# TAX INFORMATION BULLETIN

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*This TIB has no appendix*

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This *Tax Information Bulletin* is also available on the internet in PDF format. Our website is at:

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It has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

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# THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

Inland Revenue produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents.

Because we are keen to produce items that accurately and fairly reflect taxation legislation, and are useful in practical situations, your input into the process—as perhaps a user of that legislation—is highly valued.

The following draft item is available for review/comment this month, having a deadline of 31 July 2003.

| Ref. | Draft type | Description |
|---|---|---|
| IS0053 | Interpretation statement | Shortfall penalty for not taking reasonable care |

Please see page 26 for details on how to obtain a copy.

# BINDING RULINGS

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

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

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

You can download these publications from our website at **www.ird.govt.nz**

## PRODUCT RULING – BR PRD 03/12

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

### Name of the Person who applied for the Ruling

This Ruling has been applied for by TrustPower Limited ("TrustPower").

### Taxation Law

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

This Ruling applies in respect of section CF 3(1)(b) and the section OB 1 definition of "shares of the same class".

### The Arrangement to which this Ruling applies

The Arrangement is the proposed off-market, pro rata cancellation of a minimum of 40 million ordinary shares in TrustPower, arising from a share repurchase offer made by TrustPower to shareholders. Further details of the Arrangement are set out in the paragraphs following.

#### Establishment of TrustPower and current ownership

1. Currently, there are 198,274,779 TrustPower shares on issue, all being of the same class and having the same voting and dividend rights (subject to paragraph 7 below), being those rights set out in section 36 of the Companies Act 1993. There are no "non-participating redeemable shares" on issue in TrustPower. As of 17 February 2003, the ordinary shares were held by:

   (a) Infratil Limited (27.93%)

   (b) Tauranga Energy Consumer Trust (22.67%)

   (c) Australian Gas Light Company's 100% owned NZ subsidiary AGL NZ Limited (20.47%)

   (d) Alliant International New Zealand Limited (18.87%)

   (e) Others (10.07)%.

   On 20 March 2003 the shares were trading on the New Zealand Stock Exchange at $3.95, giving a market capitalisation of approximately $783 million. The shares have been listed on the New Zealand Stock Exchange since 18 April 1994.

2. TrustPower has made an offer to repurchase shares to all the holders of ordinary shares in TrustPower. The terms of the offer are as follows:

   - The offer is to repurchase two of every seven shares held by shareholders.
   - The offer price is $3.70 per share. (This is lower than the market price for TrustPower shares, which at 20 March 2003 was around $3.95 per share).

3. The offer is conditional upon:

   - TrustPower receiving valid acceptances of the offer in respect of at least 40 million shares (which will produce a repurchase amount of $148 million).
   - The increase of voting control of those shareholders who require approval to retain this increase being approved under the Takeovers Code (Class Exemptions) Notice (No. 2) by shareholders permitted to vote.
   - The passing of such other shareholder resolutions as are required to give effect to the transaction and its completion, and
   - Receipt by TrustPower of an irrevocable notice to convert the outstanding 1,000 convertible notes ("TEL Notes") on the first Interest Payment Date after the notice is given.

4. In accordance with section 60(2) of the Companies Act 1993, the offer permits TrustPower to acquire additional shares from a shareholder who wishes to sell them, to the extent that another shareholder does not accept the offer or accepts the offer only in part.

5. TrustPower has received a binding ruling to the effect that it has Available Subscribed Capital ("ASC") with respect to its ordinary shares (including those referred to in paragraph 7) of not less than $217,498,432.47 ("ASC Amount").

## TEL Notes and Voting Debentures

6. TrustPower has issued:

   (a) 14,975 million TEL Notes, issued on 31 October 1997 with a face value of $2 each, and bearing interest at 11% pa to 30 October 2002 and at the Treasury Bill rate plus 1% thereafter. These notes were issued on the basis that they were, at the holder's election, either:

      (i) convertible into TrustPower shares on a 1:1 basis on 30 October 2007, or earlier on interest payment dates. The terms of the TEL Notes provide that the shares issued on conversion:

         (AA) are not entitled to dividends declared, paid or made on or before conversion, and

         (BB) are entitled to only a pro rata portion of dividends declared, paid or made in respect of financial periods beginning before, but ending after, the conversion date, or

      (ii) redeemable for their face value, in either TrustPower shares or cash. However, the right to redeem the TEL Notes for cash expired 30 business days prior to 1 October 2000.

   The TEL Notes also have a right, in general terms, to participate in any adjustment in the share capital of TrustPower. They confer no right to vote.

   (b) 14,975 voting debentures ("TEL Voting Debentures"), issued at 1c each, with no right to any distributions, except on redemption. One TEL Voting Debenture was attached to each parcel of 1,000 TEL Notes, and cannot be severed from it. Each TEL Voting Debenture carries the same voting rights as those which would arise if 1,000 TEL Notes were converted into ordinary shares (ie 1,000 subject to any capital reconstruction).

7. On 3 January 2003, all but 1,000 of the TEL Notes, which were then held by AGL NZ Limited, were converted into TrustPower ordinary shares. In accordance with the terms of the TEL Notes, the resulting 14,974 million TrustPower ordinary shares are entitled to only 50% of the final 2003 year dividend.

## Desire to increase leverage

8. The reason for the share cancellation is to increase TrustPower's debt to equity ratio. TrustPower's debt to equity ratio at 31 March 2002, was 26%, calculated as follows:

   (a) **Debt** was $210.4 million, being the total of unsecured loans ($179.3 million) plus convertible notes ($35.5 million) less cash ($4.4 million)

   (b) **Equity** was $608 million. This was the total of reported equity in the accounts of $563 million plus a notional revaluation reserve in respect of TrustPower's retail business of $45 million. Sales of retail customer bases between arm's length parties have established that TrustPower's customer base has a value of $45million. However, this cannot be recognised in the accounts under NZ GAAP.

9. Following the conversion of the TEL Notes into TrustPower shares, TrustPower's debt-to-equity ratio is 27.7%.

10. The directors have determined that at this level, TrustPower is in a commercially under-geared position and has capital surplus to its current requirements. From the perspective of reducing TrustPower's weighted average cost of capital, and thereby also maximising returns to shareholders, a gearing of between 30-50% has been recommended by management, in consultation with external consultants. The optimal gearing was arrived at by considering the enterprise value of TrustPower under a number of different scenarios with key factors being the:

   (a) nature of the Company's assets

   (b) nature and volatility of the Company's earnings/cashflows

   (c) capital needs of the Company over the foreseeable future

   (d) available sources of future capital and the relative costs of these services

   (e) capital structure of competitors, and

   (f) tax status of major shareholders.

11. At a meeting of the Board of Directors of TrustPower held on 1 November 2001, a target gearing of 35-40% was accepted in principle. Subsequent discussions have suggested that a 50-55% ratio may be preferable.

12. A further factor which the Directors have considered relevant in determining the amount of capital to be returned to shareholders by way of a cancellation of shares is the amount of ASC which would remain after the cancellation. The Directors do not wish to leave the company in a position after the cancellation which is currently proposed where it has a significant amount of ASC which is nevertheless not sufficient to enable TrustPower to make a pro rata return of capital to its shareholders in a substantially tax-free manner (because the amount of ASC would not be sufficient to meet the 10% threshold). There is no current intention to undertake a further repurchase or cancellation.

13. The cancellation is proposed to be funded by a mixture of:

    (a) proceeds of a public issue of capital bonds—ie bonds which bear interest and which can, at the option of TrustPower, be either redeemed in cash or converted into TrustPower shares at a slight discount to their market value at the time of conversion, and

    (b) bank facilities.

    TrustPower has no current intention to convert any bonds issued.

14. The remaining 1,000 TEL Notes will not participate in the return of capital in any way.

15. TrustPower's current dividend policy is to pay at least 60% of its profits each year by way of dividend. The current directors intend to maintain or, if possible, grow the amount of dividend per share in the future, subject to compliance with their duties under the Companies Act. In particular, this policy will not be affected by the proposed share cancellation.

16. At the time of entering into this Arrangement, TrustPower has no intention to return capital to shareholders in the future.

## Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) All shares cancelled as part of the relevant cancellation will be cancelled in whole, not in part.

b) The TEL Notes and the TEL Voting Debentures were issued on commercial arm's length terms.

c) The form of the TEL Notes and Voting Debentures was chosen by TrustPower to avoid the effect of section 117 of the Companies Act 1993 and does not have a purpose or effect of defeating the intent and application of any provision of the Act whose application is dependent upon measurement of voting and market value interests.

d) If there is a market value circumstance, then the cancellation, if the offer were accepted in full by all shareholders, would not alter the market value interest or voting interests of any person in the company (except possibly by reason solely of the existence of the TEL Notes and Voting Debenture).

e) The aggregate amount paid by the company on account of the cancellation is equal to or greater than 15% of the market value of all shares in the company at the time the company first notified shareholders of the proposed relevant cancellation.

f) At the time of entering into the Arrangement, TrustPower does not anticipate issuing any shares subsequent to the cancellation. This condition will not be breached if an event unanticipated at the time of the repurchase occurs that requires the issue of further shares. An example of this would be TrustPower finding a suitable electricity generation investment and issuing shares to fund that investment.

g) TrustPower has not previously distributed amounts upon the acquisition, redemption or cancellation of TrustPower ordinary shares.

## How the Taxation Law applies to the Arrangement

Subject in all respects to any assumption or condition stated above, the Taxation Law applies to the Arrangement as follows:

- Amounts distributed to shareholders on cancellation will be excluded from the definition of dividends pursuant to section CF 3(1)(b) to the extent that they do not exceed the available subscribed capital per share cancelled.
- The shares issued on conversion of the TEL Notes and the other ordinary shares issued by TrustPower are "shares of the same class" as defined in section OB 1.

## The period or income year for which this Ruling applies

This Ruling will apply for the period 1 January 2003 to 31 March 2005.

This Ruling is signed by me on the 17th day of April 2003.

**Martin Smith**
General Manager (Adjudication & Rulings)

# PUBLIC RULING – BR PUB 99/6 EXTENDED

The following notice to extend public ruling BR Pub 99/6 was published in the *Gazette* of 19 June 2003 (issue No. 67)

## Notice of Extension of Public Ruling

1. This is a notice of extension of a public ruling made under section 91DD of the Tax Administration Act 1994.

2. Public ruling BR Pub 99/6 entitled "Car parks provided by employers – fringe benefit tax exemption" was signed on 12 August 1999 and notice of its making appeared in the *New Zealand Gazette* of 19 August 1999 (No 97, page 2,336). A copy of the ruling appeared in Inland Revenue's *Tax Information Bulletin* Vol 11, No 8 of September 1999.

3. Public ruling BR Pub 99/6 originally applied for the period from 1 November 1999 to 31 March 2002. The ruling now applies for the period from 1 April 2002 until 31 March 2005.

**Martin Smith**
General Manager (Adjudication & Rulings).

### Explanation

In the context of reviewing public ruling BR Pub 99/6, the Commissioner has reconsidered the legal interpretation of the words "the premises of the employer" as used in section CI 1(q) of the Income Tax Act 1994. These words are undoubtedly ambiguous. In public ruling BR Pub 99/6 the Commissioner took the view that they included a car park that is on land or in a building owned or leased by the employer where there is an exclusive right to occupy the property and a legal estate or interest in that property. It is acknowledged that alternative arguments can also be made for these words meaning the place in which an employer conducts their business. However, such a meaning in itself requires interpretation, and the Commissioner considers that the legislative intent in this area is insufficiently clear for a test based on this meaning (or any variation) that is capable of application to be formulated.

As this issue is scheduled to be considered and resolved as part of a policy review of fringe benefit tax which is currently in progress, and to provide continuing certainty in the meantime to taxpayers who have followed the approach in public ruling BR Pub 99/6, the Commissioner has decided to extend public ruling BR Pub 99/6 under section 91DD of the Tax Administration Act 1994.

# 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.

## ANGEL CAPITAL CORPORATION LTD V CIR

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|---|---|
| **Case:** | Angel Capital Corporation Ltd v CIR |
| **Decision Date:** | 7 May 2003 |
| **Act:** | The GST Act 1985 |
| **Keywords:** | Summary judgment, arguable defence, section 46, mandatory time limit, CIR v Sea Hunter. |

### Summary

Summary judgment application for GST refund made under section 46 GST Act 1985 and CIR v Sea Hunter (2001) 20 NZTC 17,478.

The Court found there were disputed facts as to the filing of the return and the creation of the tax invoice. Therefore the plaintiff could not satisfy the onus of showing the defendant had no defence to the claim. The Court also found the case of Sea Hunter was sufficiently different so that it did not assist the plaintiff's case.

Application for summary judgment unsuccessful. Costs reserved.

### Facts

This case concerned a claim by the plaintiff for a GST refund under section 46 of the Goods and Services Tax Act 1985 ("the GST Act") which requires the Commissioner ("the CIR") to refund an amount claimed within a certain time period unless specific criteria are fulfilled.

The plaintiff was incorporated on 12 April 2001. It was registered for GST from that date and had a monthly filing frequency. On 28 March 2003 the plaintiff entered into an agreement, as agent for a Joint Venture, with Totara Group Limited, to purchase software for $3 million. On the same day the plaintiff's sole director, Mr Anderson, allegedly filed the plaintiff's GST return claiming a $375,000 input tax credit based on the purchase. Approximately 50 other returns relating to the plaintiff and other entities Mr Anderson was involved with were filed at the same time. Although the CIR received all the other returns filed and duly processed them, the CIR had no record of ever having received the one in question.

The CIR contended, among other things, that the return had not been received until the proceedings in question were filed. The plaintiff contended that the return had been filed on 28 March 2002 and that the CIR had not responded within the 15 day time limit and was therefore obliged to refund the amount under section 46 of the GST Act.

### Decision

The plaintiff relied on Rule 136 of the High Court Rules which sets out the onus is on the plaintiff to satisfy the Court the defendant has no defence to the claim. See *Pemberton v Chapell* [1987] 1 NZLR 1 and *Towers v R & W Hellaby Limited* [1987] 3 NZCLC 100,064.

The essence of the plaintiffs claim was that, as in *CIR v Sea Hunter Fishing Limited* (2001) 20 NZTC 17,478, the CIR had failed to pay out the refund in the mandatory timeframe set out in section 46 of the GST Act. The CIR raised four grounds of defence:

#### 1. Plaintiff as agent for unregistered principle

The plaintiff contended that it purchased the software and filed the GST return as principle in its own right. The CIR disputed this and referred to the agreement for sale and purchase ("the SAPA") which described the plaintiff, as purchaser, as **"agent for a joint venture …"**. The CIR then raised the issue of the joint venture's non-registration at 28 March. The CIR argued that section 60 of the GST Act, which states supplies made to an agent are deemed to be made to the principle, would require that the principle be registered to be entitled to an input tax credit under section 20(5) and therefore section 46 of the GST Act.

Master Gendall did not consider the CIR's argument in any great detail but did note that there could be some force in it. However, he felt that in light of the description of the purchaser in the SAPA the CIR had satisfied him that the plaintiff may not be the person entitled to the refund. On this claim alone the plaintiff's application failed.

## 2. Plaintiff did not hold a valid tax invoice

The CIR argued that the plaintiff did not hold a valid tax invoice at the time the return was allegedly filed as required under section 20(2)(a) of the GST Act. See *Superannuation v Mutual Savings Ltd v Automobile Association (Auckland) Incorporated* (1989) 11 NZTC 6,124. The CIR also contended that the plaintiff did not satisfy the "invoice created by recipient" criteria under section 24 of the GST Act. The plaintiff was therefore not entitled to make a deduction of input tax under section 20(5).

Although the Master made no determinative finding on the tax invoice issue he felt there was enough doubt as to the factual circumstances surrounding it for the plaintiff's application for summary judgment to fail on this ground also.

## 3. Disputed issues of fact and credibility

There were a range of contested factual disputes between the parties. In particular, whether the return in question was filed on 28 March or whether the date stamp had been falsified. The plaintiff's application on this ground failed as the Master found there were serious factual disputes which could not be determined on the current application.

## 4. Court's discretion

As the Master found against the plaintiff on the above three grounds it was not necessary to consider whether the Court should exercise its discretion to refuse summary judgment.

## The "Sea Hunter" argument

The plaintiff contended its application for summary judgment was indistinguishable from the Court of Appeal case of *CIR v Sea Hunter*. Master Gendall however felt there were two major distinctions:

- In Sea Hunter, it was agreed by both counsel that the CIR was required to make a refund under section 20(5). The disagreement was about the application of section 46 and the strict time compliance and giving of notice under that section. That was not the case here.
- The Sea Hunter claim involved an action on a cheque as the CIR had issued a cheque and then stopped payment. An obligation to refund existed at the time the CIR issued the cheque due to section 46 and that was sufficient for action on the cheque to be upheld. No cheque had been issued in the current case.

  While the Master made no definitive determination in relation to the Sea Hunter argument he tended to the view that the circumstances in Sea Hunter were sufficiently different so as not to assist the plaintiff's case.

Costs were reserved.

## TRA 084/02

| | |
|---|---|
| **Case:** | TRA 084/02 |
| **Decision date:** | 16 May 2003 |
| **Act:** | Tax Administration Act 1994/GST Act 1985 |
| **Keywords:** | Shortfall penalty, unacceptable interpretation |

## Summary

The disputant was successful in its application for an order preventing the CIR relying on information in his Additional Statement of Position

## Facts

This case concerns the imposition of a shortfall penalty for an unacceptable interpretation (section 141B TAA) of the time of supply rules (section 9 GST Act).

After investigation, the Commissioner advised the disputant that he intended to disallow a claim for an input credit based on the construction of a vessel, and proposed an agreed adjustment to this effect. Written agreement to the adjustment was received from the disputant in August 2000.

The disputant was also advised that the imposition of a shortfall penalty was being considered under both section 141A (reasonable care) and section 141B. A NOPA and disclosure notice were issued by the Commissioner, and the disputant responded with a NOR. The Commissioner issued a statement of position (not specifically referring to section 9 GST Act). The Commissioner subsequently issued an addendum to his SOP, under section 89M(8) TAA, which did refer to section 9.

The matter then went to Adjudication, which concluded that the disputant was not liable for a shortfall penalty under section 141A, but was liable under section 141B. It is accepted by all concerned this conclusion is only possible by reference to section 9 GST Act.

Proceedings were brought before the Authority, and the disputant sought an order on a preliminary point that the Commissioner failed to raise his reliance on section 9 GST Act prior to issuing the addendum to his SOP, and was therefore precluded by the evidence exclusion rule (section 138G TAA) from relying on section 9.

## Decision

After a determination that the preliminary point raised by the disputant was able to be considered by the Authority, the facts as understood by the Authority are set out, noting that:

> "The disputant (in person) made a lengthy response and statement of position in which he adverted to section 9 contending in passing that it did not apply. ...
>
> "The disputant's statement of position appeared to alert the Commissioner to the possibility that section 9 might be relevant, and on 11 June 2002 he issued to the disputant a document entitled *"Commissioner's Statement of Position* (addendum)*.'"*"

The decision then briefly sets out the submissions of both parties, before turning to discuss them. The general purpose of the disputes resolution procedure are discussed, the statutory provisions set out, and section 89M(8) identified as the "crucial provision"—specifically the interpretation that should be given to "information".

In determining this, the Authority considers that it is a matter of "first impression", and, after considering dictionary and thesaurus meanings, states that "[c]learly the word does not mean anything which one person communicates to another."

The Authority concludes that "[i]t is the requirement of knowledge based in fact which in my view is central to "information", and that:

> "… Parliament must have intended section 89M(8) as serving the purpose of permitting the Commissioner unilaterally to pass on to a disputant any additional facts which come into his possession after he receives the disputant's statement of position."

The Authority considered that section 89M(8) did not allow the Commissioner to change the legal basis upon which he has made his disputable decision.

In considering the application of section 138G, the Authority determined that "the only propositions of law which the Commissioner is entitled to rely on are those *"disclosed in the Commissioner's statement of position.'"*"

In consequence, the Authority determined that the Commissioner's "purported" addendum, insofar as it sought to rely on the "additional ground" to support his disputable decision, was "not permitted by the provisions of the Tax Administration Act", and that the Commissioner was restricted to the legal basis set out in his original SOP.

## NZHB HOLDINGS V CIR



| | |
|---|---|
| **Case:** | NZHB Holdings v CIR (first defendant) & Wright Wiseman (second defendant) |
| **Decision date:** | 15 May 2003 |
| **Act:** | GST Act 1985 |
| **Keywords:** | Summary judgment, section 43 attachment notice, solicitor trust account, priority interests, proceeds from the sale of, Christchurch Readymix Concrete v Rob Mitchell Builders (in liquidation) |



## Summary


Summary judgment application claiming that the CIR had acted unlawfully making an attachment order under section 43 of the GST Act 1985 over proceeds from the sale of a property being held in a solicitor's trust account due to a dispute between the plaintiff and the CIR as to who had priority over the funds.

The Court awarded summary judgment to the plaintiff. *Christchurch Readymix Concrete v Rob Mitchell Builders (in liquidation)* was followed and the Court held that the CIR could not make an attachment order over the proceeds as he did not have "priority" over them and because they were not payable to the taxpayer as required under section 43.


## Facts

### Background

This case arises because there were competing debts owed by a company not a party to these proceedings, being the taxpayer, Wallace Wells & Wilson Enterprises Limited, to the plaintiff and the first defendant. The taxpayer was registered for GST and the owner of a property at Carlton Gore Road. This property was not a mortgagee sale.

The taxpayer defaulted on its obligations to both the first mortgagee and the plaintiff, and a decision was made to sell the Carlton Gore Road property. This was not a mortgagee sale.

In order for the sale to be effected, the caveats needed to be lifted and an agreement was reached between the plaintiff and the taxpayer in that respect. An attempt was also made to resolve a dispute that had arisen about whether the GST on the sale should be paid by the taxpayer before the complete satisfaction of its debt to the plaintiff. It was apparent that the taxpayer was motivated to pay the GST and maintain a good commercial relationship with the department.

Several "agreements to mortgage" were also in existence between the plaintiff and the taxpayer relating to the Carlton Gore Road property. The CIR was not privy to these agreements and it was not established in the hearing the exact nature of this equitable interest although the judgment refers to this interest as a "mortgage". With respect to His Honour, it was agreed between the parties at the hearing that the exact nature of this interest needed to be confirmed further.

This case was an application for summary judgement against the CIR by the plaintiff alleging that the CIR had no defence to the plaintiff's request for repayment of the GST obtained through the section 43 notice issued to the second defendant, Wright Wiseman.

### The Dispute

The sale of the property settled on 31 January 2002 and the taxpayer paid the plaintiff $158,000 from the proceeds of the sale. The balance of the proceeds $106,787.27 was paid to a law firm, which was holding the funds in trust for the parties as an independent third party, Wright Wiseman (the second defendant).

Wallace Wells completed a GST return for the period ending 28 February 2002 for a net amount of GST being $109,574.32. Accompanying the return was a letter from the taxpayer explaining that payment could not actually be made at present as the money being held by Wright Wiseman was in dispute with a third party.

The CIR subsequently issued an attachment notice under section 43 of the GST Act 1985 to Wright Wiseman and the sum of $109,574.32 was paid over to the CIR.

## Decision

His Honour, Judge MD Robinson reserved his judgment for the plaintiff and awarded summary judgment against the CIR.

His Honour discussed the decision of the Court of Appeal in *CIR v Edgewater Motel Limited* and how *Christchurch Readymix Concrete Limited v Rob Mitchell Builder Ltd (in liquidation)* was distinguishable from the *Edgewater* decision. His Honour accepted that *Christchurch Readymix* was binding on this decision because Venning J held that the mortgagee had priority ahead of liability for GST on the sale of a property, the sale being by the company pursuant to an agreement for sale and purchase that had become unconditional prior to the company going into liquidation. This was distinguished from *Edgewater* and the statutory provisions placing an onus on the mortgagee to pay GST when exercising the power of sale.

His Honour declined the CIR's submission to defer judgment for this case until the outcome of the CIR's appeal of the *Christchurch Readymix* was decided.

Further, His Honour held that:

- "On the existing state of the law there can be no doubt that the plaintiff is entitled to priority over the claim by the first defendant (the CIR) for GST in respect of the sale that is the subject of these proceedings".
- The evidence established that the first defendant with the full knowledge of the agreement between the plaintiff and the second defendant as to the terms and conditions under which the second defendant was to hold the net proceeds from the sale without notice to the plaintiff, persuaded the second defendant to pay those proceeds to the first defendant.
- That "taking into account the high-handed way in which the first defendant (CIR) seized the funds, I am satisfied that it would not be an appropriate exercise of my discretion to refuse the plaintiff's application for summary judgment in these circumstances".
- He considered the issue to be whether the amount held by the second defendant is an amount payable in relation to the taxpayer. The term amount payable is defined in section 43(1)(a) of the GST Act 1985 as follows:

  (a) Any amount that on the day on which a notice to the person is given under subsection (2) of this section in relation to the registered person, is payable by the person (whether on that person's own account, or as an agent, or as a trustee, or otherwise howsoever) to the registered person.
- The agreement makes it clear that the funds were either payable to the first defendant (CIR) or the plaintiff and that as the funds held by the second defendant were not at the appropriate time payable by the second defendant to the taxpayer, the first defendant had no right to require the second defendant to pay the funds to the first defendant in terms of a notice under section 42.
- That the second defendant was in breach of the agreement paying the funds. That the section 43 notice could not require payment of those funds as the funds have never been payable to the taxpayer.
- That the first defendant should have been aware that the second defendant could not be required to pay those funds to the first defendant under a notice issued pursuant to section 43 of the GST Act, that payment of those funds by the second defendant was in breach of the arrangement between the second defendant and the plaintiff, and that because the plaintiff has priority to the funds over the first defendant, the funds are held under constructive trust by the first defendant.

His Honour declined to award summary judgment against the first defendant (CIR) for $10,000 exemplary damages claimed by the plaintiff.

## JARROD PETER HESTER & ORS V CIR

**Case:** Jarrod Peter Hester & Ors v CIR

**Decision date:** 23 May 2003

**Act:** Tax Administration Act 1994

**Keywords:** Interrogatories, secrecy

## Summary

The taxpayers' interlocutory application was not successful. The Commissioner was not required to provide answer to certain interrogatories because they were not relevant. The interrogatories were also caught by section 81 of the Tax Administration Act 1994.

## Facts

The plaintiffs were the trustees of the Church of Jesus Christ of Latter Day Saints Deseret Benefit Plan (a superannuation scheme for some of the employees of the church). The plaintiffs claimed that the superannuation scheme was charitable, and was thus exempt from income tax. The Commissioner considered that it was not.

The plaintiffs filed interrogatories (written questions of fact that the Commissioner would have to answer prior to the hearing) requesting information about other superannuation funds connected to religious organisations. The Commissioner resisted this on the basis that that information was not relevant and further that he could not reveal information about other taxpayers by virtue of the secrecy provisions in Part IV of the Tax Administration Act 1994.

The plaintiffs' original statement of claim made no mention of discrimination on the part of the Commissioner. However, they amended their statement of claim and alleged that the Commissioner acted in breach of section 19 of the New Zealand Bill of Rights Act 1990 and section 21 of the Human Rights Act 1993 (discrimination on the grounds of religious belief).

The amended pleadings arguably made the Commissioner's treatment of other taxpayers relevant to the proceedings.

The plaintiffs considered that the interrogatories would provide evidence of discrimination by the Commissioner. The Commissioner opposed the interrogatories on three grounds:

1. The interrogatories did not relate to matters in question in the proceeding, and

2. The interrogatories were oppressive, and

3. Answers to the interrogatories were not necessary.

## Decision

Master Faire upheld two of the three grounds of the Commissioner's opposition.

Firstly, the Master agreed that the interrogatories were not relevant. The Commissioner provided affidavit evidence from the investigator who prepared the Commissioner's notice of response (the plaintiffs had paid the tax and then NOPAed their own return) that he had not compared his analysis to other instances where Inland Revenue had given or declined charitable status to any other church-related fund.

Inland Revenue submitted that an action for breach of the New Zealand Bill of Rights Act 1990 is not a remedy that has been traditionally been available to attack tax assessments. This was consistent with section 109 of the Tax Administration Act 1994 which limits the ways disputable decisions can be challenged. Master Faire concluded (at paragraph [20]):

> In short, those inquiries [relating to the treatment of other superannuation funds] are not relevant to the issues that are currently pleaded. What the Court will be required to do is to look at the plaintiffs' Plan and judge it against the type of analysis carried out by Heron J in *Presbyterian Church of NZ Beneficiary Fund v Commissioner of Inland Revenue*.

Secondly, Inland Revenue considered that the interrogatories were oppressive. It was submitted that Inland Revenue had an alphabetical list of some 17,266 organisations with charitable status. They were not organised into subject matter categories and there is no register of organisations which have applied for charitable status and been declined. However, Master Faire accepted that if the interrogatories were limited in some way then this ground of opposition might not be sustainable.

Finally, Inland Revenue submitted that answers to the interrogatories were not necessary, by virtue of section 81 of the Tax Administration Act 1994. The interrogatories asked a number of questions that could potentially identify other taxpayers. Master Faire concluded that the particular interrogatories were caught by section 81, and that he would have disallowed them on that basis.

# LEGISLATION AND DETERMINATIONS

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

## DETERMINATION: AMOUNT OF A SPECIFIED WITHHOLDING PAYMENT (BEING HONORARIA PAID TO MEMBERS OF THE ROYAL NEW ZEALAND PLUNKET SOCIETY (INC.)) THAT SHALL BE REGARDED AS EXPENDITURE INCURRED IN PRODUCTION OF PAYMENT

### Introduction

This Determination sets out the amount regarded as expenditure incurred in the production of specified withholding payments when those payments are honoraria paid to members of the Royal New Zealand Plunket Society (Inc.)—"Plunket".

Section NC 2 of the Income Tax Act 1994 requires anyone who makes a source deduction payment to deduct tax when making it.

Under section OB 2(1) of the Income Tax Act 1994 a withholding payment is included in the definition of "source deduction payments". Consequently, any person who makes a withholding payment must deduct tax from it at the time it is made, unless an exemption applies.

Honoraria paid to Plunket members come within the definition of "withholding payment" in The Income Tax (Withholding Payments) Regulations 1979. The regulations require withholding tax of 33% to be deducted from honoraria.

Regulation 7 of The Income Tax (Withholding Payments) Regulations 1979 allows the Commissioner to determine an amount or proportion of any specified withholding payment that is considered to be expenditure incurred in the production of that payment. If the Commissioner has made such a determination, the person paying the specified withholding payment is only required to deduct tax from the amount that exceeds this threshold.

### Application

This determination applies to payments made to Plunket members as reimbursement of costs incurred in undertaking Plunket-related matters. It applies to honoraria paid on or after 1 April 2002.

This determination will apply until 31 March 2007, unless previously withdrawn.

### Interpretation

When any Plunket member receives honoraria as reimbursement of expenditure that member had incurred in carrying out Plunket-related activities that payment, up to a maximum of $600 per annum, shall be regarded as expenditure incurred in the production of that payment.

However, if the member receives any reimbursement (in addition to honoraria) for expenditure they have incurred, the amount exempted under this determination ($600) shall be reduced by that additional reimbursement.

This determination is made by me, acting under delegated authority from the Commissioner of Inland Revenue under section 7 of the Tax Administration Act 1994.

The determination is signed on the 24th day of April 2003.

**Margaret Cotton**
National Manager Technical Standards

### Examples

***Example 1***

A Plunket member receives honoraria of $500 in respect of the Plunket-related activities carried out during the year. No other reimbursement had been paid during the year. The payer does not have to deduct withholding tax because the total payment does not exceed $600.

***Example 2***

A Plunket member receives a payment of $525 at the end of February. During the year, in May and August, the member had also received two smaller payments of $100 each as reimbursement of expenses incurred for Plunket-related activities, making a total of $725 for the year. Because the Plunket member had received reimbursement payments of $200 earlier in the year, only $400 of the honorarium received in February could be regarded as expenditure incurred under this determination. Therefore, withholding tax of $41.25 should be deducted from the balance ($125) of the honorarium.

# NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK DETERMINATION 2003

This determination may be cited as "The National Average Market Values of Specified Livestock Determination, 2003".

This determination is made in terms of section EL 8(1) of the Income Tax Act 1994 and shall apply to specified livestock on hand at the end of the 2002-2003 income year.

For the purposes of section EL 8(1) of the Income Tax Act 1994 the national average market values of specified livestock, for the 2002-2003 income year, are as set out in the following table.

## NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK

| Type of livestock | Classes of livestock | Average market value per head $ |
|---|---|---|
| Sheep | | |
| | Ewe hoggets | 62.00 |
| | Ram and wether hoggets | 58.00 |
| | Two-tooth ewes | 87.00 |
| | Mixed-age ewes (rising three-year and four-year old ewes) | 78.00 |
| | Rising five-year and older ewes | 61.00 |
| | Mixed-age wethers | 45.00 |
| | Breeding rams | 142.00 |
| Beef cattle | | |
| | *Beef breeds and beef crosses*: | |
| | Rising one-year heifers | 357.00 |
| | Rising two-year heifers | 577.00 |
| | Mixed-age cows | 672.00 |
| | Rising one-year steers and bulls | 459.00 |
| | Rising two-year steers and bulls | 639.00 |
| | Rising three-year and older steers and bulls | 784.00 |
| | Breeding bulls | 1,524.00 |
| Dairy cattle | | |
| | *Friesian and related breeds:* | |
| | Rising one-year heifers | 359.00 |
| | Rising two-year heifers | 678.00 |
| | Mixed-age cows | 835.00 |
| | Rising one-year steers and bulls | 337.00 |
| | Rising two-year steers and bulls | 538.00 |
| | Rising three-year and older steers and bulls | 701.00 |
| | Breeding bulls | 960.00 |
| | *Jersey and other dairy cattle*: | |
| | Rising one-year heifers | 305.00 |
| | Rising two-year heifers | 605.00 |
| | Mixed-age cows | 756.00 |
| | Rising one-year steers and bulls | 237.00 |
| | Rising two-year and older steers and bulls | 419.00 |
| | Breeding bulls | 721.00 |

| Type of livestock | Classes of livestock | Average market value per head $ |
|---|---|---|
| Deer | | |
| | *Red deer:* | |
| | Rising one-year hinds | 116.00 |
| | Rising two-year hinds | 232.00 |
| | Mixed-age hinds | 281.00 |
| | Rising one-year stags | 142.00 |
| | Rising two-year and older stags (non-breeding) | 256.00 |
| | Breeding stags | 1,454.00 |
| | *Wapiti, elk, and related crossbreeds:* | |
| | Rising one-year hinds | 133.00 |
| | Rising two-year hinds | 252.00 |
| | Mixed-age hinds | 302.00 |
| | Rising one-year stags | 162.00 |
| | Rising two-year and older stags (non-breeding) | 281.00 |
| | Breeding stags | 1,383.00 |
| | *Other breeds* | |
| | Rising one-year hinds | 51.00 |
| | Rising two-year hinds | 78.00 |
| | Mixed-age hinds | 99.00 |
| | Rising one-year stags | 58.00 |
| | Rising two-year and older stags (non-breeding) | 92.00 |
| | Breeding stags | 315.00 |
| Goats | | |
| | *Angora and angora crosses (mohair producing):* | |
| | Rising one-year does | 25.00 |
| | Mixed-age does | 35.00 |
| | Rising one-year bucks (non-breeding)/wethers | 27.00 |
| | Bucks (non-breeding)/wethers over one year | 28.00 |
| | Breeding bucks | 120.00 |
| | *Other fibre and meat producing goats (Cashmere or Cashgora producing):* | |
| | Rising one-year does | 35.00 |
| | Mixed-age does | 48.00 |
| | Rising one-year bucks (non-breeding)/wethers | 27.00 |
| | Bucks (non-breeding)/wethers over one year | 29.00 |
| | Breeding bucks | 98.00 |
| | *Milking (dairy) goats:* | |
| | Rising one-year does | 85.00 |
| | Does over one year | 170.00 |
| | Breeding bucks | 130.00 |
| | Other dairy goats | 25.00 |
| Pigs | | |
| | Breeding sows less than one year of age | 188.00 |
| | Breeding sows over one year of age | 268.00 |
| | Breeding boars | 303.00 |
| | Weaners less than 10 weeks of age (excluding sucklings) | 55.00 |
| | Growing pigs 10 to 17 weeks of age (porkers and baconers) | 93.00 |
| | Growing pigs over 17 weeks of age (baconers) | 153.00 |

This determination is signed by me on the 23rd day of May 2003.

**Martin Smith**
General Manager (Adjudication & Rulings)

# STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

## RETROSPECTIVE ADJUSTMENTS TO SALARIES PAID TO SHAREHOLDER-EMPLOYEES IR-SPS GNL-410

### Introduction

1. This Standard Practice Statement (SPS) sets out the criteria for considering whether the circumstances are appropriate for the Commissioner of Inland Revenue to permit retrospective adjustments to salaries paid to shareholder-employees where an error has been made in the preparation of a company's accounts.

### Application

2. This SPS replaces the QWBA item entitled *Retrospective adjustment to salaries paid to shareholder-employees* published in *Tax Information Bulletin* Vol 9, No 4 (April 1997) at page 9. It addresses the question of when a correction to a shareholder-employee's salary may be made and should not be taken as being applicable to situations where other mistakes have been made in a company's accounts and the company is seeking to rectify them.

3. This SPS will apply from 1 July 2003.

### Background

4. In *Tax Information Bulletin* Vol 9, No 4 (April 1997) at page 9 we published a QWBA item entitled *Retrospective adjustment to salaries paid to shareholder-employees.* Its effect is that where an error has been made in the preparation of the accounts of a company, Inland Revenue will amend the company's assessment to take account of the additional expenses that should have been included in the original return. However, it will not agree to consequential adjustments that the company and the shareholder-employee may wish to make in relation to any salary that was originally agreed to be paid. So neither the company's nor the individual's assessments would be amended to reflect the fact that a reduced salary would be paid.

5. Subsequently *Case U27* (1999) 19 NZTC 9,261 considered this same issue and the Taxation Review Authority, His Honour Willy DJ, arrived at a different conclusion, holding that decisions as to the amounts of a shareholder-employee's salary for two income years that were made mistakenly could be reversed or amended. The facts in that case were that the accountant was not fully informed of the company's financial affairs (there was, unknown to him, a tax dispute with Inland Revenue) and this led him to prepare end-of-year accounts that did not accurately reflect the company's true position.

6. The company had over several years fallen behind in accounting for PAYE, GST, ACC premiums and FBT to the Commissioner. The omitted taxes and penalties not accounted for in error resulted in a substantial overstatement of the resulting profit. This was important because these salaries in this company were only ever paid out of profits. So the level of salaries was based on incorrect profit figures. Although the resolutions authorising the salaries were prepared these were never signed. When the accountant discovered his mistake new resolutions were prepared to authorise the distribution of reduced salaries.

7. The Taxation Review Authority held that section 75 of the Income Tax Act 1976 (now section EB 1 of the Income Tax Act 1994), which deems a person to have derived income when it has been dealt with in the person's interest or on their behalf in any of various ways, including being "credited in account", took effect accordingly, ie it operated on the circumstances brought about by the company resolutions correcting the error. His Honour decided that the company was entitled to and did rectify the error when it came to its notice and the shareholder-employee was obliged to pay tax only on the reduced amounts of income for the relevant income years.

8. In the light of *Case U27* it has been decided that the 1997 QWBA should now be withdrawn and replaced by this item.

# Legislation

## Income Tax Act 1994

EB 1 Income credited in account or otherwise dealt with—

(1) For the purposes of this Act an amount shall be deemed to have been derived by a person although it has not been actually paid to or received by the person, or already become due or receivable, but has been credited in account, or reinvested, or accumulated, or capitalised, or carried to any reserve, sinking, or insurance fund, or otherwise dealt with in the person's interest or on the person's behalf.

(2) … .

(3) Notwithstanding anything in subsection (1), where a deduction is allowed to a company for an income year in respect of expenditure incurred by way of monetary remuneration paid or payable to a person who in relation to the company is a shareholder-employee, the shareholder-employee shall for the purposes of this Act be deemed to have derived the monetary remuneration—

(a) As to an amount equal to—

(i) The amount of the deduction allowable to the company under this Act in respect of that income year and that expenditure; less

(ii) Such amount (if any) of that expenditure as is treated as the unexpired portion of accrual expenditure by virtue of section EF 1(5)(c),—

in the same income year as that in which the deduction was allowed to the company; and

(b) As to the balance of the monetary remuneration, in such income year, or income years, as the expenditure of the company in respect of the monetary remuneration ceases to be treated by virtue of section EF 1(5)(c) as the unexpired portion of accrual expenditure of the company.

(4) For the purposes of subsection (3),—

(a) Where a company referred to in that subsection is a person with a non-standard accounting year, the "same income year" means the income year to which the accounting year in which the deduction was allowed corresponds:

(b) Where the shareholder-employee referred to in that subsection is a person with a non-standard accounting year, the "same income year" means the accounting year of the shareholder-employee that corresponds to the income year—

(i) In which the deduction was allowed to the company; or

(ii) To which the accounting year of the company in which the deduction was allowed corresponds (where the company is of the kind referred to in paragraph (a)).

## Standard Practice

9. Provided full disclosure is made, and the relevant financial statements are amended and lodged, then generally Inland Revenue, where:

- a genuine error has been made in the accounts as a result of which a deduction has not been claimed for legitimate expenditure incurred, or a receipt has been incorrectly categorized, and
- the company has passed a resolution reflecting the change in light of the relationship between the company and the shareholder-employee, and
- a request for correction has been filed with a copy of the resolution,

will consider the request in accordance with Standard Practice Statement INV-510 entitled *Requests to amend assessments* published in *Tax Information Bulletin* Vol 14, No 8 (August 2002) and the principles set out therein.

10. It is expected that requests of this nature will be made in a timely fashion. What is timely involves an exercise of judgment. There are two aspects of timeliness here:

- Once a mistake has been discovered then the parties should set about attending to it promptly. In the majority of cases a month should be a sufficient period of time to discuss, prepare amending resolutions, hold a formal meeting and then to file fresh accounts with the department.
- As to how long a mistake may go undetected, the answer is less certain. Timeliness requires that a mistake is discovered when in the course of events and in the circumstances of the taxpayer company one would have expected it to have been discovered. It could be that many months may go by before the error is detected. The Commissioner will not adopt "the *normal* course of events" criterion for some cases will be unusual. For example, *Case U27* was unusual in that there was a lack of communication between the accountant and principal shareholder and director. The latter kept certain information about the arrears of taxes to himself.

11. Where Inland Revenue agrees to approve such a retrospective adjustment, section EB 1 will deem the shareholder-employee's salary to be the amount as determined by the amending resolution and, under section 113 of the Tax Administration Act 1994, Inland Revenue will adjust the company's and employee's assessments accordingly.

***Examples***

12. The following situations may give some guidance as to when Inland Revenue will permit adjustments to be made.

    a. *Incorrect treatment of receipt*
    Where there is an error in the categorization of a loan receipt as revenue and this results in an overstatement of income, an adjustment may be made.

    b. *Omission of expenditure*
    Where an error arises from the omission of expenditure incurred in the current year an adjustment may be made. However, for a loss to trigger an adjustment it should be a real loss.

    c. *Company still in profit even though error made*
    Although an error has been made in the accounts that error is not sufficient to produce an overall loss and the company still has sufficient profit after the accounts have been corrected to cover the salary originally agreed to be paid. In this situation Inland Revenue will consider each application for an adjustment on its merits. The Commissioner will need to consider the nature of the contract between the parties and past practice. While in this circumstance there would not be the same pressing need to amend or rescind the salary declaration, nevertheless the company could find the situation inconvenient and desire that the amount credited to the shareholder-employee at least be reduced to some extent.

    d. *Accrual expenditure*
    A company has committed itself to certain expenditure in one year although it has not had to discharge or bear that expense until a following year. If such an item has been overlooked and the accounts need revision then it would be less likely for the amounts credited to the shareholder-employee as salary to be revised as well. There may still be funds available to pay them. Once again this is a matter where circumstances will vary. Where there is accrual expenditure the answer will depend on the amount of the unexpired portion of that expenditure relating to future income years. The Commissioner will consider each application for an adjustment on its merits.

This determination is signed by me on the 17th day of June 2003.

**Margaret Cotton**
National Manager (Technical Standards)

# SHORTFALL PENALTIES

A number of Standard Practice Statements are affected by changes to the shortfall penalty provisions contained in the recently enacted Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

## Withdrawn Standard Practice Statements

The following Standard Practice Statements are withdrawn from 1 April 2003, in relation to tax positions taken on or after 1 April 2003.

The affected Standard Practice Statements are:

- INV-200 Not taking reasonable care *TIB* Vol 10, No 3 (March 1998)
- INV-205 Unacceptable interpretation *TIB* Vol 10, No 3 (March 1998)
- INV-206 Unacceptable interpretation—non-application of a tax law *TIB* Vol 10, No 6 (May 1998)
- INV-210 Gross carelessness *TIB* Vol 10, No 3 (March 1998)
- INV-215 Abusive tax position *TIB* Vol 10, No 3 (March 1998)
- INV-220 Evasion or similar act *TIB* Vol 10, No 3 (March 1998)

Please note that the above Standard Practice Statements will continue to apply to tax positions taken before 1 April 2003.

Inland Revenue is reviewing the affected Standard Practice Statements and drafting new Standard Practice Statements in relation to the reduction of penalties for previous behaviour ("good behaviour") and the new promoter penalty (sections 141FB, 141EB & 141EC of the Tax Administration Act 1994). Inland Revenue will be consulting on the new items in due course.

For further information on the legislative changes, please see *Tax Information Bulletin* Vol 15, No 5 (May 2003).

# NEW LEGISLATION

## NZAID GRANTS TRANSFERRED TO OVERSEAS DEVELOPMENT PROGRAMMES

From July 2003, grants or parts of grants made by the New Zealand Agency for International Development and transferred to overseas development programmes will be exempted from GST.

The change corrects an anomaly in the law whereby no GST is payable on a government grant that is paid directly to an overseas agency, but a grant made to a New Zealand agency that transfers the money to an overseas agency attracts GST.

The change means that New Zealand recipients of NZAID grants intended for overseas use will have to return GST only on the portion of the grant that is allocated for administration and capacity building in New Zealand, typically between 1% and 4%.

The change was approved by Order in Council on 26 May 2003.

*Goods and Services Tax (Grants and Subsidies) Amendment Order 2003/113*

## FRINGE BENEFIT TAX – PRESCRIBED RATE OF INTEREST ON LOW-INTEREST, EMPLOYMENT-RELATED LOANS

The prescribed rate of interest used to calculate fringe benefit tax for low-interest employment-related loans has decreased from 7.83% to 7.74% for the quarter beginning 1 April 2003.

The rate is reviewed regularly to ensure it is in line with the Reserve Bank's survey of first mortgage interest rates. It was last changed with effect from the quarter beginning 1 October 2002.

The new rate was approved by Order in Council on 26 May 2003.

*Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations 2003/115*

## DEEMED RATE OF RETURN FOR FOREIGN INVESTMENT FUND INTERESTS

The deemed rate of return for foreign investment fund interests has decreased from 10.46% to 9.90% for the 2002-2003 income year.

The deemed rate of return, which is set annually, applies to all types of investments, including interests in superannuation schemes and life insurance policies. It is based on an average of five-year government stock rates to which a margin of 4% is added.

The change was approved by Order in Council on 26 May 2003.

*Income Tax (Deemed Rate of Return, 2002-03 Income Year) Regulations 2003/114*

# QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out answers to some inquiries we've received. We publish these as they may be of general interest to readers. A general similarity to items published here will not necessarily lead to the same tax result. Each case should be considered on its own facts.

## GENERAL DEPRECIATION DETERMINATION – FISHING NETS

We have been asked for clarification of depreciation determination DEP50 (published in *Tax Information Bulletin* Vol 15, No 5 (May 2003) at page 18). Two separate matters have been raised.

### Background

Determination DEP50 inserted two general asset classes in the "Fishing" industry category. The general asset classes are "Nets (fishing) bottom trawl, complete with accessories" and "Nets (fishing) other, complete with accessories". The depreciation rate set for bottom trawl fishing nets is based on an expected useful life of one year. All other nets have an expected useful life of two years.

There were corresponding changes to the six specific asset classes which previously covered a fishing net and its associated parts. "Nets (fishing)" was removed. "Bridles", "Sweeps" and "Trawl Boards" were also removed and are now to be treated as "accessory" items. The estimated useful life of "Wire (trawl)" was amended to one year. A further change applies to "Lines (fishing)". This has been deleted from the industry category and is now to be treated as an allowable deduction.

### The first query – fishing nets become unusable

Q Ordinarily, fishing nets are depreciated over the expected useful life of the particular asset. However, it may be that due to accident or other damage beyond normal wear and tear, the net is lost, damaged beyond repair, with the result that the actual life of a particular net is less than its expected useful life. It has been suggested that actual life of nets is highly variable and may (depending on unpredictable events) be as short as a one-off use or, with regular repairs and maintenance, a year or more. We have been asked how to account for allowable deductions for depreciation in that situation.

A These types of situations are covered by section EG 19 of the Income Tax Act 1994 which deals with dispositions of depreciable property (other than a building). The definition of "disposal" in section EG 19 is wide and includes any event as a consequence of which the property is irreparably damaged, or lost and not recovered. For example, when a net is lost in one trawl through snagging or becomes unusable as a result of other circumstances. This broad concept of "disposal" is important because, for the purposes of section EG 19, such property is deemed to have been disposed of by a taxpayer for a consideration that is less than its adjusted tax value at the time of disposition. In that situation the loss on disposition is **deductible in the income year in which the disposition occurs** (rather than there being ongoing depreciation deductions claimed).

### The second query – allowable deductions for fishing lines

Q We have also been asked to clarify the correct treatment to be applied to fishing lines. This issue is significant for long-lining operators, whose vessels do not carry nets (and so cannot account for lines as an "accessory" item), but will also be of interest to the wider fishing industry.

A Taxpayers operating in the fishing industry will normally be entitled to claim a tax deduction in respect of expenditure outlaid on the acquisition and use of fishing lines. Information available to the Commissioner indicates that a long-lining operation will typically consume large quantities of line coils each year, thus supporting the treatment of lines as potentially an allowable deduction and not depreciable property (as was previously the case). This means that the expenditure will now be allowed as an immediate deduction under section BD 2(1) as an ordinary business expense (as long as the normal tests of deductibility are met). As such, fishing lines are not covered by the potential range of accessory items now included in the two general asset classes for fishing nets. This will be the case for all fishing industry taxpayers and not only long-lining operators. It is not expected that this will result in any significant change, as lines were described as an "expense" item previously.

The effective timing of the deduction may, however, be subject to section EF 1 in the event that the lines have not been fully used up in deriving gross income at the end of the income year.

# COMPANY RESTRUCTURING: "DEMERGERS" AND "SPIN-OUTS" – BHP, WMC AND CSR

The department has noted several recent occasions on which Australian-listed companies have restructured in such a way as to distribute shares in a subsidiary of the listed company. Such restructurings are commonly referred to as demergers or "spin-outs". We have been asked about the tax consequences for New Zealand resident taxpayers who receive new shares as the result of such a "spin-out".

## Background

We are aware of demergers or spin-outs in the last twelve months by BHP Billiton Limited, WMC Limited and CSR Limited.

Typically, the restructuring company ("head" company) reduces its own capital (but without reducing the number of shares it has on issue) and applies funds on behalf of the shareholders to acquire shares in a subsidiary company (the "spin-out" company), which are transferred or issued to the shareholder.

There will sometimes also be a "demerger" dividend declared at the time of the demerger, the proceeds also being applied to acquiring the spin-out shares.

After the demerger or spin-out the head company shareholders still hold the same number of shares in the head company and also hold shares in the spin-out company. Additional shareholders may also own some (typically less than 20%) of the spin-out company.

## Issues

There are several taxation issues to consider: the dividend consequences, the treatment of gains on disposal of the new shares, and their cost base. The discussion following is specific to the above-mentioned Australian demergers as circumstances can vary from country to country and company to company.

## Dividend consequences

A "capital reduction" of the type described above resulting in a "spin-out" or "demerger", is a dividend derived by New Zealand tax resident shareholders. It is derived on the date the capital reduction is effected. The dividend must be included in the shareholder's gross income for the period. Likewise any specific "demerger" dividend is also income and must be returned.

The term "dividend" is defined in section CF 2(1) of the Income Tax Act 1994. The definition is extensive: it applies to any company, and to any payment, distribution, or transaction, whether in money or money's worth, made to or with any person, with respect to their own or another person's capacity as a shareholder in that company.

While some transactions involving the cancellation of shares are treated as not constituting dividends, the Commissioner does not consider that those rules have any application in the transactions identified above or in other similarly structured demergers, as there is no cancellation of any shares. Nor would the transactions be treated as bonus issues for New Zealand tax purposes.

The value of the dividend is the New Zealand dollar equivalent of the amount credited to the shareholder. The market value of the shares subsequently acquired on the date of distribution is not relevant for dividend calculation purposes.

For the purpose of establishing an appropriate exchange rate the New Zealand/Australia exchange rate should be used (these are set out on page 23 for the purposes of those transactions identified). Taxpayers may use the department's IR 270 exchange rate form or its online calculator, which gives the mid-month telegraphic buying rates for Australia, or obtain from their bank the actual exchange rate for the day in question.

Tax treatment of the dividend differs according to whether the New Zealand tax resident is a corporate or non-corporate shareholder.

(1) *Non-corporate shareholders (including individuals, trusts (other than unit trusts) and superannuation funds)*

New Zealand tax resident non-corporate shareholders must include the amount of the distribution derived (converted to equivalent New Zealand dollars) as dividend income, when calculating gross income in their income tax return for the relevant year.

It is unlikely that any foreign tax credits would be available as these payments (including demerger dividends) are not treated as dividends under Australian tax rules, so no non-resident withholding tax (NRWT) will have been deducted.

(2) *Corporate shareholders (including unit trusts)*

Dividends derived from a foreign company by corporate New Zealand tax resident shareholders are exempt income under section CB 10(1) ITA.

However, corporate shareholders are required by section NH 1 ITA to deduct and pay to the Commissioner an upfront dividend withholding payment from foreign withholding payment dividends. The amount of dividend withholding payment is calculated according to a formula provided in section NH 2 ITA. The formula uses the basic company income tax rate of 33%.

Underlying foreign tax credits would only be available if any person held more than 10% of the Australian head company's shares (which, in the examples discussed, is unlikely).

## Gains on any disposal of shares

The Scheme of Arrangement (or equivalent documentation) sent to shareholders for a "spin-out" or "demerger" may include a sale facility option. That is, shareholders have the ability to instruct the company to sell the "spin-out" shares and receive cash.

The normal tax rules regarding share disposals apply to New Zealand resident shareholders wishing to sell shares received under the restructuring process.

Where the shares in the "head" company are held on capital account the shares in the "spin-out" company should also be held on capital account. Thus there should be no tax implications for those shareholders who use the sale facility to sell their shares, or sell later, provided that the shares continue to be held on capital account. However, taxpayers, if uncertain, should obtain their own advice on the issue.

Sale proceeds, whether by way of the "sale facility option" or later, will be gross income if the "head" company shares which created the distribution entitlement were held on revenue account. A deduction is available for the cost of the shares.

## Cost base of shares for tax purposes

The scheme applies funds that belong to the shareholders (being the capital reduction and any demerger dividend) to acquire shares in the demerged company. Therefore the cost base for tax purposes to the shareholder of the shares acquired in the demerged company will be equal to the amount of the dividend received.

Again for tax purposes the cost base of the shares in the head company does not change.

## Recent Australian demergers

In the last twelve months at least three Australian-listed companies have demerged:

- BHP Billiton Limited: shareholders now have shares in BHP Billiton Limited ("head") and, on a one-for-five basis, BHP Steel Limited (the "spin-out") (effective 22 July 2002),
- WMC Limited: shareholders now have shares in Alumina Limited (formerly WMC Limited) and, on a one-for-one basis, WMC Resources Limited ("spin-out") (effective 11 December 2002), and
- CSR Limited: shareholders now have shares in CSR Limited ("head") and, on a one-for-one basis, Rinker Group Limited ("spin-out") (effective 11 April 2003).

Each of these will have a number of New Zealand shareholders.

Using the exchange rates on IR 270, the dividend amounts of the three demergers (both the capital reduction, and where appropriate, the demerger dividend) are:

| Head company | $A dividend per head share | $NZ dividend per head share |
|---|---|---|
| BHP Billiton Limited | $0.69 | $0.80 |
| WMC Limited | $3.51 | $3.86 |
| CSR Limited | $1.53 | $1.69 |

### Example of effect on a shareholder

Using WMC Limited as the example, the demerger involved the following steps:

- A capital reduction in WMC Limited of $A2.78 per WMC Limited share
- A "Share Scheme Dividend" or "demerger" dividend of $A0.73
- The application of the total proceeds of this, $A3.51, to acquire shares in WMC Resources Limited, and
- The renaming of WMC Limited to Alumina Limited.

The shareholder still has the same number of "head company" shares, now in Alumina Limited, at their original cost. The shareholder also has an equivalent number of shares in WMC Resources Limited at a cost of $A3.51 and has received a dividend of $A3.51.

## Return filing

While taxpayers have a duty to make due enquiry about their own tax affairs, this item is published to clarify the Commissioner's position.

Some taxpayers may have already filed tax returns for the year ending 31 March 2003 and may have overlooked inclusion of the dividends (and where applicable the proceeds of share sales) derived from the spin-out. The department will accept and process a request to amend the return from those taxpayers.

# OTHER ITEMS OF INTEREST

## LOSS ATTRIBUTING QUALIFYING COMPANIES

Inland Revenue has determined that Loss Attributing Qualifying Companies (LAQCs) must attribute all losses in full to the shareholders, and could not first offset losses to other group companies in the same way that ordinary group companies and qualifying companies can.

The *Qualifying companies* booklet (IR 435) contains the previous view that the company could elect to make inter-company offsets prior to attributing losses to the shareholders. This is now considered to be incorrect.

Page 26 of this booklet has been amended to reflect current policy and is available on our website at **www.ird.govt.nz** or you can get a printed copy of the amended version (check it is dated March 2001) by phoning INFOexpress on 0800 257 773 (have your IRD number handy).

A full review of this booklet is scheduled for later in 2003.

# REGULAR FEATURES

## DUE DATES REMINDER

### July 2003

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

**Employer deductions and employer monthly schedule**

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

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

**21 Employer deductions**

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

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

**Employer deductions and employer monthly schedule**

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

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

**FBT return and payment due**

**31 GST return and payment due**

### August 2003

**5 Employer deductions and employer monthly schedule**

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

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

**20 Employer deductions**

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

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

**Employer deductions and employer monthly schedule**

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

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

**29 GST return and payment due**

*These dates are taken from Inland Revenue's* Smart business tax due date calendar 2003 - 2004

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

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

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

**By internet**: Visit **www.ird.govt.nz**
On the homepage, click on "The Rulings Unit welcomes your comment on drafts of public rulings/interpretation statements before they are finalised . . ." Below the heading "Think about the issues", click on the drafts that interest you. You can return your comments by internet.

Name ________________________________________

Address ________________________________________

________________________________________

| | *Draft interpretation statement* | *Comment deadline* |
|---|---|---|
| ☐ | IS0053: Shortfall penalty for not taking reasonable care | 31 July 2003 |

*Items are not generally available once the comment deadline has passed*

*No envelope needed—simply fold, tape shut, stamp and post.*

Affix

Stamp

Here

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