee. They were presented as proposals in *Less Taxing Tax,* a discussion document released in September last year. Other proposals from the discussion document were enacted as part of the Taxation (FBT, SSCWT and Remedial Matters) Act 2000 or are included in the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Bill, introduced in October this year.

Key features

Incremental penalty for late payment of tax

Section 139B(2) has been amended to reduce the incremental penalty for late payment of tax from 2% to 1%.

The incremental late payment penalty is designed to provide a clear, continuing incentive to pay overdue tax. Although the penalty must be significant enough to create a preference for paying Inland Revenue over trade creditors, and so complying taxpayers can see that non-compliance is punished, it should not be so large that it exceeds the levels necessary to achieve its objective.

Reducing the incremental penalty for late payment of tax is intended to increase the fairness and integrity of the tax system. The reduction will prevent penalties accumulating that are perceived to be out of proportion to the underlying tax debt.

The amendment applies to late payment penalties imposed on and after 1 April 2001.

Grace period for use-of-money interest

Section 183C(4) has been amended to increase the grace period from use-of-money interest from fifteen to thirty days. Section 183C(5) is consequentially amended.

Use-of-money interest is applied on overdue tax payments to compensate the Government for the tax deferral. It is calculated on a daily basis. To give taxpayers some certainty about how much they owe, the interest applicable to the period between the issue of a statement of account and when the payment is made, can be cancelled if the payment is made within fifteen days of the statement being issued.

Extending the grace period to 30 days will mean that taxpayers and their agents will have significantly longer in which to make payments with certainty about the amount owed.

The amendments apply to statements of account issued on or after 1 April 2001.

Extending relief to all tax types in the case of serious hardship or financial difficulty

A new definition of "tax" is inserted into section 3(1) for the purposes of the provisions that provide relief in the case of serious hardship and financial difficulty. The new definition includes all taxes except the approved issuer levy, financial support as defined in the Child Support Act 1991 and a repayment obligation as defined in the Student Loan Scheme Act 1992.

The relief provisions previously applied only to income tax and fringe benefit tax. In practice, taxpayers face serious hardship and financial difficulties in meeting other tax obligations. In those cases Inland Revenue has been using "care and management" authority to provide a measure of relief. Section 176(7) limited the application of that relief in cases of serious hardship to income tax and fringe benefit tax. It has been repealed. Section 177 has been rewritten to achieve the same effect in cases of financial difficulty.

The extension will provide greater clarity and transparency of processes that deal with taxpayers whose circumstances are stressful, and create a more coherent package of relief provisions. It applies to applications for relief made on or after 1 April 2001 regardless of the due date of the underlying tax.

Removing the need for ministerial approval to remit or refund amounts over $50,000

Section 176(6) required applications for remission, or refund for amounts over $50,000 in the case of serious hardship to be approved by the Minister of Finance. That provision has been repealed. Section 177(5) required applications for remission or instalment arrangement for amounts over $50,000 in the case of financial difficulties to be approved by the Minister of Finance, either specifically or as a class of case. The rewrite of section 177 has removed that requirement.

Awaiting ministerial approval can be a time-consuming procedure that causes stress and anxiety for taxpayers. The delay may often affect the taxpayer's economic circumstances and may act to reduce revenue collection. It is also inconsistent with the separation of the Commissioner's statutory role of day-to-day tax administration from the Minister's role of political oversight.

The amendments apply from 1 April 2001.

Applications for instalment arrangements by telephone

Section 177(1) has been amended and new section 177(1A) inserted, so that applications for relief in the case of financial difficulty do not have to be made in writing, if the relief sought is by way of an instalment arrangement. The amendment will allow Inland Revenue call centres to process such applications.

The amendments apply from 10 October 2000.

REMEDIAL AMENDMENTS

TERMINOLOGY IN OTHER PROVISIONS APPLYING TO FINANCIAL ARRANGEMENTS

Section EH 18, Income Tax Act 1994

Section EH 18 has been amended to clarify its intended effect. The amendment to section EH 18(1) ensures that, in relation to Division 1 financial arrangements, the provisions of the Income Tax Act 1994 that were amended by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 to reflect terminology changes in the accrual rules, and the sections referred to in those provisions, continue to apply as they did before the enactment of the 1999 Act.

Section EH 18(2) and (3) has been amended to provide that where there is duplication of provisions in Division 1 and elsewhere in the Act, the Division 1 provisions apply to Division 1 financial arrangements.

Inland Revenue had indicated to taxpayers in *Tax Information Bulletin* Vol 11, No 9 (October 1999) that it would recommend to the Government that the section be clarified, with retrospective effect.

Application date

These amendments apply from 20 May 1999, the date that section EH 18 came into effect.

CONSOLIDATED GROUPS AND FINANCIAL ARRANGEMENTS

Sections FD 2(3)(d) and HB 2(1), Income Tax Act 1994

Introduction

The consolidated filing rules have been amended to ensure that dividends resulting from the remission of certain debt between members of a consolidated group are not inappropriately excluded from the gross income of the consolidated group. The concern arose from the remission of debt that was in place before the companies' election to form the consolidated group became effective.

Background

The recent reform of the accrual rules identified a deficiency in the rules relating to debt remission within a consolidated group. This was where debt was remitted by one member of a consolidated group to another member. If the debt was in place before the companies became members of the consolidated group, any remission has always been intended to result in gross income being derived.

This remission can, depending on the facts, be dealt with as a base price adjustment or as a dividend. If it is a base price adjustment it is brought to account. If it is a dividend, however, it was excluded from gross income before this amendment was made.

If a remission results in income under the accrual rules, the outcome is appropriate. However, frequently the result will be a dividend under section CF 2(1)(b) and, depending on the corporate structure, section CF 2(1)(k). Such a dividend would generally not qualify for the wholly owned group companies intra-group dividend exemption. However, sub-paragraphs HB 2(1)(a)(i) and (ii) resulted in such dividends not being recognised as gross income.

Key features

New sub-paragraph HB 2(1)(a)(vi) now includes dividends as gross income that result from the remission of debt between members of a consolidated group if that debt was in place before the consolidation became effective.

Associated with this, paragraph FD 2(3)(d), which provides that dividends between members of a consolidated group will continue to have effect, has been extended to include a reference to new sub-paragraph HB 2(1)(a)(vi).

As well, the interaction of sub-paragraphs HB 2(1)(a)(iv) and HB 2(1)(a)(v) has been clarified so that they act independently, not conjunctively.

Application date

The principal amendment applies to such dividends arising on or after 17 May 2000.

The clarification of the independence of paragraphs (iv) and (v) is backdated to 20 May 1999, the date they were last amended.

PARENTAL TAX CREDIT

Section KD 5(1BA), Income Tax Act 1994

Families can apply to receive the parental tax credit either by instalments if they apply within three months from the date of birth, or as a lump sum at the end of the year when they file their tax return or income statement.

The new section KD 5(1BA) ensures that when the three-month application period for claiming instalments spans two income years and a family applies for the credit in the second year, the credit is abated against income earned by the family in the second year. This change reflects the original policy intent of the parental tax credit legislation.

This amendment applies from 1 October 1999, the date from which the parental tax credit applied.

FOREIGN INVESTOR TAX CREDIT RULES – HOLDING COMPANY MECHANISM

Section LE 3, Income Tax Act 1994

Introduction

Section LE 3 has been amended to address an anomaly identified in the foreign investor tax credit (FITC) rules as they apply to holding companies. The anomaly arose from an amendment made to the rules in 1998 that had the unintended effect of the FITC rules not working correctly for holding companies in all situations where they should legitimately apply.

Background

The FITC rules limit the total New Zealand tax on non-residents' earnings from equity investment to 33%, thus reducing the cost of importing foreign capital for New Zealand companies. The rules allow a New Zealand company paying a dividend to a non-resident shareholder to pay a supplementary dividend (funded by the company applying a FITC for an equivalent amount against its income tax liability). Section LE 3 provides a special holding company mechanism that allows the FITC rules to be used when one or more New Zealand holding companies are interposed between the paying company and the non-resident shareholder. If a holding company receives a dividend for which a FITC has been claimed, and the dividend is not subsequently paid offshore (or to another New Zealand holding company), the FITC credit is "clawed back" to prevent misuse of the rules.

The rules were amended in 1998 to rectify a problem that prevented the claw back mechanism from working correctly when dividends were paid to a holding company that was a member of the same consolidated group as the paying company. The 1998 amendment addressed this by inserting a new sub-paragraph (c) into subsection LE 3(2), which provided that members of consolidated groups could not use the section LE 3 holding company mechanism. It was not initially thought that this would create difficulties for consolidated groups because a group could apply a FITC when paying a dividend to a non-resident against the income tax liability of any other company in the group. It subsequently became apparent, however, that the 1998 amendment was worded too broadly and created problems in the case of a chain of holding companies where a non-group member holding company is interposed between members of a consolidated group.

Key features

The new amendment reverses the 1998 amendment by removing section LE 3(2)(c). It also inserts new section LE 3(11), which provides that holding companies that are members of consolidated groups are restricted from using the section LE 3 mechanism only when the holding company receives dividends from another member of the same group. This better achieves the result sought in 1998.

Application date

The amendment has been made retrospective to match the application date of the 1998 amendment.

HOUSING NEW ZEALAND

Schedule 18, Income Tax Act 1994
Schedule 14, Income Tax Act 1976

An amendment has confirmed that Housing New Zealand Ltd (HNZ) is to be taxed as if it were a state enterprise from the date of its inception in 1992 to 4 June 1999. The policy intention was for HNZ to be taxed as if it were a state enterprise, but an Order in Council providing for that status was overlooked until 4 June 1999.

Application date

The amendment applies for the period 1 July 1992 to 4 June 1999.

DEFINITION OF "TAX"

Section 3(1), Tax Administration Act 1994

Introduction

The scope of the definition of "tax" has been restored for the purpose of the care and management provisions in the Tax Administration Act 1994 (TAA).

Background

The Commissioner of Inland Revenue is expressly charged with the care and management of the taxes covered by the Inland Revenue Acts and with any other functions conferred. When the provisions in the TAA were originally enacted they applied to all revenues and entitlements covered by the Inland Revenue Acts, but a 1995 amendment inadvertently excluded particular revenues.

Key feature

The new paragraph (c) in the definition of "tax" has the effect of re-including particular revenues such as the approved issuer levy, use-of-money interest, student loan repayments and financial support within the scope of the care and management provisions.

Application date

Because the 1995 amendment that limited the scope was effective from 1 October 1996, the amendment is retrospective to that date.

PROVISIONAL TAX FOR THOSE CHANGING BALANCE DATES

Sections MB 2, MB 2A, MB 5A, OB 1 and schedule 13, Income Tax Act 1994 Sections 3, 120K and 139C, Tax Administration Act 1994

Introduction

Minor remedial amendments to the tax rules for provisional taxpayers who change their balance date alleviate the uncertainty regarding these rules and their application. All the amendments confirm the policy underlying the rules that came into effect from the 1998-1999 income year.

Background

The rules relating to provisional tax requirements, including taxpayers in transitional years, were introduced in 1997. Those rules allowed for different calculations to the general provisional tax rules and attempted to ensure that the use-of-money interest rules were applied appropriately.

An administrative review of the application of use-of-money interest has since been undertaken. A number of issues were identified as part of that review in relation to provisional taxpayers and, in particular, those who change their balance dates. These amendments deal with those issues.

Key features

Calculation of residual income tax in a transitional year

Residual income tax of the preceding year is used to calculate the provisional tax liability for the current year. An amendment to section MB 2(6) and (7) of the Income Tax Act 1994 ensures that if the preceding year was a transitional year, residual income tax for that year needs to be adjusted to take into account the length of the transitional year. The amendment also clarifies, in section MB 2(7), that the relevant base year is the year before the immediately preceding income year. The base year used in section MB 2(6) is the immediately preceding income year.

The amendment applies to payments of provisional tax for the 1998–1999 income year that are due on or after 7 July 1998.

Election to become a provisional taxpayer

Taxpayers can elect to become provisional taxpayers if they have paid $2,500 of provisional tax by the third instalment date. Previously, taxpayers with a transitional year might have had their tax payments spread over six instalment dates, with only half being paid by the third instalment date, and therefore found that they were ineligible to elect to become provisional taxpayers. The amendment to section MB 2A(1) in the Income Tax Act 1994 allows taxpayers who have paid provisional tax of $2,500 by their final instalment date to elect to become provisional taxpayers.

The amendment applies from the beginning of the 1998–1999 income year.

Provisional tax obligations during the transitional year

Applications by taxpayers for non-standard balance dates can be approved in the period after the end of the income year in which the application is made, but before the end of the transitional year. The amendment to section MB 5A(1) of the Income Tax Act 1994 confirms that the transitional provisional tax rules apply in that period.

The amendment applies from the beginning of the 1998–1999 income year.

Calculation of transitional year provisional tax

A new section MB 5A(1A) of the Income Tax Act 1994 clarifies that the total amount of provisional tax payable is the total of all instalments due in the transitional year. It removes inconsistencies that can arise in the calculations undertaken to monitor and inform taxpayers of their liability. Consequential changes have been made to sections MB 5A(5), MB 5A(6), MB 5A(7) and MB 5A(8), which calculate the amount of individual instalments due in a transitional year.

The amendments apply from the beginning of the 1998–1999 income year.

Interest on transitional year provisional tax

Use-of-money interest is charged on underpaid provisional tax. However, the provisional tax rules were not intended to apply before a new provisional taxpayer starts up a business. Amendments to sections MB 5A(4) of the Income Tax Act 1994 and 120K of the Tax Administration Act 1994 confirm that the use-of-money interest rules are not to be applied before a taxpayer commences business.

The amendments apply from the beginning of the 1998–1999 income year.

Definition of "provisional taxpayer" in section OB 1

The provisional tax rules apply to all taxpayers entitled to become provisional taxpayers. The definition of "provisional taxpayer" in section OB 1 of the Income Tax Act 1994 has been amended to exclude taxpayers from the application of the provisional tax rules if they have not elected to become provisional taxpayers.

The amendment applies from the beginning of the 1999–2000 income year.

Definition of "new provisional taxpayer"

The existence of separate definitions of "new provisional taxpayer" in the Income Tax Act 1994 and Tax Administration Act 1994 had the potential to create confusion. To prevent this, the definition in section 3(1) of Tax Administration Act 1994 has been repealed, leaving the broader definition in section OB 1 of the Income Tax Act 1994 to apply to both Acts. Because the Income Tax Act 1994 definition covers natural persons, a number of consequential amendments have been made to rules that apply use-of-money interest to new provisional taxpayers who are natural persons in section 120K of the Tax Administration Act 1994.

The definition of "new provisional taxpayer" in section OB 1 of the Income Tax Act 1994 has been amended at the same time to correct a previous omission that excluded natural persons acting in their capacity as trustees.

The amendment applies from the beginning of the 2000–2001 income year.

Payments due after new provisional tax payer starts business

Previously, the method of calculating the number of provisional tax instalments in a transitional year could result in a provisional tax liability for new taxpayers before they start business. The amendment to Schedule 13 Part B of the Income Tax Act 1994 prevents such a liability from arising.

The amendment applies from the beginning of the 1998–1999 income year.

Late payment penalty for unpaid provisional tax during a transitional year

Late payment penalties are payable on unpaid provisional tax during a transitional year. Section 139C(2) of the Tax Administration Act 1994 has been amended to confirm that the penalty is to be calculated on a basis that takes account of provisional tax payable during a transitional year and is consistent with the rules in sections MB 5 and MB 5A.

The amendment applies from the beginning of the 1998–1999 income year.

CONSULTATION ON VALUATION OF NURSERY PLANTS TO CONTINUE

Tax Information Bulletin Vol 11, No 4 (April 1999) set out Inland Revenue's administrative practice for valuing nursery plants under the new trading stock rules for the 1998–1999 and 1999–2000 income years. That administrative practice will also apply to the 2000–2001 income year.

Background

New trading stock rules took effect from the 1998–1999 income year. Those rules apply to nursery plants that are trading stock. In response to a number of enquiries received from taxpayers last year, Inland Revenue published its view on how nursery plants should be valued under the trading stock rules for the 1998–1999 and 1999–2000 income years. It was stated at the time that the interpretation might be altered for the 2000–2001 and subsequent income years as a result of consultation with the nursery plant industry.

Extending the application of the interpretation

We are working with industry representatives to develop a new interpretation for application from the 2001–2002 income year. Once a draft interpretation has been developed, we hope to consult more widely. This is expected to occur early next year.

In the meantime, it is necessary to extend the application of the administrative interpretation issued last year, to apply to the 2000–2001 income year as well.

Growers or other interested parties who want to be involved early next year in consultation on valuation issues for nursery plants and who have not already contacted us, may contact Bhagee Ramanathan in the Policy Advice Division of Inland Revenue
ph 04 474 7083, fax 04 474 7217
PO Box 2198, Wellington, bhagee@ird.govt.nz

FRINGE BENEFIT TAX – PRESCRIBED RATE OF INTEREST

Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations (No 3) 2000

The rate of interest used to calculate fringe benefit tax for low-interest employment-related loans has been increased in line with market rates. The new rate, which will apply from the quarter beginning 1 January 2001, will be 8.5%, up from the present rate of 8.1%.

The rate is reviewed quarterly to ensure it is in line with the Reserve Bank survey of first mortgage housing rates. The last change was effective from the quarter beginning 1 July 2000.

The new rate was enacted by Order in Council on 27 November 2000.

SOCIAL WELFARE (TRANSITIONAL PROVISIONS) AMENDMENT ACT 2000

Introduction

The Social Welfare (Transitional Provisions) Amendment Act 2000 inserts two new sections into the Tax Administration Act 1994 that enable Inland Revenue to exchange information by way of mutual assistance provisions in social security agreements that New Zealand negotiates with other countries.

Background

The amendment Act enables social security agreements entered into by New Zealand with other countries to include, by way of negotiation, mutual assistance provisions for:

- the recovery of social security debts by the social security agencies of both countries, and
- the exchange of information to determine eligibility for social security entitlements and to ensure tax has been correctly deducted.

The Act amends the Social Welfare (Transitional Provisions) Act 1990, the Social Security Act 1964, the Tax Administration Act 1994 and the Privacy Act 1993 to give effect to mutual assistance provisions and provide appropriate protection for the privacy of individuals.

The new provisions were required as the Netherlands, with which New Zealand has a social security agreement, passed legislation abolishing the right to receive social pensions outside the Netherlands except under social security agreements that contain mutual assistance provisions. Previously, New Zealand did not have legislation to provide the sort of information exchange or mutual recovery of debt that the Netherlands requires. Under the new Dutch legislation all social security agreements that do not include mutual assistance provisions by 1 January 2002 will be terminated, and payments under those agreements would cease.

Key features

Two new provisions, sections 85B and 85C, have been inserted into the Tax Administration Act. These provisions govern the disclosure of information requested or supplied under mutual assistance provisions contained in social security agreements.

Section 85B enables Inland Revenue to exchange information with the Department of Work and Income (DWI), which will supply the information to a country that requests it under a mutual assistance provision.

The process for exchanging information is that a country relying on a mutual assistance provision can request DWI to supply information regarding a social security recipient. DWI can pass on the request to Inland Revenue, which will compare the information requested with information it already holds. If Inland Revenue holds the required information, section 85B enables it to supply the following information to DWI:

- a person's street address
- the name and street address of a person's last known employer
- when a comparison indicates that a person is receiving gross income or has received gross income in the previous income year, details of the gross income
- when the names and dates of birth of a person's children are known, those names and dates of birth
- any other information held by the Commissioner that is of a type specified in the social security agreement.

DWI will supply the information received from Inland Revenue to the social security agency of the requesting country.

Section 85C limits the use by Inland Revenue of information received under a mutual assistance provision. In such circumstances, Inland Revenue can only supply information to the DWI, or retain the information received from DWI, to determine the tax payable by a person or to detect tax fraud or evasion. Inland Revenue is prohibited from supplying information received under a mutual assistance provision to any other country without the prior written consent of the Chief Executive of DWI.

The supply of information under a mutual assistance provision is an "information matching programme" as defined in the Privacy Act, and as such, any exchange of information must conform with the information matching provisions of the Privacy Act.

Application date

The amendments apply from 22 November 2000, the date of enactment.

GENERAL INTEREST ITEMS

PASSIVE TRACKER FUNDS RULING APPLICATIONS

Inland Revenue's Rulings Unit has completed its review of the tax position of so-called "passive" investment funds, that track an equity market capitalisation index rather than make active investment decisions.

Details are available on the Inland Revenue website at:

www.ird.govt.nz/rulings/

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.

UNSUCCESSFUL APPLICATION FOR JUDICIAL REVIEW IN RELATION TO ASSESSMENTS BY THE COMMISSIONER

Case:	*Denys Jeremy Douglas v CIR*
Decision date:	8 November 2000
Act:	Judicature Act 1908
Keywords:	*Invalid assessments, Judicial Review*

Summary

His Honour, Wild J, found in favour of the Commissioner of Inland Revenue.

Facts

In April 1993 the Commissioner of Inland Revenue commenced an investigation into the taxpayer's taxation affairs. This followed the exercise of search warrants by the Police where, amongst other things, $36,000 of cash had been seized.

Background checking revealed that the taxpayer had not lodged tax returns for the five years 1989 to 1993 inclusive. Additionally, while the taxpayer's only apparent income was from welfare payments, he appeared to have significant assets. An assets accretion method was used to determine the income for the years 1989 to 1993.

The resulting assessments were objected to by the taxpayer. One of the grounds of objection was that the assessments were invalid. The objection was disallowed and the matter came before Barber DJ on May 8–10 and again on May 27–29, 1996.

At the hearing the validity of the assessments was not attacked. Rather the focus was on the correctness of the assessments. Barber DJ largely upheld the Commissioner's assessments. An appeal was lodged by the taxpayer but he failed to file a case stated on appeal within the nine-month period provided by s26(3) of the Inland Revenue Department Act 1974.

Having lost his appeal the taxpayer commenced these judicial review proceedings.

Decision

In regards to the taxpayer's first cause of action alleging factual errors and taking into account irrelevant considerations in the making of the assessments, His Honour, Wild J stated that factual errors, if established, go to the correctness of the assessments, not the process by which they were made. They are not the stuff of judicial review.

On the other hand, taking into account considerations irrelevant to the assessments is a recognised ground for judicial review since it affects the integrity of the decision-making process. However, His Honour found that the "alleged irrelevancies are but a camouflage for a further attack on the correctness of the assessments". Given the finding that the first cause of action was a challenge to the correctness of the Commissioner's assessments and not to the assessment process, Justice Wild held it is not a proper ground for judicial review and he dismissed it.

The second cause of action was that the Commissioner misused his powers. His Honour held firmly against the second cause of action stating that the Taxation Review Authority had upheld the Commissioner's accretion-based assessments of the taxpayer, save for those items which it found had been wrongly included. His Honour agreed with the Commissioner's submission that, absent a finding that the Authority was biased, the Authority's finding disposes of the second cause of action.

Wild J also disposed of the case brought by the taxpayer against the Taxation Review Authority.

WHETHER PAYMENTS MADE TO SERVICE STATIONS IN RELATION TO TRADE TIE AGREEMENTS WERE CAPITAL OR REVENUE

Case: *Birkdale Service Station Limited & Ors v CIR*

Decision date: 14 November 2000

Act: Income Tax Act 1976

Keywords: *Trade ties, lump sum payments, income*

Summary

The taxpayers' appeal from High Court judgment at (1999) 19 NZTC 15,493 was largely unsuccessful. In respect of five of six cases, the Commissioner of Inland Revenue was wholly successful. In relation to one contract in the sixth case, the Commissioner was successful. In relation to the other, the taxpayer succeeded. The Commissioner was successful in cross-appeal on the issue of High Court costs.

Facts

The cases concern lump sum payments made to service stations by Mobil Oil (New Zealand) Ltd (Mobil) in connection with certain agreements requiring the service stations to purchase motor spirits exclusively from Mobil (trade tie agreements). The Commissioner said that these payments were revenue payments and accordingly, assessable in their hands.

The appeal concerned ten contractual arrangements made in the years 1988–1993 for periods varying between three and ten years. They involved essentially similar terms and conditions—a lump sum for a three year or more trade tie.

There was also an eleventh arrangement (Kenlock 2), with Kenlock Motors Ltd, made for a period of 15 years in 1993. This was accompanied by a lease from Kenlock to Mobil of its service station property with a sublease back to Kenlock, giving Mobil the security of an interest in Kenlock's land and buildings.

The oil industry was deregulated by the Petroleum Sector Reform Act 1988 which came into force on 9 May 1988. The four wholesalers set about acquiring service stations which were regarded as prime outlets—those that sold the largest gallonages of motor spirits. Between them the wholesalers soon came to own 40% of the service stations in New Zealand doing 73% of sales of motor spirits. This case is concerned with some smaller retailers who were not acquired by a wholesaler. In four out of five instances they had been retailing Mobil products exclusively and were willing to continue to do so. The sixth instance involved a used vehicle dealership and related to oil purchases for its service department.

The service stations entered into arrangements with Mobil. The documentation in each case consisted of a compensation agreement, a retail supply contract and an equipment loan contract.

If the appellant retailers wanted to continue to operate their service stations in the deregulated environment they had no choice other than to tie themselves exclusively to one of the four wholesalers. They would not otherwise have been able to obtain regular and reliable supplies of petroleum products. Multi-brand trading was not an option as, by 1988, there were no longer any multi-brand retailers.

Decision

There was no suggestion that the arrangements between Mobil and its retailer were shams. The contractual documents are, therefore, to be construed in the ordinary way.

The documents in this case were obviously intended to be read together as a package. In fact, they complemented rather than contradicted one another. The Court construed them with that in mind.

The Court found that Laurenson J in the High Court had adopted the correct approach in order to determine whether the lump sum payments were capital or income. It was that followed by the Privy Council in *Wattie,* and found in the following passage from the advice of the Privy Council delivered by Lord Pearce in *B.P. Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224, 264:

> "The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
>
> > "depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process":
>
> *per* Dixon J. in *Hallstroms Pty. Ltd.* v. *Federal Commissioner of Taxation* (1946) 72 CLR 634, 648."

Except for one case, where the parties chose to modify the printed form to provide that it was an advance, the payments in this case could not be regarded as advance payments or discounts or rebates.

In the Court's view, the following three factors were relevant to determining the effect of the trade tie payments from a practical and business point of view:

The proper accounting treatment

The evidence showed that proper accounting treatment required the payments to be taken into the revenue account of the retailer.

Little was surrendered by the retailers

In this case, the appellants' apparent freedom to contract as they wished for purchases of motor spirits was illusory.

The length of the trade ties

In no instance was the initial tie for a period of more than five years and in two cases it was as short as three years. Although, in theory, at the end of that period the retailer could switch to another wholesaler, the best that could actually be hoped for was the renegotiation of a further package either with Mobil or possibly with one of the other oil companies.

The Court concluded that in all cases except Kenlock 2, the payments were typical of the conduct of one-brand motor spirits retailing businesses in the deregulated environment and, as such, revenue in nature. The receipt of compensation payments, with the anticipation of more to come upon expiry of the current tie, was a *modus operandi* of this type of business. No essential change was made in the nature or structure of the business. None of the ties was of a sufficiently long term to impart a capital character.

Kenlock 2 was in a different situation.

The Court did not find it necessary to determine whether the length of the term in Kenlock 2 (15 years) would, in itself, have been enough to constitute that transaction an affair of capital. Two factors, both singly and more powerfully in combination, made Kenlock 2 different from the other arrangements. They were, first, that Mobil obtained security for its tie by means of a 15-year lease with a sublease to Kenlock on a back-to-back basis and, secondly, that the term for which Kenlock became committed to Mobil was potentially substantially longer than 15 years. There was also a restrictive covenant preventing Kenlock and its shareholders from trading in competition with the outlet from other premises within a 10 kilometre radius of the premises during the lease term.

Kenlock Motors was altering its business structure in such a material way that the payment it received in exchange has to be regarded as capital in nature. As Lord Pearce said in *Regent Oil* (p 336), a lease/sublease transaction is "materially different both in form and in substance. By it the wholesalers obtain for a premium an interest in the land from which their goods are retailed to the public".

REGULAR FEATURES

DUE DATES REMINDER

January 2001

15 **Employer monthly schedule**

Employer deductions

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

GST return and payment due

22 **Employer deductions**

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

Employer deductions and Employer monthly schedule

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

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

FBT return and payment due

31 **GST return and payment due**

February 2001

5 **Employer monthly schedule**

Employer deductions

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

7 **End-of-year income tax**

- 7 April 2000, 1999 end-of-year income tax due for clients of agents with a March balance date.
- 7 February 2001,2000 end-of-year income tax due for people and organisations with a March balance date and who do not have an agent.

20 **Employer deductions**

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

Employer deductions and Employer monthly schedule

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

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

28 **GST return and payment due**

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